

Audit Detailed Report

July 2006



Review of Internal Audit

Lancaster City Council

External audit is an essential element in the process of accountability for public money and makes an important contribution to the stewardship of public resources and the corporate governance of public services.

Audit in the public sector is underpinned by three fundamental principles:

- auditors are appointed independently from the bodies being audited;
- the scope of auditors' work is extended to cover not only the audit of financial statements but also value for money and the conduct of public business; and
- auditors may report aspects of their work widely to the public and other key stakeholders.

The duties and powers of auditors appointed by the Audit Commission are set out in the Audit Commission Act 1998 and the Local Government Act 1999 and the Commission's statutory Code of Audit Practice. Under the Code of Audit Practice, appointed auditors are also required to comply with the current professional standards issued by the independent Auditing Practices Board.

Appointed auditors act quite separately from the Commission and in meeting their statutory responsibilities are required to exercise their professional judgement independently of both the Commission and the audited body.

Status of our reports to the Council

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body. Reports prepared by appointed auditors are addressed to members or officers. They are prepared for the sole use of the audited body. Auditors accept no responsibility to:

- any member or officer in their individual capacity; or
- any third party.

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Summary report

Introduction

- 1 The Code of Audit Practice (CoAP) requires us to review and report on:
 - the Council's financial statements and its statement of internal control; and
 - whether the audited body has made proper arrangements for securing economy, efficiency and effectiveness.

In undertaking our work the Code also requires us to seek to place maximum reliance on the work of internal audit whenever possible. Internal audit has a key role to play in relation to both our work on the financial statements and the Council's arrangements for securing economy, efficiency and effectiveness.

- 2 Every three years we undertake a detailed review of internal audit against professional standards to:
 - ensure that planned reliance on internal audit work is still appropriate; and
 - review the effectiveness of internal audit as part of the Council's arrangements for internal control.
- 3 The emphasis is on ensuring that internal audit meets the professional and statutory requirements, set out in CIPFA's 2003 Code of Practice for Internal audit in Local Government in the United Kingdom ('CIPFA Code'). The CIPFA Code provides standards for internal audit in the following areas, which were the focus for our review.

Table 1 CIPFA Internal audit Code Areas

Organisational standards	Operational standards
1. Scope of Internal audit	6. Audit Strategy
2. Independence	7. Management of Audit Assignments
3. Audit Committee or Equivalent	8. Due Professional Care
4. Relationships with management, Other Auditors, and Other Review Bodies	9. Reporting
5. Staffing, Training and Development	10. Quality Assurance

Source: 'CIPFA Code of Practice for Internal Audit in Local Government in the UK'

Audit approach

- 4 In order to make an assessment of Internal audit's performance against these professional standards we carried out an appraisal of their arrangements and procedures by drawing on a number of sources of information including:
 - our cumulative knowledge of the Council;
 - Internal Audit documentation, including a review of a sample of specific jobs; and
 - discussions with the Internal Audit Manager and Principal Internal Auditor.

Main conclusions

- 5 Overall, the extent and quality of coverage by Internal audit means that we can place reliance on their work for the purposes of our audit. We consider internal audit to be an effective part of the Council's arrangements for ensuring economy, efficiency and effectiveness through its role in the Council's systems of internal control. Internal audit demonstrate good practices in many areas and are well respected within the Council.
- 6 We have identified good working practices, including:
 - an automated working papers system which ensures consistency of approach and review stages, standardises the format of the final audit reports and includes other automated elements such as the generation of emails to service managers at key points;
 - reporting - the inclusion of hyperlinks in sections of the audit reports allows readers to easily link actions required and evidence to support conclusions; and
 - clarity of approach to fraud and corruption linked to the specific identification of fraud risks within risk registers.
- 7 We have identified a number of areas where further improvements could be made to help internal audit to fully meet the organisational and operational standards that are set out in the CIPFA Code. The most significant of these relate to:
 - the development and approval of an audit strategy in line with CIPFA standards, setting out how Internal audit will be delivered and developed;
 - consideration of the extent to which controls are compliance tested; and
 - extension of the existing quality assurance arrangements.

