



Committee report

Committee	AUDIT COMMITTEE
Date	30 JULY 2018
Title	FUTURE ARRANGEMENTS FOR INTERNAL AUDIT
Report of	THE HEAD OF RESOURCES

EXECUTIVE SUMMARY

1. This report considers the options open to the council for the future provision of its internal audit service. The council, through its Section 151 Officer, has a legal obligation to provide an efficient and robust internal audit service in order to evaluate and report on the effectiveness of risk management, control and governance processes. In doing so, the council's Section 151 officer also has an obligation to secure value for money for the council in the delivery of such a service. The recommendations set out in this report seek to best achieve these two key objectives.
2. In doing so the report seeks to evaluate the options open to the council for the future provision of the internal audit service, including consideration for a further extension to the current contract with PricewaterhouseCoopers LLP (PwC), followed by a full re-tendering exercise at the end of the contract term and the potential opportunities presented by the development of a joint internal audit service with Portsmouth City Council. These options are reviewed in the context of the continuing imperative to seek value for money as well as efficient and effective service provision.
3. The report takes into account the advantages and disadvantages of the available options, including issues relating to the adequacy of the current contract specification for the service; the potential to secure value for money; PwC's contract performance to date and opportunities presented by the current arrangements with Portsmouth City Council in the provision of the Chief Internal Auditor function.

BACKGROUND

4. Internal audit is a statutory function required by the Accounts and Audit Regulations 2015. It forms part of the requirement for the Section 151 officer to discharge responsibilities for the proper administration of the council's financial affairs under the Local Government Act 1972. The Accounts and Audit Regulations 2015, Part 2 Section 5: Internal Audit state, "*a relevant authority must undertake an effective internal audit to evaluate the effectiveness of its risk management, control and governance purposes, taking into account public sector internal auditing standards or guidance*".

5. The purpose of internal audit is to undertake an annual review of functions of the authority, to enable it to provide an opinion as to the effectiveness of the control framework within which the authority operates. The audit coverage should be sufficiently broad to enable this advice to be relied upon.
6. An internal audit service is required to comply with the Public Sector Internal Audit Standards (PSIAS). Under these standards, internal audit makes an annual assessment as to governance, risk management and control.
7. Since July 2010, following a full procurement exercise, the Isle of Wight Council has contracted out its internal audit service to PricewaterhouseCoopers LLP for an agreed annual sum. This arrangement was extended under the existing contractual agreement in May 2013.
8. Following a further full procurement exercise in July 2015, PwC were re-appointed as the service provider for a three-year period which expires in July 2018. There is provision for the agreement to be extended beyond its initial term for a period of up to two further years. The first year of this extension, to July 2019, was approved by Audit Committee at its meeting in December 2017.
9. Under the contractual agreement, PwC charge the council an agreed annual sum, which for 2018-19 has increased from £184,222 to £188,020.
10. On 1 April 2017, the Isle of Wight Council entered into a strategic partnership arrangement with Portsmouth City Council for the provision of the Chief Internal Auditor role. This is a vital role in supporting the Section 151 Officer in delivering the council's statutory duties and ensuring that the council has good governance arrangements and also acts in the capacity of contract manager in the delivery of the internal audit services as commissioned under the council's contract with PwC. The role also provides independent and objective advice to Audit Committee members.
11. The contract specification agreed with PwC provides that the internal audit service will:
 - (a) be provided across a range of activities;
 - (b) investigate internal fraud and corruption when requested to do so for an anticipated additional charge;
 - (c) improve the internal audit outcome through quality and increased cost efficiency.
12. A headline summary of the internal audit, PwC provision since 2015/16 is set out below.

Internal Audit, PwC provision for the year 2015/16
13. PwC undertook to complete 21 audits within the year. The average charge per audit was £8,772, based on the annual agreed sum of £184,222.

Internal Audit, PwC provision for the year 2016/17

14. PwC undertook to complete 19 audits within the year. The average charge per audit was £9,696, based on the annual agreed sum of £184,222.

Internal Audit PwC provision for the year 2017/18

15. PwC has undertaken to complete 25 audits within the year. The average charge per audit will be £7,368, based on the annual agreed sum of £184,222.

Internal Audit PwC provision for the year 2018/19

16. PwC has committed to undertake to complete 21 audits within the year. The average charge per audit will be £8,953, based on the annual agreed sum of £188,020.
17. In each year a number of audits were considered optional and dependent on resource availability.

