

**Report from** Financial Management Services**Date of Report:** June 16, 2016**Date of Meeting:** July 18, 2016**Report Number:** FMS-B005-2016**File:** 10.57.99**Subject:** Internal Audit Function

## Recommendation

That the report respecting the Internal Audit Function be received; and

That Staff continue to pursue the Business Improvement Program using the Lean, Kaizen and Six Sigma methodologies.

## Summary

The Internal Audit role varies across the different municipalities of Ontario. An Auditor General model, an Internal Audit department and the use of an External Audit Firm to provide audit services are three commonly used options, each with their own regulations, advantages and disadvantages.

Seven of our ten comparator municipalities have an internal audit function, with one (Kingston) who performs periodic reviews and two who operate without. Although there is limited data on the value received from the internal audit function, recommendations for improvement in operations, cost savings and greater efficiencies and effectiveness are noted benefits the function provides.

There are other alternatives that would provide similar results to those experienced with the internal audit function. They are a core service review (including alternative service delivery), external full program/service review and business/continuous improvement. These alternatives will also be reviewed in this report.

## Background

At its meeting of February 9, 2016, the BSC approved the following motion:

That staff report back to the Committee in June on what comparator communities have for Internal Audit positions, what value has been received by those communities who have an Internal Audit position, and include alternatives in municipal and private sectors; and

That staff, determine if the City is too small for an Internal Auditor function, and to identify the possibility of a commission-based core service review and the feasibility of an internal auditor position, and to budget for it over the next few years.

## **Report**

This report reviews the role of audit in other Ontario municipalities and outlines alternatives for the City of St. Catharines. In particular it will review the following items related to the Internal Audit function.

- Various Audit Functions defined
- Comparison of audit functions
- Comparator Municipalities
- Alternatives for consideration

## **Various Audit Functions**

### **External Audit**

Under the Municipal Act, 2001, all municipalities are subject to attest audits (external financial statement audits). Attest audits provide an independent opinion on the municipality's financial statements in regards to their fairness and dependability. The reference to auditor in this case is the external auditor, a public accounting firm retained through a competitive process. Subsection 223.19(2) of the Municipal Act, 2001, prohibits the Auditor General from being the City's external auditor. The function of an Auditor General differs from that of the external auditor as external auditing focuses on the fairness and completeness of the financial statements.

### **Internal Audit**

There is no legislated requirement for an Internal Auditor within the Municipal Act, 2001. An internal audit function is primarily a review of compliance with policy and procedure based on risk. An Internal Auditor's duties may also include the ability to undertake value for money (VFM) audits which determines the efficiency and effectiveness of services provided by the Municipality. The level of responsibility of the Internal Auditor can differ in regard to the scope of work, as well as reporting structure. The scope of duties for the Internal Audit function are formally set out and often include a comprehensive statement of purpose, authority, responsibilities and the reporting relationships. This approach can be used to provide a degree of independence to the Internal Audit function.

### **Auditor General**

The Municipal Act allows the municipality to "appoint an Auditor General who reports to Council and is responsible for assisting Council in holding itself and its administrators accountable for the quality of stewardship over public funds". A significant role of an Auditor General (AG) is to conduct value for money audits. These audits generally are

defined as compliance and operational reviews, combined with a component to assess whether or not the City has obtained benefit from the goods and services it acquires and provides.

## Comparison of Audit Functions

This section focuses on distinctions between and Auditor General and Internal Auditor in the context of reporting and tenure, budget and work plans, authority and responsibility.

