

To: POLICY AND RESOURCES (FINANCE) SUB COMMITTEE		Subject: AUDIT COMMITTEE PRINCIPLES IN LOCAL AUTHORITIES IN SCOTLAND
From: DIRECTOR OF FINANCE		
Date: 1 December 2004	Ref: KA/CMT	

**1. Introduction**

- 1.1 As part of the corporate governance agenda, local authorities have increasingly been expected to incorporate 'audit committee principles' into their management arrangements. The Accounts Commission/Audit Scotland recently emphasised the need for local authorities to review their audit committee arrangements in the national report on Internal Audit '*A Job Worth Doing – Raising the Standard of Internal Audit in Scottish councils: A follow-up report*' (published in July 2004). A similar recommendation was also made in the Council's Best Value Transitional Audit Report.
- 1.2 The CIPFA in Scotland Directors of Finance Section has recently published guidance that for the first time defines what 'audit committee principles' means in practice in the local government context.

**2. Background**

- 2.1 The Council does not currently have a formally constituted Audit Committee. The main mechanisms for considering audit matters are the Policy and Resources (Finance) Sub-Committee and the Chief Executive's Audit Group. Additionally, the full Policy and Resources Committee take some audit-related items of a corporate nature.
- 2.2 The Policy and Resources (Finance) Sub-Committee approves the Internal Audit Strategic and Annual Plans, receives regular progress reports from the Audit Manager during the course of the year and notes the Internal Audit Annual Report and the Audit Manager's annual opinion on the internal control framework within the Council. External audit outputs are not routinely submitted to the Committee with the exception, where appropriate, of significant national reports produced by Audit Scotland and/or the Accounts Commission.
- 2.3 The Chief Executive's Audit Group comprises the Chief Executive, the Director of Finance, two other Service Directors, the Corporate Policy and Performance Manager and the appointed external auditor. The Group approves the Internal Audit Strategic and Annual Plans, receives regular progress reports from the Audit Manager and notes the Internal Audit Annual Report and the Audit Manager's annual opinion on the internal control framework within the Council. The Group also considers the local audit outputs produced by the appointed external auditor together with certain other associated matters including, where appropriate, issues such as risk management and corporate governance.

- 2.4 The Chief Executive's Audit Group considered issues relating to the introduction of 'audit committee principles' at its recent meeting in September 2004 and concluded that proposals should be developed and taken forward for subsequent approval by elected members.

### **3. Audit Committee Principles**

- 3.1 The CIPFA Guidance Note does not require authorities to establish a separate audit committee, but it makes clear that the creation of an audit committee, or equivalent, would be seen as good practice and demonstrate acceptance of audit committee principles. The Guidance Note does not, prescribe any single organisational structure as being preferable to any other, but does indicate that:

*"Audit committee principles can only be achieved if there is (one or more) formal group(s) of elected members specifically charged with ensuring that mechanisms exist to deliver them and they are effective."*

- 3.2 The Guidance Note also provides three fundamental principles that define the expression 'audit committee principles'. These are that there should be effective mechanisms in place to provide:
- Independent assurance of the adequacy of the risk management framework and the associated control environment within the authority;
  - Independent scrutiny of the authority's financial and non-financial performance to the extent that it affects the authority's exposure to risk and weakens the control environment; and
  - Assurance that any issues arising from the process of drawing up, auditing and certifying the authority's annual accounts are properly dealt with.
- 3.3 Annex A contains a matrix which illustrates how each of these principles should be translated into specific actions together with an assessment of the extent to which the Chief Executive's Audit Group (CEAG) and the P&R (Finance) Sub-Committee currently cover such areas.
- 3.4 Given the comments from Audit Scotland, the guidance prepared by CIPFA and recent changes in the revised CIPFA Code of Practice for Internal Audit, it is considered unlikely that the Council could continue to argue that its current arrangements adequately and effectively discharge 'audit committee principles'. It is recognised that there needs to be more direct involvement of a group of elected members.
- 3.5 The Guidance Note states that the audit committee is expected to play a key role in the corporate governance of a local authority and that it is important to ensure that the status of the committee attracts the appropriate membership. The Guidance Note also stresses that the integrity of an audit committee will be demonstrated by the quality of its membership, the content of its agenda and by the manner in which the members discharge their role.
- 3.6 To be fully effective, an audit committee should contain individuals who have a good understanding of how the whole council works and a broad understanding of the controls that exist or should exist. It is also helpful if individuals have the ability to

distinguish between serious control weaknesses and those that are relatively minor and are confident about discussing audit findings with the auditors and management.

