

## **AUDIT COMMITTEE**

**11 JULY 2013**

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

Report from: Mick Hayward, Chief Finance Officer

Author: Mick Hayward, Chief Finance Officer

#### **Summary**

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

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

1.1 Decisions regarding accounts and audit issues fall within the remit of this Committee.

#### **2. Background**

2.1 The Accounts and Audit Regulations (A&AR) were amended in 2011 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.

2.2 Guidance from Communities and Local Government (CLG) 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 state that internal audit should conform to proper practices and CLG 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). Whilst this Code is the reference point for 2012/13, from 1 April 2013 this CIPFA guidance has been incorporated into the Public Sector Internal Audit Standards, and it is this standard that has been used in this compliance review.

#### **3. Options**

3.1 Guidance from the Audit Commission indicated that the annual review of internal audit's work, carried out as part of the external auditor's accounts and

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

#### **4. Advice and analysis**

4.1 This review has been undertaken by comparing the current arrangements against the CIPFA document - Local Government Application Note for the United Kingdom Public Sector Internal Audit Standards.

4.2 The assurance gained from this review is complemented by a number of other assurance mechanisms:

- external audit's view of Internal Audit as part of their accounts and governance work
- the CIPFA benchmarking exercise which compares Local Authority IA performance

4.3 The findings of the review are set out at **Annex A**.

4.4 As part of the annual review of internal audit's effectiveness the Audit Charter has been reviewed and updated and is provided, for information, at **Annex B**.

4.5 A set of proposed KPIs for monitoring the performance of internal audit has been discussed with management, and is provided at **Annex C**. The audit opinions and definitions have also been reviewed to ensure it remains fit for purpose. This has also been subject to discussion with management and is attached at **Annex D**.

4.6 There are no diversity or sustainability implications.

#### **5. Risk management**

5.1 There are no risk management implications arising directly from this report, apart from failure to observe statutory requirements.

#### **6. Financial and legal implications**

6.1 There are no financial implications arising directly from this report, but there is a legal requirement for local authorities to review the effectiveness of the internal audit system each year and for the outcome to be considered by the Audit Committee.

#### **7. Recommendations**

7.1 Members are asked to endorse the approach to the review of effectiveness of the internal audit system for 2012/13 and the outcome of the review, in support of the Committee's consideration of the Annual Governance Statement.

7.2 Audit Committee to approve the Internal Audit Charter and note the Internal Audit KPIs.

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## **Background papers**

Accounts and Audit Regulations 2011  
<http://www.legislation.gov.uk/uksi/2011/817/contents/made>

Public Sector Internal Audit Standards  
<http://www.cipfa.org/-/media/Files/Publications/Standards/Public%20Sector%20Internal%20Audit%20Standards.pdf>

## Review of effectiveness of the internal audit system

This annual review of the effectiveness of internal audit incorporates all the conformance checks and evidential requirements set out in the CIPFA Local Government Application Note for the United Kingdom Public Sector Internal Audit Standards (PSIAS).

The PSIAS came into effect 1 April 2013 but is largely in line with previous guidance, and in reviewing Internal Audit against these new standards this output provides assurance over not only compliance for the 2012/13 year, but also the ongoing compliance of the internal audit service with national standards.

### **Detail**

The review has confirmed that internal audit is fully compliant with all but three elements of the Standard.

#### Key arrangements which ensure compliance are:

- The Audit Charter which sets out the role and authority of Internal Audit – the Charter has been reviewed and updated for 2013/14
- The Audit Manual which documents the procedures and process followed during the delivery of internal audits and other services
- The regular reporting to Audit Committee of the progress against the audit plan, and provision of the audit summaries to Audit Committee
- The annual provision to Audit Committee of the proposed Annual Audit Plan and the Annual Audit Opinion
- The involvement of Senior Management in the setting of the Annual Audit Plan, and also their input into the audit process
- The reporting lines that the Head of Internal Audit (HIA) has, to the Chief Finance Officer, the Chief Executive and the Chair of the Audit Committee.

