Bath & North East Somerset Council		
MEETING:	**Corporate Audit Committee**	
MEETING DATE:	**1st February 2011**	**AGENDA ITEM NUMBER**
TITLE:	**INTERNAL AUDIT – FUTURE SERVICE DELIVERY OPTIONS**	EXECUTIVE FORWARD PLAN REFERENCE: E
AN OPEN PUBLIC ITEM		
List of attachments to this report: **Appendix 1 – Final Report**		

1 THE ISSUE

1.1 The Committee has previously received updates over the last 12 months of a project to review future options for service delivery for Internal Audit in light of the very challenging picture for public sector funding.

1.2 This report sets out the final conclusions and recommendations of this project and asks the committee to endorse these for implementation.

2 RECOMMENDATION

2.1 The Corporate Audit Committee is asked to comment on the report and specifically the recommendations for future service delivery.

3 FINANCIAL IMPLICATIONS

3.1 Financial implications are detailed within the report, these involve savings proposals of 25% of the gross Internal Audit budget which would amount to approximately £105k delivered over 2 years.

4 THE REPORT

4.1 Appendix 1 details the full report which was drafted by the Project Manager to whom significant thanks must go for his support and direction throughout the course of the project. A summary of the report is detailed as follows:-

1. <u>Introduction Background</u>

1.1 Internal Audit is defined by the CIPFA Guideline as;

"…..*an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources".*

1.2 Auditors in the public sector have a pivotal role to play in ensuring that public funds are administered properly, economically, efficiently and effectively, in the interests of the public and there is an expectation by the community that audit is protecting the public purse.

1.3 In Local Government, an internal audit service is a mandatory requirement; and all principal authorities in England and Wales are required by statute (under the Accounts and Audit Regulations and section 151 of the Local Government Act 1972, to have an adequate and effective internal audit function.

1.4 Since the last round of local government reorganisation in 1996, the Bath & North East Somerset Council Internal Audit has been delivered by an in-house team. The team currently stands at 9 FTE (7 F/T and 3 P/T staff) having been reduced from a staffing number of 14 in 1996.

In addition the team also carries out the Internal Audit of the Avon Pension Fund, all Schools (including the assessment of the Financial Management Standard in Schools) and works jointly with the audit and counter fraud service of B&NES PCT.

1.5 The gross expenditure budget for the service in 2010/11 is £434K with a net budget of £285K primarily as a result of a number of recharges which have been historically built into the budget since 1996.

1.6 In terms of benchmarking the service has, for the last ten years, participated in a national exercise co-ordinated by CIPFA (IPF).

In summary, in terms of cost, the team has consistently demonstrated a cost per day at approximately 5% - 10% lower than the Unitary average and in relation to quality, productivity and coverage it is at average levels.

1.7 During the end of 2009 the Council engaged consultancy support from PwC to carry out a Council wide diagnostic exercise to identify a range of potential solutions to its medium to long-term organisational planning. One of the areas identified for further work - amongst many others - was the Support Services block managed primarily by the Strategic Director for Resources.

1.8 Internal Audit is part of the Risk & Assurance service which is one of the smaller service blocks of the Support Services portfolio in terms of staff and budgets.

1.9 At the same time as the diagnostic exercise was being carried out, medium term service and resource plans were being prepared by each Divisional Director to indicate both priorities and objectives for the coming year and outline plans for future years.

1.10 When taking into account the indicative budget reductions being planned over the medium term at that time - at least 20% over 4 years - Internal Audit was identified as an area where further work was necessary in order to prepare itself properly to meet these tough challenges.

1.11 The key reasons identified at this time were:

a) Medium Term budget reductions would inevitably result in redundancies from 2011/12;

b) Without adequate service planning there would be a ‘tipping point’ at which the service could no longer deliver at a basic level;

c) Productivity and coverage of key risk was at average levels;

d) Skills gaps were evidenced (primarily in IT and Procurement);

e) Service Delivery was likely to be more complex in the future (less in-house provision).

f) Impacts of increasing numbers of schools becoming Academies and the potential for Adult Social Care and Health functions to form a Social Enterprise.

