

**REPORT OF:** CHIEF EXECUTIVE  
**TO:** POLICY & RESOURCES COMMITTEE  
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**Contact Details:** Dean Langton  
**Tel. No:** 01282 661602  
**E-mail:** dean.langton@pendle.gov.uk

## INTERNAL AUDIT SERVICE

### PURPOSE OF REPORT

1. This report outlines recent developments concerning the Council's Internal Audit Service and sets out the options available to the Council to ensure the effective continuation of an internal audit function.

### RECOMMENDATIONS

2. The Committee is asked to consider the content of this report and approve the following recommendations:
  - (a) that the Council outsources the provision of its Internal Audit function, and
  - (b) the Chief Executive (as Section 151 Officer) be authorised to take the necessary action, in compliance with relevant procurement regulations, to complete the above during 2020/21, and
  - (c) that a further report be presented to this Committee on the outcomes resulting from (b) above.

### REASONS FOR RECOMMENDATION

3. To ensure the Council can maintain an effective internal audit function and remain compliant with statutory and regulatory requirements.

## ISSUE

### Background

#### *What is Internal Audit?*

4. The Public Sector Internal Audit Standards (PSIAS)<sup>1</sup> define internal auditing as “an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”.

5. Whilst the Standards referred to above apply to the Council as a local authority there are also other statutory obligations that require the Council to maintain an internal audit service as follows:

- Section 151 – Local Government Act 1972

This section requires that every local authority in England and Wales should “make arrangements for the proper administration of their financial affairs and shall secure that one of their officers has responsibility for the administration of those affairs”. Whilst the words “proper administration” are not statutorily defined it is the view of CIPFA<sup>2</sup> that proper administration requires a somewhat wider consideration of all aspects of local authority financial management and should include compliance with the statutory requirements for accounting and **internal audit**.

- Accounts and Audit Regulations 2015

#### *Regulation 5 (1)*

*A relevant authority **must** undertake an effective **internal audit** to evaluate the effectiveness of its risk management, control and governance processes, taking into account public sector internal auditing standards or guidance.*

6. In their Statement on the role of the Chief Financial Officer, CIPFA set out a number of key principles and responsibilities linked to the role including the following:

*Ensuring that the authority has put in place effective arrangements for **internal audit** of the control environment and systems of internal control as required by professional standards and in line with CIPFA’s Code of Practice on Local Authority Accounting in the United Kingdom.*

7. It can be seen from the preceding paragraphs that the Council and the Chief Executive (as Section 151 Officer) must ensure the provision of an Internal Audit function. However, the precise form that this takes is open to the Council and this report goes on to outline the current arrangements and explores options for future service provision.

#### *Current Arrangements for Internal Audit*

8. Currently, the Council’s approved establishment provides for an Internal Audit function comprising two members of staff, with the Audit Manager reporting to the Chief Executive. In addition the service draws on external support from the Merseyside Internal Audit Agency for specialist IT related audit services. The approved staffing budget for the Internal Audit service in the forthcoming year is £82k. This provides for an estimated 358 ‘available audit days’ inclusive of IT audits.

9. The work of Internal Audit is performed in accordance with the Public Sector Internal Audit Standards and adopts a risk based approach to defining the audit subject areas. There is an

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<sup>1</sup> Updated March 2017 and applicable to all UK local authorities

<sup>2</sup> Chartered Institute of Public Finance and Accountancy

agreed Audit Strategy which covers a three year term together with an annual audit plan. Both these documents are developed in conjunction with the Council's Management Team prior to their consideration and formal approval by the Accounts and Audit Committee.

10. The Internal Audit Plan for 2019/20 was approved by the Accounts and Audit Committee in March 2019. The Plan is expressed in terms of available 'audit days'. Each audit subject area requires an estimated number of days to complete together with provision for contingencies, counter-fraud activity, IT and work undertaken on behalf of Pendle Leisure Trust. The plan approved for the current year equated to 356 days of internal audit activity. An updated plan for 2020/21 will be presented to the Accounts and Audit Committee in March.
11. Following the recent departure of the Internal Audit Manager the Council has an opportunity to review the provision of Internal Audit. At present the service is being maintained by the remaining member of staff bolstered by additional capacity bought in from the Merseyside Internal Audit Agency. These arrangements are not sustainable beyond the short-term and steps must be taken to ensure the on-going effectiveness of the Internal Audit service.

#### *Options available to the Council?*

12. Internal audit has a key role to play in helping the Council manage effectively through the challenges it faces by ensuring that governance, risk management and control arrangements remain effective. To do this successfully, internal audit needs to be fit for purpose and provide assurance of the necessary quality, depth and coverage. Often this will mean giving assurance on complex and potentially risky issues and using specialist resources when necessary. Internal Audit can add real value to the organisation.
13. After review it is considered that the following options are available to the Council:
  - Insourcing – i.e. maintain the current arrangements and recruit to the vacant post of Internal Audit Manager;
  - Partner with another local authority;
  - Co-sourcing – a mix of in-house resources combined with a third-party provider of services;
  - Outsourcing – resources are entirely provided by a third party provider to achieve the strategic objectives of the internal audit service;
14. The current arrangements, whereby the audit team consists of 2 members of staff have operated since April 2018. Prior to this time there was a senior manager in place who combined the role of Audit Manager with managing the Council's relationship with Liberata. This post-holder retired from the Council in March 2018 since when the audit team has been reduced to two members of staff. At this level there are clearly business risks with regard to service resilience and innovation whilst also ensuring sufficient depth and breadth of audit knowledge is maintained. The Council could recruit to the vacant post of Audit Manager but the underlying risks would still remain.
15. Informal discussions have taken place with some neighbouring authorities regarding the opportunity to combine and share audit functions but with little appetite shown for this. The County Council was asked if they could assist the Council during the current period. Whilst they expressed a willingness to do so they sought a longer-term contractual arrangement which the Council could not commit to without some form of procurement exercise.

