

12. APPROVAL/ADOPTION OF NEWLY COMPILED INTERNAL AUDIT METHODOLOGY

3/2/3/12

**DC Van Der Heever
10 April 2015**

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Internal Audit Services

1. Executive Summary

The purpose of the report is to present Council with the newly compiled Internal Audit Methodology, pursuant to it being reviewed by the Audit Committee on 25 March 2015, for approval and adoption with effect from 01 May 2015.

2. Service Delivery and Budget Implementation Plan - IGNITE

Office of the Municipal Manager
Internal Audit Services

3. Compliance with Strategic Priority

Provision of democratic, accountable and ethical governance

4. Delegated Authority

None

5. Legal Requirements

Local Government: Municipal System Act, No 32 of 2000

The Municipal Systems Act requires that the results of performance measurements in terms of section 41(1)(c) of the Act, must be audited –

(a) as part of the municipality's internal auditing processes; and

(b) annually by the Auditor-General.

Local Government: Municipal Finance Management Act, No 56 of 2003

The MFMA requires the establishment of an internal audit unit and audit committee.

Chapter 14, Section 165 – Internal Audit Unit

Chapter 14, Section 166 – Audit Committees

6. Background/Discussion

The purpose of Internal Audit Methodology is to provide a consistent basis for the delivery of Internal Audit Services. The Internal Audit Methodology is

written as a reference document that provides guidance on the key phases and activities applied in an internal audit engagement.

The Internal Audit Methodology further aims to:

- Detail the legislative framework in which Internal Audit operates;
- Specify the codes of practice and standards to which the Internal Audit Activity adheres;
- Document the scope of activities and objectives of the Internal Audit Activity; and
- Provide guidelines and procedures for the Internal Audit Activity within the Overstrand Municipality and assist members of the municipality in the effective discharge of their responsibilities.

7. Financial Implications

None

8. Staff Implications

None

9. Comments from other Departments, Divisions and Administrations

None

10. Annexures

Annexure A: Internal Audit Methodology

RECOMMENDATION TO THE COUNCIL:

that the newly compiled/reviewed Internal Audit Methodology of Overstrand Municipality **be approved** and implemented with effect from 01 May 2015.

RESPONSIBLE OFFICIAL :

D C VAN DER HEEVER

TARGET DATE FOR IMPLEMENTATION :

01 MAY 2015

INTERNAL AUDIT METHODOLOGY



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1. INTRODUCTION

1.1 Definition of Internal Audit

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes - Institute of Internal Auditors (IIA)

1.2 Background

The overall objective of the internal audit activity is to provide all levels of management with an independent assessment of the quality of the internal controls, administrative processes and the extent to which they are assisting the municipality in achieving its strategic objectives in terms of the Integrated Development Plan (IDP).

The internal auditing profession exists within an organisation to serve both management and the organisation in providing recommendations and suggestions for continuous improvements.

The progress and understanding of internal auditing has evolved from an "error" style audit approach, with an emphasis on negative reporting, to a pro-active approach aimed at adding value through performance improvements and thus becoming a useful management tool.

It is expected that internal audit coverage extends beyond merely internal controls, to include assisting in providing a systematic and disciplined approach to risk management and corporate governance.

It is recognized that internal audit must focus on providing value to the organization. Overstrand Municipality internal audit methodology encompasses many of the leading practices in internal audit and is designed to take IIA standards into consideration.

1.3 Purpose of the Internal Audit

Internal audit is a systematic, objective appraisal of the diverse operations and controls within an organisation to ensure the:

- Reliability and integrity of information;
- Compliance with policies and procedures;
- Safeguarding of assets;
- Economical and efficient use of resources; and
- Accomplishment of established objectives and goals for operations or programs.

1.4 Objective of the Overstrand Municipality Internal Audit Methodology

The purpose of Internal Audit Methodology is to provide a consistent basis for the delivery of internal audit services. The Internal Audit Methodology is written as a reference document that provides guidance on the key phases and activities applied in an internal audit engagement.

