



Internal Audit Provision from 1st April 2012

The Business Case

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1. Background: - the present arrangements for Internal Audit (NYAP)

- 1.1 It is a statutory requirement that Councils have a system of Internal Audit (IA). It is essential that all the Partner Councils have a robust effective IA service.
- 1.2 Three Councils, Scarborough Borough Council, Ryedale District Council and Selby District Council, joined together to form the North Yorkshire Audit Partnership (NYAP) using the joint committee provisions of the 1972 Local Government Act in 1999. Subsequent to the first agreement Hambleton District Council and Richmondshire District Council joined so that there are now 5 District Councils in the partnership.
- 1.3 The first Partnership Agreement ran for seven years and the current four year agreement ends on the 31 March 2012.
- 1.4 The operating environment of the Partner Councils is changing especially with the current and forecast economic cuts that are anticipated. This is leading to a change in demand for IA services. In addition the nature of the portfolio of work is starting to change with an increasing emphasis on identifying the 'added value' of Internal Audit.
- 1.5 The Partnership has a specific issue with succession planning for the post of Head of Partnership, and this is allied to a secondary, more general issue, around the age profile of its staff.

2. Executive Summary of the preferred option

- 2.1 The Partnership Board has discussed the options in outline and is of the opinion that for the Partner Councils, the merger of NYAP with Veritau, is the preferred option for the reasons set out below. Veritau is an established company jointly owned by City of York Council and North Yorkshire county Council for the provision of internal audit and fraud work to those two partners. Each Partner Council must secure approval to enter into the proposed company arrangements for the delivery of Internal Audit.
- 2.2 Linking with Veritau will bring a number of benefits: -
 - (i) Cost reduction that will flow from a merger of two organisations, as a result of the reduction in management costs and other economies of scale;
 - (ii) Eliminates the issue of succession planning of the Head of Partnership. The core issue here is that none of the second tier NYAP Audit Managers has full professional qualifications. They are AAT qualified, part IIA qualified, but not full CCAB qualified. The current CIPFA Code of Practice for Internal Audit recommends that the Head of Internal Audit should be professionally qualified. Therefore in addition there is a real risk of adverse external auditors comment if the Head of the Partnership was not so qualified;
 - (iii) Greater security and resilience in audit provision (including ICT Audit);
 - (iv) The ability to manage the increasing complexity of internal audit work due to increasing complexity of the business environment, software and systems that are in use. This also extends to the increasing use of joint service provision including Councils working together to provide services jointly;
 - (v) The need to secure flexible response capability;
 - (vi) Certainty of service delivery through greater resilience and size of team; and
 - (vii) The opportunity to access audit management and working systems software that currently is uneconomic to purchase and install for NYAP.

2.3 From Veritau's perspective the merger has the potential to unlock capacity closer to the sites being audited, reducing overhead travelling time from Northallerton/York where Veritau staff are currently based. This could be achieved by structuring the combined Veritau/NYAP around three or four discrete areas, or regionally based offices providing IA services across all Councils in their vicinity. These additional savings would lead through to a reduced daily rate for all the councils and hence the annual fee for internal audit services.

3. Why the merger of NYAP with Veritau makes good sense.

3.1 All the Partner Councils are actively involved in looking for financial savings, and this is an opportunity to realise some and combined with the very real potential for an increased quality of service.

3.2 The Councils are looking to work collaboratively, whether that is with private organisations, the formation of partnerships, or closer working arrangements with other Councils. This is leading to the Councils moving towards 'commissioning' rather than 'direct provision' of services.

3.3 As this process accelerates it is likely that the Councils, once into shared service solutions will have much fewer in-house managed services and so may require a different and more flexible approach to internal audit. Therefore to merge with Veritau offers longer term security of service, as the bigger consortium will have greater turnover of staff and so will be better placed to provide the essential flexibility of supply that will be demanded. This is evidenced through the requirement by the NYAP Partner Councils for reduced audit days from 2010/2011 and annually thereafter. Without the flexibility that the merger will bring this could lead to redundancies, and those costs would fall to the Partnership, ultimately the Partner Councils.

3.4 It will also provide greater security to staff as their opportunities are extended, and they are able to progress their careers in a larger organisation.

3.5 Also as outlined above it is a real opportunity for the Partnership to embrace modern Audit management software with all its associated benefits, e.g. easier to create a recommendations database, that as a smaller organisation it may find difficult to build a solid business case for.

3.6 The economies of scale and associated reduction in management layers will result in a reduced IA fee for partners. Initial estimates suggest that this reduction would be in the order of around 5% with no detriment to, or loss of, the service, and in the longer term an improved service.

