

By: David Tonks, Head of Audit and Risk
To: Governance and Audit Committee – 16 March 2011
Subject: **Audit Opinions and Recommendations**
Classification: Unrestricted

Summary: This paper sets out changes to audit opinions and recommendations that will be introduced for work completed as part of the 2011/12 Audit Programme.

FOR DECISION

Introduction and background

1. The Internal Audit section are asked by the Council, Committees, management, and other stakeholders (such as central government) to provide opinions as part of each individual audit engagement as well as on the overall adequacy of governance, risk management, and control within the Council. These requests may be for an assurance or opinion at a broad level for the Council as a whole (macro-level opinions) or on individual components of the Council's operations (micro-level opinions).
2. It is the view of the Head of Audit and Risk that the current "assurance levels" issued by Internal Audit need to be changed to meet the needs of stakeholders across and outside of the Council, and provide better clarity as to the assurance being given. Linked to this, the way in which recommendations are currently graded must be changed, so that the priority status is aligned to the current perception held by stakeholders across the Council.
3. It is best practice that stakeholder requirements for internal audit opinions, including the level of assurance required, should be clarified by the "Chief Audit Executive" (i.e. Head of Audit and Risk) with senior management (i.e. CMT) and the Audit Committee. CMT have already endorsed the principles outlined in this paper.

Context

Positive Assurance Opinions

4. Positive assurance or reasonable assurance opinions provide the highest level of assurance and are one of the strongest types of audit opinions. In providing positive assurance, the auditor takes a definite position, which can be binary in nature but may also include the use of a grading system. Where relevant, the expression of the opinion may also include information about the direction of the opinion since a previous audit.
5. KCC Internal Audit currently issue positive assurance opinions using the gradings of High, Substantial, Limited and Minimal. Whilst the gradings are defined, superficially there is a lack of distinction between the lowest two levels of limited and minimal, and there is no opportunity for the auditor to conclude that no assurance can be provided based on the evidence available.

6. In addition, the present definitions of the ratings (which are not repeated here) introduce concepts from risk management, whilst also being described in summary as relating to controls. Latest risk management practice recognises that there must be a strong link between audit assurance and risk management, but basing assurances on the likely exposure to risk introduces a layer of complexity to the opinions that is not well understood, either by stakeholders or to some extent the current audit staff. This therefore diminishes the value of the assurances provided.

Audit recommendations

- 7. At the conclusion of the audit reviews, the auditor currently assesses the risks resulting from the control weaknesses identified. These risk ratings use the categories ●● Critical, ● High, ● Medium and ● Low.
- 8. These ratings relate to the risk arising as a result of a potential control failure, and not the priority for implementing the recommendation made to improve the control environment. There will usually be a strong correlation between these two, but the result is that stakeholders, and on occasion auditors, talk in terms of “critical” or “medium” recommendations, inferring priority for rectification, leading to a perception gap. This process also introduces another aspect of “risk” that is not yet linked with the risk management framework of the Council, and does not feed into the Risk Based Audit planning presently used by Internal Audit.

Summary of the proposed changes

Audit Opinions

9. Internal Audit will continue to issue positive assurance opinions for the majority of the reviews completed in any one year. The annual opinion issued by the Head of Audit and Risk will also be based on this model. However, from the 2011/12 audit year the description of the assurance will be amended and the definitions relating to the assurance provided will now focus more explicitly on controls to manage risk. The new assurance levels and definitions will be:

Assurance Level	Definition
Full	The controls evaluated are well designed, appropriate in scope and applied consistently and effectively. Any issues identified are minor in nature and should not prevent objectives being achieved.
Substantial	The controls evaluated are generally well designed, appropriate in scope and applied consistently and effectively, but weaknesses have been identified that require management attention. These issues increase the possibility that objectives may not be achieved.
Limited	Some controls evaluated are generally well designed, appropriate in scope and applied consistently and effectively. However, issues of poor design, gaps in coverage or inconsistent or ineffective implementation have been identified that require immediate management attention. The issues identified, if unresolved, mean that objectives may not be achieved.

Assurance Level	Definition
No assurance	Expected controls are absent, or where evaluated are flawed in design, scope or application. The auditor is unable to form a view as to whether objectives will be achieved.