The Internal Audit Methodology further aims to:

- Detail the legislative framework in which Internal Audit operates;

- Specify the codes of practice and standards to which the Internal Audit Activity adheres;
- Document the scope of activities and objectives of the Internal Audit Activity; and
- Provide guidelines and procedures for the Internal Audit Activity within the Overstrand Municipality and assist members of the municipality in the effective discharge of their responsibilities.

NOTE: Although the Internal Auditor's judgment will be required in applying this information to specific audit assignments, the Internal Audit Methodology should provide guidance, and should not inhibit professional judgment and objectivity.

2 LEGISLATION, GOOD GOVERNANCE AND GUIDANCE

The role and purpose of Internal Audit, like most professions, is governed by legislation and that from time to time guidelines and best practices are issued and formulated in an effort to regulate and govern the activities of Internal Audit. The following legislation and guidelines are applicable to internal auditing:

2.1 Local Government: Municipal System Act, No 32 of 2000

The Municipal Systems Act requires that the results of performance measurements in terms of section 41(1)(c) of the Act, must be audited –

- (a) as part of the municipality's internal auditing processes; and
- (b) annually by the Auditor-General.

2.2 Local Government: Municipal Finance Management Act, No 56 of 2003

The MFMA requires the establishment of an internal audit unit and audit committee.

2.2.1 Chapter 14, Section 165 – Internal Audit Unit

- 1 Each municipality and each municipal entity must have an internal audit unit, subject to subsection (3):
- 2 The internal audit unit of a municipality or municipal entity must -
 - a Prepare a risk-based audit plan and an internal audit program for each financial year;
 - b Advise the accounting officer and report to the audit committee on the implementation of the internal audit plan and matters relating to –
 - i Internal audit;
 - ii Internal controls;
 - iii Accounting procedures and practices;
 - iv Risk and risk management;
 - v Performance management;
 - vi Loss control; and

-
- vii Compliance with this Act, the annual Division of Revenue Act and any other applicable legislation; and*
 - c Perform such other duties as may be assigned to it by the accounting officer.*
 - 3 The internal audit function referred to in subsection (2) may be outsourced if the municipality or municipally entity requires assistance to develop its internal capacity and the council of the municipality or the board of directors of the entity has determined that this is feasible or cost effective.*

2.2.2 Chapter 14, Section 166 – Audit Committees

- 1 Each municipality and each municipal entity must have an audit committee, subject to subsection (6).*
- 2 An audit committee is an independent advisory body which must –*
 - a Advise the municipal council, the political office – bearers, the accounting officer and the management staff of the municipality, or the board of directors, the accounting officer and the management staff of the municipal entity, on matters relating to –*
 - i Internal financial control and internal audits;*
 - ii Risk management;*
 - iii Accounting policies;*
 - iv The adequacy, reliability and accuracy of the financial reporting and information;*
 - v Performance management;*
 - vi Effective governance;*
 - vii Compliance with this Act, the annual Division of Revenue Act and any other applicable legislation;*
 - viii Performance evaluation; and*
 - ix Any other issues referred to it by the municipality or municipal entity.*
 - b Review the annual financial statements to provide the council of the municipality or, in the case of a municipal entity, the council of the parent municipality and the board of directors of the entity, with an authoritative and credible view of the financial position of the municipality or municipal entity, its efficiency and effectiveness and its overall level of compliance with this Act, the annual Division of Revenue Act and any other applicable legislation;*
 - c Respond to the council on any issues raised by the Auditor-General in the audit report;*
 - d Carry out such investigations into the financial affairs of the municipality or municipal entity as the council of the municipality, or in the case of a municipal entity, the council of the council of the parent municipality or the board of directors of the entity, may request; and*
 - e Perform such other functions as may be prescribed.*
- 3 In performing its functions, an audit committee –*

