

NORTH LINCOLNSHIRE COUNCIL

AUDIT COMMITTEE

INTERNAL AUDIT /EXTERNAL AUDIT PROTOCOL 2008/09

1. OBJECT AND KEY POINTS IN THIS REPORT

- 1.1 To consider the Internal Audit / External Audit Protocol for 2008/09.
- 1.2 Internal and external audit have different roles and responsibilities. Internal Audit is an independent assurance function within the council, whereas External Audit is responsible for giving an independent opinion on the council's financial statements and a conclusion on its arrangement for securing economy, efficiency and effectiveness in its use of resources.
- 1.3 Effective cooperation and communication between Internal and External Audit is important to ensure audit plans are coordinated and reliance is placed on each others work wherever possible to achieve the most effective audit coverage and minimise duplication

2. BACKGROUND INFORMATION

- 2.1 The relationship between internal and external audit at the council has always been very professional with good cooperation. With the recent change in External Audit provider the opportunity has been taken to develop a protocol for joint working between internal and external audit.
- 2.2 The protocol, attached at Appendix A sets out consultation and communication arrangements, the coordination of audit plans and where reliance will be placed on work undertaken by both internal and external audit to ensure duplication of effort is minimised.
- 2.3 It also provides a mechanism for the Audit Committee to ensure that a professional relationship is maintained between internal and external audit and effective liaison arrangements are in place
- 2.4 The protocol is a working document and while it will be subject to annual formal review, it will be changed as the operational and statutory need arises.

3. OPTIONS FOR CONSIDERATION

- 3.1 Options are limited in this type of report. Audit committee members are invited to consider the Internal Audit/ External Audit protocol and seek clarification on its contents as necessary.

4. ANALYSIS OF OPTIONS

- 4.1 The Code of Audit Practice for Internal Audit in Local Government 2006 recognises the benefits of strong cooperation and effective liaison between Internal Audit and External Audit and promotes the development of protocol for joint working as best practice.

5. RESOURCE IMPLICATIONS (FINANCIAL, STAFFING, PROPERTY, IT)

- 5.1 There are no staffing, property or IT implications.

6. OTHER IMPLICATIONS (STATUTORY, ENVIRONMENTAL, DIVERSITY, SECTION 17 - CRIME AND DISORDER, RISK AND OTHER)

- 6.1 External Audit and inspection duties are statutory requirements under the provisions of the Audit Commission Act 1998, the Code of Audit Practice and the Local Government Act 1999.
- 6.2 The Chief Financial Officer has a statutory duty under the provisions of the Local Government Act 1972 to ensure the proper administration of the council's financial affairs. The council also has a duty under the Local Government Act 1999 to make arrangements to secure continuous improvement in the way in which its functions are exercised, having regard to a combination of economy, efficiency and effectiveness. The requirement for an internal audit function is set out in the Accounts and Audit Regulations 2003. Internal Audit will continue to assist the Chief Financial Officer discharge his statutory duty.
- 6.3 Effective and coordinated audit services will help to promote good corporate governance, help to ensure the risk management framework addresses all key risks the council may face and promote appropriate action to manage risks to an appropriate level.

7. OUTCOMES OF CONSULTATION

- 7.1 The attached protocol is the result of consultation between Internal and External Audit managers Service Director Finance and reflects best practice as defined by professional bodies.

8. **RECOMMENDATION**

- 8.1 That the Internal Audit / External Audit Protocol for 2008/09 be approved.

