



**Council**  
22 June 2015

## **Report from the Chief Finance Officer**

### **Shared Internal Audit Services**

#### **1 Summary**

- 1.1 The council is seeking to make savings of an average of 40% in the provision of its support services, in response to the financial pressures that it faces. Officers are responding to this challenge by considering different models of service delivery, seeking to reduce costs whilst mitigating the impact on service delivery.
- 1.2 This report sets out a proposal to share internal audit services with the London Boroughs of Ealing and Hounslow. This would enable an immediate saving on management costs to be achieved, as set out in the report, whilst future proofing the important assurance and deterrence functions that the service provides. Over time the proposal would also deliver further financial savings through economies of scale and efficiencies and the opportunity to improve the service by facilitating more cross-borough working and sharing best practice. In particular it would enhance the resilience of the service.
- 1.3 Due to the particular nature of the internal audit service, decisions to change the way in which it is provided, as proposed in this report, require the approval of Council. This helps to protect the operational independence of the service. The Audit Committee, on 7 January 2015, noted the report, and was supportive of the proposal. The detailed comments of the Audit Committee appear at paragraph 6.8.

#### **2 Recommendations**

That Council:

- 2.1 Agree to delegate the provision of its internal audit service to the London Borough of Ealing with effect from 1 October 2015 or such other date as may be reasonably agreed with the London Borough of Ealing.
- 2.2 Note that the cost of operation of such delegated internal audit service by the London Borough of Ealing will be, initially, at least £75,000 less than the current service cost.
- 2.3 Agree to enter into an agreement confirming the terms of delegation and delegate authority to the Chief Finance Officer in consultation with the Chief Legal Officer to

determine the precise terms of the legal agreements necessary to achieve the same, as set out in section six of this report.

- 2.4 Agree to the proposed staffing arrangements including the transfer of internal audit and investigation staff to the London Borough of Ealing as set out in paragraphs 4.5 and 4.6.
- 2.5 Note that this proposal will enable the council to reduce the number of heads of service employed by one, the saving from which will contribute towards the £1.4m to be achieved through the corporate management restructure.
- 2.6 Authorise the Chief Legal Officer to make any necessary changes to the Council's Constitution to reflect the delegation of the internal audit function to the London Borough of Ealing.

### **3 Internal audit – background**

- 3.1 Internal audit provides an essential service to the organisation, the importance of which should never be underestimated. A good internal audit service provides a council's political leadership and senior management with assurance that business processes across the organisation are effective and that risks are identified and well managed. It assists the external auditors to judge the effectiveness of controls, driving down total audit costs as a result. It highlights exceptions to proper practices and plays the dual role of helping managers to address these whilst also holding them to account.
- 3.2 Internal audit helps to prevent fraud within the council and the borough, advising on system design to reduce fraud risk, promoting a strong anti-fraud ethic, investigating potential cases of fraud and publicising, as appropriate, the sanctions imposed on fraudsters. It provides a responsive service to management where investigations into the actions of individuals are required, and as it has a degree of independence from day to day operations, can provide assurance externally that the council is conducting its business properly.
- 3.3 Like any service, this does not make internal audit immune to change, and savings are required here just as for any other support service. The risk for the council is that, as a relatively small service, once savings beyond a certain level are delivered the remaining function becomes too small to be sustainable or have the economies of scale necessary to remain efficient.
- 3.4 If the service is simply crudely downsized then there are significant risks that it will become increasingly difficult to attract and retain staff with the right mix of skills, especially at the higher end forensic services. At the same time the contract through which most of the systems work is performed could be squeezed to the point where its management costs become unreasonably high as a proportion of total spend. In addition, accountancy firms of the requisite size to be able to provide the range of services that will always be needed may struggle to provide economic rates for small contracts, driving up day rates and unit costs.
- 3.5 These financial arguments are a relevant consideration. However, it is important to note that perhaps the more significant consideration will be the resilience of the service. Small teams lack the inherent resilience of larger teams and there is a significant risk that substantial downsizing of the service would result in a model that could no longer be confident of delivering high quality outcomes.
- 3.6 For these reasons an alternative service delivery model has been examined, sharing services with Ealing and Hounslow, who already operate a shared internal audit service.

