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FOREWORD

This Handbook has been prepared to provide those responsible for establishing and appointing Audit Committees, and members of Audit Committees, with support in their respective roles.

It has been written primarily for departments and Executive Agencies. It refers to the responsibility of the Accounting Officer in establishing the Audit Committee. In Non Departmental Public Bodies (NDPBs) the Audit Committee is established as a Committee of the Board with a primary reporting line to the Board rather than to the Accounting Officer, and detailed guidance is provided by the Cabinet Office¹. The guidance in this handbook therefore needs to be “translated” accordingly for NDPBs, but should nevertheless be of use to them. It is often possible for NDPBs to substitute “the Board” where reference is made to the Accounting Officer (depending on the specific circumstances, including whether or not the Accounting officer is a Board member, consideration will need to be given to the relationship between the Audit Committee and the NDPB’s Accounting Officer).

Because no two organisations are exactly the same it is not possible to write a “rule book” for an Audit Committee in central government. The contents of this Handbook are intended to help:

- Accounting Officers and Boards work out the best arrangements for particular circumstances
- Audit Committees and individual members of Audit Committees reflect on their role and on the ways in which they function.

The Handbook is intended to offer “good practice guidance”, capable of practical interpretation into a range of organisational structures and governance arrangements, which supports implementation of the “Policy Principles for Audit Committees” (which were first promulgated under cover of DAO(GEN) 13/00, and which are now superseded by the further developed principles as set out in the handbook). In producing this version consideration has been given to the recommendation made in the Sharman Report (“Holding to Account – The Review of Audit and Accountability for Central Government”²) and the recommendations of the Higgs³ and Smith⁴ reports to the extent possible given the context of central government accountability structures.

The essence of the function of an Audit Committee in central government is to support the Accounting Officer (or Board) by monitoring and reviewing both the risk, control and governance processes which have been established in the organisation, and the associated

¹ See <http://www.cabinet-office.gov.uk/agencies-publicbodies/guiddepts/docs/NDPB%20GUIDE%202000.pdf>

² See http://www.hm-treasury.gov.uk/documents/public_spending_and_services/audit_and_accounting/pss_aud_sharman.cfm

³ See http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf

⁴ See <http://www.frc.org.uk/publications/content/ACReport.pdf>

assurance processes. This is achieved by introducing an independent perspective and a process of constructive challenge, not to undermine the actions of the Accounting Officer or Board, but to help them to be fully assured that the most efficient, effective and economic risk, control and governance processes are in place and that the associated assurance processes are optimal. In addition, this prepares them for the formal accountability processes which they have to face (see paragraph 1.1 under policy principle 1). It is therefore important to draw the membership of the audit committee from those charged with governance who are also non-executives where such people exist. Given the governance arrangements in central government it is not always possible to meet both criteria and it is necessary to have a balance of people who together have both governance responsibilities and independence of the executive.

The role of the Audit Committee may differ in organisations which have a Risk Committee. However care should be taken to distinguish between the role of a Risk Committee, which is likely to have an executive function in the management of risk delegated to it and the role of the Audit Committee which by definition should have no executive function but should provide advice to the Accounting Officer or Board for executive decision on what action to take.

Readers seeking to interpret the guidance given here and to identify the best practices which they may be able to achieve in the context of their own organisation should note that the handbook follows a logical structure, particularly at principles 4, 5 and 6 on membership of the Audit Committee, by setting out a recommended ideal then moving on to consider what further options may be available if the ideal is not achievable.

Readers should note that this handbook deals with the constitution and activity of Audit Committees; it does **not** provide guidance on the process for making appointments of non-executives to the Board and independent external members to the Audit Committee nor does it provide guidance on the training and development of non-executives which is an important issue in its own right. More guidance on both these issues is available from the Cabinet Office.

We are very grateful for the large number of comments which we have received on the draft version of this handbook. Every effort has been made to incorporate them, but in order to keep the handbook as a document of universal benefit across the range and variety of central government organisational structures; it has not been possible to incorporate them all. Our intention is that the reader should be pragmatic in the interpretation of this guidance and seek to develop their Audit Committee in a way which works towards the ideal as set out here whilst acknowledging the constraints which may prevent its achievement.

