



MIDDLESBROUGH COUNCIL

STRATEGIC FINANCE

SERVICE

ANNUAL INTERNAL AUDIT
REPORT 2004/2005

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INTRODUCTION

The Annual Reporting Process

The main issues arising out of the reviews undertaken by Internal Audit during 2004/05 are outlined in this report. They provide an overview of the operation of internal control across the Council.

The findings of individual audits conducted throughout the year have been reported to relevant service managers and Heads of Service.

The Accounts and Audit Regulations 2003 (the Regulations) require the Council to ensure that its financial management is adequate and effective and that it has a sound system of internal control including arrangements for the management of risk. The Regulations also require the Council to review at least annually the effectiveness of its system of internal control and to include a statement on internal control with the Council's published accounts.

It is a requirement of the Regulations that up to date non-statutory proper practices are followed. Proper Internal Audit practices for principal authorities can be found in the Code of Practice for Internal Audit in Local Government in the United Kingdom, issued by CIPFA.

Under that Code the Head of Internal Audit is required to submit a formal annual report to members which should:

- Include an opinion on the overall adequacy and effectiveness of the Council's internal control environment
- Disclose any qualifications to that opinion, together with reasons for the qualification
- Present a summary of the audit work undertaken to formulate the opinion, including reliance placed on the work of other assurance bodies
- Draw attention to any issues 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 criteria
- Comment on compliance with the CIPFA Code of Practice for Internal Audit in Local Government and communicate the results of the internal audit quality assurance programme.

Section 2

REVIEW OF INTERNAL CONTROL

Internal Control and the role of Internal Audit

The requirement for an Internal Audit function is implied in Section 151 of the Local Government Act 1972 which requires that local authorities 'make arrangements for the proper administration of their financial affairs'. More specific requirements are detailed in the Accounts and Audit Regulations 2003, 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 the proper internal audit practices'.

Middlesbrough Council has delegated responsibility for ensuring that statutory internal audit arrangements are in place to the Director of Resources.

Internal Audit is established by local authorities to undertake a wide range of independent reviews of its systems and operations. The aim of these reviews is to help ensure that the organisation achieves its objectives efficiently. Internal Audit critically evaluates the Council's systems of internal control and where necessary makes recommendations for improvements in control and the introduction of best practice, throughout the Council. To carry out this role the Internal Audit Section aims to:

- Satisfy legal requirements and professional standards
- Examine, evaluate and report objectively on the adequacy of arrangements to secure proper economic, efficient and effective use of resources
- Assist management with its responsibility for establishing and maintaining internal control systems and for ensuring that resources are properly applied, risks are appropriately managed and outcomes achieved.

It is management's responsibility to establish and maintain internal control systems and to ensure that resources are properly applied, risks appropriately managed and outcomes achieved.

In accordance with the 2004/05 annual audit plan, a programme of audits, based on an assessment of risk, was carried out, covering all the Council's Services. This programme was reviewed during the year and revised to reflect changes in risk and resources available to deliver the plan.

Opinion 2004/05

No assurance can ever be absolute, however this opinion seeks to provide a reasonable assurance that there are no significant weaknesses in the Council's whole system of internal controls. ***On the basis of the audit work completed, the Council has in place a satisfactory framework of internal control, which provides a reasonable assurance regarding the efficient and effective achievement of its objectives. No significant weaknesses have been identified.***

The level of assurance given takes into account:

- All audit work completed in 2004/05
- Follow up of actions from previous years audits
- Management's response to the findings and recommendations
- Effects of significant changes in the Council's systems
- The extent of resources available to deliver the audit plan
- Quality of the internal audit service's performance
- The extent to which resource constraints may limit the ability to meet the full audit needs of the Council
- Any limitations that may have been placed on the scope of Internal Audit.

All audit reports produced have included a management action plan where recommendations have been made which will enhance the level of control, together with an opinion of the systems reviewed. Timescales for the implementation of recommendations have been agreed with manager's responsible for each area audited.