- 3.7 Internal audit currently has a Head of Service, graded Hay 4, performing the Chief Internal Auditor role, responsible for the two principal arms of the service – anti-fraud work and systems and risk audit. On the systems and risk side there is an internal audit manager and one officer, with the bulk of the work carried out by an external provider, currently Mazars. Anti-fraud services are carried out in house, with a team of long-established staff conducting investigations. This team was reduced in 2014/15 as four staff transferred to the DWP as part of the creation of a national Single Fraud Investigation Service (SFIS), and responsibility for countering HB fraud also passed from the council.
- 3.8 This is a fairly common model. Many local authorities outsource their audit and risk services to external providers, as Brent has done. As a result the directly employed staff are relatively few in number: less than 20 including the two apprentices also placed in the unit, and from time to time the council's CIPFA trainees who are also seconded to it.
- 3.9 Around 1,200 input days of systems audit and risk work was delivered in 2014/15. This total was reduced for 2015/16 as part of the agreed budget proposals. On a like for like basis this reduced the audit days to about 900, but some of this reduction has been offset by greater use of trainees. Brent's input audit days for 2015/16 will be at around the average figure for London, as other boroughs are also reducing internal audit days in response to financial pressures, whereas historically the service has tended to deliver more input days than average.
- 3.10 Anti fraud services are, by contrast, provided in house by most local authorities. An external market exists for these services, but is characterised by high day rates. For some specialist investigations it can be the appropriate way forward, but, like most authorities, Brent would only use this if the circumstances of a particular case warranted this specialisation.
- 3.11 Much of the work of the anti-fraud team is in practice focused on high volume and recurring types of fraud. For example, housing benefit anti-fraud work, until its transfer to the Department for Work and Pensions in October 2014, suited internal delivery. There was sufficient volume of attempted fraud to keep staff consistently busy, and the legislation was complex enough to require particular skills to be developed that led to economies of scale. Having an external contractor do this sort of work is not impossible, but most authorities take the view that the contractual hand-offs associated with this would be unduly complex and expensive, and that the service would be less responsive as a result.
- 3.12 The same is true of other principal categories of attempted fraud, such as tenancy fraud, which is an increasing area of focus given the housing pressures. It also, sadly, remains the case that some investigations into council employees attempting fraud or committing other financial irregularities will always be needed. Most authorities take the view that a formal external contract for these services with a commercial provider is not likely to be the best way of resourcing these investigations.
- 3.13 However, by continually reducing these services over the next four years (and the average 40% savings currently targeted for support services are only enough to balance the budget for the next two years) these economies of scale will be reduced as the team downsizes, to the point when it may become difficult to deliver an adequate service at all. And, in fraud investigation work, there are fewer opportunities to deliver efficiencies in a small team, although of course service standards and quality of work can always be improved. In this scenario staffing savings tend to look a lot more like straightforward cuts leading to less work being

done, and there are significant financial and reputational risks associated with adopting a public position of no longer trying to investigate certain types of fraud.

- 3.14 It is also relevant that the inevitable nature of a small service led at a Head of Service (Hay 4) grade is that the management overhead is necessarily high. In most other services a senior manager at this grade would manage a larger group of staff. This reflects the specialist nature of the service being provided, but the council's leaders are rightly concerned to seek to bear down on management costs.