SERVICE DIRECTOR FINANCE

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Background Papers used in the preparation of this report
Nil

Introduction

Aims

- 1 This document sets out the basis for the 'joint working arrangements and co-operation between North Lincolnshire Council's Internal Audit service (IA) and the Audit Commission (AC), as the council's external auditors. This takes into account the requirements of the revised Code of Audit Practice (Appendix 1) 2005 (the Code) for external auditors and the Terms of Reference for Internal Audit (which reflect the Code of Practice for Internal Audit in Local Government 2006).
- 2 The aims of the protocol are to:
 - clarify respective responsibilities for work associated with IA and EA codes;
 - develop further a close and effective working relationship; and the sharing of information on risks and issues facing the council;
 - facilitate the effective co-ordination of our work without impairing the independence and integrity of either party.
 - enable both organisations to place reliance on and obtain a clearer understanding of each other's work in helping them fulfil their respective roles;
 - formalise those specific areas where co-operation will minimise the overlap of effort and duplication of work and ensure cost effectiveness;
 - provide an understanding of the results of each others work to inform the scope of future work;
 - assist the audit committee to fulfil its responsibility to ensure effective liaison between internal and external audit.

Respective responsibilities

- 3 It is a fundamental principle of the AC Code that the council is responsible for putting in place proper arrangements for governance and stewardship of resources. This includes systems of internal control and arrangements for monitoring their adequacy and effectiveness in practice.
- 4 IA provides an essential element of the council's arrangements. Their principal responsibility is to meet the professional standards laid down in the Code of Practice for IA in Local Government, with a focus on identifying and addressing the control risks faced by the council and providing assurance on the council's corporate governance arrangements in accordance with the wishes of the council and the Section 151 officer.

The roles and responsibilities of Internal Audit are set out in its Terms of Reference. The primary objective of internal audit is to provide an independent and objective opinion to the council on the control environment comprising risk management, control and governance by evaluating its effectiveness in achieving the council's key priorities

The requirement for an internal audit function is set out in the Accounts and Audit Regulations 2003 (as amended), in that a relevant body must 'maintain an adequate and effective system of internal audit of its accounting records and of its system of internal control in accordance with proper practices in relation to internal control'.

Proper internal control practice for internal audit is defined as those practices contained within the Code of Practice for Internal Audit in Local Government in the United Kingdom 2006.

- 5 Under the AC Code, EA have responsibilities as external auditors to give an independent assessment of:
 - the council's Financial Statements, including the Annual Governance Statement; and
 - aspects of the council's arrangements for securing economy, efficiency and effectiveness in the use of resources.
- 6 The AC Code requires that external auditors should establish effective co-ordination arrangements with IA, and should seek to place the maximum amount of reliance on the work of IA. There are two key factors that limit the extent of such co-operation:
 - the emphasis of AC's audit approach is on ensuring that IA meet their own standards and objectives, and not on seeking to influence their programme for our own objectives; and
 - AC cannot delegate any of their Code responsibilities to IA.
- 7 Internal and external audit have different roles but many shared objectives. Both the Code of Practice for Internal Audit and the Audit Commission's Code of Audit Practice require effective co-ordination arrangements to be established and reliance to be placed on each other's work wherever possible. Effective co-operation is essential in order to minimise duplication of effort and maximise the benefits of audit. It should enable both parties to devote more time to the key audit issues and ensure that the council gets best value from its total audit resource. Both teams are committed to an open and constructive relationship, based on an understanding of each other's roles and approaches to achieving their respective objectives.

Protocol

Planning

- 8 AC plan and carry out their audit in compliance with International Standards for Audit (ISAs), relevant extracts of which are given in Appendix 2.
- 9 Both IA and AC will produce annual audit plans, by 31 March for the following year, based on risk assessment. The timing and scope of work will be discussed in advance in order to ensure the best deployment of respective resources and avoid duplication. Copies of approved audit plans will be exchanged as soon as practicable after approval.
- Progress against the respective plans will be discussed during regular liaison meetings^[a1].
- 10 To achieve benefits from co-operation and co-ordination will require commitment and delivery from both parties. AC base their audit plans on the assumption that IA share this commitment. In particular, the assumption that IA will complete their planned work to an appropriate standard.