-
- a *Has access to the financial records and other relevant information of the municipality or municipal entity; and*
 - b *Must liaise with –*
 - i *The internal audit unit of the municipality; and*
 - ii *The person designated by the Auditor-General to audit the financial statements of the municipality or municipal entity.*
 - 4 *An audit committee must –*
 - a *Consist of at least three persons with appropriate experience, of whom the majority may not be in the employ of the municipality of municipal entity, as the case may be; and*
 - b *Meet as often as is required to perform its functions, but at least four times a year.*
 - 5 *The members of an audit committee must be appointed by the council of the municipality or, in the case of a municipal entity, by the council of the parent municipality. One of the members who is not in the employ of the municipality or municipal entity, must be appointed as the chairperson of the committee. No councilor may be a member of an audit committee.*
 - 6 *A single audit committee may be established for –*
 - a *a district municipality and the local municipalities within that district municipality; and*
 - b *a municipality and municipal entities under its sole control.*

2.3 The King III report on Corporate Governance in South Africa

The King III Report recommends the minimum practices that should be adopted by any organization in relation to their corporate governance practices.

The King III Report is a non-legislated code that is applicable to:

- Companies listed on the Johannesburg Stock Exchange;
- Corporations falling in the South African Financial Services sector; and
- Enterprises that perform public functions (inclusive of those regulated by the Public Finance and Management Act and the Municipal Finance and Management Act).

2.3.1 Internal Controls

The King III Report recommends that all affected organizations establish an Internal Audit Activity, reporting at the highest level of authority, enabling it to achieve its function in terms of an appropriate charter (Internal Audit Charter).

An effective Internal Audit Activity is an independent objective assurance and consulting activity to add value and improve the organizations operations

2.3.2 Audit Committees

Organisations to which the King III Report applies should have an audit committee. The interaction between such committees and the external auditors is an essential part of corporate governance.

The audit committees should have its own charter and be chaired by a non-executive member (not a Council member), and preferably a majority of its member's should be non-executive (external persons not involved in the organisation) with sufficient experience and financial literacy.

The audit committee must be able to communicate freely with the chair of the board / Council who should not be a member of the audit committee.

The audit committee's primary functions in respect of internal auditing include:

- Approval of the appointment / dismissal of the chief audit executive;
- Approval of the internal audit plan;
- Monitoring of the achievement of the internal audit plan;
- Review of the risk management processes;
- Performance monitoring of audit engagements;
- Monitoring of internal audit professional development; and
- Ensuring that the activity remains professional, relevant and of value.

2.3.3 Internal Audit

Internal audit should provide:

- Assurance that the management processes are adequate to identify and monitor significant risks;
- Confirmation of the effective operations of the established internal control systems;
- Credible processes for feedback on risk management and assurance;
- Objective confirmation that the board receives the right quality of assurance and reliable information from management; and
- Preparation of a risk based internal audit plan linking to the risk assessment.

2.4 National Treasury Circular 65

2.4.1 Audit Committee Responsibilities

Internal Audit

The audit committee must in relation to internal audit:

- Ensure that the charter, independence and activities of the internal audit function are clearly understood and respond to the objectives of the municipality and the legal framework;
- Regularly review the functional and administrative reporting lines of the internal auditor to ensure that the organizational structure is consistent with the principles of independence and accountability;
- Review and approve the internal audit charter, including internal audit strategic plan;
- Confirm that the annual audit plan makes provision for critical risk areas in the municipality and its entities;

- Advise the municipality on resources allocated to give effect to the work outputs of the internal audit function;
- Ensure that there is support for the internal audit unit and external auditors from senior management;
- Confirm with management that internal audit findings are submitted to the audit committee on a quarterly basis;
- Confirm actions taken by management in relation to the audit plan;
- Consider and review reports relating to difficulties encountered during the course of the audit engagement, including any scope limitation or access to information reported to the accounting officer that remain unresolved;
- Evaluate the performance of internal audit activity in terms of the agreed goals and objectives as captured in the audit plan;
- Ensure that the head of internal audit has reasonable access to the chairperson of the audit committee;
- Conduct a high-level review of internal audit on an annual basis, to ascertain whether the internal audit unit complies with the International Standards for the Professional Practice of Internal Auditing;
- Concur with any appointment and termination of the services of the chief audit executive;
- Internal audit unit is accountable to the audit committee as follows:
- Maintain open and effective communication with the audit committee;
- Develop a flexible annual audit plan using a risk based methodology, addressing any weaknesses in risks or controls identified;
- Submit the audit plan to the audit committee for review and approval;
- Report on the implementation and results of the annual audit plan including special tasks requested by management and the audit committee;
- Assist in drafting the agenda and documentation, and facilitate the distribution thereof to the audit committee in advance of meetings;