1.12 The independent nature of Internal Audit meant that whilst it is part of the Support Services ‘block’, options on its future, were not linked and therefore these would need to be considered separately.

1.13 It was therefore decided to carry out a specific project to review the medium term options for the future and a brief was prepared and presented to the Audit Committee in February 2010.

2. Objectives

2.1 To review a range of options for the delivery of Internal Audit services in the medium to long-term and recommend an option for implementation

2.2 **Options to be Assessed**:

- In-House Model (Restructure)
- Outsourced Model (100% of service outsourced
- Co-Sourced Model (At least 50% outsourced)
- Partnership Models (i.e. Existing or New Partnerships)

2.3 **Scope**:

To cover the whole range of Internal Audit Services for the Council:

- Risk Based Planning
- Core Systems/Risk Based Audit
- Grant Return Audit
- FMSiS Assessments for Schools
- Specialist Audit, i.e. Pensions, IT or Procurement Audit
- Fraud & Investigation Reviews
- Policy & Procedural Guidance
- Joint working with External Auditor & Inspectorates
- Joint working on Annual Governance Review
- Joint working with PCT Internal Audit & Counter-Fraud Services
- Joint working with Audit teams within the South West region
- Reporting to Corporate Audit Committee

3. Approach

3.1 A project team was formed and an external Project Manager appointed to manage the process and provide specific independent challenge. The individual appointed has specific experience of managing local government internal audit and of letting internal audit contracts.

3.2 Four key stages were identified

- Planning
- Research
- Options Appraisal
- Reporting

3.3 The key stage of options appraisal was based around assessing each of the models against the following key criteria which were grouped and weighted in terms of a score.

Standards & Quality – 30%

- Audit Methodology
- Quality Control
- Leadership
- Access to Specialist Skills

Staff & Skills – 20%

- Investment in People
- Use of Audit Automation
- Terms and Conditions

Organisational – 25%

- Strategic Fit
- Track Record
- Use of Resources
- Governance & Accountability

Financial/VFM – 25%

- Cost of Implementation
- Flexibility of Future Costs
- Cost of Service

4. Summary of Options Appraisal

The scores were assessed through a mix of objective and subjective data collected through the different phases of the project. These were then independently challenged by the Project Manager.

In general the partnership model of service delivery - where services are shared between local authorities - has been assessed as the most effective in the long term. A summary of each assessment is detailed below followed by the assessment table.

4.1 New CUBA Partnership Model

4.1.1 This model scored the highest and was assessed as being the most effective and sustainable form of service delivery in the long-term.

4.1.2 **Key strengths**:

- Partnership delivery with neighbouring local authorities fits strategically with the future model of the organisation as well as the expectations of the new government in finding more efficient methods of service delivery;
- Providing Internal Audit through an independent Partnership strengthens both its profile and independence and enables a pooling of skills and resources which cannot be achieved when delivery services to only one organisation;
- All four Authorities already work closely together and have accepted a joint partnership provides a strong long-term option;
- Bristol City Council have moved a step further to state that it is serious in working with B&NES to develop a partnership in the next 12 - 24 months;
- All four Authorities are currently part of the West of England Partnership and agreed to work within the new Local Enterprise Partnership thereby strengthening the strategic fit of this model;
- Overheads would be lower than buying into an existing partnership which is spread more geographically, i.e. SWAP Partnership works across all of Somerset, Dorset and parts of Devon;
- Geographically the relatively compact size of the CUBA area also enables a more efficient organisational set-up by hosting all staff in one place but enabling them to deliver services to all partners, rather than being fixed on only one authority;
- There is no significant loss of strategic control, influence or local knowledge as the number of partners is relatively low as opposed to the main existing partnership model (SWAP) which currently has 11;
- Integrating resources through partnership strengthens standards and improves opportunities for staff and career development and ultimately provides greater resilience for the future.

