

AUDIT COMMITTEE

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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 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.
- 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).
- 2.4 Medway's financial rule 5 states that internal audit will also have regard to any auditing standard pronouncements issued by CIPFA, therefore the Code of Practice forms part of the guidance that the internal audit team aims to adhere to.

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 The A&ARs do not specify how the review should be conducted or define what constitutes the 'internal audit system'. However, CIPFA's Audit Panel has interpreted this as follows:
"The framework of assurance available to satisfy a local authority that the risks to its objectives, and the risks inherent in undertaking its work, have been properly identified and are being managed by controls that are adequately designed and effective in operation."
- 4.2 CIPFA guidance also states that a review of the effectiveness of the internal audit system may include:
- the process by which the control environment and key controls have been identified - the organisation's risk management system;
 - the process by which assurance has been gained over controls – its coverage of the key controls and key assurance providers;
 - the adequacy and effectiveness of the remedial action taken where there are deficits in controls, which will be led by the Audit Committee or its equivalent and implemented by management; and
 - the operation of the Audit Committee and the internal audit function to current codes and standards
- 4.3 Therefore, the annual review for 2010/11 was conducted as follows:

Topic	Assurance obtained
The process by which the control environment and key controls have been identified	<ul style="list-style-type: none">• risk management reports to Cabinet and overview and scrutiny committees• internal audit of risk management• external audit reports
The process by which assurance has been gained over controls	<ul style="list-style-type: none">• external audit reports• other agency reports (reported to other committees)• outcomes of internal audit activity
The adequacy and effectiveness of the remedial action taken where there are deficits in controls, which will be led by the Audit Committee or its equivalent and implemented by management	<ul style="list-style-type: none">• follow-up audits carried out by internal audit• items referred to other committees• directorates/departments' own actions
The operation of the Audit Committee and the internal audit function to current codes and standards	<ul style="list-style-type: none">• external audit's assessment as part of their governance reviews• external audit's view of IA as part of their accounts and governance work

Topic	Assurance obtained
	<ul style="list-style-type: none"> • self-assessment of internal audit against the CIPFA Code of Practice, with outcome reviewed by the Chief Finance Officer. • benchmarking IA performance against other local authorities

4.4 The key issues arising from the review are set out at Annex A. There is no clear recommendation from CIPFA that the annual review of the effectiveness of the internal audit system should include an external review.

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 2010/11 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 (amended 2006)

Review of effectiveness of the internal audit system

Where the review identified areas where improvements may be necessary, corrective action has been agreed and is being implemented.

The process by which the control environment and key controls have been identified

Key points were:

- Corporate risks continue to be well managed;
- Potential risks had been identified in all Cabinet reports relating to projects and procurement exercises;
- A phased approach to the management of service risks has been agreed. This is discussed in more detail in a separate report to this agenda;
- Business continuity planning for the Council as a whole is less well developed. Corporate Management Team are now committed to improvements and have agreed a series of actions to take this forward.

The process by which assurance has been gained over controls

The Audit Committee receives all reports from the external auditor and outcomes of internal audit activity. The external auditor's reports included the outcome of the audit of the annual accounts, grant claims and value for money reviews. None of these reports raised any serious concerns on the effectiveness of the control framework.

Similarly, reports from other external inspections (Ofsted and the Care Quality Commission) have not raised any concerns on the effectiveness of the control framework.

Internal Audit reports regularly to the Audit Committee on the outcomes of their work and also provides an annual summary report to support the governance statement. Whilst individual audits have identified control failures, the majority of key financial systems audited were assessed as operating a sound control framework and the operational audits have not identified any authority wide issues.

The adequacy and effectiveness of the remedial action taken where there are deficits in controls, which will be led by the Audit Committee or its equivalent and implemented by management

Where internal audit assess the management of risks as "uncontrolled", follow-up audits are carried out by internal audit and reported to the Audit Committee. Each audit report contains an agreed management action plan to rectify control issues and the purpose of the follow-up is to ascertain that the agreed actions have been taken and that senior management is aware of the outcome.

On receipt of an internal audit report, directorates have their own arrangements for ensuring that corrective action is taken,

- either by meeting with the Director, the appropriate manager and internal audit to confirm the actions to be taken are understood by all, or
- periodic summaries to a Director setting out the actions required.

The Audit Committee has referred items to other committees for them to monitor that agreed actions have been completed successfully.

The operation of the Audit Committee and the internal audit function to current codes and standards

External audit have not raised any issues in their reports. They have also confirmed in their reports that they can place reliance on the work of internal audit.

The CIPFA Code of Practice for Internal Audit in the UK identifies eleven key areas:

- 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

The self-assessment of IA's compliance with the Code of Practice identified a number of strengths and some areas where improvements can be made. Key issues arising being:

Strengths

- Position in organisation allows a degree of independence and direct access to Audit Committee;
- Effective relationship with the Audit Committee and external auditors;
- Risk-based annual audit planning process, taking account of the corporate risk register, with regular progress reports to Audit Committee;
- Carrying out audit work to professional standards, with appropriate levels of supervisory review;
- Reporting audit findings, potential risks identified and recommendations to address these clearly and concisely.

Areas for improvement

- Clarifying the responsibilities and objectives of IA and communicating these better throughout the Council;
- Develop more effective mechanisms for establishing customer perception of the internal audit service as a whole;
- Meeting targets for report production and making more effective use of the reduced staff resources available;
- Developing a strategy for the IA service, setting out objectives and performance measures;
- Following-up to confirm implementation of audit recommendations (where opinion other than 'uncontrolled');
- Widening the scope of the Head of Audit's annual report.