The Statement on Internal Control for 2004/05

CIPFA Guidance sets mandatory proper practice for the basic content of the required annual Statement on Internal Control and its approval and publication represent the end result of the annual review of internal control. The Corporate Affairs Committee are responsible for approving the Council's Statement for signing by the Chief Executive and Mayor prior to its publication with the Council's accounts.

Internal control is generally effective and the main areas for continuing action included within the Statement on Internal Control relate to:

- Improved guidance and instructions to staff and new quality monitoring arrangements in relation to Housing & Council Tax Benefit Control
- New arrangements for reconciliation monitoring in respect of Cash Receipting & Income
- Improved control processes in the payroll system applied to key documents and the appropriate type and level of checking
- Improvements in the functionality of SAP to address areas of weakness identified in authorisation and approval procedures within the Procurement IT system
- Control issues that require addressing following the review by the Audit Commission of the Financial Information System (SAP)

- a) Review of processes to address the over reliance on manual intervention by ICT for extracting feeder files prior to interface with SAP
- b) Review of access arrangements for consultants in view of excessive users with full access to application, in particular 'Consultant' access to SAP
- c) Complete reconciliation processes to be implemented and regularly carried out to address a lack of end to end source system to SAP reconciliations, possibly resulting from lack of ownership
- d) Review of staff access in view of excessive number of users with access to the journals process in SAP
- e) Monthly bank reconciliations to be completed and verified independently on view of bank reconciliation deficiencies contributed to by an under-developed understanding of processes
- f) Employment of an officer to deal specifically with Disability Discrimination Act 1995 and the allocation of additional funding.

➤ The following control issues had been identified as requiring attention during 2005/06

- a) Future provision of the audit function to be reviewed as there was insufficient capacity within the Internal Audit function and hence a risk that the audit plan would not be fulfilled
- b) In response to the increasing demand for in house project management skills and the Authority's limited capacity to carry out such work, a joint training course with IPF was proposed to expand and improve project management skills across the Authority.

Section 3

SIGNIFICANT ISSUES ARISING 2004/05

The following section provides a summary of the more significant issues that have been identified and reported during the year. This is by exception only.

1 *LOCAL PUBLIC SERVICE AGREEMENTS*

A review was undertaken of the procedures to ensure that the Council's procedures for monitoring and managing performance against Local Public Service Agreement targets are robust, supported by adequate systems of internal control and fraud prevention and are sufficiently reliable to support the information presented. Our review concluded that for a number of Agreements individual Services did not have appropriate arrangements in place to satisfy themselves about the reliability of relevant data obtained from third parties.

2 *WAIVERS OF CONTRACT PROCEDURE RULES*

Internal Audit has continued to be pro-active in offering pragmatic advice to officers on the application of Contract Standing Orders. When these rules cannot be complied with fully, advice is provided to officers on how to progress the procurement process to secure both best value and transparency. Advice is given to the Director of Resources on requests from Services for an exemption to Contract Standing Orders.

Year	Number of Requests
2000/2001	22
2001/2002	7
2002/2003	20
2003/2004	28
2004/2005	29

3 *KEY FINANCIAL SYSTEMS*

The review of the Debtors system has concluded that controls relating to debt over one year old continue to be weak. The review of the creditors system concluded that internal controls in place were adequate. However once again, Internal Audit was required to invest substantial resources in obtaining data to calculate the performance indicator for invoices paid within 30 days. Internal Audit identified payments totalling in excess of £347k, which were made on pro-forma invoices. Regulations prevent the Council reclaiming VAT on these payments without a valid tax invoice or VAT receipt. As a result, the Council has £52k of unclaimed VAT. It is important that internal control is effective in such high risk and large value areas. Necessary improvements include more detailed corporate guidance notes. Where revised

corporate guidance is issued, effective change control is required to prevent staff from inadvertently using out of date guidance.

