

**ANNUAL REVIEW OF THE EFFECTIVENESS
OF THE SYSTEM OF INTERNAL AUDIT
(Report by the Audit & Risk Manager)**

1. Introduction

1.1 As previously reported to the Panel, the Accounts & Audit Regulations 2006 require the Council to conduct an annual review of the effectiveness of its system of internal audit. The results of the review need to be reported to the Panel prior to its approval of the Statement of Assurance on Corporate Governance.

1.2 In January, The Chartered Institute of Public Finance and Accountancy (CIPFA) issued guidance (Annex A) that defined the system of internal audit 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”.

2. Framework of Assurance

2.1 In March 2008, Panel adopted an Assurance Framework to support the production of the Annual Governance Statement (AGS). The report accompanying the item, explained that risks recorded in the risk register were being mapped to the Council’s strategic objectives, and that details of internal and external sources of assurance were being identified and recorded in the risk register. (A separate report on the agenda explains the progress that has been made with obtaining assurance).

2.2 In June 2008, the Panel received a report entitled ‘Annual Review of the Internal Audit Service’. The report recognised that the system of internal audit within the Council went beyond the Internal Audit Service and linked to a number of areas already covered by the Assurance Framework (e.g. corporate governance, financial, risk and performance management, data quality, policies and procedures, third party assurances).

2.3 The CIPFA guidance states that by introducing a framework of assurance, assurance from a variety of sources will be required, not just from internal audit. The guidance continues by saying that ‘the Head of Internal Audit holds a unique role within a local authority as the only independent source of assurance on all internal controls. The Head of Internal Audit is therefore central to this framework of assurance and should acquire an understanding not only of the authority’s risks and its overall whole control environment but also all sources of assurance. This role will include responsibility both for assessing the assurance available to the authority from other sources, whether internal or external, and for implementing a plan of internal audit work to obtain the required assurance. For any body to which the regulations apply, a key input to the system should be the mapping of the framework of controls assurance deriving from the organisation’s risk management system’.

- 2.4 The approach that the Internal Audit Service has already adopted for the preparation of the annual audit plan is similar to the expectations required by the CIPFA guidance for the system of internal audit and the mapping of controls assurance from the risk management system.
- 2.5 Mapping of the risk register to the internal audit plan was carried out in 2007 and 2008, prior to the audit plan being prepared. All the risks present in the risk register as at 31 May 2008 were included within the four year strategic audit plan. Audit reviews that have clear links to risks within the risk register are specifically identified in the audit plan. When those reviews are undertaken the effectiveness of the controls that are in place to manage the risks identified are considered, together with any third party assurance that has been obtained and recorded in the register.
- 2.6 The AGS assurance framework adopted in March 2008 is similar to the system of internal audit effectiveness framework now recommended by CIPFA. It is felt that the AGS Assurance Framework is sufficiently robust and encompassing that it will deal with the review of the system of internal audit.
- 2.7 This approach also appears to meet the requirements of the Accounts and Audit Regulations 2006. They require that an annual review of the effectiveness of the system of internal audit shall be completed and the findings from that review considered as part of the consideration of the systems of governance. Following that consideration an annual governance statement shall be prepared.

3. Review of the Internal Audit Service

- 3.1 The January guidance note issued by CIPFA, makes no mention of a separate annual review of the Internal Audit Service. Self-assessment reviews of the Internal Audit Service have been carried out in the last two years and reported to the Panel.
- 3.2 The reviews of the Internal Audit Service have been completed against the 2006 Code of Practice for Internal Audit in Local Government issued by CIPFA. The Code contains 11 Standards that describe the processes that a professional internal audit service should follow and comply with.
- 3.3 Following the review presented to Panel in July 2008, which included a Peer Review by colleagues from Cambridgeshire County Council, the Panel noted the general effectiveness of the Council's Internal Audit Service in terms of the requirements of the CIPFA Code of Audit Practice. An action plan was prepared to deal with relatively minor issues (staff rotation, updating of the audit manual, benchmarking) identified from the review. Rather than undertaking a review annually, it is proposed that the next review against the Code of Audit Practice is undertaken in 2011, the same year as the next annual review of the effectiveness of the Panel.

4. Assurance Required by the Panel

- 4.1 The AGS assurance framework refers to a number of systems and processes that together, allow the Panel to sign off the AGS. Whilst changes will be required to be made to the systems and processes on a regular basis, it is

considered that the following list of items be adopted by the Panel, as the minimum issues that they require assurance upon:

- Delivery of the Council's corporate objectives
- The effectiveness of the Constitution
- The effectiveness of the Code of Corporate Governance
- Ability to identify, assess and respond to legislation, meeting statutory obligations
- Effectiveness of financial management arrangements
- Adequacy of the internal audit service
- Robustness of the performance management system
- The effectiveness of the risk management strategy
- Robust systems of internal control and the effectiveness of key controls
- Actions plan to address significant weaknesses are prepared, acted & reported on
- Partnerships are efficient and effectively delivering service objectives

5. Recommendations

5.1 It is recommended that the Panel:

- Agree that the Annual Governance Statement assurance framework will include the annual review of the effectiveness of the system of internal audit;
- Note that the next review of the Internal Audit Service against the Cipfa Code of Audit Practice will be conducted in 2011; and
- Adopt the list of systems that assurance is required upon as part of the assurance framework.

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None

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The Review Of The Effectiveness Of The System Of Internal Audit

1. Legislative changes from 1st April 2006

Regulation 4 of the Accounts and Audit Regulations (2003) ('the Regulations') was amended in 2006 (SI564/2006) with new reporting requirements, applicable to local authorities in England, on the effectiveness of the system of internal audit. The Regulations came into force on 1 April 2006 and applied for the 2006/07 reporting year. From 2007/08, the new reporting requirements have been included in the Annual Governance Statement ('AGS').