POLICY PRINCIPLES FOR AUDIT COMMITTEES with explanatory notes

1. **On the principle of having an Audit Committee:**
Audit Committees should be established in all central government bodies (Departments, Executive Agencies and Non-Departmental Public Bodies).
 - 1.1 Every Accounting Officer expects to be held to account in a variety of ways. Accounts are published, Statements on Internal Control are made, performance is measured, value for money is reviewed, the Ombudsman may investigate allegations of misadministration, and the Committee of Public Accounts may take evidence on reports from the National Audit Office.
 - 1.2 Accounting Officers cannot know the detail of everything that is going on in the organisation – so they need a means of gaining assurance about what is going on, and further assurance about the robustness of the assurance mechanisms that are in place. Knowing that there are assurances available about the way in which the organisation is conducting its business, and knowing that these assurances are robust and reliable, is also the best preparation an Accounting Officer can have for being held to public account.
 - 1.3 The main method of gaining these assurances is through an Audit Committee which carries out its work by reviewing and challenging the assurances which are available to the Accounting Officer, the way in which these assurances are developed, and the management priorities and approaches on which the assurances are premised. Whilst there is a range of detailed responsibilities which might be assigned to the Audit Committee, it is not the task of an Audit Committee to substitute for the executive function in the management of Internal Audit, risk management, corporate governance, stewardship reporting, control and risk self-assessment, or any other review or assurance function. However the Audit Committee should offer opinions or recommendations on the way in which such management is conducted. Care should especially be taken to avoid confusion between the role of an Audit Committee and that of a Risk Committee which could have a delegated executive authority to take risk management decisions.
 - 1.4 As well as providing assurance to the Accounting Officer, the Audit Committee is also a useful mechanism for ensuring appropriate high level information on risk and control is brought to the Accounting Officer's attention. From the work it does, the Audit Committee will develop good knowledge of areas of weakness in the organisation and of their significance. This can assist the Accounting Officer in identifying his or her priorities for action.

- 1.5 Because of the benefits outlined above there must be clear and strong reasons, which should be documented, for a decision not to establish an Audit Committee. In such a case, consideration should be given to making the fact that the Audit Committee does not accord with this guidance explicit in the Statement on Internal Control.

2. **On the role of the Audit Committee:**

The Audit Committee is appointed to support the Accounting Officer (and the Board in NDPBs) in monitoring the corporate governance and control systems in the organisation. The objectivity of the advice given is enhanced if the Audit Committee is chaired by a non-executive or independent external member.

- 2.1 The Audit Committee supports the Accounting Officer by offering objective advice on issues concerning the risk, control and governance of the organisation and the associated assurances. It has no authority in its own right, over the operations of the organisation or those bodies which conduct audit and assurance work (including Internal Audit). It should, however, advise the Accounting Officer on the adequacy, and the appropriateness in the light of both known and emerging risks, of the work plans of those bodies, including Internal Audit, which conduct audit and assurance work.
- 2.2 The considerations of the Audit Committee are more likely to lead to objective advice if they are not being steered (i) by somebody with executive authority in the organisation, or (ii) by the person to whom the Committee is to give advice. It is therefore preferable that a non-executive, not the Accounting Officer, should chair the Audit Committee; this does not in any way undermine either the authority or the accountability of the Accounting Officer for directing the organisation. It is also preferable that the Chair of the Audit Committee should be a non-executive Board member (see also Policy Principle 3) and should not chair any other Board committees (to avoid potential conflict of interests). In any particular case in which the Accounting Officer does Chair the Audit Committee it is suggested that this should be made clear in the organisation's Statement on Internal Control so that the nature of the Committee should be fully disclosed.
- 2.3 From time to time the Audit Committee may help the Accounting Officer prepare for being held to public account by subjecting the Accounting Officer's executive decisions to constructive challenge in the sense of encouraging him or her to ensure that they can demonstrate that they have made the best possible decisions in the light of all available evidence. This is better achieved if the Audit Committee is not steered in its considerations by the Accounting Officer. This

role for the Audit Committee is one of adding value by helping the Accounting Officer to ensure that good judgement has been exercised.

- 2.4 In departments and agencies the Audit Committee does not have a representative role on behalf of stakeholders⁵ (this is in direct contrast with the private sector where the Audit Committee has a role, through the board, on behalf of shareholders).
- 2.5 Members of the audit committee are bound by the normal civil service rules relating to disclosure of information and must respect their privileged position without which the audit committee cannot have free and frank discussions. If they consider the Accounting Officer has taken, or plans to take, an illegal action they should deal with the issue in accordance with the established policies of the organisation for handling such circumstances.