3.7 The key benefit is that it provides a secure longer term means of providing internal audit, which is at lower cost, provides greater resilience, and is beneficial to the staff.

3.8 Annex A sets out in tabular form an evaluation of the competing options.

4. Options

The various options that have been considered in detail are: -.

NYAP to continue to the end of the current Partnership Agreement (31/3/2012) and each partner procures their own Internal Audit service.

- 4.1 The Partnership will be wound up, in accordance with the provisions of the agreement. Each of the Partner Councils will then need to make their own decision on the form of Internal Audit they require, and procure it. The key issues would be:
- i. The Head of Partnership may have retired (eligible to retire from July 2011) and if so could leave a void if the post is unfilled.
 - ii. Each Council will need to secure IA services. The existing staff will transfer to the partner Councils from NYAP. The Partnership Agreement refers to staff transferring back to original Councils upon termination; best efforts to avoid redundancy and associated costs. Only three staff remain from the original cohort; and as all were at Scarborough BC that could lead to some difficulties with the transfer of other staff to the Partner Councils.
 - iii. None of the individual Councils (possibly except SBC) would have the critical mass, or the funds to have an effective in-house team so service performance will gradually decline. It would almost certainly lead to those smaller Councils needing to outsource their IA function.

Outsource completely as a group of 5 Councils to private sector

- 4.2 The key issues would be:
- a) Councils gain access to some alternative and additional services that a large private sector organisation could offer.
 - b) Councils lose a certain amount of control of the management of the audit service.
 - c) Councils lose direct control of costs, and these may rise to generate profit for contractor.
 - d) Councils lose direct control of the quality and experience of staff performing their audit work.
 - e) Significant risk of increased costs arising from any imposition in the contract for qualified and experienced staff.
 - f) Costs of the tendering process on a periodical basis.
 - g) With the implications of TUPE, the tendering process will be significant complicated exercise with an associated cost.

Continue with NYAP; all 5 partners; and new agreement from 1/4/2012

- 4.3 The key issues would be:
- a) Well established, professional service with proven governance arrangements.
 - b) Councils retain overall control of the Partnership
 - c) There may be difficulty in recruiting new head of partnership, if required, that is professionally qualified.
 - d) The partnership may have to further review its structure for the changed audit environment.
 - e) The reducing demand for IA may result in cuts to staff numbers with associated morale issues; such reductions could also result in a structure that is expensive (a highly geared ratio of managers to auditors)
 - f) Limited financial savings would be available other than through reduced audit days and a revised structure.
 - g) The Partnership in a 'reducing service' environment will not have the funds to modernise.

NYAP merge with Veritau

- 4.4 The key issues would be:
- a) Well established, professional service with proven governance arrangements.
 - b) The service provision model of a local authority owned company is now well established and working effectively with the two Councils.
 - c) Resolves a number of issues with minimal inconvenience and cost.
 - d) Relatively seamless transition.
 - e) Provides opportunities for staff to develop their careers, and thereby minimise the risk of the loss of qualified, experienced, key staff.
 - f) Provides access to modern audit management software with all the benefits at minimal cost.
 - g) IA quality will, in the short term, be maintained, and over the longer term will improve.
 - h) Provides greater long-term resilience for the NYAP Partner Councils and the NYAP staff.
 - i) Control is maintained through joint 'ownership' of the company. [see section 5. below for additional detail on the company structure and shareholding]
- 4.5 The large number of variables within each option makes it quite difficult to establish what each option would mean, in terms of daily rates, which could be used as a simple benchmark for comparing the options. What is equally, if not more, important is the non-financial considerations, particularly retaining good control and governance arrangements with the Internal Audit provider. An additional consideration is the likelihood of each option to provide a competent service, developing and being able to react to the changing local government landscape, which for internal audit means doing more with fewer resources.

Option.	Daily fee rate range.	Notes
4.1 NYAP to continue to the end of the current Partnership Agreement (31/3/2012) and each partner procures their own Internal Audit service.	£215 - £250	Richmondshire & Ryedale are too small to operate their own IA service, and would need to contract in or seek a new partnership. The size, structure and form, combined with deciding upon the qualification and status of the Chief Internal Auditor would determine the overall cost to each council. There may be redundancy costs arising from a literal interpretation of the Partnership Agreement to be met.
4.2 Outsource completely as a group of 5 Councils to private sector	£245 - £300	Estimate is based on recent info of tenders; the councils would need to ensure detailed specification to ensure quality and experience maintained. Demanding qualified and experienced staff will increase the daily rate significantly.
4.3 Continue with NYAP; all 5 partners; and new agreement from 1/4/2012	£235 - £250	The daily rate would depend upon the structure chosen and the appointment of a new Head of Partnership.
4.4 NYAP merge with Veritau	£225	Certainty of control of governance & of quality. Qualified and experienced staff.

