

AUDIT COMMITTEE

17 JULY 2014

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 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 the Department for 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 state that internal audit should conform to proper practices and these are set out in the Public Sector Internal Audit Standards, and the Local Government Application Note. 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 PSIAS.
- 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** and detail of the evidence reviewed is set out at **Annex B**. Delivery against the agreed KPIs is set out in **Annex C**.
- 4.4 As part of the annual review of internal audit's effectiveness the Audit Charter has been reviewed and updated and is provided at **Annex D**.
- 4.5 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 2013/14 and the outcome of the review, in support of the Committee's consideration of the Annual Governance Statement. Members are also asked to note and approve the Internal Audit Charter as set out in Annex D.

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Background papers

Accounts and Audit Regulations 2011
Public Sector Internal Audit Standards

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 Local Government Application Note for the United Kingdom Public Sector Internal Audit Standards (PSIAS).

This output provides assurance over not only compliance for the 2013/14 year, but also the ongoing compliance of the internal audit service with national standards.

Detail

This review has confirmed that internal audit is largely compliant with all elements of the Standard, although some areas have been identified for improvement.

Key arrangements in place are:

- The Audit Charter which sets out the role and authority of Internal Audit – the Charter has been reviewed and updated for 2014/15
- 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.

Two areas of non-compliance were identified in the 2012/13 review and have been addressed:

- Previously internal audit did not have stated performance indicators. KPIs were agreed by Audit Committee in July 2013 and performance has been measured against these indicators. The Internal Audit annual report provides confirmation of delivery against these agreed indicators
- Internal audit previously undertook an annual audit of Prevention of Fraud and Corruption. This is an area where the HIA has a management responsibility and as such to undertake an audit of corporate fraud resilience arrangements could be considered to be a conflict of interest. This annual audit is no longer performed but assurance is provided through a number of mechanisms:
 - 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.

- The Fraud Resilience Strategy 2012/14 has been updated for 2014/16. This strategy provides a roadmap for enhancing the current fraud mitigation arrangements. The strategy is reviewed 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.

Five Yearly External Review

It is a requirement for an external review of the council's internal audit compliance with PSIAS to be undertaken every five years. Consideration is underway as to how this review might best be procured and delivered. The intention is to have the full review undertaken in 2016/17. In preparation for this review we have a programme of review of audit processes and arrangements and continue to seek ways to further enhance the current working practices.

Improvements made in 2013/14:

- the key document used when undertaking audits, the Control Evaluation Schedule, has been revised to include reference to key issues which must be considered as part of the audit process, including value for money, fraud, equality and diversity and IT issues. This strengthens the audit process which in turn strengthens the overall assurance provided by internal audit
- mapped the internal audit plan to the Fraud Resilience Strategy to ensure that the work of internal audit and the Corporate Anti-Fraud Team is complementary
- presented the internal audit plan to EMT as part of the process of seeking management input into the audit planning process

In 2014/15 internal audit intends to further strengthen its arrangements by:

- increasing the use of a data interrogation IT tool – internal audit are currently leading a review of this system with the Kent Audit Group. The team currently use this in a limited way but the intention is to maximise its benefits in audits and also for fraud identification and investigation.
- obtaining greater clarity over the audit assurance provided to the council's Audit Committee in relation to 3rd party partnerships
- building on the current limited assurance mapping undertaken to ensure that audit resources complement the work of other assurance providers – both external and internal.