Audit areas

Opinion

- 11 AC are required to audit the council's financial statements and to give their opinion, including:
- whether they present fairly the financial position of the council and its expenditure and income for the year in question; and
 - whether they have been prepared properly in accordance with relevant legislation and applicable accounting standards.

In order to comply with ISA315, AC need to identify, evaluate, document and test those of the council's systems that have a material impact upon its financial statements. The Audit Commission and Internal Audit will agree the fundamental financial systems and coverage required annually. Internal audit will update systems descriptions and include within their work tests on the material controls identified by the Audit Commission.

The Audit Commission will evaluate and seek to place reliance on the work of Internal Audit in order to optimise the use of audit resources. Expectations in terms of documentation, testing requirements and timetables for work will be agreed in advance.

- 12 Final reports on these systems will be forwarded to the Audit Commission on completion of the work and working paper files made available on request. Work will be completed within the financial year to which it relates or by the end of May in the following year.

- 13** AC are also required to review whether the Annual Governance Statement (AGS) has been presented in accordance with relevant requirements, and to report if it does not meet those requirements or if the statement is misleading or inconsistent with their knowledge of the council.
- 14** IA's responsibilities require them to evaluate the effectiveness of the control environment in achieving the organisation's objectives. In part fulfilment of their responsibilities, IA carry out reviews of systems and key controls, including evaluating and testing those controls. This work is directly relevant to AC's responsibilities.
- 15** AC will seek to place reliance upon IA's systems work, provided there is assurance that:
- adequate sample sizes are used in order to support conclusions and recommendations; (guidance on AC sample sizes and the approach is contained in Appendix 3);
 - samples are selected appropriately to be representative of the population and the period covered; and
 - the work is evidenced and documented in accordance with professional standards. The AC approach to errors is outlined in Appendices 4 and 5.
- 16** AC will liaise with IA each year to identify the scope for drawing assurance from their systems work. To be successful this will involve synchronising work timetables. AC will aim to carry out our work during their interim visit. Any specific IA work that AC intend to place reliance on will need to be completed before the interim visit in accordance with an agreed timescale. AC will then need to consider whether any additional testing will need to be carried out to cover any remaining part of the year.
- 17** AC have developed a three year cyclical testing strategy (see Appendix 6) which if delivered with the co-operation of IA will help to minimise duplication of work. AC will agree in advance the controls that have to be tested on each of the systems identified.

Fraud

- 18** IA and the monitoring officer will notify AC promptly of frauds exceeding £10,000 all cases of corruption and any fraud cases of particular interest or complexity and will set out the details on an AF70 for submission to the AC Counter-Fraud Unit. If appropriate, AC will offer support and assistance to IA in investigating significant frauds.
- 19** In the event that AC suspect a fraud, the case will be passed over to the control of IA who will then be expected to investigate the case and keep AC informed of progress. AC reserve the right to retain control over a fraud investigation, although this is only likely in exceptional circumstances.
- 20** IA will forward monthly fraud reports to the Audit Commission.
- Internal Audit will co-ordinate the submission of data to the National Fraud Initiative (NFI) and will co-ordinate the investigation of all non - housing benefit

matches. Matches in relation to Housing Benefits will be investigated by the Housing Benefit Fraud Team. The outcome of investigations will be reported to the Audit Commission through the web tool.

The Audit Commission will forward any fraud flashes received and provide information on any investigations undertaken if they arise.

Performance management including best value

- 21 AC will keep IA informed of any forthcoming performance and inspection work and its scope, so that IA can plan their work appropriately. Work on best value or value for money undertaken by IA, will be considered that work as part of AC's review of the council's performance management framework.
- 22 AC will also liaise with the Strategic Procurement and VFM Team prior to carrying out any performance or inspection work.
- 23 One of AC's sources of assurance in discharging their responsibilities in relation to the council's arrangements for securing economy, efficiency and effectiveness in the use of resources is its whole system of internal control as reported on in the Annual Governance Statement. AC will work with IA to support their role in contributing to this process, and will seek assurance about the overall control environment from their work.