10. In addition to the above, three other concepts will be introduced:

- Qualified opinions
- Pure compliance opinions
- Negative assurance opinions

Qualified Opinions

11. This concept will replace the use of “split assurance opinions” that are currently used by Internal Audit. Qualified opinions will be only be given where the auditor feels that awarding a lower level opinion is not justified because the issue identified is known to be unusual in nature and/or not typical of the normal practice in the area assessed. The form of the opinion would be, “substantial assurance, except for...”. It is anticipated that this type of opinion will only be issued in exceptional circumstances, approved by the Head of Audit and Risk, where the auditor has exhausted all other economic means to reach a definitive opinion.

Pure Compliance Opinions

12. It is recognised that there will be instances where it is more beneficial to senior management or other stakeholders to have a yes/no assertion of compliance. In these instances the following opinion will be given:

Opinion	Definition
Compliant	The area assessed meets all the requirements of the legislation, regulation, policy or other guiding documentation.
Not compliant	For the area assessed there are requirements of the legislation, regulation, policy or other guiding documentation that have not been met.*

*No weighting is used as to the area of non-compliance

Negative assurance opinions

13. A negative assurance opinion is one stating that nothing came to the auditor’s attention about a particular objective, system, data return etc. that would require comment. In these cases the Auditor takes no responsibility for ensuring that the scope of the work completed is sufficient to identify all issues, and as such this type of opinion is less valuable to management than the preferred positive opinions described above. However, there will be instances where the potential scope of the work is so wide ranging that this is the only valid form of opinion that can be given. It is the intention that these types of opinion will be rare, and will

always be approved by the Head of Audit and Risk. Therefore a prescribed wording will not be defined

14. These concepts allow for greater precision for the auditor and are expected to provide greater clarity for the recipient of the final output.

Audit Recommendations

15. It is proposed to have three levels of priority for recommendations (as set out below) and remove the risk rating of control failures. This aligns perceptions of stakeholders and auditors and simplifies the process.

Proposed priorities for recommendations

Rating	Definition
High	<p>Immediate management action is required to remedy a serious failure of internal control that has led, or may lead, to one or more of the following:</p> <ul style="list-style-type: none"> • Substantial loss of resources. • Serious failure to comply with legislation and / or Council Policy. • Significant reputational damage for the Council, involving national media. • Significant adverse regulatory impact, such as a national report, intervention or suspension of services.
Medium	<p>Timely management action is required to remedy weaknesses in internal control that could lead to one or more of the following:</p> <ul style="list-style-type: none"> • Loss of resources. • Failure to comply with some aspects of legislation and / or Council Policy. • Reputational damage for the Council, involving local or regional media • Adverse regulatory impact, such as loss of external ratings or negative local report.
Low	<p>Management action is suggested to improve the quality and/or efficiency of the control environment of the Council.</p>

16. All recommendations made will include an indicative implementation date. This date will be agreed through discussion between the auditor and the review owner(s). No timescale for implementation will be specified, but it is expected that most High priority recommendations will be acted upon within one month of the final report being issued, and Medium priority recommendations within six months. The Head of Audit and Risk will have the final sanction where implementation dates relating to High priority recommendations are considered too far in the future, and in all cases where the suggested action does not meet the control deficiency.

17. High and Medium priority recommendations will be subject to more rigorous follow up and reporting to Governance and Audit Committee, which will require

detailed management responses and potential attendance at committees by those officers identified as responsible for implementing high priority recommendations.

Conclusion

18. The current basis for opinions and recommendations inhibit the precision, usability and understanding of the Internal Audit reports, thereby reducing the benefit of the potential assurance provided. Change is required to bring the current working practices of the Internal Audit section in line with the best practice offered by the Institute of Internal Audit.

Recommendations

19. Members are asked to:

- Approve the amendments to gradings and definitions for audit opinions, and approve the introduction of qualified, compliance and negative assurance opinions.
- Approve the amended prioritisation criterion for audit recommendations and the indicative timescales for implementing the recommendations.
- Approve the amended reporting to the Committee in relation to the tracking of implementation of recommendations, including the requirement for officers to attend Committee when deadlines for implementation of High priority recommendations have been missed.

David Tonks
Head of Audit and Risk
Ext: 4614