CONSIDERATIONS

18. Now is an appropriate time to review the future provision of an internal audit service for the Isle of Wight Council because:
- (a) A decision is needed before July 2019 as to whether or not to extend the current provision by PwC. This is likely to be required by December 2018, in order to offer due notice, should it be determined that the contract be terminated, and, in that scenario, to take any necessary transitional steps.
 - (b) An opportunity has been presented by the potential expansion of the Portsmouth City Council provision of Chief Internal Auditor Services, to consider whether an outsourced solution continues to represent the most appropriate option for the Isle of Wight Council.
 - (c) Ongoing financial pressures necessitate continuing consideration of all the opportunities for achieving value for money for the residents of the Isle of Wight.
19. In completing this review, there are several areas which merit consideration:
- (a) The adequacy of the current contract specification.
 - (b) The value for money generated by an outsourced or co-sourced solution.
 - (c) PwC's contract performance to date.
 - (d) The possibilities available by expanding the current partnership arrangements with Portsmouth City Council in the provision of Chief Internal Auditor services.

Each element is discussed in detail in the sections which follow.

Adequacy of the current contract specification

20. The current contract specification developed by the Isle of Wight Council for the period July 2010 to date has delivered audits that cover 60 per cent of the audit universe, however this has also resulted in the following:
- 40 % of the audit universe (133 Audits) has not been audited since 2010 although audits have been undertaken in the council's highest risk areas. (It should be noted that the current audit universe does not include all relevant Children's Social Care Services or Fire & Rescue and therefore the percentage of auditable areas not audited since 2010 are higher than 40 %)
 - 16 % (22/133) of the audit universe are medium to high risk auditable areas - these have not been audited over the period.
 - 29% of all auditable areas are not undertaken within the recommended frequency.
21. Key risk areas identified by the council's Section 151 officer that are not covered by the current contract specification, include:
- Delivery of counter fraud arrangements, including a programme of activities encompassing training, awareness and ongoing fraud checks.
 - Investigations.
 - Data analytics, for example the identification of duplicate payments.
 - National Fraud Initiative (mandatory requirement by the Cabinet Office).
 - Grant verifications.
- These gaps in contract specification are currently sourced through the council's strategic partnership with Portsmouth City Council for the provision of the Chief Internal Auditor function.
22. A key consideration for the committee will be whether the extent of the audit coverage specified by the council, in its current audit contract is sufficient to provide the necessary assurance to the council that its major risk areas are operating adequately.
23. Under a budget provision of £188,020 the agreement with PwC is naturally limited with regard to the extent of resources that can be dedicated to the council for internal audit activity and this is reflected in the audit coverage each year. In consequence, the annual audit opinion is based on a lesser coverage of both risk and the audit universe.
24. Within the current contractual arrangement, there is no capacity to take on special investigations without additional costs being incurred or there being a resultant detrimental impact on the extent of audit coverage that can be achieved.
25. Any extension of the contract would be subject to an indexation (the means of aligning charges to the costs of providing the service, based on numerous variables) review which could increase the cost of the service.

Value for Money & Flexibility using Outsourced or Co-Sourced Solutions

26. There appears to be a range of characteristics inherent to the operation of outsourced or co-sourced solutions (outsourced meaning by an external provider under contract for services and co-sourced meaning where services are a combination of both in-house and external provider), which either result in additional, potentially unbudgeted costs, or restrictions on the flexibility of the internal audit service, in year.
27. One such challenge is that any additions to the agreed audit plan either incur additional cost (charged at full rate), or require the new work to be swapped with an existing audit. When considering new work, which may arise from time to time as the council responds to emerging situations, the external provider automatically has first call, meaning that value for money cannot be guaranteed with sufficient certainty.
28. The current contractual arrangement with PwC also means that service flexibility can also be restricted. Tactically, for example, it may be deemed that an audit could benefit from a capability such as the use of data analytics to assist with the audit process. However, this would typically incur additional costs, should it be deemed a necessary tool for the audit. Such a situation may result in a reluctance to deploy the best solutions, to minimise unplanned spend.
29. As these arrangements involve a contracted and therefore regulated, client-supplier relationship, there may be formalities applied (e.g. by provider working practices), which impede effective and flexible service delivery. Examples identified through recent or current practice include:
 - (a) Restricted access to the working papers of an audit, which could limit client-side understanding of how findings have been reached.
 - (b) Fixed and inflexible lines of communications (e.g. material only submitted to certain people).
 - (c) Fixed formats for submissions (.pdf), which whilst protecting document integrity, may introduce administrative delay, an example is where pdf, draft reports are issued, which prevents the ability to propose amendments electronically.
 - (d) Outsourced or co-sourced providers not using direct access to systems. This requires extra client side input, as Isle of Wight officers are needed to operate systems.
30. Such elements are not likely to be unique to any particular outsourced or co-sourced provider. In fact they are likely to be a necessary requirement to maintain financial and profit margins any outsourced or co-sourced contracts require. Such arrangements can still represent value for money, where the contract can achieve *significant* savings versus a public sector based offering. However, as the gap narrows, it does become opportune to consider whether removing the profit imperative can aid achievement of value for money and more flexible service delivery.

