

Audit Committee

30th June 2011



Annual Internal Audit Report 2010/11

Report of Manager of Internal Audit & Risk

Don McLure, Corporate Director Resources

Purpose of the Report

1. The purpose of this report is to present the Annual Internal Audit Report for 2010/11 (copy attached at Appendix 2).

Background

2. The Council has a responsibility for maintaining sound systems of internal control that support the achieving of its objectives and for reviewing their effectiveness.
3. This report fulfils the requirement of the CIPFA Code of Practice for the Head of Internal Audit to provide, "a written report to those charges with governance timed to support the Statement of Internal Control", which is now incorporated as part of the Council's Annual Governance Statement.
4. The Annual Internal Audit Report should therefore be considered in the context of fulfilling the requirement to provide an opinion on the overall adequacy and effectiveness of the Council's control environment during the year, and how this opinion has been derived.
5. The opinion on the control environment and any significant issues arising will be reflected in the Council's Annual Government Statement which will be published as part of the Council's Annual Governance Statement of Accounts for 2010/11.
6. Based on the work undertaken, Internal Audit is able to provide a **Moderate** overall assurance opinion on the adequacy and effectiveness of internal control operating across the Council in 2010/11. This moderate opinion ranking provides assurance that there is basically a sound system of control in place, but there are weaknesses and evidence of non-compliance with controls or ineffective controls. Control objectives are often achieved.

Recommendation

7. That the Annual Internal Audit Report and the overall opinion provided on the adequacy and effectiveness of the Council's control environment for 2010/11 is noted.

Contact: Avril Wallage Tel: 0191 383 3537

Appendix 1: Implications

Finance

There are no direct financial implications arising for the Council as a result of this report, although we aim through our audit planning arrangements to review core systems in operation and ensure through our broad programme of work that the Council has made safe and efficient arrangements for the proper administration of its financial affairs.

Staffing

None

Risk

This report requires no decision and so a risk assessment has not been carried out

Equality and Diversity

None

Accommodation

None

Crime and disorder

None

Human rights

None

Consultation

None

Procurement

None

Disability

None

Legal Implications

None

DURHAM COUNTY COUNCIL

Internal Audit

**Annual Report
2010-2011**

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Introduction

1. This report summarises work carried out by internal Audit during 2010/11 and provides assurance on the effectiveness of the Council's control environment, risk management and corporate governance arrangements.
2. The requirement for an internal audit function is implied by Section 151 of the Local Government Act 1972 which requires that Local Authorities to, "make arrangements for the proper administration of their financial affairs and ensure that one of its officers has responsibility for the administration of those affairs".
3. The Accounts and Audit (England) Regulation 2011 requires the Council to, "undertake an adequate and effective system of internal audit of its accounting records and its system of internal control in accordance with the proper practices in relation to internal control". The Council has delegated this responsibility to the Corporate Director Resources and the Internal Audit & Risk service carry out the Internal Audit Role.
4. The guidance accompanying the legislation states that proper internal control practice for internal audit is that contained within the CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom
5. This report fulfils the requirement of the CIPFA Code of Practice for the Head of Internal Audit to provide, "a written report to those charges with governance timed to support the Statement of Internal Control", which is now incorporated as part of the Council's Annual Governance statement.

Service Provided and Audit Methodology

6. Internal Auditing is an independent, objective assurance and consultancy activity designed to add value and improve an organisation's operations.
7. The primary objective of Internal Audit is to provide an independent and objective opinion on the Council's control environment.
8. The Internal Audit Charter, agreed by the Audit Committee, establishes and defines the role, authority, scope of audit work, organisational independence, resource requirements, and reporting lines of Internal Audit.
9. Audit services are also provided to a number of external clients including the Durham Police Authority, Durham and Darlington Fire & Rescue Authority and the Durham and Mountsett Crematoria Joint Committees.
10. The service is also responsible for the audit of the Durham County Pension Fund.
11. The outcome of reviews for external clients is reported direct and the opinion given in this report does not reflect this work.
12. The service was also the external assessor for the Financial Management Standard in Schools (FMSiS) for Durham schools, until its abolition in November 2010. The outcome of this work is included in this report.