3.7 The Guidance Note recognises that training and support will be required to help members become effective audit committee members. In addition, the guidance also recognises that some Councils have co-opted skilled and independent people onto audit committees to supplement elected member representation.

3.8 The Guidance Note suggests terms of reference, provides details of the roles and responsibilities of those likely to be involved and stresses that the application of audit committee principles should reinforce good corporate governance and contribute towards providing additional assurance that the Council is complying with its statutory duties and has adequate controls and risk management systems in place.

3.9 A number of options have been identified which the Council could consider:

- amending the existing remit of the P&R (Finance) Sub-Committee;
- creating a stand-alone audit committee;
- incorporating a specific audit remit as part of revised scrutiny arrangements; and
- establishing a wider standards/audit/corporate governance committee.

3.10 These options are considered at Annex B

#### **4. Chief Executive's Audit Group - preferred option**

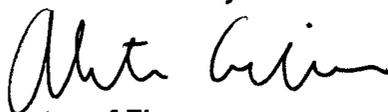
4.1 These options were considered by the Chief Executive's Audit Group at its September 2004 meeting where it was decided that the creation of an Audit and Governance Panel as part of revised scrutiny arrangements reporting directly to the Policy & Resources Committee was the Group's preferred option. Suggested terms of reference for the Panel are at Annex C. Additional detailed information about the proposed working and associated information are at Annex C.

4.2 As well as presenting an opportunity for a review of the effectiveness of the current scrutiny arrangements, the creation of an Audit and Governance Panel will require some minor changes to existing terms of reference for the Policy and Resources (Finance) Sub-Committee to change responsibility for audit arrangements.

#### **5. Recommendations**

5.1 The Committee is asked to:

- acknowledge the need for the Council to revise its current audit arrangements to comply with good practice; and
- to agree the creation of an Audit and Governance Panel reporting directly to the Policy & Resources Committee as part of revised scrutiny arrangements



**Director of Finance**

## Annex A Assessment of current arrangements against Audit Committee principles matrix

<b>Principle 1 – The Control Environment</b>		
Independent assurance of the adequacy of the risk management framework and the associated control environment within the authority.		
	<b>CEAG</b>	<b>P&amp;R (Finance)</b>
Consideration of Internal Audit periodic plans and strategy	Yes*	Yes
Monitoring of achievement of internal audit plan	Yes*	Yes
Review of summary/selection of audit reports, main issues arising and implementation of recommendations	Yes*	Partly
Ensuring that risk assessment has been carried by the Audit Manager	Yes*	Partly
Review of annual report and assurance statement to committee from the Audit Manager	Yes*	Yes
Existence of strong/effective relationship between external audit, inspection agencies and internal audit	Yes*	No
Ensuring that the value of the audit process is actively promoted	Yes*	No
<b>Principle 2– Risk Related Performance</b>		
Independent scrutiny of the authority’s financial and non-financial performance to the extent that it affects the authority’s exposure to risk and weakens the control environment.		
	<b>CEAG</b>	<b>P&amp;R (Finance)</b>
Consideration of the effectiveness of the corporate risk assessment process	Partly*	No
Consideration of significant risk related performance issues raised by auditors and other inspectors	Yes*	No
Monitoring of implementation of improvement action plans	Partly*	No
<b>Principle 3– Annual Accounts and the External Auditor</b>		
Assurance that any issues arising from the process of drawing up, auditing and certifying the authority’s annual accounts are properly dealt with.		
	<b>CEAG</b>	<b>P&amp;R (Finance)</b>
Review of audit certificate and consideration of matters arising from audit	Yes	Yes
Consideration of annual report to members from external auditor and monitoring the implementation of agreed action plans	Yes	Yes
Consideration of external audit reports, main issues arising and implementation of recommendations	Yes	No

**Note:**

Where the assessment is marked with an asterisk, this is in recognition that although the Chief Executive’s Audit Group discharges this function, the Group’s current composition means that it cannot be seen as wholly independent as specified by the Audit Committee principles.