5. Legal implications

- 5.1 The Councils have the necessary legal powers to create a shared service company however; any such arrangement must comply with the EU public procurement regime and the Public Contract Regulations 2006. Specific case law (including Teckal and Carbotermo SpA) has established that if a local authority wishes to award a contract to supply services, to a company set up by that local authority, then the authority does not need to carry out a competitive tender exercise before awarding such a contract provided that the following principles apply:
- the authority must exercise a similar degree of control over the company to that which it exercises over its own departments;
 - the exercise must be 'a power of decisive influence over both the strategic objects and significant decisions of the company';
 - the essential part of the company's activities must be carried out on behalf of the controlling authority. Any activities undertaken for bodies other than the controlling authority can be of no more than marginal significance.
- 5.2 The exemption also applies to companies controlled by more than one authority, providing the principles set out above are complied with.
- 5.3 With a view to demonstrating compliance with the Teckal principles, the provision of services to external customers by Veritau is currently limited to no more than 10% of the shared service company's total activities. This will continue to be the case with the expanded group.
- 5.4 In the event that the company did want to provide services to other bodies then it would be up to those organisations to consider, in accordance with their own procurement rules, whether to award a contract to the company.
- 5.5 There are also restrictions on the ability of local authorities to undertake trading activities through such a company. A local authority can make a decision to carry out an activity or provide a service which it considers is likely to improve the economic, social or environmental well being of its area (Local Government Act 2000). The well being function is an "ordinary function" for the purpose of Section 95 of the Local Government Act 2003. Section 95 provides a general power to local authorities to undertake trading activities. The general power is further regulated through the Local Government Power to Trade Order. This business case is considered to satisfy the requirements of the Local Government Power to Trade Order.
- 5.6 Section 95 also defines the type of company that an authority can use for trading activities. The Section states that the company must be a company regulated by Part V of the Local Government and Housing Act 1989, which limits the proposed structure to:
- companies limited by share;
 - companies limited by guarantee with or without share capital;
 - unlimited companies;
 - societies registered under the Industrial and Provident Societies Act.
- 5.7 The company would be funded from the public sector so its own procurement activities would be bound by the Public Contract Regulations.

- 5.8 Veritau will form a subsidiary company; Veritau (North Yorkshire) Ltd to deliver the additional services. The subsidiary company will be limited by shares, with Veritau holding 50% of the share capital and each District Council holding 10% (50% in total; an equal share).
- 5.9 The parent company (Veritau Ltd) will continue to provide services to its existing customers, including NYCC and CYC. Staff currently employed by Veritau would also remain as employees of the parent company. The subsidiary company; Veritau (North Yorkshire) Ltd, would provide services to the NY district councils and would employ the staff who were transferred. In practical terms the Veritau 'group' would operate as a single entity with common systems, working practices and one overall management structure.
- 5.10 The subsidiary company will have a board of directors comprising an officer from each District Council and two directors appointed by Veritau;
- 5.11 The creation and future operating arrangements of the subsidiary company would be governed by a formal Shareholders' Agreement. The Agreement will set out the rights and obligations of the shareholders and the continuing relationship between each Council and Veritau as participants in the venture;
- 5.12 The services to be provided to each District Council will be specified in separate Service Agreements, identical or similar to the existing Service Agreements which Veritau currently has with NYCC and CYC;
- 5.13 The length of the new Service Agreements would be coterminous with Veritau's existing Service Agreements. Each District Council would retain the right to terminate its Service Agreement by providing written notice;
- 5.14 The proposed transfer of staff will be regulated by the Transfer of Undertakings (Protection of Employment) Regulations 2006 which guarantee that there will be equivalence of terms and conditions of employment. NYAP staff will be given the option of transferring from their existing terms and conditions to those of Veritau.
- 5.15 In addition, Veritau (North Yorkshire) Ltd has admitted body status to the North Yorkshire Pension Fund. All current and future staff will then be entitled to be members of the Local Government Pension Scheme (administered by NYCC).

6. Benefits

The preferred option of NYAP merging with Veritau will bring benefits in terms of: -

6.1 Tangible and realisable cost savings:

- Reduced daily rate, of around 5% which combined with reductions in volume of internal audit required will give a material saving on the IA budget to partner Councils.
- Change to 'fee for audit' with lower annual fees.