Audit Quality Assurance framework

13. The Internal Audit Charter sets out the performance and quality framework for the service.
14. Key contacts, determined by the appropriate head of service, agree the terms of reference for each audit review and are able to challenge the findings and content of draft reports prior to them being finalised.
15. A summary of our performance against agreed indicators is given in **Appendix A**.
16. In general actual performance against target is considered satisfactory. As can be seen the % of planned assurance work complete from the original 2010/11 approved plan is below the target set of 90%. There are several reasons for this as summarised below:
 - Reduction in audit days available due to retirement, secondment and unusual high levels of long term sickness
 - Inadequate contingency provision to respond to new or emerging risks
 - Changing priorities within services leading to requests to defer work
 - Assurance being provided through other source so no added value
 - Changing priorities due to new or emerging risks
 - Inadequate provision for fraud and irregularity work
 - Inadequate provision for follow up work
 - Volume of other unplanned/advice and consultancy work
 - Some reviews no longer relevant due to external circumstances
 - Inadequate provision to complete work in progress carried forward from last year
 - Some reviews taking longer than originally expected
 - Over programming to maintain flexibility over the timing of work
17. A number of service improvements have been made during the year. In particular we have improved our progress reporting, follow up and escalation procedures which have resulted in fewer outstanding draft reports and earlier implementation of agreed recommendations by service managers. In addition, the devotion of dedicated resources to counter fraud has seen improved awareness and increased the effectiveness of the Council's Counter Fraud strategy, resulting in an increase in the number of potential fraud and irregularities being reported and investigated.
18. The Accounts and Audit (England) Regulation 2011 requires the Council to carry out an annual review of the effectiveness of Internal Audit. The outcome is reported to Audit Committee and is subject to independent review by the external auditor. The last review took the form of a self-assessment compliance review against the CIPFA Code and concluded substantial compliance but some areas were identified for improvement. With reducing internal audit resources it is particularly important that the service adopts an effective risk based approach. The audit strategy has therefore been revised during the year and reflected in an updated Internal Audit Charter. As a result of this revised strategy audit processes and procedures are also being systematically reviewed and any identified training needs are being addressed. Work will continue in 2011/12 to ensure full compliance with the Code.

19. In accordance with the CIPFA Code, it would be irresponsible for the service to undertake work where it did not have the necessary skills, knowledge or experience to give a reliable opinion. The area of the Pension Fund is one area where specialist skills were considered necessary in order to provide a reliable assurance opinion. Consequently an external partner has been engaged to improve pension fund assurance. This partnership arrangement will improve assurance provided and allow for skills transfer and further improvements to be made to the in house provision.
20. Independent quality reviews are undertaken by audit managers as a matter of routine and periodically by the head of internal audit to ensure consistent application of agreed processes and procedures and to ensure expected quality standards are maintained.
21. The external auditor, although no longer required to carry out a formal tri-annual review of the effectiveness of internal audit, carries out brief periodic reviews as part of final accounts audit process. The last such review was in June 2010. Areas for improvement in relation to the provision of audit services for external clients were identified and are being addressed.
22. During the year CIPFA issued a statement on the Role of the Head of Internal Audit in the Public Sector. A compliance assessment is to be carried out in consultation with the Corporate Director Resources to inform the forthcoming annual review of effectiveness. The outcomes, and any further improvements identified, will be reported to Audit Committee. One significant change made during the year, which reflects the practice advocated in the Code, is that the Head of the Internal Audit, now reports directly to the Corporate Director Resources rather than the Head of Finance as previously. This will improve the effectiveness of the service by helping to raise its profile within the Council and will provide a better platform for the work of the service to influence senior management.
23. Internal Audit continues to be a member of the CIPFA Audit Benchmarking Club. 2009/10 was the first year comparative unitary data was available. The outcomes, reported to Audit Committee, indicated that the cost of the service was well below average. Performance, in terms of chargeable days, was also below average. The latter was considered primarily due to the move to unitary status and the need to develop and embed consistent policies and procedures. The need to reduce controllable overheads has been recognised as an area for improvement and is being addressed.