4.1.3 **Key Issues**:

- The partnership would be based on a 5 or 10 year legal agreement which can be approved without the need for any procurement exercise. However it has to be formed from scratch and so set-up costs and timescales to implement are relatively long, it is estimated it would take at least 12 – 24 months;
- At present only one Authority is in a position to work with B&NES (Bristol CC) to implement a partnership. This in itself is not particularly negative as it will speed up implementation and enable the other 2 authorities to join at a later stage much more easily;
- Rebasing of budgets before joining the partnership is critical. B&NES Internal Audit will be reducing costs by 25% before a partnership is formed so providing stability for the immediate future (3 - 5 years). Other partners must also reflect on their costs before entering the partnership and decide on their own client arrangements;
- The partnership would be based on one authority 'hosting' the partnership, a single head of partnership and having a single methodology and supporting systems and software and IT links to partners networks;
- All staff would transfer to the 'hosting' authority but would retain all other employment rights, i.e. local government terms and conditions and access to the pension scheme;
- The partnership would however have freedom to operate as a separate entity within this framework and would have its own 'branding' and operating name;
- The Head of Partnership would report to a Partnership or Management Board consisting of each partner. This board would sign off the budget, business plan and audit and resource plans for the partnership;
- Existing Audit Committees would remain as now for each partnership authority and the Head of Partnership would report direct to each committee on the performance of Internal Audit;
- There is a wider opportunity to link together in the long-term with the SWAP partnership and other regional delivery models to provide even greater efficiency and resilience including sharing contracts and resources;
- Initially the partnership would be for B&NES and Bristol CC to form but would be set-up to allow North Somerset, South Gloucestershire and potentially other local authorities or other public sector bodies to join in future years;
- It is recommended this option is seriously considered for the medium to long-term as part of a phased implementation and an optimum time for implementation would be the 2013/14 year.

4.2 In-House Re-Structure

4.2.1 This model was assessed as second and scores very highly in terms of the short term - at least 2 years - and is the easiest and most economical to implement.

Key Issues:

- Enabling an in-house team to continue to deliver Internal Audit when resources have been reduced by 25% is only viable if it is integrated with the Risk Management function;
- This effectively means creating a joint audit and risk team and replacing the redundant auditor posts resource from the risk management team, which would equate to an extra 200 audit days;
- The key advantages of integrating the functions are significant savings in time, cost and management capacity. The re-structure could be fully implemented in less than 3 months for no cost;
- The new team will give between 9% and 15% more audit coverage than the other proposed partnership models and be able to replace some of the skills gaps, i.e. procurement;
- There will be a stronger emphasis on risk based auditing and whilst there will be a reduction in risk management support to services, this can be mostly replaced through targeted audit coverage;
- As the authority will be going through a severe period of organisational change, risks of fraud and misuse of resources are much higher and so having full flexibility and control of audit resources throughout at least a 2 year period is assessed as being highly beneficial;
- The restructure would be based and operated on preparing for partnership by re-evaluating audit planning methodologies and re-prioritising investment in standards and training;
- It is therefore recommended that the in-house restructure is chosen as part of a phased approach to longer-term partnership by implementing it immediately for a period of at least 2 years.

4.3 SWAP (South West Audit Partnership) Model

4.3.1 This model scored third in the assessment and has broadly the same strengths and issues as a new CUBA partnership except for the following differences:

- The SWAP partnership is hosted from South Somerset District Council, has 11 partners including 2 Counties (Somerset and Dorset) and a number of District Councils all the way down to Weymouth and Portland;
- The partnership has been in existence for over 5 years and has an extensive set of governance and legal arrangements in place;
- Geographically the partnership is spread over a vast distance so organisationally existing teams primarily stay serving their original authority with some minimal flexibility outside of this, in terms of working for different partners;
- Whilst the strengths are primarily the same as a new CUBA partnership would be, its key advantage is that it is already in existence and is successful and therefore set-up and implementation is relatively short (3 - 6 months);
- However as a model it is not considered to be as strong as a new, more local partnership which would have lower overheads, a stronger strategic fit in terms of joint working and a more flexible operation by having a single ‘hosted’ team working on a variety of partners.
- Additionally there would be a substantial loss of strategic control and influence due to the number of partners within the partnership and in most cases those partners have yet to ‘downsize’ their audit budgets thereby creating additional risk in the medium term;
- As all local authorities will be going through a period of severe organisational turbulence and change it may be advisable to delay any decision on joining SWAP until the future is clearer and the impacts on the SWAP partnership are evidenced;
- It is recommended this option is retained as an alternative solution position for potential implementation in 2013/14 in case a new local CUBA partnership is not able to be implemented or delivered.

