

## **AUDIT COMMITTEE**

### **25 SEPTEMBER 2008**

## **REVIEW OF EFFECTIVENESS OF THE INTERNAL AUDIT SYSTEM**

Report from: Mick Hayward, Chief Finance Officer

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### **Summary**

Members are required to review annually the effectiveness of the internal audit system, as set out in the Accounts and Audit Regulations.

#### **1. Budget and Policy Framework**

1.1 Following the Council's decision to establish this committee, it is within the remit of this committee to take decisions regarding accounts and audit issues.

#### **2. Background**

2.1 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 governance issues, which leads to the approval by this Committee of the Annual Governance Statement and subsequent publication of the Statement with the annual accounts.

2.2 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.

2.3 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).

2.4 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.

2.5 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.

2.6 The A&AR does not specify how the review should be conducted or define what constitutes the "internal audit system".

### **3. Current Arrangements**

3.1 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.

3.2 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.

3.3 Therefore, the annual review for 2007/08 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 as identified in a follow up audit
  - o Customer satisfaction responses

3.4 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.

3.5 There is no clear Cipfa recommendation that the annual review of the effectiveness of the internal audit system should include an external review.

3.6 The key issues arising from the 2007/08 review are set out at Annex A.

#### **4. Financial and legal implications**

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

#### **5. Recommendations**

5.1 That this committee endorses the approach of the review of the effectiveness of the internal audit system for 2007/08 and the outcome of the review in support of the committee’s consideration of the Annual Governance Statement.

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#### **Background papers**

Accounts and Audit Regulations.

## 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 in recent 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 has reported independently to the audit committee from 1998 and wherever possible, the outcomes of internal activity are reported in open session of the audit committee.
- The use of audit opinions in reports from 1998.
- The assessment showed good scores in all eleven areas of the code of conduct.
- All key assurance work completed, although some operational audit activity was curtailed 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 – areas assessed as “unsatisfactory” are subject to a follow up audit. However, where control is assessed as “adequate” or above, no recommendation tracking takes place. The Chief Finance Officer considers that this is primarily the responsibility of directorate management to ensure that recommendations are implemented. For “satisfactory” or “good” opinions, no IA action is considered necessary but the CFO and the Audit Services Manager will consider how best to achieve effective monitoring bearing in mind the impact this might have on the current level of resources.
- 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. The review did confirm that IA does not carry out any non audit functions and therefore, the total resource is used on audit activities.
- 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. This is a common problem within authorities and no research has yet offered a solution. However, work will continue to identify other ways of obtaining relevant feedback.