Summary of audit work carried out

Assurance Work

24. Our work programme for the year was determined by the approved Internal Audit Plan. However, for the service to be effective, audit plans need to be flexible to respond to changing circumstances and new and emerging risks. Consequently, the original approved plan has been subject to numerous changes during the year requiring a number of planned assurance reviews to be cancelled or carried forward to 2011/12.

25. A summary of assurance work complete, together with that undertaken in 2009/10, to provide a more informed opinion on the control environment, is attached at **Appendix D**.
26. Work cancelled from the 2010/11 plan but which is still considered to be high risk has been carried forward for priority consideration in the first quarter of the 2011/12 plan.

Added Value Work

27. All planned reviews are designed to add value as they provide independent assurance, through evaluation and challenge, on the adequacy and effectiveness of arrangements in place to manage risks. This evaluation and challenge supports the effective and efficient use of resources and VFM.
28. Through our advice and consultancy work we are able to add value pro-actively and reactively.
29. Reactive work involves responding to ad-hoc requests for advice and reviews added to the plan to address new or emerging risks. It also includes responding to potential fraud or irregularities and we ensure that all such incidents are properly investigated and that appropriate action is taken by managers, whether or not fraud or malpractice is proven. This work is delivered from the contingency provision within the plan
30. A summary of added value work undertaken is attached at **Appendix B**.

Key Areas for Opinion

31. The key areas of the control environment where assurance is required to inform our overall opinion are:
 - Financial Management
 - Risk Management
 - Corporate Governance
32. Assurance has been provided on some aspects of all key financial systems during the year. Key issues arising from this work where controls have improved or further improvements have been identified are summarised in **Appendix C**.
33. Independent assurance on the effectiveness of the Council's risk management arrangements has been provided by a peer review carried out by Zurich as part of the Council's insurance arrangements. The review concluded that overall risk management arrangements are robust and effective, work well and are of benefit to the managers that use it. A number of improvements were identified which will enhance and further embed risk management within the Council.
34. The Council's corporate governance arrangements were considered through a self-assessment exercise in preparation for the CAA Use of Resources inspection prior to its abolition in May. Although no formal feedback could be provided, the Audit

Commission have provided informal feedback that their assessment would have resulted in an improved score for 2009/10. This provides some independent assurance that arrangements are effective. Further improvements identified from the self-assessment exercise have been implemented during 2010/11. Significant areas identified for improvements in the 2009/10 Annual Governance Statements have been regularly monitored and reported to Audit Committee during the year. Processes and procedures for the preparation of the 2010/11 have been further developed to continually enhance the annual effectiveness review.

35. Internal Audit has undertaken work aimed to provide assurance on the effectiveness of key corporate governance policies and procedures, both in a compliance and an advice and consultancy role. Recommendations made to improve the control environment helps to embed effective risk management and strengthen the effectiveness of the Council's corporate governance arrangements. Significant areas of concerns where there was no or only limited assurance are also summarised in **Appendix C**.
36. Independence assurance is also provided on the effectiveness of the Council's Corporate governance arrangements through a number of external inspection bodies. A summary of those reported in 2010/11 is provided in the following table:

Other Assurance Sources
External Audit's Annual Audit Letter and Annual Governance Report – unqualified accounts VFM opinion- adequate except for: - timely and reliable financial reporting that meets the needs of internal users, stakeholders and local people; and - managing its risks and maintaining a sound system of internal control.
Audit Commission's Housing Benefit Inspection (Sept 2010): Rated 'fair' with 'promising' prospects for improvement.
liP Standard retained
Care Quality Commission
Services for People who have had a Stroke and their Carers - Better Performing
Social Services Response to People's First Contact - Best Performing
Adult Social Services Assessment of Performance 2009/10 – Excellent
OFSTED
Adoption Service – Outstanding
Annual Children's Services Assessment Performs Adequately

37. At the present time the external inspection regime is undergoing substantial change and the Council's assurance framework is consequently therefore also changing. An exercise has begun to map the assurance framework to identify any gaps and or potential duplication and ensure that arrangements are put in place to identify any potential control, risk management or governance implications arising from external sources of assurance.