Function	Internal Auditor	Auditor General
Reporting and Tenure	Reports through Senior Staff to Council  Typically permanent employees of the municipality	Reports directly to Council  Typically fixed- term contract positions
Budget and Work Plan	Budget approval goes through the same administrative process as municipal departments.  The work plan is based on independent risk assessment.	Budget is approved directly by Council and is set by by-law.  The work plan is based on independent risk assessment.
Authority	Internal Auditors are able to conduct most of the same work as an Auditor General under the general powers granted to municipalities by the Municipal Act.	Subsection 223.19 (1.1) of Municipal Act, 2001 requires the Auditor General to perform his or her responsibilities in an independent manner.  Council may add to the responsibilities specified within the above sections of the Act but may not reduce the responsibilities of the Auditor General.
Responsibilities	Focused mainly on the control environment and compliance reviews, but are not precluded from carrying out value for money audits	Focused mainly on value for money audits, but also undertakes compliance or financial control reviews.

## Comparator Municipalities

This section compares the audit functions used by the City's comparator municipalities. As indicated in the chart below the majority of our comparators have an internal audit function.

<b>Municipality</b>	<b>Audit Function</b>	<b>Annual Budget</b>	<b>Staff</b>
Guelph	Internal Auditor - established in September, 2012	\$338,000 for 2016, but this has been revised downward	Employee- one staff member (occasionally using staff from finance department)
Oshawa	The City had an Auditor General from 2003 until 2013. From 2015 outsourced to KPMG	\$96,300 (for 2016 extra \$150,000 redirected from staff savings)	Outsourced
Windsor	Internal Audit department established in late 1990s and early 2000s. From 2008 until 2012 Auditor General office with 5 staff members. From 2012 outsourced to PWC for 3 years contract and recently Council has authorized a four years extension	\$300,000 per year	Outsourced
Kitchener	Internal Auditor- established in 2004	\$150,000 per year	Employee – 1 staff member - Occasionally using an outside contractor
Thunder Bay	Internal Audit department established in 2004	\$225,000 per year	Employees – 2 staff members (manager and analyst)
Cambridge	Internal Auditor – new position	No information available	Employee – 1 staff member, new position

Barrie	Internal Auditor – new position established in 2015	No information available	Employee – 1 staff member, new position
Kingston	No formal Internal Auditor/Audit department; however, they have a similar protocol developed internally for identifying and carrying out regular compliance reviews. Financial analysts perform most of the audit duties. Periodically, the City contracts an outside consultant for specific reviews		
Waterloo	No internal Auditor/Audit Department		
Niagara Falls	No Internal Auditor/Audit Department		

Out of the ten examined municipalities above, seven have an internal auditor/audit department, where two are newly established positions. The cost associated with this service varies from \$96,330 to \$338,000 per year. With the exception of Thunder Bay, five of the other municipalities have one dedicated staff position with the use of additional internal audit help within the Finance department or an outsourced contractor. Two municipalities outsource this function to a public accounting firm.

### **Types of audits completed and value received**

Based on our review of our comparator municipalities, we have summarized the types of audits performed as well as the value received. We have identified the following types of audits:

- operational audit;
- control and compliance audits;
- business process review that includes effectiveness and efficiency;
- risk management; and
- follow-up audits.

Although there is limited data regarding the value received from the various types of audits conducted in those municipalities, recommendations were made for improvement in operation and control, cost savings, improved effectiveness and efficiency, and updated/facilitated training and procedures development.

When looking at an Internal Audit function, performed by hired staff or by a Professional firm through a competitive bid process, the role performs detailed procedural and control audits, as well as value for money and operational review type audits. The audit focuses strictly on procedures, controls, efficiency and value. The following chart compares the advantages of having internal audit function to outsourcing this function.

