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| <b>Audit Committee Meeting</b> | <b>Agenda Item:</b> |
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| <b>Meeting Date</b>     | 25 May 2011                                     |
| <b>Report Title</b>     | Internal Audit: Terms of Reference and Strategy |
| <b>Portfolio Holder</b> | Performance and Finance                         |
| <b>SMT Lead</b>         | Corporate Services Director                     |
| <b>Head of Service</b>  | Head of Audit Partnership                       |
| <b>Lead Officer</b>     | Head of Audit Partnership                       |
| <b>Key Decision</b>     | No  |
| <b>Classification</b>   | Open  |

|                        |   |
|------------------------|---|
| <b>Recommendations</b> | 1. That the Audit Committee endorse the Internal Audit Terms of Reference and the Audit Strategy as set out at Appendix I and Appendix II |
|------------------------|---|

## **Purpose of Report and Executive Summary**

- 1.1 The report seeks the endorsement of the Audit Committee to the Internal Audit Terms of Reference and the Internal Audit Strategy.

## **2 Background**

- 2.1 Internal Audit within Local Government is required to operate in accordance with the standards set out in the Code of Practice for Internal Audit 2006, published by the Chartered Institute of Public Finance and Accountancy (CIPFA). The standards require that the purpose, authority and responsibility of Internal Audit must be formally defined by the Council in terms of reference consistent with the Code. The Code also requires that the Head of Internal Audit must produce an audit strategy, which is a high-level statement of how the internal audit service will be delivered and developed in accordance with the terms of reference and how it links to the organisational objectives and priorities.
- 2.2 The triennial review of Internal Audit by the Audit Commission in 2009/10 highlighted the need for a Terms of Reference and a Strategy which is consistent with the Code of Practice. The documents, which are attached at appendix I and appendix II are compliant with the Code of Practice.
- 2.3 The Accounts and Audit Regulations 2011 (effective from 31 March 2011) set out some minor changes to the definition of the statutory requirement for internal audit. The statutory requirement is now as follows:

*'A relevant body must undertake an adequate and effective internal audit of its accounting records and of its system of internal control in accordance with the proper practices in relation to internal control.'*

2.4 The Terms of Reference shown at appendix I include the new statutory definition.

### **3 Proposal**

3.1 The creation of Terms of Reference which meet the expectation of the Code of Practice helps to clarify the role of Internal Audit to those 'charged with governance' and is therefore an important document. The Audit Strategy helps to provide clarity on how the Internal Audit service will be delivered; again this transparency is helpful to effective governance. The Committee is asked to endorse the Terms of Reference and the Strategy.

### **4 Alternative Options**

4.1 Terms of Reference and a defined Strategy for Internal Audit help to make the responsibilities and approach of Internal Audit clear to all stake-holders and are important elements in ensuring compliance with the statutory Code of Practice. Therefore, it would be inappropriate if the Audit Committee was unable to endorse them.

### **5 Consultation Undertaken or Proposed**

5.1 The Terms of Reference and Strategy have been designed to meet the statutory Code of Practice; therefore consultation is inappropriate in this case.

### **6 Implications**

| <b>Issue</b>                     | <b>Implications</b>  |
|----------------------------------|--|
| Corporate Plan                   | none identified at this stage  |
| Financial, Resource and Property | none identified at this stage  |
| Legal and Statutory              | The Council is required to 'undertake an adequate and effective internal audit' under the Accounts and Audit Regulations 2011. The requirement for formal Terms of Reference and Strategy is set out in the statutory Code of Practice for Internal Audit. |
| Crime and Disorder               | none identified at this stage  |
| Risk Management and Health and   | none identified at this stage  |

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|------------------------|-------------------------------|
| Safety                 |                               |
| Equality and Diversity | none identified at this stage |
| Sustainability         | none identified at this stage |

## **7 Appendices**

7.1 The following documents are to be published with this report and form part of the report

- Appendix I: Internal Audit Terms of Reference (Audit Charter)
- Appendix II: Internal Audit Strategy