Audit Opinion Statement

38. The Council has responsibility for maintaining a sound system of internal control that supports the achieving of its objectives.
39. Internal Audit is required to provide an opinion on the Council's risk management, control and governance process.
40. In giving this opinion it should be noted that assurance can never be absolute and therefore only reasonable assurance can be provided that there are no major weaknesses in these processes.
41. In assessing the level of assurance to be given, we based our opinion on:
 - All audits undertaken during the year
 - Follow up action on audit recommendations
 - Any significant recommendations not accepted by management and the consequent risk
 - The effects of any significant changes in the Council's systems
 - Matters arising from previous reports to the Audit Committee
 - Any limitations which may have been placed on the scope of the internal audit
 - The extent to which resource constraints may impinge on internal audit's ability to meet the full audit needs of the Council
 - The outcomes of the audit quality assurance process
 - Consideration of other sources of assurance
 - Consideration of the direction of travel on the adequacy and effectiveness of the control environment since unitary status as illustrated in **Appendix D**.
42. We are satisfied that sufficient internal audit work has been undertaken to allow us to draw a reasonable conclusion as to the adequacy and effectiveness of the Councils system of internal control. Based on the work undertaken, we are able to provide a **Moderate** overall assurance opinion on the adequacy and effectiveness of internal control operating across the Council in 2010/11. This moderate opinion ranking provides assurance that there is basically a sound system of control in place, but there are weaknesses and evidence of non-compliance with controls or ineffective controls. Control objectives are often achieved.
43. Where Internal Audit has identified areas for improvement, recommendations were made to minimise the level of risk, and action plans for their implementation were drawn up and agreed by management.

PERFORMANCE INDICATORS

Efficiency			
Objective: To provide maximum assurance to inform the annual audit opinion			
KPI	Measure of Assessment	Target & (Frequency of Measurement)	Q4 Actual
Planned audits completed	% of planned assurance work from original approved plan complete to draft report stage as at 31 st	90% (Quarterly)	55% (adjusted to 65% when work in progress considered 70% of revised approved plan (adjusted to 80% when work in progress considered)
Timeliness of Draft Reports	% of draft reports issued within 30 Calendar days of end of fieldwork/closure interview Average time taken is also reported for information	90% (Quarterly)	91% 12 days on average
Timeliness of Final Reports	% of final reports issued within 14 calendar days of receipt of management response Average time taken is also reported for information	95% (Quarterly)	92% 5 days on average
Quarterly Progress Reports	Quarterly progress reports issued to Corporate Directors within one month of end of period	100% (Quarterly)	96%
Terms of Reference	% of TOR's agreed with key contact in advance of fieldwork commencing	95% (Quarterly)	97%
Quality			
Objective: To ensure that the service is effective and adding value			
KPI	Measure of Assessment	Target & (Frequency of Measurement)	
Recommendations agreed	% of Recommendations made compared with recommendations accepted	95% (Quarterly)	99%
Post Audit Customer Satisfaction Survey Feedback	% of customers scoring audit service good or above (4 out of 5) where 1 is poor and 5 is very good	100% (Quarterly)	87% Overall average score 4.49
Customers providing feedback Response	% of Customer returning satisfaction returns	70% (Quarterly)	56%
Cost			
Objective: To ensure that the service is cost effective			
KPI	Measure of Assessment	Target & (Frequency of Measurement)	
Cost per chargeable audit day	CIPFA Benchmarking Club – Comparator Group (Unitary)	Lower than average (Annually)	Not yet available

VALUE ADDED WORK

Information Governance

The service is represented on the corporate Information Governance Group to provide advice and guidance and to carry out independent assurance work on the Council's information governance arrangements.