The way forward

- 8 The recommendations arising from the review of internal audit are detailed in the attached Action Plan. The implementation of these should strengthen the Council's controls and help achieve full compliance with the CIPFA code of Practices.

Detailed Report

Organisational standards

Scope of Internal Audit

The scope of Internal Audit is adequate, properly communicated and understood throughout the organisation.

- 9 The Council has set down the purpose, authority, and responsibility of Internal audit within the Internal audit Charter. Arrangements to communicate the internal audit charter throughout the Council are in place, ensuring that its role is clear to both internal audit and its clients. The charter clearly outlines the responsibility for systematic review and evaluation of the internal control environment, with procedures in place to identify new developments and significant changes that affect that environment.
- 10 The internal audit manual and charter do not currently fully reflect the coverage and activities of internal audit and it would be helpful to update these to include clarification of the scope and limit of internal audit's role in consultancy work and advice.

Independence

Arrangements are in place to ensure that internal audit is sufficiently independent although there are potential issues about the degree of their involvement in risk management.

- 11 Internal Audit is managed by the Internal Audit Manager who reports directly to the Head of Financial Services who has sufficient status within the organisation's management structure to facilitate effective discussion and implementation of audit work. The Internal Audit Manager also has direct access to the Chief Executive where necessary. Audit priorities are determined following a risk assessment in consultation with management.
- 12 The Council has made arrangements to be advised on the discharge of responsibilities in respect of Internal Audit via an Audit Committee. Internal Audit report to this committee on a regular basis presenting the internal audit plan, reporting progress against that plan, key issues arising from completed assignments and reporting on the systems of internal control within the organisation.

- 13 Corporate arrangements are in place for positions deemed politically sensitive to declare any potential conflicts of interest which they may have that will affect their ability to remain independent and objective. Our review confirmed that both the internal audit manager and principal auditor make annual declarations in line with Council requirements.
- 14 Whilst organisationally arrangements are in place to protect the independence of Internal audit, the team do become heavily involved in the development of management processes from time to time, for example the Council's approach to procurement, risk management and project management. In particular internal audit remain heavily involved in the risk management of the authority including maintaining registers and assisting services to identify risks.
- 15 This approach has been very helpful in the short-term providing the Council with much needed capacity in this area. In the longer-term however, it is not ideal, potentially making it less likely that service managers will take ownership and creating potential difficulties for internal audit to independently evaluate risk assessments and the effectiveness of risk management.

Audit Committees

Appropriate arrangements are in place for internal audit to report to those charged with governance.

- 16 The Internal Audit Manager attends all committee meetings, and provides progress reports to the Audit Committee including copies of all assignments completed during the period.
- 17 To increase operational manager accountability a review of items taken to Committee has been made. A summary of assignments completed will be reported with full reports mailed to members at the point of distribution. Internal audit's reports to the Audit Committee will detail the main issues identified and internal audit will provide further explanations on requests from the Committee. Attendance and reports from operational managers to explain any issues identified through audit work will be required.
- 18 The Audit Committee Terms of Reference was last reviewed and updated in 2003. Subsequently the Accounts and Audit regulations introduced the requirement for Councils to produce a wider statement on internal control. The Audit Committee have taken on a role in helping to provide assurance for this statement but this is not yet reflected in the terms of reference.

Relationships

Robust relationships with management and external bodies are in place and maintained.

- 19 The internal audit terms of reference set out the principles for liaison with management when planning audit work. Auditees are asked to complete a post audit satisfaction survey and high satisfaction ratings are recorded by most auditees in this respect.

- 20 The CIPFA code of practice states that the organisation should define the respective roles and responsibilities of management and Internal audit in respect of fraud and corruption. If internal audit does not consider that line management have made appropriate decisions in this respect, then this should be reported to those charged with governance. The principles and arrangements for liaison with external agencies are clearly defined within the Anti Fraud and Corruption Strategy.
- 21 A good working relationship exists between ourselves and the Internal Audit Manager. Regular dialogue is maintained, and a joint audit working arrangements protocol is in place.

