

ROYAL BOROUGH OF KENSINGTON AND CHELSEA

**CABINET AND CORPORATE SERVICES OVERVIEW AND SCRUTINY
COMMITTEE – 12 SEPTEMBER 2005**

ARRANGEMENTS FOR MEMBER SCRUTINY OF AUDIT MATTERS

**REPORT OF THE EXECUTIVE DIRECTOR OF
FINANCE, INFORMATION SYSTEMS AND PROPERTY**

This paper reviews the Council's arrangements for audit matters and invites Members to consider future options, including creation of a stand-alone audit committee, for recommendation to the Cabinet, Administration Committee and Council.

FOR DISCUSSION

1. Background

1.1 Responsibilities for audit matters within the Council are currently split.

- The **Administration Committee** is charged with receiving the Council's Statement of Accounts, and hence, under Audit Commission rules, is also the body to which the external auditors must report their Annual Audit Plan and Audit Opinion. The Statement of Accounts is accompanied by a Statement of Internal Control (SIC), signed by the Leader and the Town Clerk and Chief Executive. The external auditor presents the Audit Opinion to the Committee.
- The **Cabinet** receives the Annual Audit and Inspection Letter, presented by our external auditor.
- The **Cabinet and Corporate Services Overview and Scrutiny Committee (OSC)** has responsibility for a variety of matters under the Council's Audit Procedure Rules, including receiving quarterly and annual reports from the Head of Internal Audit. It also receives the Annual Audit and Inspection Letter and the External Audit Plan. However, the statutory duty to receive this now sits with the Administration Committee, because it receives the Accounts.
- The **Cabinet Member** for Finance and Property is charged with 'arrangements for audit'.

Our external auditors therefore report to a number of Member bodies and there is some dispersal of responsibility for audit matters across different bodies.

- 1.2 Audit arrangements have been considerably tightened in the corporate sector in recent years. Standards are becoming increasingly international and expectations are also migrating from the private to the public sector. The functions of an audit committee form part of those expectations.
- 1.3 A stand alone audit committee is expected to give a sharper focus on audit and on risk management as essential foundations of stewardship. The Audit Commission has made it clear that it now regards it as best practice for local authorities to have a full audit committee. The Audit Commission says in its Annual Review (published July 2005):
"Establishing an effective audit committee, which plays a vital role in raising the profile of financial reporting and internal control issues and provides a focus for the work of both internal and external auditors, is an essential element of good corporate governance... Working in partnership with other national stakeholders, we will continue to advocate the setting up of audit committees in local government, and their existence and effectiveness will be a key factor in auditors' use of resources judgement for CPA 2005."
- 1.4 An extract from the new "harder test" Comprehensive Performance Assessment (CPA) assessment framework for audit and internal control is shown below. It sets out, at high level, the terms on which a committee would operate, including that the Chairman should be suitably experienced. The assessment framework implies that this Council would be at level two on the specific point "There is no audit committee but the core functions of an audit committee have been identified and are being undertaken by a member group." Starred items are essential in 2005/06 and their absence will bar progression to higher levels of the assessment. Other items are expected to become requirements in the following year.

4. INTERNAL CONTROL		
How well does the council's internal control environment enable it to manage its significant business risks?		
Key line of enquiry		
4.2 The council has arrangements in place to maintain a sound system of internal control		
Audit Focus		
Evidence that:		
<ul style="list-style-type: none"> • the council reviews and reports on its system of internal control • the council has an audit committee or equivalent and an internal audit function 		
Criteria for Judgement		
Level 2	Level 3	Level 4
* An appropriate member group has responsibility for review and approval of	* The council has put in place an assurance framework that maps	The assurance framework is fully