Grant Work

As the Council strives to maximise external funding to help it deliver its objectives, we have been increasingly required to provide independent assurance that funding is correctly spent by certifying grant claims. Such work adds value by ensuring no grant is lost through claw back or reputation damage that may impact on future external funding opportunities. We have also worked closely with the Corporate Funding Group to improve the identification, monitoring and reporting of external funding sources and to establish mechanisms for co-ordinating potential funding bids, to optimise success, and reduce the risk of grant claw back due to failure to meet grant conditions.

Due to work being carried out to confirm the accuracy of the remaining LAA Stretch Targets, additional reward grant of £54K was secured via a target which had previously been declared inoperable by the CLG.

Partnership Governance

We have worked with colleagues within ACE to improve the Councils Partnership Governance framework by developing and implementing an annual self-assessment tool kit. The outputs from the 2010/11 exercise will be risk assessed to identify partnerships where further assurance on the adequacy of governance arrangements in place is required.

Personalisation of Care Services

We have continued to work closely with social care staff implementing the new personalisation process for care services. Internal Audit are represented on the Finance and Contributions Sub Group to provide independent advice and challenge to ensure that effective controls are incorporated into the Resource Allocation System (RAS) mechanism for allocating personal budgets to clients as it develops.

Final Accounts

We assisted external audit in their substantive testing of journals and asset verification as part of their 2009/10 audit resulting in a saving of external audit fees.

Financial Management Systems (FMS) Project Board

We were a member of the FMS Project Board. As part of this Board we were tasked to review and report on several areas, including; the use of credit cards and procurement cards, and compliance with the Payment Card Industry Data Security Standard (PCI DSS). These reviews identified a number of key weaknesses, and action plans to address these weaknesses have been developed.

Oracle E Business Suite

We have continued to work closely with our colleagues in Finance to provide advice and guidance on the development of Oracle, including a review of the 'procure to pay' process. A number of issues were highlighted as part of this review, and these will be addressed through the development of various workstreams which have now been established.

New Revenues and Benefits System

We are represented on the implementation board and support the project development in an advisory and consultancy role, as well as providing hands on assurance work on testing the integrity and accuracy of data uploads.

Membership of the Strategic Procurement Network (SPN)

The SPN is a corporate group and Internal Audit provides independent advice and challenge on internal control and VFM issues as they arise.

Counter Fraud

Internal Audit is responsible for developing, promoting and monitoring the Council's arrangements for managing the risk of fraud and corruption. These arrangements have been reviewed during the year resulting in a revised Counter Fraud Strategy, and supporting Fraud Response Plan being approved by Audit Committee. Internal Audit continues to lead an awareness campaign, 'Combating Fraud through Awareness', to ensure that these arrangements are embedded across the Council.

The strategy requires that all potential cases of fraud and irregularity, with the expectation of benefit fraud which is dealt with by a specialist fraud and error team within the Revenues and Benefits Service are reported to the Head of internal Audit. In total 59 potential cases were reported during the year. We monitor and report upon the effectiveness of the Council's Counter Fraud Strategy, including progress and outcomes of investigations, to Audit Committee every 6 months.

Review of Creditor Payments

Internal Audit carried out work throughout the year to identify potential duplicate payments made by the Council. Due to our limited resource, Internal Audit focuses its attention on the higher value potential duplicates invoices (i.e. those of more than £1,000 each). To date, Internal Audit has confirmed 27 duplicates totalling more than £115,000. Action is being taken to recover this money. A strategy is to be developed with service managers to ensure that appropriate action is taken to investigate other potential duplicates identified. Control weaknesses highlighted through this work are being addressed through a review of the Procure to Pay Process (P2P).