External Audit

The audit committee must in relation to external audit:

- Take cognizance of the scope of work undertaken by the external auditor and the extent of co-ordination with the internal audit unit;
- Review annual external audit plans, audit fees and other compensation;
- Review reports and monitor management's implementation of audit recommendations and municipal council resolutions in the new financial year;
- Review the report on the financial statements and matters raised therein for reasonability and accuracy;
- Review any interim reports issued in order to take cognizance of the issues raised in determining the follow up work of the internal audit;
- Conduct a review of the extent to which previously reported findings by the external auditor have been addressed by the municipal council;

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- Provide advice to the accounting officer on actions taken relating to significant matters raised in external audit reports;
 - Liaise with the external auditors on any matter that the audit committee considers appropriate to raise with the external auditor;
 - Ensure that the external auditors have reasonable access to the management and chairperson of the audit committee;
 - Address any potential restrictions or limitations with the accounting officer and council;
 - Address outstanding matters raised by the external auditors and any findings are dealt with conclusively in an expeditious manner.

Annual Financial Statements

The accounting officer must prepare Annual Financial Statements (AFS) of the municipality. These financial statements should have been reviewed by the audit committee two weeks before submission to the Auditor-General. The audit committee must review the annual financial statements of the municipality:

- Confirming if the municipal audit file is prepared in line with the applicable standards and guidance contained in MFMA Circular 50, or as updated;
- Reviewing the unaudited annual financial statements of the municipality to ensure that the quality, integrity and content is consistent with applicable standards and compliant with the legal framework;
- Evaluating the annual financial statement of the municipality and its entities for
 - reasonableness, completeness and accuracy, and provide comment thereon, on a timely basis;
- Considering the Auditor-General's opinion on the quality and appropriateness of the municipality's accounting policies and that of its entities; and
- Reviewing efficiency and effectiveness of internal controls over AFS preparation and reporting
- Specifically with regards to Annual Financial Statements, the Audit Committee should:
 - Review and challenge where necessary:
 - Arithmetical accuracy and consistency;
 - Consistency of, and any changes to, accounting policies, comparing to prior years;
 - Methods used to account for significant or unusual transactions where different approaches are possible;
 - Whether the Municipality has followed appropriate accounting standards and made appropriate estimates and judgments, taking into account previous audit outcomes;
 - The quality of disclosure in the Municipality's financial reports and the context in which statements are made;
- All material information presented with the financial statements, such as the operating and financial review and the corporate governance statement (insofar as it relates to the audit and risk management);

- All material issues in prior reports by the AGSA have been appropriately accounted for, resulting in fair presentation;
- Conduct Analysis of trends and other financial ratio calculations e.g. year-on-year comparisons and composition of primary group e.g. salaries as a component of operations, whether operations are undertaken on a sustainable basis, operations at surplus or deficit, efficiency and solvency ratios, etc.

Risk Management Activities

The accounting officer is responsible for the establishment of effective risk management within the municipality. It is expected that the committee will provide an independent and objective view of the effectiveness of the municipality's risk management. It must also provide feedback to the accounting officer and municipal council on the adequacy and effectiveness of risk management in the municipality and its entities.

Control Environment

The audit committee members need to have a good understanding of the control environment, in fulfilling this responsibility the committee should:

- Ensure that management follows a sound process to draw conclusions on the adequacy and effectiveness of the system of internal control;
- Establish whether management has relevant policies and procedures in place and that these are adequate, effective and regularly updated;
- Determine whether appropriate processes are followed and complied with on a regular basis;
- Consider measures applied on any required changes to the design or implementation of internal controls;
- Assess steps taken by management to encourage ethical and lawful behavior; financial discipline and accountability for use of public resources.