<b>Consideration Items</b>	<b>Internal Audit Function</b>	<b>Outsource</b>
Number of audits	With one or two internal staff the number of audits completed in year is limited	Many different audits can be taken on simultaneously
Knowledge	Finding one Auditor that has experience in performing audits in both the traditional financial areas and all the other operating type audits (value for money/operational reviews) will be difficult	Direct municipal experience of large firms provides base knowledge that would take an individual Auditors years to acquire.
Impact of sickness, vacations and turnover	With a department of one or two staff availability of staff is impacted with sickness, vacations or turnover	No interruption of audit work due to vacation, sickness or turnover
Flexibility	With a staff of one or two ability to take on additional audits not in the work plan would be extremely limited	Ability to take on ad hoc audits, as required, without having to postpone or interrupt ongoing audits

## **Alternatives for Consideration**

1. Internal Audit Services
  - a. In-House
  - b. Share with another municipality
  - c. Outsourcing
2. Core Service Review (including Alternative Service Delivery)
3. External Full Program/Service Review
4. Business/Continuous Improvement Program

### **1. Internal Audit Services**

Municipalities have three main internal audit sourcing strategies to choose from. The selection of a sourcing strategy will be driven by the model that best fits the City's requirements and meets its objectives. The models presented below are

based on leading corporate governance practices. Central to leading corporate governance practices is the requirement that management must retain responsibility for the system of internal controls and that Council must retain oversight of the internal audit function. In the Corporate World this occurs through the Audit Committee. This includes approval of the vision, values, strategic objectives, internal audit delivery structure, allocation of financial resources and the respective performance measurements.

The alternative sourcing strategies are:

**a. In-House**

Resources are provided by the City to achieve the strategic objectives of the Internal Audit Function. A key advantage of the In-House model is that it provides the arena for developing future leaders within the organization. Members of the internal audit department are trained on various functions within the organization and obtain a comprehensive understanding of the key risks and challenges that face the organization, enabling individuals to enhance their decision-making process. Other advantages include a higher level of ownership of the internal audit function and a better understanding of the organization's culture that permits internal auditors to master the relationship with various process owners.

The key disadvantage of the In-House strategy is the difficulties internal auditors face in acquiring or maintaining the depth and breadth of specialized skills due to the high cost associated in investing in the skills required. Another drawback is the lack of flexibility to accommodate the increasing demands from oversight bodies to provide control assurance.

**b. Share with another municipality**

In this model, the City would approach another municipality or municipalities for the purpose of putting together a joint request for proposal (RFP) process for the audit services. This arrangement is considered to be more complex and difficult to coordinate. This option could restrict the City in the terms of the contract content in order to satisfy all municipalities involved. Also, this option would require the continuous investment in the in-house internal audit department with respect to training, recruitment and the technology used.

The main advantage of this option is the ability to cost-share the in-house audit department costs. This cost-sharing can potentially provide an increase in the depth and breadth of the specialized skills of the internal audit department staff and improved diversification of staff competencies.

### **c. Outsourcing**

Resources are entirely provided by a third party provider of services to the City in order to achieve the strategic objectives of the Internal Audit Function. The key benefit of a fully outsourced internal audit service model is that many audits could be undertaken simultaneously. The City has the ability to request proficient and qualified staff with core competencies from the service provider in the pursuit of adding value to the organization. Large audit firms have the capacity to do all levels of audits from traditional to value for money audits. The service provider bears the investment costs for training, tools, technology and the Intellectual Capital required and internal auditors are able to maintain financial independence.

The main drawback of this option is that expertise does not reside in-house and accordingly, there is an evident limitation on the ability to transfer knowledge and build the capabilities of the internal audit function within the City.

## **2. Core Service Review (including Alternative Service Delivery)**

Many municipalities have already completed or anticipate conducting some form of service delivery review in the very near future. These reviews are known by a variety of different names but in practice tend to be very similar. To help clarify the differences, the following explanations are provided:

A core service review is a process where the primary focus is on "what" programs and services municipalities should or can afford to deliver and at "what" level or standard of service. This type of review may result in some programs/services being discontinued or service levels being adjusted. In contrast, a program or service delivery review is primarily focused on "how" best to deliver a program or service. It is a systematic process for the collection, analysis, interpretation and presentation of information in order to make administrative and operational judgments about the effectiveness of the program and the efficiency of delivery.