PwC's Performance Under Contract

31. Outside of the inherent challenges to use of any outsourced or co-sourced model, it needs to be noted that there no material issues with the performance of the current provider, PwC, under the terms of the contract procured. It is also important to

recognise that PwC's performance is not being utilised as the basis for consideration of future service provision arrangements. Rather, the driver for this review is one of a value for money evaluation of the alternative options available together with the potential for additional added value of working in a partnership with Portsmouth City Council that is already in place.

The possibilities available by expanding the strategic partnership arrangements with Portsmouth City Council in the provision of the Chief Internal Auditor function.

32. When the current contractual arrangement with PwC was originally procured 8 years ago, it reflected the best available solution at that time, in terms of circumstances at the time and audit coverage needed. At that time, the current partnership arrangements between the Isle of Wight Council and Portsmouth City Council were not in place, and the breadth of service now offered under the Portsmouth City Council's internal audit service were not as they are. The council has, in recent years entered into a number of strategic partnerships with neighbouring authorities to build capacity and resilience as well as to reduce costs. These partnerships afford stability and growth for all parties involved and present credible alternative opportunities to be considered.
33. Any partnership arrangement in respect of both the scale and scope of internal audit provision would by necessity be subject to the determination of a new partnership agreement and detailed arrangements for any such partnership would be subject to mutual agreement of the terms. The scale and scope of the required audit plan would also need to be determined by the Isle of Wight Council. The potential opportunity that exists is that:
- (a) The internal audit service to be provided within a strategic partnership with Portsmouth City Council. Portsmouth City Council would act as the 'host partner' for the delivery of internal audit services
 - (b) A small team (two members of staff) would be employed directly by the Isle of Wight Council, to work on site, with the balance of services being delivered flexibly and according to identified need, via arrangements established with Portsmouth City Council.
 - (c) Oversight would continue as now, with a shared Chief Internal Auditor, and a shared Section 151 officer.
34. Under this arrangement, potential benefits which could be realised include:
- (a) There would be expanded services available to the council at lower cost. This would include activities not currently covered within the existing contract specification, such as risk management advice; the development of governance policies and associated advice; fraud detection and investigation; whistleblowing and anti-money laundering policy guidance. A counter fraud programme would include coverage of high risk fraud areas such as council tax discounts and potential service user abuse, such as within the direct payments scheme.
 - (b) The synergies that exist between local unitary authorities enable local solutions to be developed, for a unique area. It provides for a local offer, but with the breadth of skills and experiences which match a national organisation.

Currently the Chief Internal Auditor post is a shared post across Portsmouth, Southampton and the Isle of Wight. By developing a shared service across these authorities, the internal audit service would reap the benefits of the existing partnerships, audit officers' local government knowledge and wider local knowledge. There would also be an opportunity for officers across each of the authorities to share insight and best practice with regard to historic audits and high risk areas. Officers would also be able to attend joint training events with a potential cost saving to the council. This has already been utilised for Regulatory Investigative Powers Act 2000 training, undertaken in May 2018.

- (c) There would be greater visible, permanent onsite presence available to the council, enabling the audit team to develop greater local knowledge and to more quickly identify emerging issues and immediately aid the council on matters of advice relating to the control environment.