	2011/12 IA plan days (incl Risk Mgt)	Annual Fee NYAP @ £235/day	Annual fee Veritau @ £225/day	Saving
Hambleton	365	£85,775	£82,125	£3,650
Richmondshire	240	£56,400	£54,000	£2,400
Ryedale	260	£61,100	£58,500	£2,600
Scarborough	655	£153,925	£147,375	£6,550
Selby	435	£102,225	£97,875	£4,350
			Total saving	£19,550

6.2 Efficiency gains:

- larger staffing base with wide and varied expertise;
- a reduction in group costs and lost time arising from the potential to locate operational staff nearer to their workplaces (principally a benefit to Veritau, with spin offs through enhancing NYAP staff's roles in their offices);
- use of audit management software to speed up the review and reporting process;
- use of audit management software to effectively monitor the implementation of agreed recommendations (something that audit committees are starting to look for).

6.3 Improved quality:

- resilience of service;
- access to wider knowledge base. The District Councils also gain knowledge of new and emerging issues with the City and County Councils that may affect the District Councils;
- access to external ICT audit expertise;
- opportunity to develop ICT audit skills with a larger client base to service.

6.4 Process improvement through the use of electronic audit management software and working papers.

6.5 Potentially enhanced controls and the benefit of a wider experience base to allow innovative solutions to control issues to evolve.

6.6 Ease of project operation and thereby likelihood of success:

- Seamless transition
- Overcomes issue of succession for the current Head of Partnership (NYAP)

6.7 Benefits to staff of NYAP (and Veritau):

- Part of a larger team with greater personal career development opportunities;
- Greater job security as part of the larger team with opportunities across the whole service;
- Reduces the risk of redundancy from revised IA service requirements by Partner Councils as a result of the changing Council environment and from budget cuts.

- 6.8 The move from a 'wholly owned' Partnership to being part of a wider one fits with the emerging ethos of commissioning, as future IA services will, in effect, be commissioned from Veritau.
- 6.9 Some of the benefits outlined above are tangible and can be easily measured, whilst others are less so. However that does not diminish the value of those benefits. Clearly the cash benefits from reduced internal audit volumes will be realised by the partner Council in the relevant year, but the reduction in daily fee rate of the merged service are continuous. Certain other benefits will only be discernable through the annual review of the effectiveness of the system of internal audit.

7. Costs and timescales

- 7.1 There will be some costs associated with merging NYAP with Veritau, currently estimated at £14,000, and the proposal is that these costs are shared equally between NYAP and Veritau. The existing reserves of the Partnership can meet the share for NYAP Councils.
- 7.2 It is expected that the following will be the principal cost items: -
- ICT preparation to accommodate the use of audit management software. As this is not the full package and is predominantly licence fees they will not be significant.
 - Legal costs incurred in ensuring the Councils are properly represented and have proper and fair representation in the legal agreement that governs Veritau.
- 7.3 A draft budget has been prepared with Veritau. A copy of the proposed budget is attached as annex B for reference purposes and features the following:
- This budget suggest that the daily rate for NYAP partners will be £225; a reduction of around 5%, compared to the current NYAP rate of £235.
 - This reduction combined with the anticipated, and now requested, reductions in audit volumes will give overall savings to each Council. The actual percentage saving for each Partner varies due to the varying volume changes, but they contribute to making the whole project viable.
- 7.4 There are costs associated with the winding up of NYAP. There are sufficient reserves, combined with any surplus for 2011/2012, in the Partnership to meet all anticipated costs.

8. Summary of Key Risks associated with the preferred option

- 8.1 The significant risks associated with the preferred option of merging NYAP with Veritau are:

The Councils will be tied in for a 7 year period, to 31/3/2019.

This period is not significantly different to the period that any future NYAP agreement would have been agreed to run. Each Council has the right to termination their membership with appropriate notice (a minimum of 12 months notice).

There is a risk that Councils will lose a certain amount of management and financial control.

This mitigated by the fact that the District Councils will have parity on the board of the company, so there will be minimal difference in levels of managerial and financial control. The Council's will continue to set their own audit planning work programmes.

There is a risk of some short term loss of service quality in the transition period.
This will and continues to be mitigated by starting the transition process early with shared workshops, joint team days, establishing ICT linkages in good time, and training on the audit management software to allow a quick and seamless transition.