#### The only areas where work is continuing in order to ensure compliance from 2013/14 onwards are in relation to:

- Monitoring performance of Internal Audit against KPIs – the proposed set of KPIs has been developed and is presented to the Audit Committee for information
- External Review of Internal Audit – this is something required every five years and to date has not been undertaken for Medway's services. The Kent Audit Group, of which Medway is a member, is looking into how external reviews might best be procured and delivered
- Whilst fraud resilience remains a line management responsibility, as the Corporate Anti-Fraud team broaden their scope to investigating all forms of fraud committed against the council, the HIA does have operational responsibility for the investigation of fraud. The HIA also has some operational responsibility for the detection of fraud through the National Fraud Initiative, and the increasing of fraud awareness through delivery of a series of presentations. Audit Services should not deliver work for which the Head of Internal Audit has any operational responsibility, and it is for this reason that the annual Prevention of Fraud and Corruption Audit will not be conducted in future years. A paper to the Audit Committee in March set out how the

assurance regarding anti-fraud measures would still be obtained through other mechanisms. The key points of this paper were:

- Every internal audit undertaken includes consideration of the level of fraud risk and how it is mitigated. Any issues identified relating to the management of this risk are highlighted in the individual audit report.
- BDO, as the Council's External Auditor, provide annual assurance over the anti-fraud arrangements in place across the Council.
- In 2011 the Council commissioned a piece of work from PKF to measure the Council's fraud resilience, the outcome of which was reported to Audit Committee
- The Fraud Resilience Strategy presented to Audit Committee in March 2012 provides a roadmap for enhancing the current fraud mitigation arrangements. The Strategy is renewed annually, and Audit Committee receives twice-yearly updates on the progress being made.
- The cyclical audit plan makes provision of assurance over compliance issues, and periodically this would include reviews of fraud-related processes and policies
- Assurance over the Council's arrangements is also gained through the results of the *Audit Commission Annual Fraud Survey*.
- Consideration could be given to commissioning an external review within five years to provide independent assurance on the Council's arrangements.

Further enhancements have been made to the Audit Manual documenting:

- How consultancy arrangements are undertaken
- The process for reporting control issues arising from investigations undertaken by Audit Services
- The auditing of arrangements such as partnerships and joint ventures, particularly being aware of how data should be shared. The details of this process will be clarified throughout 2013/14 and formally documented in the Audit Manual for 2014/15.

Evidence Reviewed	
A	Internal Audit Charter
B	Internal Audit Manual
C	2012/13 Internal Audit Monitoring Spreadsheet
D	Email regarding team being made aware of the Code of Conduct
E	Email to team regarding checks to be undertaken as part of the PDR process
F	Template for declaration of interest Fi) demonstrates work in progress to review council wide process for declaring interests
G	Email to team regarding Yamma – demonstrates awareness of need to ensure team actions are appropriate
H	Email to team circulating Public Sector Internal Audit Standards
I	Example of training record maintained each year
J	HR guidance on gifts and hospitality
K	Audit Committee Meeting – shows attendees
L	Email regarding Audit Committee agenda – demonstrating Chief Audit Executive input into the Committee meetings
M	Internal Audit Annual Report – July 2012
N	Audit Committee Agenda September 2012 – shows review of risk management and annual governance report. Also shows presentation of Fraud Resilience Strategy. Standard papers also shown – including progress on audit work programme
O	Diary record of meeting between Chief Audit Executive and Chair of Audit Committee, including discussion of annual plan
P	Email example to show audit plan circulated to Chief Executive
Q	July 12 presentation to Audit Committee of the outcome of the Audit Effectiveness Review
R	2013/14 proposed Audit Plan to Audit Committee March 2013 – includes explanatory notes, mapping of plan against identified risks and key systems, and table showing intended allocation of resources
S	Audit Committee minutes that demonstrate presentation of the Audit Strategy and Plan – and Members approval of the same
T	Report to Audit Committee of Internal Audit Work Programme
U	Email example of how previous employment of IA staff determines allocation of audit work – in order to avoid any potential conflict of interest
V	Prevention of Fraud and Corruption Audit 2012/13
W	2012/13 Audit of IT External Assurances Wi) is external audit documentation of council IT arrangements
X	Training provided to Internal Audit Team re handling of fraud – March 2012
Y	Internal Audit Team Meeting November 2012
Z	Internal Audit Team Meeting April 2013
AA	Action Plan from 2012 Audit Effectiveness Review
AB	Service Plan 2012/13
AC	Internal Audit Team Meeting October 2012
AD	Meeting with External Audit March 2013
AE	Email which includes reference to the intention to provide assurance on progress on Ofsted findings