Performance Management

Audit Committee members need to have a good understanding of the performance of the municipality and its entities. These include:

- Review and comment on compliance with statutory requirements and performance management best practices and standards;
- Review and comment on the alignment of the Integrated Development Plan, the Budget, Service Delivery and Budget Implementation Plan and performance agreements;
- Review and comment on relevance of indicators to ensure they are measureable and relate to services performed by the municipality and its entities;
- Reviews compliance with in-year reporting requirements;
- Review the quarterly performance reports submitted by internal audit;
- Reviews and comments on municipality's and entities annual financial statements and timely submission to the Auditor-General by 31 August, each year;

- Review and comment on the municipality's and entities annual reports within the stipulated timeframes; and
- Review and comment on the municipality's performance management system and make recommendations for its improvement.

Information Technology (IT) Governance

The audit committee also needs to provide advice on IT governance, controls, access, safeguarding of information in the municipality and its entities. Specific expertise may be required from within or outside the municipality from time to time, to assist the internal audit unit and audit committee formulates recommendations on systems and controls. The committee may have to advise on the appropriateness of disaster recovery and continuity plans supporting IT risks, regular testing and evaluation of plans, systems and processes.

2.4.2 Internal Audit Responsibilities:

Circular 65 states that Internal Audit Activity should:

- Develop a risk-based audit plan,
- Understand the control environment of the organization,
- Include the following types of audits:
 - 1) Risk based audits,
 - 2) Cyclical audits and,
 - 3) Ad hoc audit requests

In addition, Internal Audit Activity should ensure that the following is in place:

- **Quality Assurance and Improvement**

The activities of the internal audit must be guided, monitored and supervised at each level of operation to ensure that they are consistently performed in accordance with the International Standards for the Professional Practice of Internal Audit. The quality assurance and improvement programme should include periodic internal assessments within a short time prior to an external assessment which can facilitate and reduce the cost of the external assessment.

- **Internal Assessments**

The Chief Audit Executive must ensure that internal assessments are performed. Internal assessments should include ongoing reviews of the performance of the internal audit activity. These should be performed through self-assessment or by other persons within the municipality with knowledge of internal audit practices and the IIA Standards. The chief audit executive, at least annually, must report on the results of internal assessments. Internal assessments should appraise among others, compliance with the legislative framework, definition of internal auditing, standards, internal audit charter, code of ethics and methodology.

- **External Assessments**

The internal audit must be subjected to an external assessment at least once every five years, the results of which should be communicated to the audit committee and accounting officer. An external assessment must be conducted by a qualified reviewer or review team from outside the municipality. On completion of the external assessment, the review team should issue a formal

report containing an opinion. The chief audit executive in consultation with the accounting officer should prepare a written action plan in response to comments and recommendations in the report.

- **Coordination of efforts with other assurance providers**

Internal audit should share information and co-ordinate its activities with other assurance providers within the municipality or municipal entity. This is done to ensure appropriate coverage of risk areas and minimise duplication of efforts. There should be access to each other's audit plans and audit reports. There should be periodic meetings held between internal audit and external audit. At these meetings key risks, audit scope and audit findings should be discussed and priorities should be emphasized.

3 THE PROFESSION OF INTERNAL AUDITING

The profession of internal auditing requires affiliation with a professional body, for example the Institute of Internal Auditors, which is an international body.

The environments and organisations in which internal audit activities are performed throughout the world are highly diverse. Moreover, these activities may be in-sourced or outsourced. This diversity affects the practice of internal auditing in each environment and organisation. Nevertheless, compliance with the International IIA Standards is mandatory for individuals and entities providing internal auditing services. However, to accommodate the diversity of practice, the language of the International Standards is broadly inclusive, and more specific guidance is left to other pronouncements.

3.1 The IIA International Standards

According to the IIA, the International Standards are intended to:

- State basic principles for the practice of internal auditing.
- Provide a framework for performing and promoting value-added internal audit activities.
- Establish the basis for evaluating internal audit performance.
- Improve organisational processes and operations.