Grant claims, Data quality and Use of Resources Assessment

- 24 AC has devised separate arrangements for the audit of Grant Claims, Data Quality and the Use of Resources. The AC will maintain a dialogue with IA relating to these areas in order to share matters of concern so that both parties can consider them when planning specific work in these areas.

Other work areas

- 25 The following additional areas of IA activity may also be relevant to AC's work:
 - ad hoc investigations into suspected fraud or corruption;
 - reviews of systems development and replacement; and
 - any work undertaken to inform the council's Annual Governance Statement.

Liaison arrangements

- 26 Liaison meetings will be held regularly. This is likely to be at least quarterly to fit in with the Audit Committee timetable. Other meetings as required will take place on an ad hoc basis.
- 27 Standard agenda items for liaison meetings are likely to include:
 - update of progress against IA and AC plans;
 - issues affecting delivery of plans;
 - reports finalised since last meeting (specific reports to be agreed prior to the meeting);

- key findings and emerging issues from current work;
 - details of special investigations and sensitive issues;
 - IA involvement in systems development work etc;
 - general audit news and intelligence from IA and AC networks (internally and externally)
 - Changes of key personnel; and
 - Issues arising from the review of internal audit’s work or the review of the effectiveness of internal audit.
- 28** IA audit plans and key issues arising from IA’s work will be reported to the council’s Audit Committee. A representative from the Audit Commission will be available to attend Audit Committee meetings and any other sessions regarding audit matters. As a minimum an AC representative will attend the Committee to present the Audit and Inspection Plan, present the ISA 260 report and the Annual Audit and Inspection Letter.
- 29** Where appropriate and without compromising AC’s independence both the AC and IA will assist the Audit Committee
- 30** Key contacts for purposes of communications on the common areas of work are shown in Table 1.

Table 1 Key audit contacts

First contacts for enquiries on specific audit areas

Work area	IA Key Contact	AC Key Contact
Planning, control and reporting	Carol Andrews	Alan Oliver
Financial systems	Debbie Baker	Andrew Kershaw
Opinion		Rob Walker
Anti-fraud and corruption	Carol Andrews/ Debbie Baker	Sherie Newbould
Grant claims	Carol Andrews	Andrew Kershaw
Data quality	Caroline Wilson	Sherie Newbould
Use of Resources	Carol Andrews	Sherie Newbould
Review of Internal Audit	Carol Andrews	David Jones
Performance/inspection	Carol Andrews	Joanne McDonough/Tony Gledhill
IT	Debbie Baker/ Stuart Anderson	Fred Woodruff

Audit documents and reporting

31 AC have to satisfy themselves that IA's work meets required standards and can be relied upon for assurance on the council's control arrangements. Reviewing relevant files is an essential step in this process. IA have agreed to provide AC with access to their records and reports upon request. Any records removed from the IA office will be logged out and kept secure at all times. (Providing lockable facilities are provided by the Council)

32 Whilst AC will consider all requests for IA access to external audit files, they will have to take account in each case of the statutory restrictions on the disclosure of information by external auditors. AC will include IA on the distribution list for all their final reports.

The Audit Commission will evaluate and seek to place reliance on the work of Internal Audit in order to optimise the use of audit resources. Expectations in terms of documentation, testing requirements and timetables for work will be agreed in advance.

Review of Internal Audit

33 As part of AC's assessment of the council's governance framework, an annual overall assessment of the IA function will be performed, including planning, management and reporting. At least every three years a comprehensive review (starting 2007/08) will be carried out. All of these reviews will assess IA against CIPFA's Code of Internal Audit Practice. The Audit Commission will also review the adequacy of Internal Audit annually as part of their annual Use of Resources assessment. The results of this review will be included as part of the annual review of the effectiveness of internal audit and reported to the Audit Committee.

