

<i>COMMITTEE</i>	Standards Committee
<i>DATE</i>	21 September 2005
<i>TITLE OF REPORT</i>	Work of Internal Audit
<i>RESPONSIBLE OFFICER</i>	Richard Humphrey, audit services manager, central finance

1. PURPOSE OF REPORT

- 1.1 At the July 2005 meeting of this committee, Members asked that they receive a report on the work of internal audit.

2. RECOMMENDATIONS

- 2.1. That Members note the contents of the report.

3. BACKGROUND

- 3.1. At the July 2005 meeting of this committee, Members endorsed the findings of the audit on Corporate Governance. As part of the debate, Members asked that they receive background material on the work of internal audit.
- 3.2. The attached annex provides this background material in a “frequently asked questions” format.

4. FINANCIAL AND LEGAL IMPLICATIONS

- 4.1 There are no financial or legal implications arising from this report.

5. BACKGROUND PAPERS

- 5.1. None.

CONTACT POINT

Richard Humphrey – audit services manager, ☎ 332355

What is Internal Audit?

The Chartered Institute of Public Finance and Accountancy (Cipfa) defines internal audit as: -

“Internal Audit is an assurance function that primarily provides an independent and objective opinion to the organisation on the control environment comprising risk management, control and governance by evaluating its effectiveness in achieving the organisation’s objectives. It objectively examines, evaluates and reports on the adequacy of the control environment as a contribution to the proper, economic, efficient and effective use of resources.”

Auditing guidance also states “It is management’s responsibility to determine the extent of internal control.....which should not depend on internal audit as a substitute for effective controls.” Therefore, managers are responsible for the operation of controls, not internal audit.

Cipfa further defines organisations and control environment as follows:-

Organisation - *The body that is subject to internal audit. It also has specific meaning under the Accounts and Audit Regulations 2003 in that the organisation or “relevant body” (i.e. the members) has the responsibility for “ensuring that the financial management and accounting control systems of the body are adequate and effective, that the body has a sound system of internal control which facilitates the effective exercise of that body’s functions and which includes risk management” and also for conducting “a review at least once in a year of the effectiveness of its system of internal control and shall publish a statement on the adequacy of internal control with any statement of accounts it is obliged to publish in accordance with regulations”.*

Internal Control Environment - *The internal control environment comprises the organisation’s policies, procedures and operations in place to:*

- a. establish, and monitor the achievement of, the organisation’s objectives*
- b. identify, assess and manage the risks to achieving the organisation’s objectives*
- c. facilitate policy and decision-making*
- d. ensure the economical, effective and efficient use of resources*
- e. ensure compliance with established policies (including behavioural and ethical expectations), procedures, laws and regulations*
- f. safeguard the organisation’s assets and interests from losses of all kinds, including those arising from fraud, irregularity or corruption*
- g ensure the integrity and reliability of information, accounts and data, including internal and external reporting and accountability processes.*

It encompasses elements of corporate governance and risk management.

Why do you need it?

There are two reasons why an internal audit function is necessary within a local government organisation.

Firstly, the requirement for an Internal Audit function derives from local government legislation, including section 151 of the Local Government Act 1972. The Act requires that authorities “make arrangements for the proper administration of their financial affairs” and proper administration includes Internal Audit. Furthermore, in England, more specific requirements are detailed in the Accounts and Audit Regulations 2003, in that a relevant body must “maintain an adequate and effective system of Internal Audit of its accounting records and of its system of internal control in accordance with the proper Internal Audit practices”.

Secondly, it is considered good practice to have an internal audit function. Governance issues have given cause for concern in the private sector, particularly in the last decade and this has prompted improvements in private sector auditing standards.

Within central and local government, audit is well established and it is viewed as an essential part of the overall internal control framework. In fact, the oldest Select Committee of the House of Commons, the Public Accounts Committee, which deals with audit issues, has been in existence for over 150 years. Therefore, in the public sector, internal audit is seen as “best management practice” and exists because of this.

Who are our Stakeholders?

Members, Chief Executive, Director of Finance and Corporate Services (the Chief Financial Officer), other directors, managers, external audit and taxpayers.

Members play a key part either through the Audit Committee and they may request specific pieces of audit work, as can Portfolio holders and overview and scrutiny functions.