## **8 Background Papers**

8.1 The Audit Commission Triennial Review of Internal Audit at Swale (reported to the Audit Committee on 26 May 2010).

8.2 The Code of Practice for Internal Audit in Local Government in the United Kingdom 2006 (published by CIPFA).

## **APPENDIX I**

### **SWALE BOROUGH COUNCIL INTERNAL AUDIT TERMS OF REFERENCE (AUDIT CHARTER)**

#### **Responsibilities and Objectives**

Internal Audit is an assurance function that provides an independent and objective opinion to the organisation on the control environment by evaluating its effectiveness in achieving the organisations 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.

#### **Reporting lines and relationships**

Internal Audit forms part of the Corporate Services Directorate.

The Head of Internal Audit Partnership reports on an administrative basis directly to the Director and reports functionally to the appropriate 'client' Head of Service or Director.

The Internal Audit Manager (Swale and Maidstone) has responsibility for the operational aspects of the Internal Audit function.

The Audit Committee is the prime recipient of reports on the functional aspects of Internal Audit and the outcomes arising from audit work. The Committee receive a report on a six-monthly basis providing a summary of the results of internal audit work and progress against the Audit Plan. The Audit Committee is responsible for endorsing the Strategic Audit Plan.

In recognition of the statutory duties of the 'Responsible Finance Officer' and the views of CIPFA on his relationship with internal audit, a formal protocol has been adopted to form the basis for a sound and effective working relationship. The protocol is attached to this Charter.

#### **Independence and accountability**

Internal Audit will remain sufficiently independent of the activities that it audits to enable auditors to perform their duties in a manner which facilitates impartial and effective professional judgements and recommendations. Internal auditors have no operational responsibilities.

Internal Audit is involved in the determination of its priorities in consultation with those charged with governance. The Head of Internal Audit Partnership has direct access and freedom to report in his own name and without fear or favour to all officers and members and particularly to those charged with governance.

Accountability for the response to the advice and recommendation of Internal Audit lies with management, who either accept and implement the advice/recommendation or formally reject it.

### **Statutory role**

Internal Audit is a statutory service in the context of the Accounts and Audit Regulations 2011, which state in respect of Internal Audit that:

“A relevant body must undertake an adequate and effective internal audit of its accounting records and its system of internal control in accordance with the proper practices in relation to internal control”

The statutory role is recognised and endorsed within the Councils Financial Rules, which provide the authority for access to officers, members, documents and records and to require information and explanation as necessary.

### **Internal Audit Standards**

There is a statutory requirement for Internal Audit to work in accordance with the ‘proper practices’. These ‘proper practices’ are in effect ‘the standards’ for local authority internal audit. The guidance accompanying the Accounts and Audit Regulations has made it clear that ‘the Standards are those shown in the CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom 2006’ The CIPFA Standards have been adopted by Swale Borough Council Internal Audit.

### **Internal Audit Scope**

The scope for Internal Audit is the ‘entire control environment’. This includes all of the Council’s own operations, resources, services and also its responsibilities in relation to other bodies. This description shows the very wide potential scope of Internal Audit work.

In order to turn the ‘control environment’ into actual subjects for audit, the Head of Audit Partnership uses a Risk Assessment Method which allows all high risk subjects to be identified. Although this process inevitably identifies the Councils fundamental financial systems as being ‘high risk’ through their sheer materiality, other non financial systems and functions are also identified as important areas for review by Internal Audit.

## **Internal Audit Resources**

Internal Audit must be appropriately staffed in terms of numbers, grades, qualification levels and experience, having regard to its objectives and to the Standards. Internal Auditors need to be properly trained to fulfil their responsibilities and should maintain their professional competence through an appropriate ongoing development programme. The Head of Audit Partnership is responsible for appointing the staff of the Internal Audit Service and will ensure that appointments are made in order to achieve the appropriate mix of qualifications, experience and audit skills. The Section maintains an annually updated Training and Development Analysis Plan which sets out an ongoing development programme for Internal Audit staff.