4.4 Co-Sourcing & Outsourcing

4.4.1 Co-Sourcing is effectively downsizing the team by approximately 50% and then letting out that part of the audit service to external providers, i.e. IT Audit or Core Systems Audit. Outsourcing is transferring the whole function to an external provider (i.e. PwC). These models scored fourth and fifth.

Key issues:

- In theory both these models should work well, with the ability to replace skills gaps and invest in areas of highest risk;
- Key advantages are an ability to flex costs, seek private sector expertise and enable standards to rise;
- However, research identified that the co-sourced model had been generally ineffective in relatively small audit functions with poor standards, inconsistent management and effectively two different sets of methodologies being employed;
- Additional compulsory redundancies would be required to further reduce the audit function by at least 25%. This reduction would be both costly (and unaffordable) and would not replace the skills being lost with anything that was discernibly different;
- In terms of outsourcing the market told us that they would prefer to use their own staff and not TUPE existing staff into their own organisation. The relative size of our service was not therefore attractive enough to make it a viable proposition;
- However in the short-term there could be cost advantages but these were countered by little in the way of any track record of positive service delivery and an uncertain future for staff transferred. Indeed there was no history of a sustainable and quality service being delivered by an external firm for a Unitary Authority;
- In addition, the loss of any real flexibility of the audit resource through a time of severe organisational change was not considered to be advantageous;
- Implementation would take at least six months and involve a significant amount of management capacity and the value of either exercise was not considered beneficial;
- It is recommended that neither option is chosen.

4.5 Assessment

Detailed on the next pages is the scoring assessment table, together with an analysis for each of the options, and the implications on audit coverage in terms of numbers of days and estimations of cost and timescales of implementing each option.

Scoring Assessment Table

Overall Summary of Options		%	WEIGHTING	In House Restructure	Co-Source	Existing Partnership (i.e. SWAP)	New Partnership (i.e. CUBA)	Fully Outsourced
Standard & Quality	**TOTAL SCORE**	**29%**	**10**	**33**	**32**	**36**	**37**	**34**
Audit Methodology			3	9	9	9	9	9
Quality Control			3	12	9	9	12	9
Leadership			2	8	6	8	8	6
Access to specialist skills			2	4	8	10	8	10
Staff	**TOTAL SCORE**	**20%**	**7**	**22**	**22**	**28**	**25**	**19**
Investment in People			3	9	9	12	12	9
Use of audit automation			1	4	4	4	4	4
Terms and Conditions			3	9	9	12	9	6
Financial / VFM	**TOTAL SCORE**	**26%**	**9**	**36**	**21**	**27**	**27**	**21**
Cost of Implementation			3	15	6	9	3	6
Flexibility of Future Costs			3	6	9	9	12	9
Cost of Service			3	15	6	9	12	6
Organisational	**TOTAL SCORE**	**26%**	**9**	**33**	**30**	**32**	**37**	**27**
Strategic fit			3	9	12	12	15	9
Track Record			2	6	4	6	6	6
Use of resources			2	10	8	6	8	6
Governance and Accountability			2	8	6	8	8	6
	TOTAL SCORE	**100%**	**35**	**124**	**105**	**123**	**126**	**101**