The responsibility for ensuring that Medway has an adequate and effective Internal Audit rests with the Director of Finance and Corporate Services as the Chief Financial Officer for this Authority.

External Audit are also customers of Internal Audit.

Who does the work?

The internal audit section comprises of two teams. These are;

- traditional audit function (7 staff), of which the majority either hold or are studying for a professional qualification,
- counter fraud, primarily dealing with verification of Housing Benefit claims (6 staff) or investigating allegations of Housing Benefit fraud (8 staff).

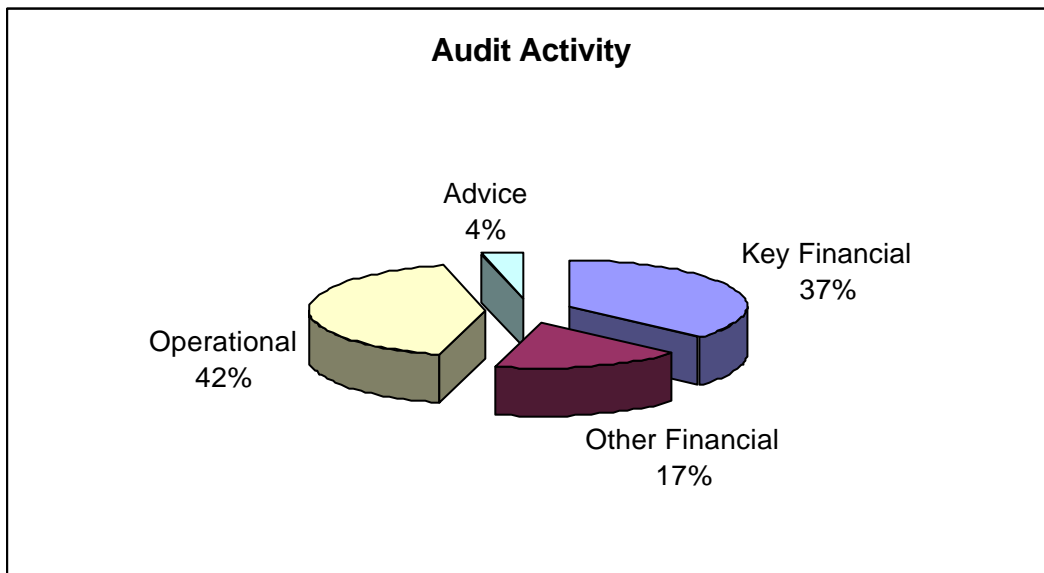
How do we do our work?

Our work plan is based on a number of factors. These are:-

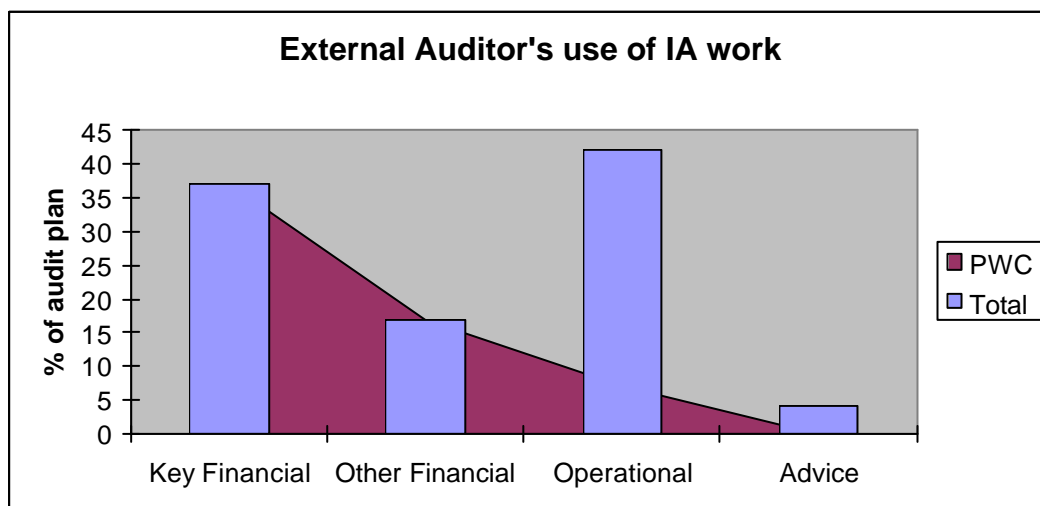
- risks identified by directorates as part of their business and service planning processes,
- risks identified by internal audit,
- consultation with directorates,
- joint working with the external auditors to maximise the use of audit resources,
- specific request from Members either through the Audit Committee, portfolio holders or the overview and scrutiny function.