3. ***On the Audit Committee relationship with the Board:***

In Departments and Agencies which have a Management Board structure, and in NDPBs, the Audit Committee should be a committee, or a sub-committee, of the Board. The Audit Committee should corporately own an appropriate skills mix to allow them to carry out their overall function. In some small bodies the Board may sit separately as the Audit Committee.

- 3.1 Many Accounting Officers in departments and Executive Agencies have a Board to support them in the corporate management of the organisation. Although these Boards generally have no legal or corporate status and do not dilute the personal accountability of the Accounting Officer, they do play a significant role in developing the management strategy of the organisation. It is therefore appropriate that the work of the Audit Committee links closely to the work of the Board, particularly in understanding the management priorities and concerns of the Board.
- 3.2 There should therefore be a two-way link between the Board and the Audit Committee through an element of common membership. If (at least) the majority of Audit Committee members are also members of the Board it ensures that the Audit Committee knows and understands the Board's priorities. The Accounting Officer may prefer that the Audit Committee formally reports back to them through the Board in order that the whole Board may consider the assurances and advice provided by the Audit Committee and an element of common membership

⁵ This is a particular issue which may be different in NDPBs where the Board is appointed by Ministers. The exact circumstances for the establishment of the body will have to be considered.

- helps ensure that Audit Committee views are properly represented in Board discussions. In any case the minutes of the Audit Committee should always be available to members of the Board. The Board / Audit Committee link is strengthened if the Board secretary also acts as the Audit Committee secretary (the practice of using a member of the Internal Audit team to act as Audit Committee secretary can give rise to conflict of interest, especially if the Committee decides to sit in private to discuss the performance of Internal Audit).
- 3.3 Notwithstanding the need for an element of common membership between the Audit Committee and the Board, it is also important that the Audit Committee should include (ideally a majority of) members who are **not** executive members of the Board (see Policy principles 4 and 5). This enhances the ability of the Committee to challenge the risk, control and governance processes, and associated assurance processes, which have been put in place and to help the Board consider whether improvement in these areas is possible.
- 3.4 An Audit Committee requires a range of competencies to allow it to be effective in its functions. These competencies will include, at least, understanding the government environment and accountability structures; understanding of the function of the organisation; financial / accountancy skills; management skills. A more detailed listing is at Annex 3. It is also important that those appointed to the Audit Committee are provided with suitable induction training to allow them to understand the organisation and effectively contribute to the achievement of the Committee's Terms of Reference. New members of the Audit Committee should discuss their induction training needs with the Chair of the Committee.
- 3.5 It is recognised that some organisations will be numerically small and the creation of a separate Audit Committee may be impracticable. In such cases the Board may sit as the Audit Committee (but at a different time from its sittings as the Board to help it develop an objective mindset separate from its management role). This should **not** be the 'default' option for smaller organisations; before deciding to take this course of action careful consideration should be given to other options. Consultation with the providers of both the internal and external audit services may be helpful, as may consultation with any sponsoring department. If the Board does sit as the Audit Committee, other actions to enhance objectivity are essential, such as a non-executive taking the chair. In these circumstances the constitution of the Audit Committee should be made explicit in the Statement on Internal Control to avoid a reader misconstruing the reference to the Audit Committee which arises there.

4. ***On using non-executives of the Board:***

In bodies which have non-executive members on the Management Board the membership of the Audit Committee should be drawn as far as possible from these non-executive members.

- 4.1 In government departments and Executive Agencies, non-executives do not share the responsibilities of their private sector namesakes. Because there is no corporate structure it is not possible for non-executives to hold the executives “in check” in the same way as happens in the private sector; non-executives in government are differently motivated as they do not share in the corporate liability of the board as they would if they were Directors of a private sector company. The primary purpose in appointing a non-executive to the Board of a government organisation is to provide external advice and expertise in association with independence of thought which informs the decision making processes of the Board.
- 4.2 Nevertheless, it is still the case that non-executive members of the Board are well suited to providing a bridge between the Board and the Audit Committee and to taking up the “challenge” function with a good knowledge of the priorities and concerns of the Board.
- 4.3 If there is a sufficient number of non-executives on the Board the Audit Committee should be formed entirely, or at least primarily, from non-executives (while taking account of the need for a suitable mix of skills and sufficient knowledge and experience of the organisation’s business). This is the preferable constitution to both enhance the objectivity and independence of the Audit Committee and gain maximum advantage from its work.
- 4.4 It is not the purpose of this publication to provide detailed advice on the appointment of non-executives. If consideration of Audit Committee and risk, control and governance issues leads an organisation to consider making appointments of non-executives to its Board where they do not already have established procedures for doing so, they should take note of Cabinet Office guidance on public appointments⁶.