The Head of Audit Partnership is responsible for ensuring that the resources of the Internal Audit Section are sufficient to meet its responsibilities and achieve its objectives. If a situation arose whereby he concluded that resources were insufficient, he must formally report this to the Director of Corporate Services and the 'Section 151 Officer', and, if the position is not resolved, to the Audit Committee.

## **Fraud and Corruption**

Managing the risk of fraud and corruption is the responsibility of management. Audit procedures alone, even when performed with due professional care, cannot guarantee that fraud or corruption will be detected. Internal Audit does not have responsibility for the prevention or detection of fraud and corruption. Internal auditors will, however, be alert in all their work to risks and exposures that could allow fraud or corruption. Internal Audit may be requested by management to assist with fraud related work.

The Head of Internal Audit Partnership has made arrangement to be informed of all suspected or detected fraud, corruption or improprieties so that he can consider the adequacy of the relevant controls, and evaluate the implication of fraud and corruption for his opinion on the internal control environment.

## **Reporting Accountabilities**

A written report will be prepared by the appropriate auditor for every internal audit project. The report will be agreed with the Audit Manager and subsequently the Head of Audit Partnership before being issued to the responsible Head of Service. The report includes an 'opinion' on the adequacy and effectiveness of controls for an audited activity, which is shown as an assurance level within four categories. The use of an assurance level is consistent with the requirement for managers (and Members) to consider the degree to which controls and processes can be relied upon to achieve the objectives of the reviewed activity.

The Head of Service will be asked to respond to the report in writing, within 30 days, although this period can be extended by agreement. The written response must show what actions have been taken or are planned in relation to each recommendation. If the recommendation is not accepted by the manager, this must also be stated. The Audit Manager is responsible for assessing whether the managers response is adequate.

Every Internal Audit report is subject to a follow-up, normally within six months of its issue, in order to ascertain whether the action stated by management in their response to the report has been implemented.

### **Review of the effectiveness of the control environment**

The Council is responsible for ensuring that financial management is adequate and effective and that the Council has a sound system of internal control which facilitates the effective exercise of the Council's functions and which includes arrangements for the management of risk.

The Council is required to conduct a review at least once a year of the effectiveness of its system of governance. Following the review, the Audit Committee must approve an Annual Governance Statement (AGS). The statement is signed by the Chief Executive and the Leader of the Council.

### **The Head of Internal Audit's annual audit opinion**

The Head of Audit Partnership will provide a written report to the Audit Committee timed to support the Annual Governance Statement. The Head of Internal Audit's annual report will:

- include an opinion on the overall adequacy and effectiveness of the Council's control environment
- disclose any qualification to that opinion, together with the reasons for the qualification
- present a summary of the audit work from which the opinion is derived, including any reliance placed on the work of other assurance bodies
- draw attention to any issues the Head of Internal Audit judges particularly relevant to the preparation of the Statement on Internal Control
- compare the work actually undertaken with the work that was planned and summarise the performance of the internal audit function against its performance measures and targets
- comment on compliance with the standards contained within the Code of Practice for Internal Audit in Local Government in the United Kingdom 2006 and the results of the internal audit quality assurance programme.

The Head of Audit Partnership will also report to the Audit Committee on an annual review of the effectiveness of internal audit so that the Committee can consider the effectiveness of internal audit.

## **THE PROTOCOL FOR THE RELATIONSHIP BETWEEN INTERNAL AUDIT AND THE SECTION 151 OFFICER AT SWALE BOROUGH COUNCIL**

In recognition of the statutory duties of the 'Responsible Finance Officer' (RFO) and the views of CIPFA on his relationship with internal audit, the following protocol has been adopted at Swale Borough Council to form the basis for a sound and effective working relationship:

- The Head of Audit Partnership will seek to maintain a positive and effective working relationship with the Council's designated Section 151 Officer.
- Internal Audit will review the effectiveness of the Council's system of internal controls and report on whether the controls operate effectively in practice.
- The RFO will be asked to comment on those elements of the Internal Audit Section's plan of work that relate to the discharge of his statutory duties. In devising the Audit Plan and in carrying out internal audit work, the Head of Internal Audit Partnership will give full regard to the comments of the RFO.
- The Head of Audit Partnership will regularly monitor the performance of the Internal Audit Team against the Audit Plan and will notify the Section 151 Officer if there are any major deviations which impact on his areas of responsibility.
- The external auditors and the RFO need to be able to rely on the work of Internal Audit. The Head of Audit Partnership will seek to ensure that the expectations of the external auditors and the RFO are met through the work of the Internal Audit Team.
- In order to meet the expectations of the external auditors, provide adequate assurance to Management and Members and contribute fully to good standards of corporate governance, the Audit Plan needs to be fundamentally achieved on an annual basis. The Head of Audit Partnership will therefore ensure that deviations from the plan are kept to a minimum in order to allow the work contained in the Plan to be achieved.
- The RFO will, on request, be provided with appropriate assurance that the audit staff are competent, well trained and effective in their work.
- The RFO will be specifically informed by the Head of Audit Partnership where any matter is identified that impacts on his Section 151 role.
- In order to ensure that the Section 151 Officer is aware of the financial issues arising from all Internal Audit reviews, he will be provided with a copy of every Internal Audit report.



- The RFO will specifically make the Head of Audit Partnership aware of any concerns that he has about internal control that might lead to the need for an internal audit investigation or review.
- The Internal Audit Team will operate in accordance with the CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom.

## APPENDIX II

### SWALE BOROUGH COUNCIL INTERNAL AUDIT STRATEGY

#### Introduction

The audit strategy sets out how the internal audit service will be delivered and developed in accordance with the terms of reference and how it links to the organisational objectives and priorities.

The strategy informs the Internal Audit Service Plan and links the audit objectives in the Internal Audit Terms of Reference to the Internal Audit planning process.

The strategy sets out the contribution that Internal Audit makes to the organisation and includes:

- Internal Audit objectives and outcomes
- How the Head of Internal Audit will form his opinion on the control environment to support the annual Statement on Internal Control
- How Internal Audit's work will identify and address significant local and national issues and risks
- How the service will be provided
- The resources and skills required to deliver the strategy

The strategy is subject to approval, but not direction, by the Audit Committee.

#### Internal Audit objectives and outcomes

The Internal Audit Terms of Reference are in accordance with the CIPFA Code of Practice for Internal Audit in Local Government in the UK 2006.

The Terms of Reference include the following definition of Internal Audit:

*Internal Audit is an assurance function that provides an independent and objective opinion to the organisation on the control environment by evaluating its effectiveness in achieving the organisations 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.*

The Internal Audit service aspires to:

- understand the whole organisation, its needs and objectives
- understand its position with respect to the organisation's other sources of assurance and plan its work accordingly
- be seen as a catalyst for change at the heart of the organisation
- add value and assist the organisation in achieving its objectives

- be forward looking – knowing where the organisation wishes to be and aware of the national agenda and its impact
- be innovative and challenging
- help to shape the ethics and standards of the organisation
- ensure the right resources are available, recognising that the skills mix, capacity, specialisms, qualifications and experience requirements all change constantly
- share best practice with other auditors
- seek opportunities for joint working with other organisations auditors

By meeting these challenges the Internal Audit service intends to be a vital component of a successful organisation - Swale Borough Council.

### **The Head of Internal Audit's opinion on the control environment to support the Annual Governance Statement**

The key subject areas for the annual Internal Audit report are set out in the Term of Reference.

The opinion on the control environment will be principally formed through the results of Internal Audit work during the previous financial year. However, the following factors will also be considered:

- The results of external audit work during the previous year and any concerns expressed by the External Auditor.
- The effectiveness of the Council's risk management arrangements
- Significant control breakdowns during the financial year, whether they were found by Internal Audit or not
- The effectiveness of senior management in resolving control weaknesses.

### **Internal Audit's work will identify and address significant local and national issues and risks**

The majority of the work of Internal Audit is identified in the Three-Year Strategic Audit Plan which will take full account of organisational objectives and priorities.