The annual plan that is produced from these sources is approved by the Member Audit Committee.

The following graph shows the breakdown of the 2005/06 plan.



Whilst this graph shows how our work is used by the external auditors and how we maximise the use of audit resources.



How do we report?

To ensure ownership of any necessary action, every final audit report contains an “agreed management action plan”. This details what we have recommended, the managers response, who will carry out the actions and the date by which this will be done.

Generally, internal audit reports identify areas where improvement in the control process should be made. However, even where recommendations are prioritised, the recipient of the report has no indication of how well the overall control process is operating. Furthermore, there is no standard within the internal audit profession of grading the overall control environment.

To aid managers, Internal Audit has introduced a grading system so that managers have a clear understanding of the operation of the control environment in their area. The audit opinion, which is set at one of four levels, is formed on completion of the audit testing and evaluation stage but **before** management implement any of the recommendations.

Medway Council established a Member Audit Committee in November 1998 and the outcomes of all audits are reported to the Audit Committee irrespective of whether they have been reported separately to Cabinet, Overview and Scrutiny or the Standards Committee.

To ensure independence of reporting, the head of internal audit reports to members in his own name. Independent reporting is essential to the success of any audit committee and internal audit has been encouraged and supported to do this by Members and the Chief Financial Officer. To demonstrate that this does happen you have only to look at what is reported to the audit committee, particularly where audits have been critical of operations run by the Finance and Corporate Services Directorate.

Where and When does audit operate?

Although Internal Audit is located within the Finance and Corporate Services directorate, the audit work can cover any aspect of the Council’s activities and we do not audit just financial systems. The in-house team provides continuous coverage throughout the year.

Internal Audit’s rights of access are set out in the Council’s financial rules as is the independence of the section.

Does it provide VFM?

To provide good VFM requires a high level of service delivery at a reasonable cost. For service delivery goals to be attained, a team needs to have defined standards that are followed. Furthermore, an independent assessment of the work carried should be obtained. Costs of service delivery can be measured by a benchmarking exercise with other authorities.

The Council’s financial rules state that internal audit section shall follow auditing guidance published by Cipfa. The section operates in accordance with a number of publications

including the Code of Practice for Internal Audit in Local Government, Local Government Internal Audit Manual, System Based Auditing (Series I-III) and Computer Audit Guidelines

These publications cover: -

- Purpose, authority and scope of internal audit
- Independence, ethics and due professional care
- Relationships
- Staffing, training and development
- Internal control and risk
- Audit strategy and planning
- Types of audit work
- Managing audit assignments
- Audit reporting
- Quality assurance and performance management

Every year, the external auditor assess the work of internal audit so that they can reach a view as to whether they can rely upon internal audit's work, thereby reducing the volume of work that the external auditor needs to carry out. This review covers the section's standards, how that is translated into their work and examines whether there is sufficient evidence to justify the internal audit opinions provided. The last review conducted by the external audit confirmed that they continue to place reliance on the work of internal audit and this covers work on the Performance Plan, governance and financial control. Furthermore, as part of the 2004 Comprehensive Performance Assessment process, the external auditor assessed Internal Audit at the highest level, scoring 4 points out of a maximum of four.

Since 2000, internal audit has participated in a national annual audit benchmarking exercise run by Cipfa. This allows comparison between Medway Council's internal audit costs and those of other unitary authorities. The last results, published in 2004, show that the overall cost of internal audit is one of the lowest and that it is in the lowest cost quartile nationally.

One of the Audit Committee's roles is to monitor the quality and delivery of the internal audit service. Each year, the audit committee receives a report on the outcome of the external auditor's review and the benchmarking exercise. At their last meeting in July 2005, they reached the view that the internal audit provided a good quality service at a low cost and congratulated the audit team on the outcome.