Membership of the Information Security Forum (ISF)

The ISF is a corporate group and Internal Audit provides advice and guidance on information security issues. We also carry out assurance work on the information security arrangements which assist in the Council's ability to retain its compliance with the information security standard (ISO27001).

This assurance work has identified significant weaknesses, for which action is being taken. These include weaknesses around formalising the ICT Business Continuity arrangements, and the control arrangements for providing third parties access to the Council network.

Implementation of Online Expenses

We provided advice and guidance to the group responsible for implementing the Online Expense system. This included participating in the pilot exercise.

VFM

The service has supported a number of VFM exercises during the year which included the review of the cash office function which identified savings in excess of £200K. A review of the Northumbria Water Authority Contract identified continued benefit to the Council of £126K. Substantial support was provided on the identification of costs in relation to the Community Buildings Review. A review of integrated transport arrangements identified a number of areas to improve efficiency and budgetary control. Reviews of business processes in place relating to grounds maintenance and the rationalisation of the building and property help desk facilities were begun during the year to help identify potential efficiency savings. General assistance was also provided in extracting CIPFA statistics for the ACE to help improve performance management and identify potential efficiency savings.

Free School Meals

Work in confirming the eligibility of free school meals claimed on the January census returns for all primary schools resulted in £128K being recovered from school budgets. This money was set aside to meet in year costs from infant class size claims and ILS.

Financial Management Standard in Schools (FMSiS)

Internal Audit confirmed over the lifetime of the FMSiS inspection process, that for Durham schools a total of 35 secondary schools and 231 primary/special schools obtained the Standard. A further 13 secondary schools and 2 primary schools completed the reassessment prior to the announcement from Government that FMSiS was to be abolished with effect from 15th November 2010.

Contract Tickets, Contract Hire and Post 16 Transport

Concerns raised over the arrangements for Contract Tickets, Contract Hire and Post 16 Transport resulted in a £20K reduction in payments claimed by a bus service provider.

Private School Funds

A review of Private School Funds resulted in the identification and transfer of £80K incorrectly allocated to the PSF back into the delegated school budget.

SIGNIFICANT CONTROL ISSUES

Key Financial Systems

As can be seen from Appendix D, the overall assurance opinion on the financial control environment is considered to be moderate. In some specific areas, only limited assurance could be provided. Weaknesses identified in relation to these areas are considered significant and may put the system objectives at high risk. Consequently controls in these areas are not considered adequate to manage potential risks effectively.

The development and implementation of the new revenues and benefits systems and a new cash collection system concurrently with the amalgamation of the service into a single locality may have contributed to weakening financial controls in this area.

Issues relating to the accuracy of asset databases and clarification of roles and responsibilities in relation to income collection and reconciliation have resulted in a delay in the identification and raising of rental invoices of a substantial sum. This is being addressed.

A number of Improvements in the operation of the Oracle E Business Suite have been implemented during the year, notably in relation to performance following cessation of Northumberland hosting the Oracle database. Further work is planned ensure that its implementation satisfies the business needs of the Council and delivers efficiencies in operational processes. In particular work continues to improve the efficiency and control environment of the procure to pay processes following the migration from the former district feeder systems.

Until such time as greater reliance can be placed on the controls the Council is at greater risk from loss through fraud, error, inefficiency, and inaccurate financial information.

Wherever weaknesses in controls have been identified management actions plans for improvement have been agreed. Progress made on the implementation of audit recommendation is monitored and reported.

Information Security

The Council is currently accredited with the information security standard (ISO27001). To help ensure this accreditation is retained Internal Audit carried out on-going assurance reviews. Testing carried out during the year identified weaknesses in several policies that if not addressed could result in the failure to retain the standard, increasing the likelihood of reputation damage to the Council which in turn could impact on the achievement of Council objectives. Management are well aware of the risk and are taking the necessary action to implement improvements in controls to mitigate the risk to an acceptable level.