Staffing, training and development

Internal Audit is adequately resourced with staff who have received appropriate training and development.

- 22 Internal audit currently has adequate resources, including a mix of skills and experience, to enable it to meet its work objectives efficiently and effectively. A skills gap in relation to IT audit has been identified which has been resourced via the purchase of external audit experience. For 2004/05, 86 per cent of the planned days were delivered. The shortfall was largely due to maternity leave. A budget to buy in additional resources as and when needed now exists which should help with short-term shortfalls in the future. For 2005/06 there was a reduced shortfall in planned days delivered with 92 per cent being delivered.
- 23 A significant proportion of the planned assignments (24 per cent) were not completed in 2005/06 largely due to the role the audit team took on co-ordinating the Council's use of resources assessment, delays in obtaining external input for IT and providing cover for maternity leave of the Council's procurement officer. As in previous years re-consideration of the Internal Audit planned programme took place to take account of these changes and decisions were taken with the Audit Committee over what work could be delayed and re-prioritised. Given the inherent necessity to re-consider plans and the arrangements in place to do so, we are not concerned about the level of non-delivery against the plan this year, although if this were a continuing trend then there may be a need to review the level of internal audit resource and the extent of advice/consultancy work provided by them.
- 24 The complement for the internal audit team is 3.8 whole-time equivalent staff and the Internal Audit Manager. The Internal Audit Manager is a CIPFA qualified Accountant and all other audit staff are fully qualified accounting technicians.
- 25 The opportunity to continue professional development is encouraged and provided for within the departments training budget. Structured personal development reviews are used to identify any training needs and training plans are in place for all staff.

Operational standards

Audit Strategy

A formally reported audit strategy does not exist although consideration has been given to the elements which would form such a strategy and an annual plan is presented to members.

- 26 The Code of practice expects that an audit strategy will be produced setting out how the Internal audit service will be delivered and developed. This should include:
- how the service will be provided, ie internally, externally or a mixture;
 - how Internal Audit will contribute to the assurance required for the annual statement of internal control, including how it will contribute to the review of governance arrangements, risk management processes and key internal control systems;
 - the overall level of resources and skills required for its delivery; and
 - the relative allocation of audit resource between assurance and fraud related or consultancy work.

The strategy should be approved by the organisation.

- 27 Currently there is no such formal strategy submitted to members for approval although the above elements have been considered by the Internal audit Manager as part of the management of his service and the production of the annual plan. The production of a formal strategy and its submission to the Audit Committee would have the added advantage of ensuring that members have also clearly considered the above elements in determining how the internal audit service is provided.
- 28 An Internal Audit annual plan is developed and approved by members each year. The plan takes account of known risks and is drawn up following discussions with the Head of Financial services and the management team. Changes to the annual audit plan in respect of individual reviews are agreed in conjunction with service managers and approval is given by the Audit Committee.
- 29 The annual plan identifies assignments to be completed and resources required. It also shows details of any gaps in resources and action to be taken to address the shortfall. A detailed monthly plan is used which is reviewed and discussed with audit staff at team meetings.

Management of audit assignments

Effective arrangements are in place to manage audit assignments.

- 30 Internal audit apply a risk based approach to planning assignments based upon information gathering and evaluation of controls. Assignment briefs are prepared and agreed for all audits. These clearly define the scope, objectives and timing for all projects. Work undertaken at each stage of the assignment is designed to provide the evidence needed to support the audit opinion.
- 31 The Internal Audit manual details the audit process ensuring a consistent approach. An in house automated working papers system has been developed which is used to record all audit work and automatically generates the final report and action plan. The system also acts as a prompt for follow up assignments to be completed six months after the original work was completed. Full system guidance procedures have been produced.
- 32 All audit documents are required to be retained in line with statutory requirements. Internal audit follow corporate policy for the retention of hard copy papers but have yet to develop a policy covering the automated working paper system.
- 33 The CIPFA code states that the head of Internal Audit should control access to audit records and should obtain the approval of relevant management before releasing records to external parties. The growth of partnership arrangements increases the likelihood of the need to share internal audit documents and reports with external parties. Currently the audit manual does not refer to the arrangements for releasing documents to external parties.
- 34 Recommendations made by Internal Audit are included as part of the final report within an agreed action plan. Progress against each agreed action is monitored and where inaction is noted written explanations are obtained. Reports to audit committee highlight areas of inaction and requests by members are made for further explanations from service managers. The process could be strengthened by the formalisation of escalation procedures for any areas of inaction. This would help ensure that the risk of not taking action is understood and accepted at a senior level.