⁶ See <http://www.cabinet-office.gsi.gov.uk/public/Default.htm>

5. On independent external members:

In bodies which have insufficient non-executive Management Board members, appropriate individuals should be sought for appointment as independent external members of the Audit Committee.

- 5.1 If no non-executives are available from the Board, or if the number of non-executives available from the Board is small, consideration may be given to appointing independent external members directly to the Audit Committee so as to achieve a majority of non-executives. When this is done, mechanisms will need to be established to ensure that they understand the business and priorities of the organisation. For example it is important to make board papers available to those AC members who are not also on the board. They also need an induction process.
- 5.2 It is important to note that there is a difference between an *independent* external member and an external member who is there to represent the interests of a third party (for example, a representative of the sponsoring department sitting on the Audit Committee of an Executive Agency). Such external appointees should have some sort of relevant experience which will help them to be sympathetic to the business and the particular concerns of the organisation. In some cases, if understanding the mechanisms of government and the issues involved in policy work is a high priority, the most appropriate source of external members may be other government organisations. In making appointments of independent external Audit Committee members, attention should be given to the Cabinet Office's guidance on public appointments.
- 5.3 Appointment of independent external members of the Audit Committee should be for an appropriate period of time. This should be long enough to allow them to become effective in their role and to make a useful contribution but short enough to prevent their becoming 'stale' in their role. Initial appointment for a period of three years is suggested, with renewal of appointment being possible.
- 5.4 In these circumstances in which no non-executives are available from the Board, or the number of non-executives available from the Board is small, the ideal is that the non-executives and independent external members of the Audit Committee should comprise the majority of the Audit Committee (continuing to bear in mind the need for a suitable overall skills mix).

6. On the use of executives on the Audit Committee:

In those organisations which have a sufficiently large number of senior executive staff, the members of the Audit Committee with executive responsibility in the body (other than the Accounting Officer) should be rotated on an appropriate cycle (three years will generally be appropriate) to provide for objectivity in the long term and to avoid the development of any apparent “right” of a particular executive interest to be represented on the Audit Committee.

6.1 An Audit Committee has to ensure that it takes an unbiased view of the whole range of risk, control and governance issues in the organisation. For the incumbent of any particular executive post to serve on the Audit Committee for too long can potentially generate an unwitting bias in the Audit Committee’s view of the organisation; rotation of executive membership is a guard against this possibility.

6.2 Within the need to actively control against any unwitting bias, there is also a need to generate sufficient stability in the membership of the Audit Committee to ensure that there is consistency over time in its considerations and that experience in undertaking the work of the Audit Committee is built up. It is therefore important that rotation of executive membership is not over-rapid.

7. On the size of the Audit Committee:

The number of members on the Audit Committee should ideally be in the range of three to five members. The Accounting Officer (or Chief Executive) and the Principal Finance Officer (or Finance Director) should normally attend meetings, as should the Head of Internal Audit and the External Audit representative. Membership count should not include those who regularly attend but are not members of the Audit Committee.

7.1 The Audit Committee needs a sufficient number of members to ensure that an appropriate skills set is corporately established amongst its members (see 3.4 above). At the same time the Committee needs to be small enough to ensure that all members can participate actively in discussions.

7.2 The recommended size of the Audit Committee does not prohibit the Committee from seeking contributions from others when it considers that its work can be enhanced by seeking specialist support. For example, if a significant issue arises in Audit Committee discussions in relation to a specialist area of the organisations

operations, the Committee may invite an appropriate specialist to join them for the purpose of ensuring that their discussions are appropriately and adequately informed. If such specialist advice has to be bought in for the Audit Committee, it should be at the cost of the organisation.