## Annex B Possible organisational structures for delivering audit committee principles

Option	Pros	Cons
Add 'Audit Committee' remit to existing P&R (Finance) Sub-Committee arrangements	<ul style="list-style-type: none"> <li>• Avoids creating additional committee;</li> <li>• Avoids duplication of effort by Internal Audit function and others Council officers required to attend and service meetings of the committee/panel;</li> </ul>	<ul style="list-style-type: none"> <li>• Too many members to work effectively as audit committee;</li> <li>• No specific evidence that optimal membership of any Audit Committee is necessarily shared with existing membership of P&amp;R (Finance);</li> <li>• Doubtful that committee chaired by the Finance Convenor would be seen as sufficiently independent;</li> <li>• Limited evidence that current method of operation of the Sub-Committee would allow proper discharging of audit committee remit;</li> <li>• Potential impact on current role of Finance Sub-Committee</li> </ul>
Create additional sub-committee dealing wholly with audit matters reporting to the P&R (Finance) Sub-Committee	<ul style="list-style-type: none"> <li>• Achieves elected member involvement</li> <li>• Minimises duplication of effort by Internal Audit function and others Council officers required to attend and service meetings of the committee</li> <li>• Could be chaired by someone perceived as more independent than the Finance Convenor</li> </ul>	<ul style="list-style-type: none"> <li>• Possible lack of status and importance</li> <li>• Doubts over whether structure would allow proper discharging of audit committee remit</li> </ul>
Amend CEAG to incorporate involvement of Elected Members	<ul style="list-style-type: none"> <li>• Achieves elected member involvement</li> <li>• Minimises duplication of effort by Internal Audit function and others Council officers required to attend and service separate meetings of the Member and Officer groupings</li> <li>• Achieves involvement of senior officers with good understanding of key issues</li> </ul>	<ul style="list-style-type: none"> <li>• Hybrid of elected member and senior officers may undermine effectiveness;</li> <li>• Would not be formally constituted within the decision-making structure of the authority</li> </ul>
Consider separate audit committee	<ul style="list-style-type: none"> <li>• Achieves elected member involvement</li> <li>• Would discharge expectations and requirements to meet 'audit committee principles'</li> <li>• Avoids creating hybrid group with disparate roles/responsibilities</li> </ul>	<ul style="list-style-type: none"> <li>• Creates an additional Council committee;</li> <li>• Possibly difficult to attract right membership and provide/generate status required for effective operation;</li> </ul>
Amend existing scrutiny arrangements to incorporate audit committee principles	<ul style="list-style-type: none"> <li>• Achieves elected member involvement</li> <li>• Recognises shared interest in service performance and accountability issues;</li> </ul>	<ul style="list-style-type: none"> <li>• May weaken or undermine the effectiveness of the current scrutiny arrangements</li> <li>• Current membership of panels too large for effective audit committee</li> </ul>

## Annex C Proposed remit for Audit and Governance Panel

### MODEL TERMS OF REFERENCE FOR AN AUDIT AND GOVERNANCE PANEL

The Council has established an Audit and Governance panel to assist the Council in monitoring the corporate governance, risk and control systems in the organisation and associated assurance frameworks.

The Audit and Governance Panel will be responsible to the Council for considering and reporting on the following matters:

<b>Internal Audit</b>
<ul style="list-style-type: none"><li>• To consider and agree internal audit strategic and operational plans and ensuring that internal audit work is planned with due regard to risk, materiality and coverage;</li><li>• To monitor and review Internal Audit reports including the main issues arising and actions taken on internal audit recommendations;</li><li>• To monitor the achievement of internal audit plan and review of internal audit performance;</li><li>• To review the Internal Audit Annual report and the annual statement on internal controls.</li></ul>
<b>External Audit</b>
<ul style="list-style-type: none"><li>• To review the external audit planning memorandum;</li><li>• To review all matters relating to external audit outputs;</li><li>• To monitor the implementation of external audit recommendations;</li><li>• To review the arrangements for ensuring satisfactory and effective liaison between external and internal audit.</li></ul>
<b>Risk management</b>
<ul style="list-style-type: none"><li>• To review and assess whether an appropriate corporate risk management strategy and procedures have been drawn up;</li><li>• To review and assess whether risk management procedures are being satisfactorily carried out.</li></ul>
<b>Annual accounts</b>
<ul style="list-style-type: none"><li>• To consider the accounting policies and the accounts of the organisation, including the process for preparation and review of the accounts prior to submission for audit, levels of error identified by the audit process, and management's letter of representation to the external auditors;</li><li>• To review the audit certificate/wording and any matters reported;</li><li>• To review the annual Final Report to members from the external auditor and the implementation of audit recommendations arising.</li></ul>
<b>Corporate Governance</b>
<ul style="list-style-type: none"><li>• To consider the adequacy of management response to issues identified by other regulatory and inspection functions where they affect the organisation's overall performance;</li><li>• To ensure systematic appraisal and assurances of the Council's control environment and framework of internal control to provide reasonable assurance of effective and efficient operations consistent with the corporate governance requirements for the organisation, e.g. relating to the Council Leader signing corporate governance statements or similar;</li><li>• To assess whether high standards of corporate governance have been demonstrated.</li></ul>