#### **4 Shared service model**

- 4.1 In this context a shared service model has, on the face of it, significant potential attractions. There are several such services already operating in London, for example Kingston and Richmond, OneSource (Newham and Havering), the tri-borough service and Ealing and Hounslow, with whom it is proposed to enter into a shared service arrangement.
- 4.2 Hounslow and Ealing operate a shared internal audit service. This was initially established as a relatively informal arrangement, with staff employed by their host authority but managed for practical purposes by a shared Head of Audit. More recently this arrangement has been formalised with a TUPE transfer of staff underway from Hounslow to Ealing to create a true shared service. The service is led by Ealing, who employ the Chief Internal Auditor, who performs this service for both boroughs, with reporting lines in to each Chief Executive and Audit Committee chair as required. Both are satisfied that the service has worked effectively, and in particular Hounslow, as the customer of the service, is satisfied that it receives the assurances that it needs from the service.
- 4.3 Officers have discussed this model, and propose joining the service on the basis set out below.
- 4.4 The model proposed is a 'delegate and buy back' service. This would mean that, if the arrangement were to go ahead, Brent would delegate its audit function to Ealing and enter into an arrangement to buy the service back. This is significantly simpler in procedural terms than establishing a special purpose vehicle or other local authority controlled company or joint committee arrangement. There is the added advantage of joining a known arrangement, rather than trying to create something new. This means that the proposal could be implemented quickly and with fewer risks.
- 4.5 This would mean that the staff concerned would transfer across to Ealing, and TUPE would apply. The immediate staffing saving would be delivered because in the new model the cost of the Head of Internal Audit would be shared between three boroughs, whereas at present Brent pays the entire cost of this role.
- 4.6 It is not proposed to undertake budget reductions for the other staff prior to the transfer. This reflects the fact that the sharing of services is only partly being driven by the need to make immediate reductions in the budget, with a more significant driver being securing a future service, with planned future cost reductions built into the business plan. There are no redundancy costs associated with this proposal.
- 4.7 The advantages of this arrangement are as set out below.
- 4.8 This is joining an existing and successful arrangement. This 'starting small and then expanding' model is a preferable way to achieve successful shared services, as has been demonstrated by the difficulties some larger partnerships have faced.
- 4.9 The boroughs are geographically close. Despite advances in technology it is the nature of internal audit and investigation work that a significant amount of work on site will always be required. Having an arrangement with geographic partners

therefore has advantages over, for example, entering into an arrangement with One Source or Richmond and Kingston. This geographic closeness will also enable the development of a co-located audit function with its headquarters in Ealing.

- 4.10 However, it is the nature of the audit function that a high proportion of the work requires an on-site presence, to conduct interviews or to review evidence first-hand, for example. Staff would therefore need to retain a regular presence at the Brent Civic Centre, and continue existing flexible working arrangements, for example to access the council's zip cars to make efficient site visits and so on.
- 4.11 Buying in to this shared service arrangement will enable the development of expertise. On the systems and risk side of the business there would be increasing opportunity for collaboration. It is, for example, obviously more efficient to carry out the standard audits of those systems that always need to be reviewed annually (creditors, council tax and so on) on a three borough basis. The same person can do the audit three times, sharing good practice and reducing the average time taken to do the same element of work. The efficiency gains from this are unlikely to be major, although they would be real. The opportunity for sharing best practice is a more significant opportunity that could lead to material enhancements in the service.
- 4.12 In anti-fraud activities the potential value of such ready access to data sharing across three boroughs will obviously be significant, although care will be needed to ensure that responsibilities under the Data Protection Act are preserved. Would be fraudsters do not limit their activities by borough boundaries, and the ability to co-ordinate more easily internal audit activities across three boroughs could improve detection rates and the deterrence value of the service.
- 4.13 Within a larger service there will also be more opportunity to create staffing structures that promote career development opportunities. Staff will be able to develop expertise in particular areas, or by exposure to different London boroughs gain a wider insight into governance and risk management issues, enhancing their skill sets.
- 4.14 The contracts are also aligned (Ealing and Hounslow operate the same model of service delivery as Brent, with an external provider for most of the systems and risk work and internal staff for the anti-fraud work). Mazars provide internal audit services to all three boroughs, with a common expiry date of March 2016, so a collective re-procurement exercise can be carried out for 2016/17.
- 4.15 There are significant advantages to the shared service option arising from contract management efficiencies. As the three authorities' contracts are essentially similar it would be much cheaper for one officer to manage them all. This would also enable a more co-ordinated approach to be taken to hold the external contractor to account in the event of under performance.
- 4.16 Future contract re-procurement is also likely to be cheaper, certainly in terms of the internal resource needed to manage the process but also in terms of being able to offer a package that will be more attractive to the market.
- 4.17 As has been noted above, adopting this model would reduce the overall cost of management and its proportion of the total internal audit cost. Discussions with Ealing have shown that they would be able to offer enhanced service standards in some areas to that currently achieved. In summary, this proposal offers the opportunity to deliver at least the existing standard of service, and in many respects a better standard, for a lower cost.