AF	Audit Committee report re Internal Audit Work Programme showing proposed deferral of audits
AG	Audit Services Office Guide
AH	Probity Audit Terms of Reference
AJ	Audit Terms of Reference
AK	Public Health Audit
AL	Follow up Report – Markets Income – demonstrating revision in opinion
AM	Staff Code of Conduct
AN	Resource Calculation for 2013/14
AO	Public Sector Internal Audit Standard Shared with Audit Committee
AP	Schools Report
AQ	Liaison re Terms of Reference
AR	Liaison re Audit Report
AS	Meeting senior management re Audit Plan
AT	Kent Audit Group/London Audit Group/Home Counties Chief Internal Auditors Group – attendance and liaison
AU	Strategic Information Group Internal Audit attendance
AV	Presentation to Audit Committee of Fraud Resilience Strategy
AW	Terms of Reference discussed within the Internal Audit Team
AX	Partnership discussion document for audit
AY	Possible Amendments to the Internal Audit Manual – to be completed once the draft Key Performance Indicators and revised Audit Opinions agreed
AZ	Draft Key Performance Indicators and Audit Opinions for discussion

## Internal Audit Charter

This Charter sets out the way in which Internal Audit works at Medway Council. The Charter is a formal document that defines the internal audit activity's purpose, authority and responsibility. It is presented each year to the Audit Committee for formal approval.

The audit team complies with the CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom 2006, (the CIPFA Code), and also with the Chartered Institute of Internal Auditors (CIIA) Standards and Code of Ethics.

From 2013 Internal Audit Services ensures compliance with the Public Sector Internal Audit Standards. The role of Internal Audit at Medway Council is summarised in the Financial Rules (Section 5), which form part of the Constitution.

The CIIA Definition of Internal Audit:

"Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes".

CIPFA Code:

"Internal audit is an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports upon the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources."

### **Authority**

The authority of Internal Audit is set out in the Medway Council Financial Rules. To provide meaningful assurance Internal Audit seeks to work in partnership with managers and staff. The Financial Rules state that "The Chief Executive and directors shall ensure all their staff co-operate with the Council's internal and external auditors and provide information and working papers required for the proper conduct of audit."

To ensure effective delivery Internal Audit has to have unfettered access to all of Medway's affairs, with right of access to any Council owned premises, plant, equipment, books, accounts, receipts, vouchers, computer records or other materials. Access to the property of those with whom the Council are in partnership, and those under contract to the Council, should be set out in the formal agreements with the other parties.



## Audit Committee

Internal Audit reports to the Audit Committee, and seeks annual approval from this Committee for the Charter and the Annual Audit Plan. Any proposed changes to the agreed plan will also be presented to the Audit Committee for approval. In addition Internal Audit provide to the Audit Committee, for information:

- progress against plan – at each meeting
- summaries of the outcomes of audits performed – at each meeting
- summary of the follow ups performed – annual
- internal audit report and opinion – annual
- summary of the outcome of investigations – ad hoc

## Governance

Medway Council's Financial Rules state that "Internal audit shall be sufficiently independent to enable the auditors to perform their duties in a manner, which will allow their professional judgements and recommendations to be effective and impartial." There are appropriate safeguards in place to ensure that this is so.

To support the compliance with and demonstration of objectivity of the team no auditor will undertake any audit work in a management area in which they had worked within the last two years, and audits are assigned on a rotational basis. Furthermore, all members of the Internal Audit Team complete a declaration of interest form that is reviewed each year.