An assessment of alternative service delivery (ASD) opportunities may complement either type of review. ASD is a process of public sector restructuring to improve the delivery of programs/services to citizens. On one hand, a municipality may choose to continue to offer a program/service but contract out the service delivery or enter into a partnership. On the other hand, a municipality may choose to discontinue a program/service altogether where there is low public interest in the service, or where the service is or could be provided by the private, other public, non-for-profit, or volunteer sector.



Municipalities that assess "what" and "how" they deliver programs/services understand the need to find more sustainable approaches to managing expenditures. They understand that the public is looking for governments to make choices about "what" and "how" programs/services are delivered based on good information and sound analysis.

The goal of the service delivery review is to find long-term, sustainable solutions to ongoing budget challenges and provide quality, affordable municipal programs/services in the most efficient and effective manner while maintaining responsible taxation.

### **3. External Full Program/Service Review**

This option is a review of a large number of programs/services including an ASD analysis. This option would be undertaken partially or completely by an external consultant, typically a management accounting firm. While this approach might ensure the objectivity of the analysis, it is very costly. It would bring the expertise of skilled consultants and additional resources to the City recognizing that administration has limited time and resources to devote to this exercise. One major disadvantage of this option is that the consultant does not work day to day in the City's business providing services. Although municipalities provide very similar services, "how" these services are delivered can vary greatly. Therefore this type of review can lead to solutions that are impractical or too costly to implement.

### **4. Business/Continuous Improvement Program**

The objective of this program is to find efficiencies and improve effectiveness as part of doing business. The approach looks at a selected number of services which are thought to contain the potential for savings rather than taking a comprehensive review of the entire operation. In this way, the approach is less coordinated and may not achieve as much as a more rigorous review.

In support of the continuous improvement program, a framework would be developed to provide more formal oversight and foster a more coordinated and integrated approach to continuous improvement across the organization. The framework would be comprised of a governance model and a set of principles that the program would operate under. Implementation of the framework can help ensure the most effective approach is taken in the delivery of City programs/services and the best outcomes for the City are achieved, maximizing the return on taxpayer dollars. The program can also provide coordination across departments, stronger performance management, and change management practices. Opportunities to utilize lean methodologies for process and program reviews to help eliminate "waste" from the system can also be recognized. A continuous improvement program is an ongoing process and may take many years to achieve the desired outcomes. This option more concretely

puts a process in place to build upon Senior Management's current practice. This is the approach taken by the City of St. Catharines.

Research has shown that there is not a one size fits all solution for municipalities reviewing programs and service delivery. Most often, Councils prefer to retain existing programs/services but deliver them at reduced costs through acceptable service level adjustments and improved efficiencies. This is the approach that is currently occurring in the City of St. Catharines with the Business Improvement Team performing formal and informal lean reviews. This is coupled with the use of zero-based budgeting, with the movement towards service level budgeting, where departments are responsible for developing decision-packages to represent the various services and projects that they would like funded. Overall the City of St. Catharines' Business Process Improvement program with the knowledge of existing system continues with the focus on the effectiveness and efficiency of City services.

## **Financial Implications**

The City does not have a separate department for Internal Audit Services or Business Improvement Services. Business Improvement Services are part of the Financial Management Services (FMS) annual operating budget.

If the City were to move to an Internal Audit Function, provided internally or externally, additional operating budget dollars would be required as these costs are not part of the City's annual operating budget. Looking at the budgets for the internal audit function of our comparator municipalities the average annual budget is \$222,000. A one-percent tax increase is approximately \$958,000. Therefore the impact to start an internal audit function would be approximately 0.23%.

## **Relationship to Strategic Plan**

The City's Economic Sustainability is enhanced by being an affordable city for young people, families and retired older adults. An internal audit function, continuous improvement program, core service reviews and service level budgeting are all tools that can be utilized to better understand the costs of city operations and services. In addition these tools allow staff to identify ways to manage costs and to work towards achieving a budgetary tax rate increase at or below the rate of inflation by 2018.

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