Annex B

Audit Effectiveness Review 2013/14 – Evidence Reviewed	
A	Internal Audit Charter
B	Internal Audit Manual
C	2013/14 Internal Audit Monitoring Spreadsheet
D	Email regarding team being made aware of the Code of Conduct and making declarations of interest as part of team checks as part of PDR
E	Template for declaration of interest
F	Example of training record maintained each year
G	Coverage at PDRs regarding performance measurement
H	Audit Committee Meeting 11.07.13 – shows attendees
I	Email regarding Audit Committee agenda – demonstrating HIA input into the Committee meetings
J	Internal Audit Annual Report – July 2013 and draft 2014
K	Audit Committee Agenda Sep 2013 – 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
L	Diary record of meeting between HIA and Chair of Audit Committee, including discussion of annual plan
M	Presentation to EMT of audit plan and fraud resilience strategy
N	July 13 presentation to Audit Committee of the outcome of the Audit Effectiveness Review
O	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
P	Audit Committee minutes March 2014 that demonstrate presentation of the Audit Strategy and Plan – and Members approval of the same
Q	Report to Audit Committee of Internal Audit Work Programme March 2014
R	External audit documentation of council IT arrangements
S	Training provided to Internal Audit Team re handling of fraud
T	Liaison with External Audit
U	Employee Code of Conduct
V	Standards of Public Life highlighted to Internal Audit team
W	Internal Audit Team Meeting April 13 shows feedback from Kent Audit Group and training attended by team members
X	KAG minutes (showing feedback from an external review undertaken at one district council) and KAG Chair, KAG lead at conference, and lead on liaison regarding enhancement of IDEA usage in Local Authorities
Y	Internal Audit KPIs
Z	Internal Audit recommendations and opinions definitions
AA	Internal Audit formal feedback
AB	Internal Audit unsolicited feedback
AC	Calculation of audit resources as part of planning process 2014/15
AD	CES template including governance and ethical considerations as part of each audit
AE	Service Plan
AF	Terms of Reference template

AG	Offers of Gift and Hospitality Guidance
AH	Audit Services Office Procedures Guide
AI	Draft additional quality review checklist
AJ	Confirmation of key audit documents for 2013/14 shared with Internal Audit team
AK	Internal Audit Data Protection local protocol
AL	Terms of Reference – audit of Equality and Diversity – ethical audit
AM	Risk Management audit report – governance requirement
AN	Schools overall audit report – demonstrating overall audit opinion provided as a result of probity reviews undertaken
AO	Waste Management – demonstration of follow up reviews undertaken and audit opinions revised as a result
AP	Payment Card Industry – CES, TOR and Report to demonstrate full audit trail provided throughout audits
AQ	Responses from AD and Chief Executive to a draft audit report – demonstrating appropriate opportunities provided for management response
AR	KPI delivery review

Delivery Against Agreed KPIs in 2013/14

KPI	Delivery
Confirmation in the annual audit opinion that there is sufficient coverage to provide the Annual Audit Opinion	This confirmation is provided in the Annual Audit Report provided to the Audit Committee in July 2014. <u>Target Met.</u>
Satisfaction level on feedback from audit clients at 90% or higher	100% of returned feedback stated satisfaction with audit delivery Feedback received on 15 audits, further feedback requests to be issued and will be reported in 2015. <u>Target Met.</u>
All audit staff undertake some professional training in-year	All staff within Audit Services have undertaken some professional training in year <u>Target Met.</u>
Completion of 85% or more of the audit plan	One audit was deferred but another three were added to the plan. Two audits await completion, one (Better for Less) delayed due to awaiting management's review of lessons learned, the other delayed due to time constraints. <u>Target Met.</u>
Follow ups delivered with no more than 3 months delay	Six follow ups completed, four were within timeframe but two were not. <u>Target Not Met.</u>
Compliance with PSIAS	This review of audit effectiveness confirms compliance with the PSIAS requirements <u>Target Met.</u>
External Audit content to place reliance on the work undertaken by Internal Audit	External Audit confirmed satisfaction with quality of internal audit as part of their end of year audit in 2013/14 <u>Target Met.</u>

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.

Internal Audit ensures compliance with the Public Sector Internal Audit Standards, which is based on the CIPFA Code, and the Chartered Institute of Internal Auditors (CIIA) Standards and Code of Ethics.

The role of Internal Audit at Medway Council is summarised in the Financial Rules (Section 5), which form part of the Constitution.

The PSIAS 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.

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, and the PSIAS. 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 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 utilise 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 Audit forms part of the council’s Audit Services which also includes the Corporate Anti-Fraud Team. The team is led by the Head of Internal Audit and Counter Fraud. 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 Head of Internal Audit (HIA) 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 HR/Audit Services investigation protocol. 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 HIA.

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 HIA 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 HIA 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 HIA.

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 and the council's information policies.

Resources

The Internal Audit team has six posts: two Principal Auditors and four Auditors. The HIA and the Principal Auditors hold professional internal audit qualifications and undertake Continuing Professional Development. Training and development of all team members is supported on an ongoing basis. 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 HIA reviews whether there are sufficient resources to provide the required coverage and assurance. The HIA 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.

July 2014 – to review annually