34 In addition to the above, AC will undertake detailed reviews of specific pieces of work upon which reliance will be placed. This will encompass a review of the audit file to assess the scope of the work and the adequacy of sample sizes, standards of evidence and documentation, quality assurance and reporting. This may involve re-performing some tests, or testing an additional sample, if deemed appropriate.

35 If AC come to a view that they are unable to rely upon Internal Audit work, this will be discussed with the council the further work needed in order to support their audit opinion on the accounts, and how that work is to be resourced.

36 AC's conclusions from all of this work will be discussed with the Audit and Risk Manager and summarised in a report.

Implementation of recommendations – following up Audit Commission recommendations

Internal Audit will follow up implementation of recommendations arising from the work of the Audit Commission and report the findings to the Audit Commission and the Audit Committee.

Where the Audit Commission follow up specific pieces of work, the results will be reported to the Audit and Risk Manager.

Review

This protocol will be reviewed on an annual basis.

The way forward

37 An action plan for joint working is contained at Appendix 7.

Appendix 1 – Code of Audit Practice 2005

- 1 In auditing the financial statements the auditor's responsibilities are:
 - to be satisfied that the accounts comply with statutory requirements;
 - to be satisfied that proper practices have been observed in compiling the accounts; and
 - to express an opinion on the accounts.
- 2 In carrying out their audit of the financial statements in accordance with the Code, auditors should comply with auditing standards currently in force, and as may be amended from time to time, and have regard to any other relevant guidance and advice, issued by the Auditing Practices Board (APB), including that covering the work of auditors in relation to audited bodies. Auditors should also comply with the APB's Ethical Standards currently in force, and as may be amended from time to time.
- 3 The relevant auditing standards, supported by the APB, are the International Accounting Standards (ISAs) (UK and Ireland).
- 4 In auditing the Annual Governance Statement (AGS), the auditor's responsibilities are to review whether the Annual Governance Statement (AGS) has been presented in accordance with relevant requirements and to report if it does not meet these requirements or if the Statement is misleading or inconsistent with other information of which the auditor is aware. In doing so auditors should take into account the knowledge of the audited body gained through carrying out audit work in relation to the body's arrangements for securing economy, efficiency and effectiveness in the use of its resources.
- 5 In auditing the Use of Resources the auditor's responsibilities are:
 - to be satisfied that proper arrangements have been made for securing economy, efficiency and effectiveness in the use of resources;
 - where the Commission has issued a direction, under section 44 of the Act, requiring relevant bodies to publish information relating to their activities, to be satisfied that such audited bodies have proper arrangements for collecting, recording and publishing the information (BVPIs); and
 - to audit the annual performance plan published under section 7(1) Local Government Act by a best value authority.

Appendix 2 – Extracts from relevant International Standards for Audit (ISAs)

- ISA 315: The external auditor should assess the risks of material misstatement in the council's financial statements through gaining an understanding of the council and its environment and of those controls and risk management arrangements that are relevant to ensuring the council's affairs are presented fairly in their accounts.
- ISA 330: When, in accordance with paragraph 108 of ISA (UK and Ireland) 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.
- ISA 610: The external auditor should consider the activities of Internal Auditing and their effect, if any, on external audit procedure. The external auditor should obtain a sufficient understanding of Internal Audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures. The external auditor should perform an assessment of the Internal Audit function when Internal Auditing is relevant to the external auditor's risk assessment. When the external auditor intends to use specific work of Internal Auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.
- ISA 240: In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud. The auditor should make inquiries of management, Internal Audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. The auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