PROPOSAL

- 35. It is recommended that the committee considers the options outlined below and determines its preference on the direction for the future provision of its internal audit service.
- 36. The four options to be considered are as follows:
 - (a) Option 1: To retain PwC for one further year which will exhaust current contract provisions and then complete a full re-tendering exercise.
 - (b) Option 2: To enter into a strategic partnership with Portsmouth City Council for the provision of an internal audit service. This comes in two potential variants:
 - 2 (a): Retain PwC for one further year which will exhaust the current contract provisions and then enact a partnership agreement.
 - 2 (b): Give the requisite 6 months' notice to PwC then enact a partnership agreement to take effect from 1 April 2019 to coincide with the financial year.
 - (c) Option 3: As per Option 2, but with consideration of local public-sector partners beyond Portsmouth City Council.
 - (d) Option 4: Return to direct delivery of an in-house internal audit solution.

EVALUATION OF OPTIONS

- 37. At this stage, no detailed comparison of potential service offers is feasible. No specification of required internal audit service has been determined by the Isle of Wight Council, against its future needs and not all parties have had the opportunity to fully outline what their future plans might be. However, it is considered possible to complete a strategic options appraisal, based on the fundamental differences between each model in order to assist with decision making.
- 38. In completing an appraisal, the following criteria are used:

Suitability: Effectiveness Economy Efficiency	Feasibility: Deliverability Practicality	Acceptability: Stakeholder view
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Each of these criteria are rated on a simple four point scale (the higher the score, the better). The full appraisal, and definitions for each criteria and score, can be found in Appendix 1.

39. From this appraisal, it is clear that Option 2(b) is the most appropriate option at this time. However, it is recognised that options 1 and 2(a) also remain viable. However, Members are recommended to pursue **Option 2(b)**. This is because:
- It addresses the limitations experienced under a pure co-sourced offer as is currently in place.
 - It provides enhanced opportunities for value for money.
 - It would improve service coverage and flexibility.
 - There would be greater and more responsive onsite presence and enable recruitment from the local area.
 - Transition impacts are minimised, with the entering into a strategic partnership, no re-tendering exercise is required.
 - It aligns with neighbouring authorities who have reconsidered their operational model and brought back in-house services previously outsourced or co-sourced.
 - Supports the council's current strategic partnership ethos and direction of travel.
40. Should option 2(b) be pursued, this would be implemented through the following stages:
- Portsmouth City Council will finalise the audit services offer available to the council.
 - Subject to satisfactory terms, to be agreed by the Chief Executive, the Isle of Wight Council would enter into a strategic partnership arrangement with Portsmouth City Council, under the relevant provisions of the Local Government Act 1972.
 - Formal notice will be issued to PwC for cessation of contract and complete any necessary consultations with affected PwC staff and undertake required transfer processes. Under the Transfer of Undertakings TUPE (Protection of Employment) Regulations 2006 as amended by the "Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations 2014, it is likely that any PwC personnel, who currently complete the bulk of their work for Isle of Wight Council would be subject to transfer.
 - Formalise a new partnership agreement.
 - Recruit the new team, mobilise the new service, recruit and complete the handover from PwC.
41. If agreed, the proposed date for commencement of the new service would be 1 April 2019, to coincide with the new financial year, and associated agreed audit plan. It is proposed that a strategic partnership agreement be put in place for a period of three years, with the option to extend for a further period, to be determined after review. This is considered to afford both stability of service provision, as well as flexibility for

any potential future change in administration and desire to source alternative service provision.

42. Longer term, it is anticipated that the arrangements with neighbouring authorities could evolve into a formal partnership arrangement across the Solent region with shared governance and shared cost saving arrangements.

STRATEGIC CONTEXT

43. The considerations within this report are consistent with the council's corporate objective of securing a financially balanced and sustainable council. The proposed recommendation is also aligned with one of the council's core values to engage with partners to maximise integrated working. As such the proposals and considerations presented are consistent with securing the successful delivery of the council's corporate plan 2017-2020.

FINANCIAL / BUDGET IMPLICATIONS

44. The current budget allocated to Internal Audit has been agreed at £188,020 for the year 2018-19. Should the Committee decide to remain with the existing provision or seek to pursue a full tender option it is anticipated that, with inflation, the cost will remain at a cost of circa £200,000 per annum. In addition to the contract with PWC for the provision of the council's internal audit service, there is an additional costs of £28,000 under the strategic partnership agreement with Portsmouth City Council for the provision of the Chief Internal Auditor function & counter fraud arrangements.
45. Should the committee support the recommended Option 2(b), and enter into a new partnership agreement with Portsmouth City Council for the provision of a shared internal audit service, the costs of providing both the internal audit service and Chief Internal Auditor function would be no more than the anticipated ceiling cost of £200,000 as set out above. This would represent a saving on current expenditure and it is anticipated that there will be a greater level of audit and policy coverage offered as part of the agreement than is currently available. Subject to the agreement between the Section 151 officer and the Audit Committee regarding a lower level of audit coverage but still achieving an acceptable level of control risk, the cost of the shared service arrangement could be lower than the anticipated £200,000 cost.
46. Following development of the service, it might also be possible to provide internal audit services to external clients such as academies and colleges, thereby providing a further income stream to the Isle of Wight Council. Option 2 (b) therefore also provides for potential future income streams and cost savings for the council which other alternatives do not, without disruption to the required level of audit coverage.
47. If the council decides to go out to tender for internal audit provision, a further financial appraisal will be required as a component of that process.