Since the last audit of the Council Tax system, Internal Audit found that significant improvement in adherence to controls had been made. However, not all of the recommendations were being applied effectively: particularly the use of the notepad and 'Anite' to provide clear reference and documentary evidence in support of all transactions. Difficulties in locating basic documentation to support individual transactions were also of concern in the Non Domestic Rating system. Other weaknesses in control reported to managers include: use of shared user ids at the highest level of access; timeliness of dealing with schedules to and from the Valuation Office; authorisation of relief applied to the system and recovery not being carried out. Three of the weaknesses identified in this year's report were highlighted in the 2003/04 report. However, they have been addressed for financial year 2005/06.

The main issue arising from the audit of the Housing & Council Tax Benefit system is that of quality control; in particular the quality of documentation to support claims which impacts on the ability to demonstrate compliance with the relevant Housing & Council Tax Benefit and verification framework regulations. Problems in locating basic documentation to support individual transactions were also of concern in the Payroll system. For a sample of transactions (such as additions to the payroll and amendments to allowances), Internal Audit are contacting managers to confirm that they have been appropriately authorised.

The system for administering pensions continues to be carried out efficiently and effectively. However there still remains scope for some controls to be strengthened. The audit review identified a lack of documentation supporting reconciliations between the pensions administration system and the main accounting system and data input for transfers in. This latter area was the subject of a recommendation in the previous audit.

Audit coverage during the year also concluded that controls in the Treasury Management, Pension Fund Investment systems continue to operate satisfactorily.

4 *GENERAL AUDITS*

Schools

The majority of time was spent undertaking full scheduled audits of 9 schools.

Based on the detailed work undertaken in 2004/05 and the findings from previous years, our overall opinion is that the control environment within Middlesbrough's schools is generally adequate. At one school the audit report identified concerns over the mismanagement of lettings income and petty cash. There were no effective procedures and controls to ensure that proper account was taken of all income and expenditure. Recommendations made to management during the course of the year should help to ensure improvements take place.

Social Services

Internal Audit committed a substantial amount of resource to audits undertaken at Ayersome Industries and Teesside Community Equipment Store. At Ayersome Industries an audit was undertaken to establish accurate stores and work in progress figures for inclusion in the

2003/04 financial accounts. Based on the documentation and internal controls in operation at Ayersome Industries, Internal Audit could give no assurance that the stock valuation as at 31/3/04 was accurate. The findings identified that stock had been undervalued and that this had contributed to the reported deficit of £250,000. The absence of complete records prevented determination of an accurate figure for stocks held at the end of the year; however using available information and financial documentation it was estimated that closing stocks were undervalued by at least £103,000.

Internal Audit was able to provide some assurance that risks material to the achievement of the objectives of the Teesside Community Equipment Store were adequately managed. The major findings were a failure to comply fully with the Council's financial regulations, increasing the risk of poor procurement practices. Controls over stock were assessed as poor. Deficiencies in the Mesal's software used to record all purchases, issues and return of equipment contributed to the overall deficiencies in the control environment. A new version of the Mesals system with improved access and data input controls should go some way to improving the control environment. Disappointingly five of the thirty-eight recommendations contained in the report had been made following an audit undertaken in January 2003 but had not been implemented.

5 *SAP FINANCIALS*

The implementation of the SAP system has continued to have a significant impact on the development and operation of the key financial systems.

Although this has resulted in some areas of control weakness in the transitional arrangements for processing and recording of financial transactions, Internal Audit are satisfied that there are sufficient compensating controls in place to prevent these weaknesses from having material consequences. Auditors attended weekly post implementation meetings chaired by the Deputy Director of Finance to address problems as they arose. One of the issues arising out of the post implementation meetings was the absence of a register of authorised signatories. As a result HBS employees responsible for making payments were unable to satisfy themselves that an appropriate officer had certified payment documentation. Internal Audit was asked to work with services to produce a register of authorised signatories.

6 *CONTINGENCY*

Unplanned Audits

During the year, unplanned audits were undertaken in connection with the transfer of assets to Erimus Housing as part of the LSVT. Additional work was also undertaken in respect of the fall in the Council Tax and Non Domestic Rates collection rates.

Fraud & Corruption

Internal Audit investigated 8 other incidents involving alleged theft of Council assets and corruption. Although many referrals are relatively minor, one resulted in a complicated and lengthy investigation.