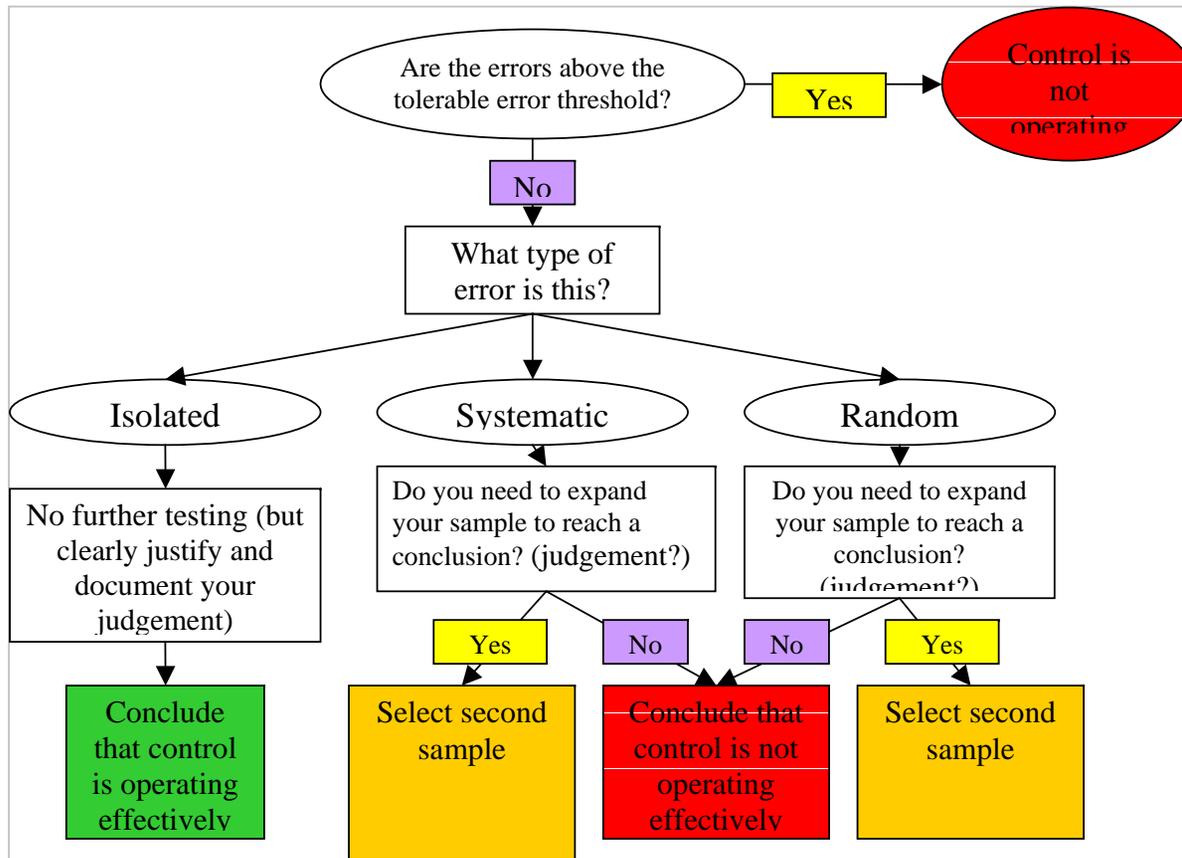
Appendix 3 – Sample sizes which impact on opinion work

Table 2 Sample sizes and coverage

Control type	Frequency of control	Sample size
Manual or high risk automated	Operating quarterly	2
	Operating monthly	2
	Operating weekly	5
	Operating > weekly	20
Low risk automated		1

- 6 Audit samples should be selected across the year in order that conclusion can be drawn as to whether the control in question operated effectively during the whole audit year.