- 7.3 It is important that the Accounting Officer, the Finance Director, the Head of Internal Audit and the External Audit representative should regularly attend Audit Committee meetings (the Audit Committee may also ask other members of staff to attend so as to provide them with information to inform their considerations). Their participation in discussions is beneficial in informing the discussion among the full members of the Committee, in particular to brief the Committee on the detail behind papers which will have been prepared for it. However, the Committee may choose to ask particular executives not to attend for a particular item of business, or even to meet from time to time with only "full members" of the Committee present, to facilitate open discussion about a particular issue. For example, if the Committee wanted to discuss the strategy for management of the internal audit function, they would want to hear the Head of Internal Audit's views but they may also wish to subsequently discuss what they have been told without the HIA being present. The Audit Committee may sometimes find it beneficial to discuss issues at the end of a meeting after those who are not members have withdrawn. This allows the Audit Committee to decide by themselves what they want to put on the record as their advice to the Accounting Officer.
- 7.4 It is beneficial if the Chair of the Audit Committee makes arrangements to meet with each of the Accounting Officer, the Finance Director, the Head of Internal Audit and the External Audit representative bilaterally at least once a year.
- 7.5 There is often an inter-relationship between the Audit Committee of an Executive Agency (or NDPB) and the sponsoring department. Where that relationship involves attendance by representatives of the sponsoring department at the sponsored body's Audit Committee, care should be taken to clarify whether the representative is there as an observer to gain assurance on behalf of the sponsoring department or as a member of the Audit Committee. The former option is preferable; the latter option may give rise to a conflict of interest as the Committee's primary responsibility is to the body in which it functions, not to the sponsoring department.

8. ***On the Terms of Reference of the Audit Committee:***
Audit Committees should have documented terms of reference from the Accounting Officer/Board.

- 8.1 The exact role of the Audit Committee will depend on the particular circumstances of the organisation. For example, the role of the Audit Committee may vary depending on whether or not a separate Risk Management Committee has been established. It is therefore important that the Audit Committee knows exactly what its remit is, and how it is expected to relate to, interface with, and receive information from other forums such as the Management Board or a Risk Management Committee. A model Terms of Reference for the Audit Committee is provided at Annex 1.
- 8.2 The areas of responsibility listed in Annex 1 is not exhaustive – the Audit Committee may be given other roles (for example, considering the stewardship reports submitted by line managers, or considering the outputs from a strategic management programme of risk and control workshops)
- 8.3 Further guidance on the key questions which the Audit Committee might ask on the issues which it is required to consider is at Annex 2, 'Key Questions for the Audit Committee to Ask'.
- 8.4 In order to be effective in these responsibilities the Audit Committee will need to possess a range of skills (see 3.4 above). A basic range of skills corporately required by an Audit Committee is at Annex 3.

9. ***On audit access to the Audit Committee:***
The Head of Internal Audit and the senior member of the external audit team should have right of access to the Audit Committee.

- 9.1 The Audit Committee has to consider the planned activity and results of both internal and external audit work. It is possible that auditors may have concern about the way in which either the planning of their work is being subjected to influence by management or the way in which the results of their work is being handled by management. In addition, auditors, in particular internal audit, will have escalation procedures for addressing weaknesses which they have identified and which they seek to have corrected in order to allow them to give assurance

that risks are appropriately controlled and managed. Both the Head of Internal Audit and the External Audit representative should have free access to the Chair of the Audit Committee in order to raise any such concerns which they may have. In this respect the Audit Committee adds value to the audit process by protecting the independence of the audit function and advising auditors on the way in which the Committee interprets the particular results arising from audit work and the related advice which they would give to the Accounting Officer.

10. On meetings of the Audit Committee:

The Audit Committee should meet regularly and normally at least four times a year.

- 10.1 Larger organisations in particular will need four or more meetings of the Audit Committee in a year in order to cope with the workload. Some smaller organisations with a smaller Audit Committee workload may find that three meetings are sufficient.
- 10.2 Much of the work of the Audit Committee can be related to particular times in the year. For instance consideration of proposed internal audit plans should be carried out when a specific audit plan has been developed and before the financial year begins, whilst consideration of an audit opinion as a contribution to preparing the Statement on Internal Control can only be carried out once the audit opinion has been drafted which is likely to be some time after the end of the financial year.
- 10.3 In addition the quantity of work which the Audit Committee will have to carry out if it is to meet its obligations under Annex 1 is such that it is unlikely to be able to do so effectively if it has less than four meetings a year.
- 10.4 For guidance only, a potential core programme of 'seasonal' work for an Audit Committee which meets four times a year might be as set out below (the timings may vary depending on exactly when meetings take place and the faster closing initiative may impact on the programme as organisations bring forward the finalisation of their accounts). In addition to the seasonal work, the Audit Committee should expect to review the results of specific Internal Audit assignments which have been completed at each meeting.

Spring meeting

- Comment on the accounts for the year just finished prior to their finalisation and submission for audit

- Advise on the content of the Statement on Internal Control for the year just finished, to be presented alongside the finalised accounts
- Review Internal Audit's finalised periodic work plan for the financial year just begun.