LEGAL IMPLICATIONS

48. Internal audit is a statutory function required by the Accounts and Audit Regulations 2015. It forms part of the requirement for the Section 151 officer to discharge responsibilities for the proper administration of the council's financial affairs under the Local Government Act 1972. The Accounts and Audit Regulations 2015, Part 2

Section 5: Internal Audit state, “a relevant authority must undertake an effective internal audit to evaluate the effectiveness of its risk management, control and governance purposes, taking into account public sector internal auditing standards or guidance”.

49. The legislative authority for local authorities to share services is in the Local Government Act 1972. Section 112 provides that local authorities may appoint officers to enable them to discharge their own functions and any functions they carry out for another local authority. Section 113 allows a local authority to enter into an agreement with another authority to place its officers at the disposal of the other authority, subject to consultation with the staff concerned and negotiation about any changes in terms and conditions. Additionally, section 1 of the Local Authorities (Goods and Services Act) 1970 enables a local authority to enter into an agreement to provide another local authority with goods and services, including administrative, professional or technical services.
50. Whilst the cost of the internal audit function means that in order to enter into a contract, a formal procurement process would need to be undertaken, where two public bodies enter into a shared arrangement, such as that proposed in option 2 (b), an exemption to the need for a formal process can be applied.

EQUALITY AND DIVERSITY

51. The council, as a public body, is required to meet its statutory obligations under the Equality Act 2010 to have due regard to eliminate unlawful discrimination, promote equal opportunities between people from different groups and to foster good relations between people who share a protected characteristic and people who do not share it. The protected characteristics are: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation.
52. Under the Equality Act 2010 we are required to have due regard to our equality duties when making decisions, reviewing services, undertaking projects, developing and reviewing policies. The contents of this report are not considered to have any affect the protected characteristics under the Equality Act 2010.

RISK MANAGEMENT

53. The internal audit service needs to be sufficient to review the internal control framework of the authority. The audit coverage therefore needs to be of an appropriate extent to enable the Chief Internal Auditor to give an annual opinion. If reliance cannot be placed on internal audit provision, external audit will be required to undertake further work, at greater cost to the authority.
54. Where there is insufficient audit coverage, the council also exposes itself to reputational risk in circumstances where it is viewed to operate an inadequate internal control framework.

EVALUATION

55. The overall aim of this report, from the considerations and options presented, is to assist members of the Audit Committee to determine the most cost effective means by which to deliver its internal audit service, secure the broadest possible audit coverage

to minimise risk exposure to the council and in meeting its statutory duties and responsibilities.

56. Four options have been identified and evaluated (under Appendix 1) and from this, a proposed way forward has been identified and a recommendation made.

58. RECOMMENDATION

Members of the Audit Committee are recommended:

- (a) To take the opportunity to consider the future arrangements for the council's internal audit service provision for the council.
- (b) To give consideration to the options presented within this report.
- (c) That subject to the agreement of mutually accepted terms, to agree option 2 (b) as the preferred option, that is:

“To enter into a strategic partnership with Portsmouth City Council for the provision of an internal audit service with effect from 1 April 2019 and give the requisite six months' notice to PwC with immediate effect.”

APPENDICES ATTACHED

[Appendix 1](#) - Options appraisal and associated scoring regime, for future provision of internal audit services for the Isle of Wight Council.

BACKGROUND PAPERS

Isle of Wight Council Internal Audit Plan 2015/16

Isle of Wight Council Internal Audit Risk Assessment and Plan, 2016/17

Isle of Wight Council Internal Audit Risk Assessment and Plan, 2017/18

CLAIRE SHAND
Head of Resources

COUNCILLOR MICHAEL MURWILL
*Cabinet Member for
Procurement, Projects and Forward Planning*