2. Existing related guidance on the Accounts and Audit Regulations 2003

The Department for Communities and Local Government ('CLG') issued guidance on the amended Regulations in August 2006. This Guidance covers the significant changes made to the 2003 Regulations. Apart from simplifying and streamlining the 2003 regulations, the changes were intended to strengthen governance and accountability through a new requirement to carry out and consider the findings of a review of the effectiveness of the system of internal audit in Regulations 6 (3) and 6 (4) of the amended 2003 Regulations.

The Guidance on the new requirements relating to the review of the effectiveness of the system internal audit (Regulation 6) states:

"Regulation 6 of the 2003 Regulations was amended in 2006 to require relevant bodies to conduct an annual review of the effectiveness of its system of internal audit and for a committee of the body to consider the findings. This process is also part of the wider annual review of the system of internal control. As with Regulation 4 above, this does not require the establishment of an audit committee, although such a committee would provide an appropriate means through which to carry out the review of internal audit as it has a role in monitoring internal audit but is independent from it."

The Guidance cites the CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom ('the Code') as proper practice in relation to internal audit in local authorities. For smaller relevant bodies, the reader is directed to other publications.

The Guidance does not provide a definition of the system of internal audit nor does it address how relevant bodies should undertake an annual review of its effectiveness. The CIPFA Audit Panel has therefore produced this document to assist local authorities in interpreting the Regulations. It would like to acknowledge the comprehensive assistance of the Finance Advisory Network's Rough Guide working group.

3. The definition of the system of internal audit

The 'system of internal audit' is a new term introduced by CLG in 2006, and not a term as yet with any commonly understood meaning. After lengthy consultation amongst practitioners, the CIPFA Audit Panel has interpreted this term 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.

The framework of assurance will comprise a variety of sources and not only the authority's internal audit service. However, the Head of Internal Audit holds a unique role within a local authority as the only independent source of assurance on all internal controls. The Head of Internal Audit is therefore central to this framework of assurance and should acquire an understanding not only of the authority's risks and its overall whole control environment but also all sources of assurance. In this way, the Head of Internal Audit will be able to indicate whether key controls are adequately designed and effectively operated, regardless of the sources of that assurance. This role will include responsibility both for assessing the assurance available to the authority from other sources, whether internal or external, and for implementing a plan of internal audit work to obtain the required assurance.

For any body to which the regulations apply, a key input to the system should be the mapping of the framework of controls assurance deriving from the organisation's risk management system. There can be no prescriptive definition of what is included in the system of internal audit in every local authority; the key principle is that the system will include more elements than just the internal audit function acting alone.

For example, in most local authorities there is likely to be a set of risks relating to health and safety. The authority may have an in-house team of health and safety advisors with responsibility for checking compliance with both legal and internal requirements and will also periodically be subject to inspection by the Health and Safety Executive. In these circumstances, the Head of Internal Audit needs to understand and assess the assurance provided by these teams that any health and safety risks are being adequately and effectively controlled. This would include a review of this assurance but, unless it is found to be inadequate, no further audit work is to be expected.

Examples of other sources of assurance may include external agencies, such as the Commission for Social Care Inspection, as well as in-house compliance teams independent of the internal audit service, for example a contracts audit team which may not be integral to the internal audit team; or staff responsible for assessing the integrity of the authority's performance information.

The Head of Internal Audit is accountable to the audit committee or equivalent body, which is responsible for assessing the quality of the assurance available to the authority and concerns itself with the adequacy and effectiveness of the authority's internal control environment as assessed.

The internal audit plan will be risk-based and reflect the audit committee or equivalent's requirement for assurance (as well as current audit knowledge and the requirement to

follow up earlier work). The internal audit plan will include work undertaken directly by the internal audit service, but will also recognise assurance work undertaken by other parts of the organisation or by external organisations, the adequacy of which will be assessed by the internal audit team on a risk basis.

The output of the system of internal audit will be the annual report by the Head of Internal Audit to the authority which will, as required by the Code, include an opinion on the overall adequacy and effectiveness of the organisation's control environment. This will now clearly include reference to the assurance made available to the authority by other providers as well as directly by the internal audit service.

4. Review of the effectiveness of the system of internal audit

The audit committee, or whosoever is charged with carrying out the review of the effectiveness of the system, should examine its key elements, which may include, but are not limited to:

- 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.

The mechanism by which this review is undertaken will vary with the needs of each organisation and may encompass procedures ranging from considering reports from, or carrying out interviews with the Head of Internal Audit and their team, to detailed evidence gathering of the documentation supporting each stage of the assessments.

Any areas for improvement should be identified, together with an action plan, within the report produced by the review.

5. Who should undertake the review

The Regulations require the following: 'the findings of the review...shall be considered by a committee of the relevant body, or by the members of the relevant body meeting as a whole'. The CLG Guidance suggests that an audit committee is the appropriate group to receive and consider the results of the review as this committee already has an oversight of internal audit.

There are a number of options available to authorities, for carrying out the review which include:

- The Head of Internal Audit
- A sub-group of the audit committee
- A review group of officers
- Peer review
- External assessment, or
- A group of members and officers.

Whoever carries out the review, it is vital that all participants are appropriately skilled and have relevant technical support available to them.

6. The timing of the review

Just as the preparation for the AGS needs to start early in the year to which the signed statement relates, the review of the effectiveness of the system of internal audit should not be left to the year end. The review feeds into the AGS and should, therefore, be completed first. This guidance is therefore applicable from the 2008/09 financial year.