Auditors ensure that they are acting in accordance with the Ethics and Independence requirements laid down in Medway's Code of Conduct, the PSIAS and the CIPFA and CIIA Codes. Four key requirements of Internal Audit are:

Integrity	The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.
Objectivity	Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgements.
Confidentiality	Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
Competency	Internal auditors apply the knowledge, skills and experience needed in the performance of internal auditing services.

## Scope

Internal Audit is responsible for providing assurance on the effectiveness of internal control across all areas of the Council's activity, including Medway's Schools.

The internal audit activity is determined largely on the basis of risk, although there are some audits required on an annual basis to meet legislative or regulatory requirements.

The identification of what assurance the Council requires from internal audit also takes into account other providers of assurance, including External Audit. The Audit Services Manager (ASM), as the Head of Internal Audit, meets with the External Audit Manager at least twice a year i.e. at the time the annual internal audit plan is being developed and during the year-end external audit review. Each year internal audit performs audits of key financial systems on which external audit will place specific reliance. These reviews are undertaken using the external audit test strategies.

## **Services provided**

Internal Audit has developed over time from being a “tick box” approach to one that is “risk-based”. However it should be noted that the audit approach is determined based on the objective of the audit assignment. The intended approach to be adopted for each audit will be documented on the annual audit plan and on the terms of reference agreed with management. There are times when an audit should be conducted using a systems or compliance approach, and some assignments will require a “developing systems” approach where a project or new development is underway.

Internal Auditors are alive to the risk of fraud in all the work that they undertake. Potential fraudulent activity is handled with consideration of the following: duty of care to employees; the maintenance of confidentiality; the protection of assets; and the preservation of evidence. Any concern that a member of the audit team has about the possibility of fraudulent activity is raised with the ASM as soon as possible.

On occasions Internal Auditors are required to undertake or assist in fraud investigations, and these will be performed in line with the Fraud Response Plan. Any allegations received by a member of the audit team under the Public Interest Disclosure Act (PIDA) “whistleblowing” arrangements are also reported immediately to the ASM.

Other regular undertakings by the audit team include the sign-off of grant claims in line with the grant terms and conditions. The audit team also provides risk and control advice to management, but auditors maintain their independence by not being involved in the actual development of control systems.

## **Reporting**

Audit Services is a team within Finance. As such the ASM reports managerially to the Chief Finance Officer, as Section 151 Officer with responsibility for ensuring there is a robust financial control framework in place and that there is ongoing compliance with laid down financial procedures. In addition the ASM also has independent reporting access to the Chief Executive, the Chair of the Audit Committee, and External Audit.

All audit reports are shared with the Senior Management, and a summary of the audit findings is provided to the Audit Committee.

An Audit Opinion will be stated for each audit output, and each recommendation will be graded as Significant (High), Material (Medium) or Point of Practice depending on the level of risk the Council is exposed to, and the urgency of the action needed to address the identified weakness.

## **Audit Delivery**

The internal audit methodology is set out in the Internal Audit Manual, which is reviewed annually.

All audit work is subject to supervision by a Principal Auditor or the ASM.

Audits are conducted in such a way as to minimise the time required by management. Where possible internal audit use a collaborative approach, working with management to determine the appropriate scope, approach and timing of the audit, to identify risks and controls, and identify solutions to weaknesses in the control systems.

Delivery to agreed KPIs is reported annually to the Audit Committee.

## **Documentation**

Each audit undertaken has an agreed terms of reference, and a full trail from audit findings through to the draft and final report. The audit files are available for review by External Audit. Files and documents are stored and destroyed in line with the requirements of the Data Protection Act, Medway's Quality Assurance/Quality Records policy and Retention Guidelines for Local Authorities 2003.

## **Resources**

The Internal Audit team is part of the Audit Services Team, which also includes the Corporate Anti-Fraud Team.

The ASM leads the Internal Audit team. The team has six posts: two Principal Auditors and four Auditors. The ASM and the Principal Auditors hold internal audit qualifications and undertake Continuing Professional Development. Training and development of all team members is supported on an ongoing basis, all staff in the team attend the annual Kent Audit Conference, and identification of training requirements is formally documented in the annual staff reviews.