Analysis of Top 3 Options	In House	Existing Partnership (i.e. SWAP)	New Partnership (i.e. CUBA)	Explanation of Scoring
Standard & Quality	**33**	**36**	**37**	
Audit Methodology	9	9	9	Equal score for each option
Quality Control	12	9	12	The SWAP model was assessed as having less direct management resource than could be provided in the future through an in-house restructure or new CUBA partnership. The potential implication of this would directly affect quality control.
Leadership	8	8	8	Equal score for each option
Access to specialist skills	4	10	8	SWAP currently have access to a broader range of specialist skills via a mix of internal skills but moreover, an external contractor. A new CUBA Partnership could mirror a similar arrangement, whilst the in-house option could not match either model.
Staff	**22**	**28**	**25**	
Investment in People	9	12	12	Economies of scale allow both SWAP and a new CUBA partnership to invest more in staff in terms of professional training and career development. This area is currently a particular strength of the SWAP model.
Use of audit automation	4	4	4	Equal score for each option
Terms and Conditions	9	12	9	Although not in every case, the SWAP model is able to offer the potential for improved pay for staff.
Financial / VFM	**36**	**27**	**27**	
Cost of Implementation	15	9	3	The In-house model would be almost cost neutral and achieved in a very short timescale. The SWAP Model would take longer but has the benefit of a tried and trusted approach with its existing partners, thereby saving time and cost. A new CUBA Partnership has to be built from scratch and will therefore take the longest to implement, although SWAP have offered to assist in the implementation process.
Flexibility of Future Costs	6	9	12	Very significant savings are being delivered upfront. Due to the very nature of the models, the in-house option then has very limited to no scope to deliver further savings in the next 3-5 years. Due to their size and scale, the partnership models have more opportunity to achieve efficiencies. The new CUBA model is considered to have the greatest long-term opportunity due to the way the model would be constructed.
Cost of Service	15	9	12	All the models deliver less audit days than currently. The in-house restructure delivers the most coverage in terms of audit days as it is replacing lost resource with new skilled staff from the risk management function. SWAP delivers a reasonable return on its cost per day but it was assessed that a new CUBA model could deliver approx 5% more coverage due to the way the model could be structured and potential for lower overheads.

Analysis of Top 3 Options	In House	Existing Partnership (i.e. SWAP)	New Partnership (i.e. CUBA)	Explanation of Scoring
Organisational	**33**	**32**	**37**	
Strategic fit	9	12	15	The partnership options score well but the new CUBA model provides a perfect fit in terms of the future council model and the direction of travel of support services in general through public/private sector partnership.
Track Record	6	6	6	Equal score for each option
Use of resources	10	6	8	An in-house service offers total (100%) control and flexibility over the audit resource which enables it to score highest. This flexibility is considered important in the short term (2 years) whilst the overall organisation is changing significantly. The new CUBA model scores slightly better than the SWAP model based on the way it was assessed that the resource would be set up and allocated.
Governance and Accountability	8	8	8	Equal score for each option
	124	**123**	**126**	

	2011/12			2012/13			2013/14			2014/15		
	In-house	SWAP	CUBA	In-house	SWAP	CUBA	In-house	SWAP	CUBA	In-house	SWAP	CUBA
Proposed Annual Savings (Cumulative in Brackets)	£45K	£45K	£45K	£60K (£105K)	£60K (£105K	£60K (£105K)	-	-	-	-	-	-
Proposed Savings as % of Gross/Net Expenditure	10% (Gross) 16% (Net)	-	-	15% (Gross) 25% (Net)	-	-	-	-	-	-	-	-
One-Off Set-up Costs	-	-	£10K	-	£15K	£10K	-	-	-	-	-	-
Set-up Timeframe	Implemented by April 2011	No Work in 11/12	All of 11/12 (12 Mths)	-	Oct – Mar (3 - 6 Mths)	All of 12/13 (Up to 12 Months)	-	-	-	-	-	-
Set-up Complexity	Implemented (V. Low)	-	High	-	Med	High	-	-	-	-	-	-
Estimated Audit Days (Currently 1609)	1423	-	-	1423	-	-	1423	1235	1310	1423	1235	1310
Transfer of Risk for Service Delivery	None	-	-	None	-	-	None	Yes	Yes	None	Yes	Yes

5. Recommendations

The following recommendations are made in relation to the future service delivery for Internal Audit based on the results of the above assessment above.