Each of the possible long term options are assessed against a series of key criteria linked to the vision and objectives of the shared service. The results of this analysis are given below:

Options

Option A – NYAP ~ continue (Joint Committee)

Option B – Veritau ~ NYAP merger

Option C – Fully Outsourced Service

Criteria	Options		
	A	B	C
<i>OWNERSHIP AND VISION</i>			
Will this option be able to deliver the vision for the shared service and are there clear links to Corporate Objectives at each Council?	✓	✓	✓
Will the service be perceived as a genuine equal 'partnership' between the Partners (and Councils)?	✓	✓	
Will all Councils have sufficient control and influence over the strategic direction and future development of the service?	✓	✓	
Would this option avoid the need for Councils to establish a separate 'client' structure to monitor the contract?	✓	✓	
<i>IDENTITY</i>			
Will this option allow the service to develop its own identity?	✓	✓	✓
<i>AFFORDABILITY</i>			
Are the set up costs / required investment for this option likely to be affordable?	✓	✓	
<i>COST EFFECTIVENESS</i>			
Is this option likely to be affordable on an ongoing basis, and does it represent value for money?	✓	✓	
Will this option achieve economies of scale and deliver the expected efficiencies in service delivery?		✓	✓
<i>IMPLEMENTATION</i>			
Are the skills and resources readily available to implement the proposed option?	✓	✓	
Is there general support from within the Councils to implement this option?	✓	✓	
Would the Councils be able to support the change management needs associated with this option?	✓	✓	

Criteria	Options		
	A	B	C
SERVICE AND CAPACITY IMPROVEMENTS			
Is this option able to provide continuity of service in the long-term, irrespective of short-term problems and/or changes in key personnel?	✓	✓	✓
Is this option likely to deliver the required improvements in operational capacity?		✓	✓
Is this option likely to achieve the required focus on quality and enhance the professionalism of the service?	✓	✓	✓
FINANCIAL / BUSINESS OPPORTUNITIES			
Does this option allow external income to be generated by selling services to other public sector bodies?		✓	✓
Does this option offer the capability and capacity to identify and develop other business opportunities?		✓	✓
LEGAL CONSIDERATIONS			
Do the Councils have the legal powers to implement the proposed option?	✓	✓	✓
Does this option avoid the need to undertake an EU compliant tender exercise?	✓	✓	
RISKS			
Are the financial risks associated with this option considered to be acceptable to the Councils?	✓	✓	
Are the risks to future service delivery associated with this option considered to be acceptable to the Councils?	✓	✓	
Do all Councils have an equal or proportionate share of risk and reward?	✓	✓	
INNOVATION / SERVICE TRANSFORMATION			
Is this option innovative and does it offer the opportunity to address the government's transformational policy agenda?		✓	✓
Is this option suitable for helping to develop new methods of partnership working and service delivery in the future?	✓	✓	✓
Can this option allow the service to be expanded to provide other back office functions to the Councils?	✓	✓	✓
Would this option be attractive to other potential partners in the future?	✓	✓	✓

Annex B

DRAFT Budget 2012/13

	Veritau		NYAP	Veritau (NY)Ltd	TOTAL
	2011/12 £	2012/13 £	2011/12 £	2012/13 £	2012/13 £
Payroll, incl. NI, Pension etc	1,112,500	1,101,500	426,900	335,387	1,436,887
Travel costs	34,100	32,100	17,500	15,000	47,100
Other Staff costs, incl. training etc.	23,000	31,000	7,500	7,700	38,700
Supplies & Services	76,500	79,900	22,525	18,225	98,125
	<u>1,246,100</u>	<u>1,244,500</u>	<u>474,425</u>	<u>376,312</u>	<u>1,620,812</u>
Proposed Fee 2012/13		225.00		225.00	225.00
Existing Fee 2011/12		229.50		235.00	
Reduction		1.96%		4.26%	

When merged the budget would be as shown: -

	Veritau 2011/12 £	NYAP 2011/12 £	TOTAL 2011/12 £	Combined 2012/13 £	Saving 2012/13 £
Payroll, incl. NI, Pension etc	1,112,500	426,900	1,539,400	1,436,887	102,513
Travel costs	34,100	17,500	51,600	47,100	4,500
Other Staff costs, incl. training etc.	23,000	7,500	30,500	38,700	(8,200)
Supplies & Services	76,500	22,525	99,025	98,125	900
	<u>1,246,100</u>	<u>474,425</u>	<u>1,720,525</u>	<u>1,620,812</u>	<u>99,713</u>
Existing Fee 2011/12	229.50	235.00			
Proposed Fee 2012/13	225.00	225.00		225.00	
Reduction – per day (£)	£4.50	£10.00			
Reduction – per day (%)	1.96%	4.26%			