Appendix 4 – Approach to errors



Appendix 5 – Follow-up of errors

- 7 Where a control test has failed further substantive test should be undertaken on the failed transaction. For example if a control is that a payroll starter form is authorised and testing of a starter finds the form is not authorised confirmation should be sought that the 'starter' is employed by the council and that the pay rate etc is correct.
- 8 Where any test discovers error the amount should be quantified as an amount and a percentage and consideration given to the impact of the error on the population as a whole
- 9 What do we mean by a control is failing? Our procedures require that where 2 or more of the sample of 20 fail then we cannot rely upon the control. We have to look for compensating controls and test those or apply larger substantive samples to the failing control.
- 10 Substantive sample size is determined by the formula:
$$\text{Population value} / \text{Materiality value} \times 2$$

Materiality is determined by formula based on gross expenditure in the 'Net cost of services' in the statement of accounts. The value is around £3.3m. (To be revisited)

Appendix 6 – Cyclical testing strategy

Table 3 Cyclical testing strategy

System (FOR EXAMPLE- NEEDS AGREEING)	2007/08	2008/09	2009/10	2010/11
WE NEED TO JOINTLY IDENTIFY				
General ledger	√	√		
Payroll	√		√	
Creditors	√			√
Debtors	√			√
Carefirst expenditure - adult residential	√	√		
Carefirst expenditure – supporting people	√	√		
Servitor	√		√	
Loans	√			√
Investments	√			√
Cash – ??	√			√
Internal invoicing	√			√
Asset Management	√		√	

Appendix 7 – Action plan for joint working

Recommendations	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Audit planning					
Both internal and external audit plans will be shared and discussed between IA and AC.	3	Both	Yes	Progress against audit plans will be discussed during update meetings. Timing of audit work will be discussed in advance to avoid duplication.	Ongoing.
Opinion audit					
AC will seek to place reliance on IA systems work on an annual basis.	2	Both	Yes	In addition to their own responsibilities it would be helpful if IA could cover testing of those systems identified in the AC cyclical plan in line with the AC sample size methodology (as far as possible). AC will share in advance the controls that require testing. AC will share its own flowcharts/systems documentation with IA if required and vice versa.	Ongoing.
Fraud					
IA will notify AC of all frauds > £10,000, all cases of corruption and any fraud cases of particular interest or complexity.	2	Both	Yes	IA will provide details to ensure that AC can complete the AF70 return to the AC counter fraud unit. IA's monthly fraud reports to be forwarded to Audit Commission for information. AC will offer support and assistance to IA investigating frauds if required.	Ongoing.

Recommendations	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Performance management					
AC will keep IA informed of the scope and timing of performance and inspection work.	3	AC	Yes	Where IA or the Strategic Procurement and VFM Team undertakes work on performance management or value for money AC will consider that work as part of our review.	Ongoing.
IA should report on the control environment in line with the Code of Practice for Internal Audit.	3	IA	Yes	As part of AC responsibilities in relation to assessing the council's arrangements for securing VFM in the use of resources AC will seek assurance from IA's opinion on the internal control environment.	30 June of the financial year.
Grant claims					
AC will consider any work carried out by IA in any areas subject to audit.	1	Both	Yes	AC will share any significant findings from the work on grant claims with IA.	Ongoing.
Use of Resources/ Data quality					
AC will share with IA the KLOEs for data quality and a list of BVPIs that require testing. AC will agree with IA the approach to any joint working.	2	Both	Yes	IA and AC to agree approach for future years.	Ongoing.

Recommendations	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
Liaison arrangements					
IA and AC will meet regularly throughout the year to discuss audit plans and findings.	3	Both	Yes	Standard agenda items could include: <ul style="list-style-type: none"> • update of progress against IA and AC plans; • reports issued; • key findings; • special investigations; and • any other issues. 	Ongoing.
Audit documents					
The Audit Commission will make systems files and working papers available to IA to facilitate their audit. The Audit Commission have access to IA files for the purposes of their audit.	3	Both	Yes	The Audit Commission will continue to supply copies of our audit testing requirements on those areas where we work together.	Ongoing.
Review of IA					
The Audit Commission will review the IA function on an annual basis; a more detailed review will be carried out every third year. (Starting 2007/08)	3	AC	Yes	The next full review will take place in 2007/08	Ongoing.