Summer meeting

- Consider Internal Audit opinion for the financial year just finished
- Consider (emerging) External Audit opinion for the financial year just finished
- Discuss the implications of the result of the Accounting Officer's review of effectiveness of the system of internal control in relation to the SIC

Autumn meeting

- Consider mid year report on emerging findings from Internal Audit
- Consider the External Audit management letter for the previous year and any emerging findings from the current interim / in-year work of External Audit
- Consider any residual actions arising from the previous year's work of both internal and external audit

Winter Meeting

- Advise on the internal audit strategy and the periodic work plan for the beginning of the new financial year.
- Consider areas in which the Committee will particularly promote co-operation between auditors and other review bodies in the coming year
- Re-visit emerging findings from auditors and review actions in response to the External Audit management letter
- Consider the Committee's own effectiveness in its work

ANNEX 1

Model Terms of Reference for an Audit Committee

The Accounting Officer (*Board for NDPBs*) has established an Audit Committee to support them in their responsibilities for issues of risk, control and governance and associated assurance.

Membership

- The members of the Audit Committee are:
 - Non-executive Board members : *List those who are appointed to the Audit Committee*
 - External members : : *List those who are appointed to the Audit Committee*
 - Other members : : *List those who are appointed to the Audit Committee (in all cases indicate the date of appointment and when the appointment is due to end / become eligible for renewal)*
- The Audit Committee will be Chaired by
- The Audit Committee will be provided with a secretarial function by.....

Meetings

- The Audit Committee will meet at least four times a year. The Chair of the Audit Committee may convene additional meetings as they deem necessary.
- A minimum of ... members of the Audit Committee will be present for the meeting to be deemed quorate.
- Audit Committee meetings will normally be attended by the Accounting Officer, the Finance Director, the Head of Internal Audit, and a representative of External Audit.
- The Audit Committee may ask any other officials of the organisation to attend to assist it with its discussions on any particular matter.
- The Audit Committee may ask any or all of those who normally attend but who are not members to withdraw to facilitate open and frank discussion of particular matters.
- The Accounting Officer (or Board) may ask the Audit Committee to convene further meetings to discuss particular issues on which they want the Committee's advice.

Access

The Head of Internal Audit and the representative of External Audit will have free and confidential access to the Chair of the Audit Committee.

Reporting

The Audit Committee will formally report back in writing to the Accounting Officer (*or Board if appropriate*) after each meeting.

Responsibilities

The Audit Committee will advise the Accounting Officer (or Board) on

- the strategic processes for risk, control and governance and the Statement on Internal Control
- the accounting policies, the accounts, and the annual report of the organisation, including the process for review of the accounts prior to submission for audit, levels of error identified, and management's letter of representation to the external auditors.
- the planned activity and results of both internal and external audit
- adequacy of management response to issues identified by audit activity, including external audit's management letter
- assurances relating to the corporate governance requirements for the organisation
- (where appropriate) proposals for tendering for either Internal or External Audit services or for purchase of non-audit services from contractors who provide audit services

Information requirements

- The Audit Committee will be provided with:
 - For each meeting:
 - A report summarising any significant changes to the organisation's Risk Register
 - A progress report from the Head of Internal Audit summarising:
 - work performed (and a comparison with work planned)
 - key issues emerging from Internal Audit work
 - management response to audit recommendations
 - changes to the Periodic Plan
 - any resourcing issues affecting the delivery of Internal Audit objectives
 - A progress report from the External Audit representative summarising work done and emerging findings.
 - As appropriate
 - Proposals for the Terms of Reference of Internal Audit
 - The Internal Audit Strategy
 - The Head of Internal Audit's Annual Opinion and Report
 - Quality Assurance reports on the internal audit function
 - The draft accounts of the organisation
 - The draft Statement on Internal Control
 - A report on any changes to accounting policies
 - External Audit's management letter
 - A report on any proposals to tender for audit functions
 - A report on co-operation between Internal and External Audit

The above list suggests minimum requirements for the inputs which should be provided to the Audit Committee. In some cases more may be provided. For instance, it might be agreed that Audit Committee members should be provided with a copy of every Internal Audit assignment report, or with copies of management Stewardship Reports if these are used in the organisation.

ANNEX 2

Key Questions Which The Audit Committee May Ask

This list of questions is not intended to be exhaustive or restrictive, nor should it be treated as a tick list substituting for detailed consideration of the issues it raises. Rather it is intended to act as a "prompt" to help an Audit Committee ensure that their work is comprehensive.