The Strategic Plan is prepared using a risk based approach which is applied to potential subject areas identified from:

- The Council's Strategic Plan
- The systems that exist to deliver the Strategic Plan and the Council's key objectives
- The Strategic Risk Register
- The Council's fundamental financial systems
- The Corporate Revenue and Capital Budget Book
- The Budget Strategy
- The Capital Programme

- Consultation with management, most particularly the Chief Finance Officer and Heads of Service

The Plan will give specific consideration to:

- the arrangements for the prevention of fraud and corruption
- corporate governance
- compliance with legislation/changes in legislation
- compliance with codes of conduct
- compliance with constitutional rules (e.g. Financial Rules, Contract Rules)
- The 'national agenda' for example strategic partnerships, shared services working, localism and Big Society.
- coordinating work, or at least as much as practical, with the external auditors in order to ensure that best use is made of audit resources

The Plan will seek to:

- provide sufficient coverage of the control environment to allow conclusions to be drawn on its effectiveness
- give adequate coverage to allow the external auditors to place reliance on the work of Internal Audit
- Allow objective examination, evaluation and reporting on the adequacy of the control environment as a contribution to the proper, economic, efficient and effective use of resources.

In developing the individual audit assignments further consideration will be given to:

- Performance Management
- Operational Risk Registers
- Value for money aspects, including benchmarking.
- CIPFA control matrices

Increasing use will be made of the Council's risk management process to plan internal audit work as risk management becomes more embedded within the organisation and the Council becomes increasingly mature in its approach to risk.

The completed and approved Strategic Audit Plan will form the basis of the work of the Internal Audit service over the three-year period. The delivery of the Plan will provide the means to address significant local and national issues and risks through the provision of Internal Audit reports to management which identify control weaknesses and make recommendations for control improvements.

### **How the service will be provided**

The service will be provided through a partnership with Ashford, Maidstone and Tunbridge Wells, which is managed by the Head of Audit Partnership.

An Audit Manager (Swale and Maidstone) will be responsible for operational audit issues.

The operational team consists of two full-time operational auditors and a 0.5 fte provided by means of contracted auditors.

The partnership requires that one third of the work of each operational auditor is carried out at an alternative site (i.e. not the employing site). This is done on a quid pro quo basis in order to ensure that all four partner authorities get an equivalent benefit.

### **The resources and skills required to deliver the strategy**

The resources which have been allocated by Swale Borough Council to deliver the strategy are principally:

- A staff establishment comprising 2.5fte operational auditors managed by an Audit Manager (shared with Maidstone).
- A Head of Audit Partnership (shared with Ashford, Maidstone and Tunbridge Wells).

An auditor resource assessment is carried out on an annual basis in order to match audit resources to audit needs.

The resources are not sufficient to allow all elements of the Council's operations to be reviewed on a frequent basis. Therefore, it is necessary to use a risk assessment process to identify the most important operations (in terms of materiality and other risks) which will allow audit work to be focused to areas of greatest need and to be programmed within a reasonable timeframe.

In terms of skills, the delivery of the strategy requires a mixture of skills and experience. An objective of the four-way internal audit partnership was to jointly create a broader base of skills and experience than would be available to each team separately. The current audit partnership staff mix contains individuals with a broad range of internal audit experience ranging from six to thirty years.

In terms of relevant qualifications, the joint team includes:

- Chartered Institute of Internal Auditors (IIA)– Advanced Diploma
- Chartered Institute of Internal Auditors (IIA) - Diploma
- Association of Accounting Technicians
- CISA (Certified Information Systems Auditor)
- CIPFA Certificate of Investigative Practice
- CIPFA diploma in Public Audit.

In addition to the professional skills acquired through study, members of the team have developed particular skills in contract audit, accountancy, fraud investigations, disciplinary investigations, IT audit, risk management, partnership working and the use of computer assisted audit techniques. All of these skills are required and will be used, to deliver the audit strategy.