As part of the annual planning process the ASM reviews whether there are sufficient resources to provide the required coverage and assurance. The ASM will report to management and the Audit Committee any shortfall that might impact negatively on the ability to provide the required annual assurance.

Networks for sharing good practice and information are maintained, including the Home Counties Chief Internal Auditors Group, the Kent Audit Group, and the London Audit Group and its sub-groups. Medway also takes part in the annual CIPFA internal audit benchmarking exercise.

## Internal Audit KPIs

### 1. Audit Planning

Proposed Annual Audit plan shared with Chief Executive, Chief Finance Officer, Directors and External Audit prior to presentation to the Audit Committee in March. The Annual Audit plan is drawn up in such a way as to ensure it provides appropriate and sufficient coverage to support the Annual Audit Opinion.

***Target – confirmation in the annual audit opinion that there is sufficient coverage to provide such an opinion***

### 2. Quality

Delivery of audits to agreed scope, and any change to the scope informed to the Director or Assistant Director in a timely manner. Measured through feedback from Director/Assistant Director at the Draft Final Report stage of each full audit.

***Target Satisfaction Level – 90%***

### 3. Professional Training

All audit staff undertake some relevant professional training in year and meet all CPD requirements set by professional bodies.

### 4. Completion of audit plan

Delivery of the agreed annual audit plan. Measuring delivery of actual number of full audit reports presented to Audit Committee by July each year, against total outputs included in the annual audit plan provided to the Audit Committee in March of the prior year. The statistics will be provided separately for full audits and the delivery of probity reviews.

***Target – 85%***

### 5. Delivery of follow ups

Measured against the timescale agreed with management.

***Target – No follow up to slip by more than 3 months***

### 6. Compliance with Public Sector Internal Audit Standards

Measured against the CIPFA PSIAS compliance check list.

***Target – 100% compliance or agreed, documented and reported exceptions (via the audit effectiveness review)***

### 7. External Audit

Annual liaison with External Audit regarding the Annual Internal Audit Plan.

***Target - External Audit satisfied with the quality of work undertaken by Internal Audit so that they are content to place reliance on the work performed (External Audit should document this in the Annual Accounts)***

PROPOSED DEFINITION OF AUDIT RECOMMENDATION LEVELS	
<b>Significant (High)</b>	The finding highlights a weakness in the control arrangements that exposes the Council to significant risk (determined taking into account both the likelihood and the impact of the risk).
<b>Material (Medium)</b>	The finding identifies a weakness in the control arrangements that exposes the Council to a material, but not significant, risk (determined taking into account both the likelihood and the impact of the risk).
<b>Point of Practice</b>	Where the finding highlights an opportunity to enhance the control arrangements but the level of risk in not doing so is minimal, the matter will be shared with management, but the detail will not be reflected in the audit report.

DEFINITIONS OF AUDIT OPINIONS	
<b>Strong (1)</b>	<p><u>Risk Based:</u> Appropriate controls are in place and working effectively, maximising the likelihood of achieving service objectives and minimising the Council’s risk exposure.</p> <p><u>Compliance:</u> Fully compliant, with an appropriate system in place for ensuring ongoing compliance with all requirements.</p>
<b>Sufficient (2)</b>	<p><u>Risk Based:</u> Control arrangements ensure that all critical risks are appropriately mitigated, but further action is required to minimise the Council’s risk exposure.</p> <p><u>Compliance:</u> Compliant with all significant requirements, with an appropriate system in place for monitoring compliance. Very minor areas of non-compliance.</p>
<b>Needs Strengthening (3)</b>	<p><u>Risk Based:</u> There are one or more failings in the control process that leave the Council exposed to an unacceptable level of risk.</p> <p><u>Compliance:</u> Individual cases of non-compliance with significant requirements and/or systematic failure to ensure compliance with all requirements.</p>
<b>Weak (4)</b>	<p><u>Risk Based:</u> There are widespread or major failings in the control environment that leave the Council exposed to significant likelihood of critical risk. Urgent remedial action is required.</p> <p><u>Compliance:</u> Non-compliant, poor arrangements in place to ensure compliance. Urgent remedial action is required.</p>