On the strategic processes for risk, control and governance:

- How is the organisational risk management culture generated, and is it appropriate?
- Is there a comprehensive process for identifying and evaluating risk, and for deciding what levels of risk are tolerable?
- Is the Risk Register an appropriate reflection of the risks facing the organisation?
- Is appropriate ownership of risk in place?
- How does management know how effective internal control is?
- Is risk management carried out in a way that really benefits the organisation or is it treated as a box ticking exercise?
- Is the organisation as a whole aware of the importance of risk management and of the organisation's risk priorities?
- Does the system of internal control provide indicators of things going wrong?
- How meaningful is the AO's annual 'Statement on Internal Control' and what evidence underpins it?
- Does the SIC appropriately disclose action to deal with material problems
- Have the implications of the results of the effectiveness review been discussed at Board level?

On the planned activity and results of both internal and external audit:

- Is the Internal Audit strategy appropriate for delivery of a positive reasonable assurance on the whole of risk, control and governance?
- Will the periodic audit plan achieve the objectives of the Internal Audit strategy, and in particular is it adequate to facilitate a positive, reasonable assurance?
- Does Internal Audit have appropriate resources, including skills, to deliver its objectives?
- Are there any issues arising from management not accepting Internal Audit recommendations and are agreed internal audit recommendations appropriately actioned?
- What assurance is there about the quality of Internal Audit work?
- Is there appropriate co-operation between the internal and external auditors?

On the accounting policies, the accounts, and the annual report of the organisation:

- Do the accounting policies in place comply with relevant requirements, particularly the Resource Accounting Manual?
- Has there been due process in preparing the accounts and annual report and is that process robust?
- Have the accounts and annual report been subjected to sufficient review by management and by the Accounting Officer and / or Board?
- When new or novel accounting issues arise how is appropriate advice on accounting treatment gained?
- Is there an appropriate anti-fraud policy in place and are losses suitably recorded?
- Are suitable processes in place to ensure accurate financial records are kept?
- Are suitable processes in place to ensure fraud is guarded against and regularity and propriety is achieved?
- Does financial control, including the structure of delegations, enable the organisation to achieve its objectives with good value for money?
- Are there any issues likely to lead to qualification of the accounts?
- If the accounts have been qualified, is appropriate action being taken to deal with the reason for qualification?
- Are issues raised by the External Auditors given appropriate attention?

On the adequacy of management response to issues identified by audit activity:

- Are agreed procedures in place for monitoring progress with the implementation of recommendations?
- If management reject audit recommendations which the auditors stand by, are suitable resolution procedures in place?

On assurances relating to the corporate governance requirements for the organisation:

- Is the range of assurances available sufficient to facilitate the drafting of a meaningful Statement on Internal Control?
- Do those producing the assurances understand fully the scope of the assurance they are being asked to provide and the purpose to which it will be put?
- What mechanisms are in place to ensure the assurances are reliable?
- Are the assurances 'positively' stated (ie – premised on sufficient relevant evidence to support them)?
- Do the assurances draw out material weaknesses or losses which should be addressed?
- Does the Statement on Internal Control realistically reflect the assurances?

On the work of the Audit Committee itself:

- How does the Audit Committee know if it is being effective in achieving its terms of reference and adding value to corporate governance and control systems of the organisation?
- Is the Audit Committee content that it has the appropriate skills mix?
- Is the Audit Committee content with its level of understanding of the purpose and work of the organisation?
- Is the Audit Committee content that it has sufficient time to give proper consideration to its business?
- Is the Audit Committee content that it is avoiding any conflict of interest?
- Is there evidence of the Audit Committees advice having an impact on the organisation?

ANNEX 3

Audit Committee Competency Framework

All members of the Audit Committee should have, or acquire as soon as possible after appointment:

- Understanding of the objectives of the organisation and current significant issues for the organisation
- Understanding of the organisation's structure, including key relationships such as that with a sponsoring department or a major partner
- Understanding of the organisation's culture
- Understanding of any relevant legislation or other rules governing the organisation
- Broad understanding of the government environment, particularly accountability structures and current major initiatives.

The Audit Committee should corporately possess:

- Knowledge / skills / experience (as appropriate and required) in:
 - Accounting
 - Risk management
 - Audit
 - Technical or specialist issues pertinent to the organisation's business
- Experience of managing similar sized organisations
- Understanding of the wider relevant environments in which the organisation operates
- Detailed understanding of the government environment and accountability structures

ANNEX 4

PRECIS OF CENTRAL GOVERNMENT ACCOUNTABILITY, AUDIT AND GOVERNANCE ARRANGEMENTS

This annex is primarily intended to help those coming to Audit Committee responsibilities from outside government to grasp some of the relevant key issues in the government environment. It summarises, for easy reference, the key issues in central government accountability and audit structures. It does not substitute for, or supersede, Government Accounting or any other extant Treasury manuals or instructions; it is solely intended to provide a convenient and generalised summary to assist the reader in understanding the environment.

