

AUDIT COMMITTEE

28 JUNE 2007

REVIEW OF EFFECTIVENESS OF THE INTERNAL AUDIT SYSTEM

Report from: Mick Hayward, Chief Finance Officer

1 Summary

- 1.1 To advise Members of changes to the Accounts and Audit Regulations which require Medway Council to review annually the effectiveness of the internal audit system.

2 Decision issues

- 2.1 Decisions on accounts and audit issues are within the remit of this committee.

3 Background

- 3.1. The Accounts and Audit regulations (A&AR) were amended in 2006 to require relevant bodies to conduct an annual review of the effectiveness of the internal audit system. This process is also part of the wider annual review of the effectiveness of the internal control system, which leads to the approval by this Committee of the Statement on Internal Control and subsequent publication of the Statement with the annual accounts.
- 3.2. Guidance from the Department of Communities and Local Government (DCLG) advises that where an Audit Committee exists, such a committee should consider the outcome of the annual review as the audit committee has a role in monitoring internal audit but is independent from it.
- 3.3. The A&AR also states that internal audit should conform to proper practices and the DCLG advises that proper practice for internal audit is set out in the Code of Practice for internal audit in local government in the United Kingdom published in 2006 by the Chartered Institute of Public Finance and Accountancy (Cipfa).
- 3.4. Financial Rule 5 states that internal audit will also have regard to any auditing standard pronouncements issued by Cipfa. Therefore, Cipfa's Code of Practice forms part of the guidance that the internal audit team aims to adhere to.
- 3.5. Guidance from the Audit Commission has indicated that the annual review of internal audit's work carried out as part of the external auditor's accounts and

governance audit, will not in itself, be sufficient to meet the needs of the annual review required by the A&AR.

- 3.6. The A&AR does not specify how the review should be conducted or define what constitutes the “internal audit system”.

4. Previous Arrangements

- 4.1. The predecessor committee received reports on the outcomes of internal audit work and played a key role in monitoring the performance of the internal audit team by receiving reports by the external auditor and on the results of benchmarking (quality and cost) exercises and local performance indicators. The issues from all these data sources were contained in a report submitted annually to the committee.

5. Current Arrangements

- 5.1. By its very definition, effectiveness is concerned with results and having an effect. Whilst efficiency can be defined simply as “doing things right”, effectiveness is more concerned with “doing the right things”. Thus, any review is more than how the internal audit team operates within its own procedures and following industry professional guidance. A review will need to embrace issues surrounding how the annual plan is comprised, the means whereby the organisation allows internal audit to operate, independent reporting methods, independence from management of control functions and the status of the team, the organisation’s anti-fraud and corruption culture and how managers respond to internal audit recommendations.
- 5.2. The new requirement, as set in the A&AR, will encompass the existing arrangements but will need additional information to cover the issues raised in the above paragraph.
- 5.3. Therefore, the annual review for 2006/07 was conducted as follows: -
- Self assessment against the Code of Practice for internal audit in the UK. This provides an analysis of where we are now and what needs to be done to meet fully the requirements of the code. The outcome of this assessment (Annex A) was reviewed by the Chief Finance Officer.
 - External audit’s view of IA as part of their accounts and governance work.
 - Performance indicator outcomes covering service delivery information. The indicators or reports that are currently provided are as follows: -
 - o Reliance on IA work by the external auditor
 - o Percentage of audit plan completed
 - o Percentage of time on non assurance or non-audit duties
 - o Percentage of time that is chargeable
 - o Finding a significant improvement in control in a follow-up audit
 - o Issuing final reports within two weeks of the formal response by management
 - o Managers implementing or failing to implement audit recommendations
 - o Customer satisfaction responses

5.4. The following indicators were not considered appropriate:-

- o Percentage of recommendations accepted by management. As the final audit report contains an “agreed management action plan”, this would always show 100%. If managers were not to accept key recommendations in the audit report, this would be reported as part of the outcomes of audit activity which this committee receive on a regular basis.

5.5. There is no clear Cipfa recommendation that the annual review of the effectiveness of the internal audit system should include an external review. This could be carried out by the external auditor or by an independent consultant. For 2006/07, this was not proposed as any external review would wish to base their examination on the self assessment and the measures stated in paragraph 5.3. However, an external review could be planned in for 2007/08 but no provision for this has been made in the 2007/08 budget build.

5.6. The key issues arising from the 2006/07 review are set out at Annex A.

6 Financial implications

6.1 There are no financial implications arising directly from this report.

7 Legal implications

7.1 There is a legal requirement for Medway Council to conduct a review of the effectiveness of the internal audit system each year and for outcome to be considered by the audit committee.

8 Recommendations

8.1 That this committee endorses the approach of the review of the effectiveness of the internal audit system for 2006/07 and the outcome of the review in support of the committee’s consideration of the Statement of Internal Control.

9 Background papers

9.1 Accounts and Audit Regulations.

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Review of the effectiveness of the internal audit system

From the outset, the review recognised that the effectiveness of the internal audit system was not solely about the extent of compliance by internal audit with the Cipfa code of practice. In essence the need for the review is to ensure that the opinions offered by internal audit may be relied upon as a key source of evidence in assessing the SIC. Nor does effectiveness include VFM, and although this is an important issue, the focus of the review should be on outputs and outcomes.

The Cipfa Code of Practice identifies eleven key areas as follows:-

- Scope of IA (terms of reference and scope of work)
- Independence
- Ethics for internal auditors
- Audit Committees
- Relationships (management, other auditors, members)
- Staffing, training and continuing professional development
- Audit strategy and planning
- Undertaking audit work
- Due professional care
- Reporting
- Performance, quality and effectiveness

Key Outcomes

The review identified a number of strengths and some areas where improvements can be made. The key strengths are

- Reliance on IA work by the external auditor. For a number of years the external auditor has requested that IA carry out work on their behalf. This work and the reliance placed upon it, has been recognised in the annual audit letter. There have been no critical comments of IA in the annual letter during the past three years.
- The starting point for audit planning is the authority's own risk identification processes. This ensures that audit work is geared towards the authority's key objectives. This approach is enhanced through the use of IA's own risk assessment to identify key areas for audit activity.
- Use of private sector resources to supplement the in-house team's skills and competencies and to learn from how the private sector carries out such work.
- The level of request from directors and senior managers to carry out audit work.
- A member audit committee has been in existence since Medway Council's creation in 1998.
- Open reporting to members. IA have reported independently to the audit committee from 1998.
- The use of audit opinions in reports from 1998.
- The assessment showed good scores in all eleven areas of the code of conduct.

- High level of audit plan completion, although the current year's performance dipped from the previous high levels of 2004/05 and 2005/06. This was primarily due to staff vacancy level.
- Comprehensive performance assessment – internal control – was assessed by the external auditors as “score 3 out of 4, consistently above minimum requirements - performing well”.

The key areas for improvement are :

- Recommendation tracking – recent and isolated instance of internal audit recommendations not being pursued requires changes to the monitoring arrangements. The Chief Finance Officer and the Audit Services Manager will consider how best to achieve effective monitoring.
- Benchmarking data has consistently shown that audit resource levels are one of the lowest in the country. Whilst high risk areas are identified and audited, any loss of staff has an immediate impact on the team's ability to carry out their work.
- Comprehensive performance assessment – internal control – the area identified for improvement was risk management, particularly developing the focus on key risks and staff training.
- Customer feedback is positive but the level of responses from auditees is low. Research will be carried out to identify other ways of obtaining relevant feedback.