Due professional care

Arrangements are in place to ensure due professional care is maintained. There is scope for improvement in the areas of compliance testing and the review of detailed work undertaken.

- 35 Auditors carry out their work with competence and diligence and a high level of client satisfaction is indicated.
- 36 The internal audit manual contains corporate policies governing ethics with all staff having signed an acknowledgement of understanding and acceptance. Each member of the audit team is also issued with a copy of the CIPFA code of practice which details the code of ethics for internal auditors.

- 37 The CIPFA code states that appropriate methodologies should be in place to identify intentional wrong-doing, errors, and omissions, inefficiency, waste, lack of economy, ineffectiveness, failure to comply with management policy and conflicts of interest. Our review of IA's approach and individual jobs indicates that a greater focus of work is placed on the identification of risks and the controls in place to reduce that risk, than with compliance testing to confirm their operation. The review of a sample of assignments selected identified that compliance with procedures and policy is not always tested and it is not clear how IA have decided which controls to compliance test. There is therefore a residual risk that the approach would not identify compliance failures.
- 38 A review process exists to ensure the quality of assignments although this is currently limited to key stages; agreeing the risks and scope of the work and the final report. The internal audit manager has taken the view that a review of the detailed work completed on each job is not necessary given the experience of the staff involved. To ensure the continuing relevance of such a judgement it would be helpful if a small sample of jobs were fully reviewed in detail each year.

Reporting

Effective reporting arrangements are in place. There is scope to more clearly identify the relative importance of specific recommendations made.

- 39 The primary purpose of reporting is to provide management with an opinion on the adequacy of the internal control system and to inform management of significant findings, conclusions and recommendations.
- 40 Internal Audit uses an agreed reporting style generated by the automated working papers system, which leads to a consistent approach to reporting. Procedures ensure that reports cover relevant and important weaknesses, ensuring all aspects of the assignment link and support the conclusions made within the report. All reports are agreed with the relevant service managers before being issued. This includes agreeing responsibilities and timescales.
- 41 The Chief Internal Auditor prepares and presents interim reports throughout the year to the Audit Committee with an annual report following the year-end. These reports outline issues of concern, emerging issues and provide the Committee with an opinion on the overall adequacy and effectiveness of the internal control environment. A comparison of actual work undertaken against work planned is also included.
- 42 Currently the recommendations reported within individual reports are not prioritised. The allocation of priorities to agreed action would:
- help inform the formulation of the SIC by quickly identifying any significant weaknesses identified via audit work;
 - enable the audit committee to assess the importance of any action or inaction on specific recommendations; and
 - allow follow up assignments to be agreed on the basis of risk.

Quality assurance

Quality assurance processes require further development

- 43 Existing arrangements include a system of review at key stages of each assignment and the use of client feedback questionnaires. The results of this process are not currently reported to the Audit Committee and there are no pre-set performance measures which are reported on other than reports on completion of the audit programme. The Internal Audit Manager should develop a quality assurance programme to provide assurance that the work of Internal Audit is compliant with the CIPFA Code of Practice and achieves its objectives.
- 44 The CIPFA code requires that internal quality reviews should appraise:
- quality of audit work;
 - quality of supervision;
 - compliance with CIPFA CoP;
 - compliance with IA Manual;
 - how it benefits the organisation; and
 - achievement of performance measures.

The results of such reviews should be periodically reported to the audit committee.