## **5 Other options**

- 5.1 Other options have been considered, and these and some other considerations are set out below.
- 5.2 The systems audit and risk management service could be brought back in house. The difficulty with this is that the team to provide the service would be fairly small and therefore hard to sustain. This was what drove many local authorities to outsource it in the 1980s and 1990s when teams were significantly larger. Brent has a total of around 1,200 internal audit days, of which over 900 are provided by the external contractor and the balance by the in house team.
- 5.3 If this part of the service were to be entirely in-sourced the team required to deliver it would be around five FTEs (assuming 900 total audit days), within which it would be difficult to have the full range of skills required. There would also be a high management overhead, as audit programmes for each piece of work would have to be designed individually, whereas an external provider has significant economies of scale. Most local authorities therefore rely on external provision for this. However, where there is scope for variation is in the balance of externally and internally provided audit days.
- 5.4 The option of entirely insourcing the internal audit service has therefore not been pursued. However, the shared service option, with its economies of scale, could in future increase the proportion of audit days delivered internally. This would have the effect of driving down costs and also providing greater training opportunities for the council's apprentices and CIPFA trainees.
- 5.5 Savings could just be delivered by reducing the number of investigation staff. No further reductions in the number of purchased systems and risk management days are proposed at the present time, other than already set out in this report, since this would expose the council to unreasonable levels of risk. The current team of investigators could be reduced from those currently employed in order to deliver immediate savings. However, this is not recommended as it would significantly limit the ability of the council to deliver anti-fraud services. However, the council will retain the right to reduce the cost of this service in the future, under the shared service proposal. This will give the council the ability to deliver future savings in a planned and managed way, preserving the quality of the service.
- 5.6 Other partners have been considered. However, a key issue here is geography. Internal audit is very much a service where outputs are closely correlated to input hours. Of course, the quality of staff and management matters, as for any service, as does the technology required to support, for example, the data matching services that can help to identify fraud risks. Nevertheless, the fact remains that, certainly for the more standardised elements of audit services, such as for routine audits into standard systems or investigations into high volume fraud areas like tenancy and housing benefits, input hours will be a significant determinant of outputs.
- 5.7 In this context a shared service offering not based on geographic proximity is likely to add costs and reduce flexibility. This is not just to do with staff travel to work times, but with the ability of staff to work across more than one site in any short period of time to share best practice and gain efficiencies of scale.
- 5.8 The Ealing offer certainly has the benefit of this geographic continuity. An alternative provider could be OneSource, the shared service vehicle between Havering and Newham. This has been considered, but rejected in this instance because of the distances involved, certainly to Romford. Similarly the Richmond and Kingston shared service is based too far away to be likely to be successful. Discussions with other potential partners in the London boroughs have not revealed any significant appetite for adding to existing shared service models.
- 5.9 The Ealing model is established and stable. Circumstances can of course change, but decisions need to be progressed based on the current conditions, and at present

Ealing have the model that best suits the rapid achievement of a shared service, as well as the advantage of being geographic neighbours.

- 5.10 A more radical option might be to opt for a very different sort of contract for systems audit and risk services. Some of the accountancy firms are developing offers for internal audit services based on higher day rates and more sophisticated data analysis tools. They claim to be able to provide the same or greater levels of assurance at no increase in overall cost. However, these models are relatively new and adopting one at this stage would be a high risk strategy. It would also almost certainly not be cheaper. Officers propose to keep this under review in line with the proposed re-tendering of the three contracts for April 2016.
- 5.11 From this option appraisal officers believe that the best way to secure the future of the internal audit service at a lower cost is to proceed with the shared service option with Ealing.