Section 4

AUDIT PERFORMANCE

The Audit Commission relies on the work that Internal Audit do on key financial systems to gain assurance that the systems are operating as intended. Such assurances contribute to them being able to 'sign off' the Council's accounts and contribute to their conclusions on the financial aspects of corporate governance. Whilst the Audit Commission are currently auditing the Council's accounts for 2004/05, they have commented in their interim audit report for financial year 2004/05 that:

'Internal Audit have adequately reviewed and tested the key financial systems in accordance with CIPFA standards and their own quality manual. Their compliance testing found significant exceptions to established controls in the following systems: Payroll; Creditors; Cash Receipting; Housing Benefits; Council Tax and NNDR'.

Analysis of Issues

The Internal Audit Section consists of 15 staff delivering the equivalent of 13 full time posts.

Nine staff are professionally qualified with CIPFA or the AAT.

There were a number of changes during the year. The trainee auditor resigned her post after having concluded that she did not want to take up internal auditing as a career. The post of Trainee Auditor was advertised and the vacancy filled in November. The vacant half of the Audit Clerk's post was filled in July; however the member of staff occupying the other half of the post resigned in January to follow a career in Nursing. Two Auditors also resigned during the year, to take up positions with the Durham and Tees Valley Audit Consortium leaving one and a half-vacant posts. Despite efforts to recruit to the Auditor post vacated in the previous year, the position has not been filled. On a positive note, the vacant position of Finance Officer was filled part way through the year. As a result, of the various changes a total of 565 days were lost due to vacant posts.

Despite all the changes in personnel and the resulting additional pressures, time lost due to sickness was nearly half that experienced in the previous year.

In addition to the days lost to vacancies and sickness, the time taken to complete audits continued to exceed planned time: that is, jobs took longer than was originally envisaged and there was therefore less time to spend on planned audits. Overruns against planned time could be found on audits of the key financial systems as well as audits of operational systems managed by Services and establishments. Comparisons with other Internal Audit sections established that the time allowed in the annual plan to complete individual audits was adequate. Most of the slippage was against medium priority audits, however the audits of some key financial systems were again carried forward into the following year.

For the first time the Internal Audit Section used external contractors to deliver selected audits.

In recognition of the recruitment difficulties faced by the Internal Audit Section in the last few years, the Director of Resources has indicated in the Statement of Internal Control his intention to review the way that the Internal Audit Service is delivered to address shortages in capacity. The Audit Commission have indicated that they share the Council's concern about the capacity of Internal Audit to deliver an appropriate, risk based work programme and provide the Section 151 Officer and Members with the assurance they need to fulfil their statutory roles.

Section 5

MEASURING THE PERFORMANCE OF INTERNAL AUDIT

The following table summarises the internal audit coverage across all Council Services during 2004/05:

Service	Plan Days	Actual Days
Education		
Life Long Learning	24	90
Standards	5	0
Inclusion	36	32
Planning & Information	63	17
Schools	185	367
Environment		
Transport	33	61
Street Scene	72	76
Housing General Fund	39	45
Housing Revenue Account	64	59
Community Protection	83	5
Sport & Leisure	114	42
Regeneration		
Middlesbrough Town Centre Company	0	0
Museums & Galleries	10	2
Library & Information	43	5
Cultural Services	24	1
Economic Development & Community Regeneration	100	92
Planning & Regeneration	15	1
Social Services	347	193
Corporate Centre		
Finance	69	49
Legal Services	5	0
Chief Executive's Office	3	0
Members' Office	0	3
Performance & Policy	74	74
Corporate Systems	367	446
Contract Audit	94	2
IT Audit	165	58
Contingency	160	86
Total Audit Days	2194	1806

The performance of Internal Audit is shown by the figures shown below.

	Actual for Year
Chargeable days per FTE employee <i>(Audit Commission benchmark = 175)</i>	169
No. of Recommendations made	616
No. of audits completed	99
Completion of annual audit plan	51%
No. of days spent on audits carried forward from previous year	218