- 45 From 1 April 2006 the Accounts and Audit regulations have been amended by the Accounts and Audit (Amendment)(England) Regulations 2006. These include a new requirement under regulation 6 (3) for Councils to 'at least once in each year, conduct a review of the effectiveness of the system of internal audit'. New Regulation 6(4) goes on to say – 'The findings of the review referred to in paragraph (3) shall be considered, as part of the consideration of the system of internal control.'
- 46 The objective here is that all bodies when considering the Statement of Internal Control review the operation of the internal audit function. The Council will need to consider during the year how they will meet this requirement. We understand that CIPFA may produce some further guidance on this.

Appendix 1 – Action Plan

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Organisational Standards						
Terms of Reference and Audit Manual						
<p>There are a number of areas within the formal framework which would benefit from greater clarification and further expansion to reflect actual practice.</p>	<p><i>R1 The Internal Audit manual should be updated to include:</i></p> <ul style="list-style-type: none"> • clarification of the scope and limit of any consultancy role; • a policy for the retention of all audit documents including electronic working papers; • arrangements for obtaining necessary management approvals for the release of Internal audit documents to external parties; and • the escalation procedures for any areas of inaction on audit recommendations. 	Low	Internal Audit Manager and Principal Auditor.	Yes	<p>Scope and limit of consultancy role may change from year to year. Escalation procedures will include the Audit Committee's review of risk reports and requests for managers' reports into implementation of agreed actions.</p>	December 2006

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
	<i>R2 The Audit Committee Terms of Reference should be updated to reflect the Committee's role in providing assurance for the statement on internal control.</i>	Low	Internal Audit Manager	Yes	This will be reported to the Audit Committee in September 2006 with a recommendation to Council.	December 2006

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
<i>Independence</i>						
<p>Internal audit is heavily involved in the risk management of the authority including maintaining registers and assisting services to identify risks. This approach has been very helpful in the short-term providing the Council with much needed capacity in this area. In the longer term however, it is not ideal, potentially making it less likely that service managers will take ownership and creating potential difficulties for internal audit to independently evaluate risk assessments and the effectiveness of risk management.</p>	<p><i>R3 Consider the degree of internal audit involvement in risk management and consider re-allocating responsibility in the longer term. This could help with embedding risk management as well as enabling internal audit to fulfil a clear audit role in terms of risk management.</i></p>	<p>Medium</p>	<p>Internal Audit Manager</p>	<p>Yes</p>	<p>A programme has been established to have risk registers fully implemented and managers trained by 31 Dec 2006. This will enable Internal Audit's role to be redefined for the 2007/08 audit plan.</p>	<p>March 2007</p>

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
<i>Operational Standards</i>						
<i>Audit Strategy</i>						
<p>The Code of Practice expects that an audit strategy will be produced setting out how the Internal audit service will be delivered and developed. This should include:</p> <ul style="list-style-type: none"> • how the service will be provided, ie internally, externally or a mixture; • how internal audit will contribute to the assurance required for the annual statement of internal control, including how it will contribute to the review of governance arrangements, risk management processes and key internal control systems; 	<p><i>R4 Internal Audit should develop and maintain a formal strategic plan for delivering the internal audit service as per the CIPFA Code. This plan should be approved by members.</i></p>	High	Internal Audit Manager	Yes	<p>Considering the current position regarding Business Planning, it is intended to develop a 'dummy' plan for 2006/07.</p> <p>This will be formalised for the 2007/08 round of business planning</p>	<p>September 2006</p> <p>March 2007</p>

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
<ul style="list-style-type: none"> • the overall level of resources and skills required for its delivery; and • the relative allocation of audit resource between assurance and fraud related or consultancy work. <p>The strategy should be approved by the organisation. Currently there is no such formal strategy submitted to members for approval although the above elements have been considered by the Internal Audit Manager as part of the management of his service and the production of the annual plan. The production of a formal strategy and its submission to the Audit Committee would have the added advantage of ensuring that members had also clearly considered the above elements in determining how the Internal Audit service is provided.</p>						