## **6 Governance and risk**

- 6.1 The shared service model proposed will need effective governance in place to work. The precise details will be resolved through the legal agreement. They will have to include (and are not in any way contentious with Ealing):
- Rights of access of the joint Chief Internal Auditor to the Chief Executive and Chair of the Audit Committee
  - Briefings for the Chair and other Members of the Audit Committee and attendance at them
  - Regular meetings (at least monthly) with the Chief Finance Officer and Monitoring Officer
  - Regular meetings (at least quarterly) with the Chief Executive
  - Attendance at DMTs or other relevant meetings with Directors, for example to address significant audit findings, assist in audit planning and risk identification and to progress confidential matters
  - Liaison with external auditors as appropriate
  - Assurances as to the level and quality of service to be provided
  - Procedures to follow to address complaints or other issues of service quality, including ultimately Brent's rights to terminate the agreement.
- 6.2 Ad hoc meetings on urgent issues as they arise will of course be required, and the nature of the shared service model proposed, with its reduction in management costs, inevitably poses some risks in the situation where urgent issues arise in two or more authorities at once. These have been managed successfully by Ealing and Hounslow and there is no reason in principle to assume that they could not be extended, and to a large extent the risks simply flow from the reduced management costs, which are being managed across the council.
- 6.3 Officers recommend at this stage delegating the management of the contract with Mazars to Ealing, rather than formally novating the contract. (Strictly speaking, the contract is with the London Borough of Croydon, who have let a framework contract which Brent accesses). This will enable maximum flexibility in the run up to re-procurement in April 2016.
- 6.4 A nominated point of contact within Brent for day to day contract management issues and for intelligence gathering and briefing will be required. This is proposed to be the Operational Director, Finance. However, the sensitive nature is such that the Chief Finance Officer will continue to exercise close personal oversight of the head of internal audit, albeit that this will become a relationship managed under a shared service agreement rather than under an employment contract.

- 6.5 In conclusion, the shared service option with Ealing and Hounslow offers a robust opportunity to reduce costs without introducing significantly greater risks. The shared service could enhance efficiencies and the quality of service offered, for example by allowing economies of scale and sharing of best practice.
- 6.6 The disruption to staff through the transfer would of course need to be carefully handled. However, TUPE will apply with all the protections that implies, and the transfer will be to another local authority rather than to a private company. In the slightly longer term the model should also offer staff better career paths through being part of a larger service.
- 6.7 Above all, from a managerial perspective, it offers the chance to deliver savings in management costs and efficiencies, rather than wholesale service reductions and the accompanying significant increase in risk.
- 6.8 The Audit Committee considered the proposal at its meeting on 7 January 2015, and commented as follows:
  - 6.8.1 The Audit Committee is supportive of the principle of the proposal
  - 6.8.2 The Audit Committee considered it essential that a full and proper legal agreement was entered into to underpin the shared service arrangement to protect the Council's interests
  - 6.8.3 The Audit Committee were reassured by officers that a satisfactory legal agreement would be entered into prior to commencement of the proposal, ensuring in particular that the arrangements for the head of audit to report directly to the Audit Committee, Chief Executive and Chief Finance Officer would remain unchanged
  - 6.8.4 The Audit Committee noted that the audit plan for 2015/16 would be agreed prior to commencement of the proposal and that the annual governance statement and head of audit's certificate for 2014/15 would need to be completed
  - 6.8.5 The Audit Committee agreed to receive a report within one year of commencement evaluating the effectiveness of the new arrangements
  - 6.8.6 The Audit Committee noted that in due course there might be scope to consider adding other services into the arrangement, if a satisfactory business case existed.

## **7 Financial implications**

- 7.1 The gross expenditure budget for the current service is £1.1m, of which £0.8m relates to staffing costs and £0.3m to the internal audit contract. Some amendments to this will be required in 2015/16, to reflect transfers of staff to the Single Fraud Investigation Service earlier in the year
- 7.2 On a like for like basis agreeing this proposal would deliver a saving of approximately £75,000 through sharing the costs of the Chief Internal Auditor.
- 7.3 There are good grounds for assuming that further efficiency savings could be delivered through this arrangement in the future. This could be achieved through more efficient procurement and contract management by achieving economies of scale, for example. Enabling more cross borough working and staff specialisation will also create opportunities for service enhancement.

## **8 Legal implications**

- 8.1 Section 101 Local Government Act 1972 enables an authority to make arrangements for the discharge of its functions by a committee, subcommittee or officer of the



authority or by another authority (sections 19 and 20 Local Government Act 2000 deal with executive functions).