ACCOUNTABILITY

Normally the Permanent Secretary or Chief Executive of a government organisation is also appointed as the “Accounting Officer” (AO). The AO is individually and personally accountable for achieving good value for money, regularity and propriety in the administration and operation of the organisation⁷.

In departments and Executive Agencies, there is no legal or statutory corporate structure to senior management, unlike the private sector in which the Directors are individually and severally accountable and liable for the decisions of the Board. Management Boards in these bodies are essentially tools of the AO and are more akin to private sector “Executive Committees” than to private sector Boards. Although responsibilities will have to be delegated by the AO to other senior managers, formal accountability cannot be delegated or shared.

In NDPBs there will be a Board for which the legal responsibilities and liabilities will be set out in the legislation establishing the body. Some NDPBs are registered Companies or Charities, in which case other legal responsibilities will attach to board members.

AOs are held to account by Parliament through the Committee of Public Accounts, usually in response to reports prepared by the National Audit Office (see below). Similarly the accounts and associated statements that they prepare are laid before Parliament. There is no direct equivalent of the private sector annual shareholders meeting at which the Board is held to account by the shareholders.

An important boundary to the responsibility of the AO lies in the area of policy formulation. There is a separation between the policy *decisions* made by the Minister and the policy *advice* provided by the AO. If the AO considers a decision made by the Minister would represent poor value for money, they can request written direction to proceed with the policy which moves accountability for any consequences from the AO to the Minister (the issue of a direction

⁷ For more detail see “Responsibilities of an Accounting Officer” published by HM Treasury.

instigates a review by the National Audit Office of the circumstances – see below). Ministers are held to account by Parliament through the relevant Select Committee. This contrasts with the private sector arrangements whereby the Board will normally be accountable for all aspects of policy decisions.

THE ROLE OF NON-EXECUTIVES

Government departments and Executive Agencies may choose to appoint non-executives to their Board and/or independent external members to their Audit Committee. In the private sector non-executives have a clearly defined role of acting as a ‘check’ on the executive whilst also having a liability for the corporate actions of the Board. Because government departments and Executive Agencies have no comparable corporate Board structure non-executives are more like external advisors or consultants. Their role is to provide an effective “challenge” function to the executive. Guidance on the appointment and liabilities of non-executives is currently being developed by the Cabinet Office.

AUDIT

Every AO is required, by Government Accounting, to make suitable provision for Internal Audit in accordance with the “Government internal Audit Standards”. This provision may be made through an in-house team or the function may be bought in under contract. In some Executive Agencies and NDPBs the service is provided by the sponsoring department’s Internal Audit service. Internal Audit is therefore mandatory in central government organisations.

Generally speaking, the External Auditor for departments and Executive Agencies is the Comptroller and Auditor General (C&AG) whose establishment is the National Audit Office. The C&AG is an officer of, and reports to, Parliament. There is consequently no role for the Audit Committee in recommending the appointment of external auditors. As well as certification of accounts, the C&AG investigates the circumstances in which Ministers have issued written directions to AOs, and may choose to conduct value for money studies into the activities and operations of government organisations.

GOVERNANCE

Although central government organisations have no corporate structure, AOs are required to make governance statements (a “Statement on Internal Control”) alongside their accounts. These statements are modelled on the Stock Exchange’s requirements in their Combined Code, and mirror and adapt the relevant guidance produced by the Turnbull Committee as far as possible and practicable. Detailed guidance on the requirement for governance statements has been produced by the Treasury⁸ and is supported by strategic guidance on the implementation of business risk management processes.⁹

⁸ Government Accounting – Chapter 21 “Risk Management and the Statement on Internal Control” (due to be issued in December 2003)

⁹ “Management of Risk – A Strategic Overview”

Although there is great similarity in governance statements in central government and in the private sector, there are subtle but significant differences. Whilst both are designed to deliver assurance that assets are protected and robust processes are in place for assessing and taking business risks, those of the private sector are focussed on maximisation of shareholder value whilst those in central government are focussed on delivering the public service objectives (within the policy set by Ministers) of the organisation with good value for money, regularity, and propriety.