The International Standards consist of Attribute Standards (currently 1000 – 1340), Performance Standards (currently 2000 – 2600), and Implementation Standards (integrated with other Standards).

- Attribute Standards concern the traits of Internal Audit Activities and individuals providing internal auditing services.
- Performance Standards describe internal audit activities and criteria for evaluation of their performance.
- Attribute and Performance Standards furnish guidance for all internal auditing services (assurance, consulting and other).

3.2 The IIA Code of Ethics

The Code of Ethics was adopted by the Institute of Internal Auditors, with a purpose of promoting an ethical culture in the profession of internal auditing.

The Institute's Code of Ethics extends beyond the definition of internal auditing to include two essential components:

- Principles that are relevant to the profession and practice of internal auditing; and
- Rules of conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors. The rules of conduct are defined into:
 - ❖ Integrity;
 - ❖ Objectivity;
 - ❖ Confidentiality; and
 - ❖ Competency

4 THE SERVICES OF THE INTERNAL AUDIT ACTIVITY

The Internal Audit Activity is a line function and serves the reports to the Accounting Officer (administratively) and to the Audit Committee & Performance Audit Committee (functionally).

4.1 Services Provided

Services provided by the Internal Audit Activity include inter alia:

- Provide consulting services, including counsel, advice, facilitation and training;
- Provide audit assurance;
- Communicating audit knowledge and best practices (experiences);
- Draw and share comparisons in terms of best practice and industry norms.
- Provide advice and guidance to the Accounting Officer, Management and Audit & Performance Committee;
- Review the adequacy, effectiveness and efficiency of systems of internal control;

4.2 Internal Auditors responsibility to Management

Each Directorate will have different business risks or concerns upon which management may request feedback from the internal auditors. These may vary according to factors such as size, industry geographical location, regularity requirements, management style and culture and the availability of feedback from other sources. The table below provides some examples of typical risks and the related internal audit engagements.

RISKS	POTENTIAL INTERNAL AUDIT ENGAGEMENTS
<ul style="list-style-type: none"> • Non-compliance with laws and regulations 	<ul style="list-style-type: none"> • Control self assessment review • Compliance review • "Health checks"
<ul style="list-style-type: none"> • Financial management 	<ul style="list-style-type: none"> • Control system review

RISKS	POTENTIAL INTERNAL AUDIT ENGAGEMENTS
	<ul style="list-style-type: none"> • Fraud prevention / detection review
<ul style="list-style-type: none"> • Reliability and integrity of information 	<ul style="list-style-type: none"> • Security review • Control self assessment review
<ul style="list-style-type: none"> • Fraud / Misrepresentation 	<ul style="list-style-type: none"> • Investigations • Preliminary assessments
<ul style="list-style-type: none"> • Reliability of financial and other management information 	<ul style="list-style-type: none"> • Systems review • Analysis review • Information Systems review
<ul style="list-style-type: none"> • IT systems 	<ul style="list-style-type: none"> • Systems development life cycle review • Pre assessment review • Process re-engineering
<ul style="list-style-type: none"> • Efficiency of service delivery 	<ul style="list-style-type: none"> • Post system implementation reviews • Value for money or operational review • Cost vs. benefit (feasibility) • Performance management review

4.3 Main Control Environment Focus Areas

Listed below are the main control environment focus areas of the Internal Audit Activity when reviewing a business process:

4.3.1 Ensure reliability and integrity of information

- Review the control measures (access levels, storage, etc) around the safeguarding of data and information.
- Review the accuracy and completeness of information and data.
- Review the need for information and data in the existing format.

4.3.2 compliance with policies, plans, procedures, laws and regulations

- Determine the regulated and approved legislation applicable to the given business process.
- Assess the application of the legislation by the business unit.
- Bring the lack of compliance with statutory / mandatory requirements to the attention of the Municipal Manager and relevant Management for remedial action.

4.3.3 Ensure safeguarding of assets

- Review register / listings of assets / inventory to ensure that it is complete and accurate
- Determine if assets are marked and assigned to the applicable responsible business unit.