<i>Due professional care</i>						
<p>The CIPFA Code states that appropriate methodologies should be in place to identify intentional wrong-doing, errors, and omissions, inefficiency, waste, lack of economy, ineffectiveness, failure to comply with management policy and conflicts of interest. Our review of assignments selected identified areas where compliance with procedures and policy has not been tested and it is not clear how Lancaster have decided which controls to compliance test. There is therefore a residual risk that the approach would not identify compliance failures.</p>	<p><i>R5 Ensure that the methodologies used include an appropriate level of compliance testing and decisions not to compliance test are clearly documented.</i></p>	<p>High</p>	<p>Internal Audit Manager and Principal Auditor</p>	<p>Yes</p>	<p>It is recognised that recent audit emphasis has meant a reduction in compliance testing. Changes to the audit approach in relation to risk and risk registers will provide greater emphasis on focussed compliance testing.</p>	<p>March 2007</p>

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
<p>A review process exists to ensure the quality of individual pieces of work but this is currently limited to key stages; agreeing the risks and scope of the work and the final report. The internal audit manager has taken the view that a review of the detailed work completed on each job is not necessary given the experience of the staff involved. To ensure the continuing relevance of such a judgement it would be helpful if a small sample of jobs were fully reviewed in detail each year.</p>	<p><i>R6 A small sample of jobs covering all staff should be reviewed in detail to confirm ongoing compliance with standards.</i></p>	<p>High</p>	<p>Internal Audit Manager and Principal Auditor</p>	<p>Yes</p>	<p>Sample review of jobs will be carried out. Also a system of post-completion review of individual assignments, feeding into the EDPA process.</p>	<p>December 2006</p>

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Reporting						
<p>Currently audit recommendations are not prioritised. The allocation of priorities to agreed actions would:</p> <ul style="list-style-type: none"> • help inform the formulation of the SIC; • enable the Audit Committee to assess the importance of any action or inaction; and • allow follow up assignments to be agreed on the basis of risk. 	<p><i>R7 Develop and implement an approach to enable prioritisation of agreed actions included within final reports.</i></p>	Medium	Internal Audit Manager and Principal Auditor	Yes	The approach to reporting will be reviewed to make the most of available risk information, so as to identify 'priorities'.	March 2007

Issue	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Quality Assurance						
<p>Existing arrangements include a system of review at key stages of each assignment and the use of client feedback questionnaires. The results of this process are not currently reported to the Audit Committee and there are no pre-set performance measures which are reported on other than reports on completion of the audit programme. The CIPFA Code requires that a provision for internal quality reviews should be made and that this should appraise:</p> <ul style="list-style-type: none"> • quality of audit work; • quality of supervision; • compliance with CIPFA Code of Practice; • compliance with Internal audit Manual; • how it benefits the organisation; and • achievement of performance measures. 	<p><i>R8 A full coverage quality review should be undertaken annually which meets the CIPFA standards on quality assurance. This should include the setting and monitoring of performance measures. The results of the quality assurance review should be reported to the audit committee. Implementation of recommendation 6 would assist with this.</i></p>	High	Internal Audit Manager	Yes	Relevant and SMART performance measures will be developed in tandem with the production of a Strategic Plan (see R4).	March 2007

<p>From 1 April 2006 the Accounts and Audit regulations have been amended by the Accounts and Audit (Amendment) (England) Regulations 2006. These include a new requirement under regulation 6 (3) for Councils to ‘at least once in each year, conduct a review of the effectiveness of the system of Internal Audit’. New Regulation 6(4) goes on to say – ‘The findings of the review referred to in paragraph (3) shall be considered, as part of the consideration of the system of internal control’.</p> <p>The Council will need to consider during the year how they will meet this requirement.</p>	<p><i>R9 The Audit Committee should consider how it will comply with the new requirement within the Accounts and Audit regulations to annually review the effectiveness of Internal Audit.</i></p>	<p>High.</p>	<p>Internal Audit Manager.</p>	<p>Yes.</p>	<p>A report will be taken to the Audit Committee in September 2006 setting out the options for complying with this requirement.</p>	<p>September 2006</p>
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