16. By default the current arrangements have evolved in to a co-sourcing model with additional support bought in from the Merseyside Internal Audit Agency. This is a temporary arrangement and will require further consideration in the near future. Under this arrangement the Council retains control over the internal audit function whilst benefitting from the additional skills and resources of the Agency. However, this model still requires the Council to address issues around in-house staff training, recruitment and the technology used.
17. Given the limited in-house audit capacity and the difficulties of recruiting it is recommended that the Council outsources its internal audit function. If successful this should address issues of resilience, innovation and ensure access to a wider base of audit skills and knowledge. An evident downside to this approach is that the knowledge and skills then lie outside the organisation with no scope to build internal capabilities. On balance however, given current circumstances it is felt that outsourcing represents the best way forward for the Council at this time.
18. If the Committee agrees to this recommendation then more detailed work will be undertaken to determine the scope of internal audit services required and the approach to take to the market. The former will draw on the emerging Audit Plan for 2020/21 combined with the updated Audit Strategy. It is expected that these documents will be submitted to the Accounts and Audit Committee during March. The approach to the market can take different forms. The Council could, for example, be quite prescriptive in what it requires (an input based approach) or alternatively it could invite proposals from bidders based on a proposed contract sum (an output based approach). The latter should encourage greater innovation and flexibility provided the Council ensures it appropriately covers key business risk areas.
19. Whilst there are expected benefits from outsourcing, notably improved resilience and innovation it is likely that the 'rate per audit day' will increase compared to the in-house service option. This will require the Council to focus internal audit resource on key areas of business risk and/or review the frequency of audit coverage for some activities.
20. It is crucial that the Council receives a good level of service from Internal Audit. Not only is it a key check and balance in the Council's governance framework it is also relied upon by External Audit who place reliance on the assurance work undertaken by Internal Audit. Where this work cannot be relied upon to the extent required by External Audit it could have additional fee implications for the Council. The report author has made External Audit aware of this report and will keep them updated on related developments.

#### *Procurement of Internal Audit*

20. If the Committee agrees to outsource internal audit it will require a formal procurement process to be undertaken. The minimum contract term is likely to be three years with scope to extend potentially. In this scenario the Council will have to ensure compliance with EU procurement regulations which apply to contracts for services with a total value in excess of £189,330.
21. Such a procurement process has prescribed stages and time limits in the interests of transparency and fairness to service providers. Subject to approval, this would commence during the second half of 2020 and be concluded in time for the incoming provider to be operational in Q4 of 2020/21 so that they are fully prepared for the 2021/22 financial year.
22. There may also be TUPE considerations linked to outsourcing given the remaining Internal Audit team member. Advice will be taken from Human Resources in connection with this and the member of staff will be kept informed of developments as they progress.

23. A competitive procurement process would be open to private and public sector providers. Evaluation and award criteria will need to be drawn up whilst ensuring compliance with EU procurement regulations.

### *Conclusions*

24. The Council needs an effective and sustainable Internal Audit. There are legal as well as sound business reasons for this. At present the Council's internal audit function comprises one member of staff with additional support bought in externally. This is not a sustainable position.
25. In an effort to address this, informal discussions have taken place with local authority partners in an effort to collaborate on internal audit but to no avail. The Council needs to resolve the current position. In response this report recommends that the Council outsources its Internal Audit function.
26. If agreed, this will be subject to a formal procurement process with HR and legal support drawn on as required.
27. Subject to approval, it is hoped that the incoming service provider will be appointed and operational during the second half of 2020.

## **IMPLICATIONS**

### **Policy**

28. The outsourcing of Internal Audit would represent a change of policy compared with current service provision. However, outsourcing is not new to the Council and where it is done well it can deliver positive benefits to the organisation.

### **Financial**

29. Some elements of the budget for Internal Audit will remain with the Council even if outsourcing goes ahead. Examples include certain overheads such as accommodation and internal market charges. Allowing for these costs it is estimated that the residual budget available for the Internal Audit service is £82k per annum.
30. The adequacy of this budget will not be known until the procurement process is concluded and there is clarity on the bidders' proposals. In the event that additional resources are needed this would be subject to a further report and approval by Members.

### **Legal**

31. The Council is required to comply with relevant procurement regulations and will need to ensure TUPE considerations are appropriately addressed.

### **Risk Management**

32. Internal Audit is a key element of the Council's overall corporate governance framework. At present the service has limited capacity and lacks resilience. This is a risk for the Council. Procurement is also not without risks and these include the level of market interest, suitability of providers and levels of cost. Whilst the Council can take steps to mitigate such risks it remains to be seen how the market will respond to this opportunity.

### **Health and Safety**

33. There are no health and safety implications arising directly from the contents of this report.

### **Climate Change**

34. There are no climate change or sustainability implications arising directly from this report.

### **Community Safety**

35. There are no community safety issues arising directly from the contents of this report.

### **Equality and Diversity**

36. There are no equality and diversity implications arising from this report.

### **APPENDICES**

None.

### **LIST OF BACKGROUND PAPERS**