- 8.2 Support Services such as Internal Audit Services are classified as non-executive functions under the Local Authorities (Functions and Responsibilities) (England) Regulations 2000 SI 2000/2853 as amended (Paragraph 1 39 of Schedule 1), as are staffing matters under Section 112 Local Government Act 1972. As a result, the decision regarding delegation of the service needs to be made by a non-executive body, such as full Council.
- 8.3 It should be noted that the arrangements proposed are not intended to amount to a procurement of services which would fall within the scope of the EU Procurement Rules. Instead, Brent is delegating its internal audit function to the London Borough of Ealing and it is the London Borough of Ealing exercising the function on behalf of Brent, rather than agreeing some form of contractual arrangements, similar to those which would pertain with an external provider of internal audit services.
- 8.4 In practice this means that the Chief Internal Auditor is carrying out the audit function on behalf of Brent and the collaboration agreement records the terms upon which costs will be shared and the other practical issues which have been documented for the arrangements. It also means that various roles and responsibilities will need to be reflected in Brent's Constitution which is likely to require amendment as a result of the new arrangements. Until the full details of the legal agreement governing the terms of the delegation are agreed, it is not possible to specify all the changes that may be required to Brent's Constitution.
- 8.5 As indicated at paragraph 4.5, staff would transfer to the London Borough of Ealing pursuant to TUPE. When TUPE was first drafted it applied when there was a transfer of a recognisable economic entity. The precise definition of what a recognisable economic entity amounted to was the subject of a huge amount of debate and litigation. The result of that was that some transactions that involved staff transfers, in their non legal meaning, were held not be covered by TUPE. As a result the ambit of TUPE was widened so as to include service provision changes ("SPC").
- 8.6 An SPC has a very wide definition and was designed deliberately on that basis to essentially bring as many transactions within the ambit of TUPE as possible. In this case it seems relatively clear that TUPE would apply as the **"activities cease to be carried out by a person on his own behalf and are carried out instead by another person on the client's behalf..."** This definition is capable of covering a huge amount of situations and the one proposed here is caught, beyond doubt, and as such TUPE is certain to apply.
- 8.7 TUPE as a process is not that difficult to manage but there is a lot of accumulation and tabulation of detail required. Similarly, there are positive duties to inform and consult on various matters that have to be observed as a matter of law. Failure to observe such matters could result in litigation and the potential for compensation to be awarded. As a result it will invariably be the case that the earlier that an HR Manager can be appointed to project manage that process the more successful and smoother that process is likely to be.
- 8.8 As the internal audit function is being delegated to the London Borough of Ealing, Brent will suffer a loss of direct control over the delivery of the internal audit service and the management of staff. In order to mitigate against this, there will be a collaborative agreement setting out in detail governance and service delivery requirements. Appropriate performance management arrangements and exit clauses would be needed to negotiated, as is standard in any such arrangement.

- 8.9 There is no statutory requirement for auditors to be employees of the Council nor is there any statutory requirement for an auditor to be employed by the Council to present evidence at a disciplinary or other hearing. There have been various challenges made to individuals investigating and presenting cases at disciplinary hearings who are not direct employees. However, none of those challenges have ever succeeded, primarily as there is no legal requirement for this to be the case and secondly, because the test is essentially whether it is reasonable to appoint an individual who is not an employee. As long as the individual is competent and able, their employment status is not an issue.

## **9 Staffing and equalities implications**

- 9.1 Staff would be protected by TUPE transfer. Change processes would need to be handled in accordance with policy, including the proposed change of work locations.
- 9.2 Becoming part of a larger team with shared expertise will allow some improvement to staff development opportunities. Staff have been consulted, through briefings to the entire team and one-to-one follow up meetings as requested.
- 9.3 Staff have raised a number of issues in the consultation. Staff understood the principles on which it was being proposed and commented on the benefits that could flow from this, as well as the risks involved and how these would need to be managed. The application of TUPE significantly lessens the material financial consequences of the change for individual employees, but suggestions were made as to the importance of not creating significant or unnecessary travel time. A number of practical comments were also made, such as around access to IT systems and equipment, all of which can be taken into account during the TUPE transfer process.

## **10.0 Background Papers**

- 10.1 None

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