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TO: DEPARTMENTAL ACCOUNTING OFFICERS

APPOINTMENT OF PRIVATE SECTOR FIRMS TO INTERNAL AUDIT WITHIN THE PUBLIC SECTOR

1. Since the issue of DAO (DFP) 10/07 in August 2007, a number of public and private sector organisations have raised questions with me regarding the interpretation of this guidance.
2. Before addressing these issues it is worth setting out the context. Internal audit must, by definition, be an independent and objective appraisal service within an organisation. The Government Internal Audit Standards clearly state that internal audit should be sufficiently independent of the activities which it audits to enable auditors to perform their duties in a manner which facilitates impartial and effective professional judgements and recommendations. Internal auditors should have no executive responsibilities.
3. The C&AG commented in his annual report last year (NIA 65/06-07 Financial Auditing and Reporting: 2005-2006) on auditors and potential conflicts of interest. Specifically he recommended, and DFP accepted, that DFP expands the existing guidance to refer to potential conflicts of interest in relation to internal audit as well as external audit. The most recent DAO (DAO(DFP)10/07), produced after consultation with the NIAO and departmental heads of internal audit, addresses these concerns and remains in place.
4. The DAO deals with two scenarios: firstly where an in-house head of internal audit engages an external firm to undertake internal audit work under his or her direction; and secondly where the accounting officer engages a firm to provide the whole internal service including by definition the head of internal audit role. The likelihood of a potential conflict of interest is greater in the

second scenario, that is, where a firm is engaged to carry out the complete internal audit function but is also employed on consultancy or other types of non-internal audit work, within the same public sector body.

5. In circumstances where staff from a private firm are engaged under the direction of an in house head of internal audit, there is less danger of conflicts of interest arising because, ultimately the head of internal audit has to manage the external staff, including conflicts of interest issues, and provide his or her opinion as normal in support of the statement of internal control.
6. However, if an organisation decides to use a private firm to provide all internal audit functions, then a member of staff from the firm must act in the capacity as head of internal audit, and has to supply the annual opinion to the accounting officer. Whilst this type of arrangement can provide an organisation with a high level of expertise, there is a much greater potential for a conflict of interest if the same firm is contracted to provide other non internal audit work including consultancy. The guidance within the DAO does not preclude this happening, but it states that the accounting officer must be able to justify this, particularly during the period of the audit contract.
7. In essence, this comes down to a judgement about whether or not non internal audit work undertaken by a firm could be reasonably seen as having an impact on the independence and objectivity of internal audit, and hence breaching one of the key principles behind internal audit. In making this decision, accounting officers should take into consideration the extent, nature and value of any non internal audit work undertaken by a firm, the relative level of risk to the organisation in such areas and the impact such work has on the organisation's aims, objectives and overall control framework. You will want to pay particular attention to non internal audit work involving significant fees, sensitive subjects or major operational or financial control issues.
8. I am conscious that your review of the effectiveness of the system of internal control will be informed by the work of executive managers, external auditors and the departmental board and audit committee as well as the internal audit function. However as the head of internal audit's opinion is a key element in the completion of the annual statement of internal control, it is a fundamental that accounting officers ensure satisfactory internal audit arrangements are in place which can be justified and indeed which can be defended against conflict of interest claims. For that reason I would recommend that you should document the decision making process made when you are considering engaging a private firm to provide the internal audit function, or following engagement, contracting that firm to conduct other services, so that it is clearly established that any decision reached has considered all relevant issues, particularly those set out in paragraph (7) above.



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