## **Annex D Additional information**

### **Proposed Membership of the Audit and Governance Panel**

The Audit and Governance Panel shall have at least 4 and no more than 7 members. Members of the Panel should not be chair or vice-chair of any other Council committee. The political composition of the Panel should broadly reflect the political composition of the Council subject to all major political groupings having at least one member on the Panel. The members of the Panel shall elect a Chair. The Council may also co-opt no more than 2 non-elected Members to the Panel. The Audit and Governance Panel should corporately own an appropriate skills mix to allow it to carry out its overall function.

### **Meetings**

The Audit and Governance Panel will meet around four times a year.

The Chair of the Audit and Governance Panel may convene additional meetings, as he/she deems necessary. The Chief Executive or the Council may also ask the Audit and Governance Panel to convene further meetings to discuss particular issues on which they want the Audit and Governance Panel's advice.

A minimum of three members of the Audit and Governance Panel will be present for the meetings to be deemed quorate.

Audit and Governance Panel meetings will normally be attended by the Chief Executive, the Director of Finance, the Audit Manager (or his/her representative), and a representative of external audit. The Audit and Governance Panel may ask any other officials of the organisation to attend to assist it with its discussions on any particular matter.

The Audit and Governance Panel 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 Audit Manager and the representative of external audit will have the right to unrestricted and confidential access to the Chair of the Panel (it is expected, however, that exercise of this right would be on an exceptional basis only).

The Director of Administration will provide administrative and secretarial services to support the workings of the Panel.

### **Reporting**

The Audit and Governance Panel will provide the Policy and Resources Committee with an annual report containing a general assurance that the Panel is operating in accordance with relevant guidance and any significant issues addressed. An indicative list of questions that should be addressed by the Panel is at Annex 2.

## **Key questions which the Audit and Governance Panel might 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 the Audit and Governance Panel ensure that their work is comprehensive.

### **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?
- Does internal audit have appropriate resources, including skills, to deliver its objectives?
- Are 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 audit?
- Are there any issues likely to lead to qualification of the accounts?
- Are issues raised by the external audit given appropriate attention?
- Are external audit's plans for coverage reasonable?
- Does external audit keep the organisation informed of emerging findings?
- Are external audit recommendations appropriately actioned?

### **On the strategic processes for risk, control and governance:**

- How, in broad terms, 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 management process fully integrated with the business planning and performance management processes?
- Is the high-level risk register an appropriate reflection of the risks facing the organisation?
- Is risk management fully embedded in the organisation, including the development and maintenance of Risk Registers at all appropriate levels?
- Is appropriate ownership of risk in place?
- How does the organisation ensure that risks are being effectively managed and that internal control is effective?
- 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 (where appropriate) is the Chief Executive's annual Statement on Internal Control (SIC) or equivalent and what evidence underpins them?
- Does the SIC appropriately disclose action to deal with material problems?

### **On the accounting policies and the accounts of the organisation:**

- Do the accounting policies in place comply with relevant statutory requirements?
- When new or novel accounting issues arise, how is appropriate advice on accounting treatment gained?
- Is there an appropriate anti-fraud policy in place?

- What levels of fraud are being reported and 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, budgetary processes and procedural instructions enable the organisation to achieve its objectives with good value for money?
- Are suitable processes in place to ensure accurate financial records are kept?

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

- Are agreed procedures, including the use of action plans and follow-up action, in place for monitoring progress with the implementation of recommendations?
- If management reject audit recommendations that 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 assurance statement?
- Does the Chief Executive's assurance/SIC realistically reflect the assurances?
- What mechanisms are in place to ensure the assurances are reliable?
- Are the assurances 'positively' stated (i.e. based on sufficient relevant evidence to support them)?
- Do the assurances draw out material weaknesses that should be addressed?
- Do those below the Chief Executive 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?