It is recommended that:

a) Planned redundancies and reductions in budget in Internal Audit are implemented to reduce costs by approximately 25%.

b) No further reductions or cuts proposed for internal audit for 5 years within this period and costs fixed at this new level.

c) The remaining in-house team is restructured and integrated with the risk management function with effect from the 1st of April 2011.

d) Service delivery to be maintained in-house for a period of at least 2 years pending the results of the work on the alternative partnership models.

e) Risk Management support to be reduced and replaced with a strengthened risk-based approach to audit coverage of service areas.

f) Development work with Bristol CC is sanctioned to start in 2011/12 to investigate the detailed model for a potential internal audit partnership to cover both authorities.

g) Any model should be flexible to take into account the client roles of the respective authorities and be able to add additional parties as required.

h) The model is based on a single shared service to be hosted by one authority with audit teams from both organisations fully integrated.

i) That a report to be received back to the respective audit committees by April 2012 on the full implications and detailed requirements of the new proposed partnership model.

j) Full implementation is to be proposed from April 2013 for at least a 5 year period with shadow arrangements to be in place during 2012/13.

k) It is agreed that the SWAP (South West Audit Partnership) is retained as an alternative solution if it is decided that a local partnership cannot be implemented or agreed upon by April 2012.

l) If this is the case approval for SWAP to deliver Internal Audit for B&NES should be taken by June 2012 to enable implementation by April 2013.

6. Staffing & Financial Implications

6.1 Budget

6.1.1 In order to implement any of the proposed options it is recommended that the audit service should plan effectively for a stable future and so the equivalent of a gross 25% reduction in resources is proposed. This will then enable the future team to have some sense of certainty in the medium term by fixing the budget for future years.

6.1.2 Financially this results in a total reduction of approximately £105K in audit resources over 2 years and equates to approximately 3 members of staff.

6.1.3 The cost of redundancies and any resulting strain on the fund will be repaid by the service in accordance with the corporate requirements agreed by the Strategic Directors Group and Cabinet.

6.1.4 The revised budget and costs for internal audit should be fixed for between 3 and 5 years with no further reductions or cuts proposed within this period.

6.2 Redundancies

6.2.1 During summer 2010, an exercise was carried out to identify those staff wishing to take voluntary redundancy within Internal Audit.

6.2.2 Two members of Internal Audit staff volunteered and have been accepted for redundancy, one of these left in November with the other leaving in March.

6.2.3 The integration of the risk management and internal audit teams places both posts of Audit Manager and Risk Manager at risk.

6.2.4 Following discussion, the Audit Manager has also volunteered for redundancy and early retirement during 2011/12.

6.2.5 The three volunteers therefore enable a saving of 25% of the gross budget.

6.3 Impact of Redundancies

6.3.1 The impact of losing staff through redundancy means that the existing Risk Manager will become the new Group Manager (Audit & Risk) with responsibility for both the provision of Internal Audit and Risk Management (including all Corporate Governance functions).

6.3.2 The Corporate Governance Manager will also move across to the wider audit and risk team and be structured into an Audit Team Leader post entitled Risk & Governance to simplify the structure.

6.3.3 The previous posts of Audit Manager and Risk Manager would be deleted.

6.3.4 All other staff will remain in their existing posts with the only effective change being a new manager of the two functions.

6.3.5 These changes are recommended to be implemented by the 1st of April 2011.

6.3.6 The current Audit Manager will remain until August 2011 to ensure a smooth transition, to be able to work on the development of the partnership with Bristol CC and complete a number of specific outstanding one-off projects.

6.3.7 The wider impact of deleting the post of Risk Manager will mean the Business Continuity & Emergency Planning Manager reporting direct to the Divisional Director and a minor restructure required in the Information Governance team to ensure a reporting line direct to the Divisional Director.

5 RISK MANAGEMENT

5.1 A proportionate risk assessment has been carried out in relation to the Councils risk management guidance.

6. EQUALITIES

6.1 A proportionate equalities impact assessment has been carried out using corporate guidelines, no significant issues to report.

7 CONSULTATION

7.1 Consultation has been carried out with the Section 151 Finance Officer, Cabinet Member for Resources and Chief Executive.

8 ADVICE SOUGHT

8.1 The Council's Section 151 Officer has had the opportunity to input to this report and have cleared it for publication.

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Background papers	Feb 2010 Audit Committee - Project Brief – Internal Audit Options for Future Service Delivery
Please contact the report author if you need to access this report in an alternative format	