<p>the SIC and considers it separately from the accounts.</p> <p>* The council has conducted an annual review of the effectiveness of the system of internal control and reported on this in the SIC.</p> <p>* The sources of assurance to support the SIC have been identified and are reviewed by senior officers and members.</p> <p>* There are action plans in place to address any significant internal control issues reported in the SIC.</p> <p>* There is no audit committee but the core functions of an audit committee have been identified and are being undertaken by a member group.</p> <p>* The council has an internal audit function that operates in accordance with the CIPFA code of practice for internal audit in local government.</p> <p>* There are procedure notes/manuals in place for those systems identified by the council as being business-critical.</p> <p>* There are standing orders, standing financial instructions and a scheme of delegation in place.</p> <p>* The council has arrangements in place to ensure compliance with relevant laws and regulations, internal policies and procedures,</p>	<p>the council's strategic objectives to risks, controls and assurances.</p> <p>* The assurance framework provides members with information to support the SIC.</p> <p>There is a specific member group (such as an audit sub-committee or member panel) which has audit and governance issues as the principal responsibility in its terms of reference.</p> <p>The member group provides effective leadership on audit and governance issues. It is proactive and has a forward looking programme of meetings and agenda items to ensure comprehensive coverage of all responsibilities in relation to the internal control environment.</p> <p>The procedure notes/manuals for those systems identified by the council as being business-critical are reviewed and updated at least annually.</p> <p>The standing orders, standing financial instructions and scheme of delegation are reviewed at least annually.</p> <p>* Compliance with standing orders, standing financial instructions and the scheme of delegation is monitored by management, and any breaches identified and appropriate action</p>	<p>embedded in the council's business processes.</p> <p>The council can demonstrate corporate involvement in/ownership of the process for preparing the SIC.</p> <p>There is an audit committee which is constituted as a full committee of the council and is independent of both the Executive and Scrutiny functions.</p> <p>The council has taken steps to ensure that the audit committee chair either has previous knowledge of, or has received appropriate training on, financial and risk management, accounting concepts and standards, and the regulatory regime.</p> <p>Audit committee members are provided with specific training relevant to their responsibilities.</p> <p>The audit committee has terms of reference which are reviewed on an annual basis, taking into account relevant governance developments and how it integrates with other committees within the council.</p> <p>The standing orders, standing financial instructions and scheme of delegation make specific reference to partnerships.</p>
--	--	--

<p>and that expenditure is lawful.</p> <p>* All reports to members have been formally considered for legal issues before presentation.</p> <p>There are partnership agreements in place for all the council's significant partnership arrangements.</p>	<p>taken.</p>	<p>Partnership agreements are subject to regular review and updating.</p>
---	----------------------	---

- 1.5 The Chartered Institute of Public Finance and Accountancy (CIPFA) has also published a consultative position paper on Audit Committee Principles in Local Government which recommends that there should be a full Audit Committee. The paper emphasises that the local authority should have overt mechanisms to give:
- 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.
- 1.6 Many issues are common between public and private sectors. However, there are some differences. For example, auditor selection is undertaken by the Audit Commission, with local authorities being consulted only, and audit independence is governed by Audit and Inspection Regulation.
- 1.6 Practice between local authorities varies. A recent survey of London Boroughs showed that, of those responding, most had sub-committees with an audit remit and only two had full stand-alone committees. It is likely that most will be reviewing their position following the Audit Commission guidance.

2. Audit Committee Functions

- 2.1 The purpose of having an audit committee is to provide greater focus on stewardship, internal control and risk issues than might be achieved when this is one part of a wider committee agenda. As the council extends its ambitions there is a strong argument that it

needs to have correspondingly excellent systems in place to ensure it takes only calculated risks based on solid systems and good information. An audit committee is one way of underwriting and challenging those processes. It is also a guardian of stewardship and a representative of the taxpayer interest in the use of resources.

2.2 HM Treasury guidance on the establishment of audit committees in central government says, *'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 that have been established in the organisation, and the associated assurance processes. This is achieved by an independent perspective and a process of constructive challenge, not to undermine the actions of the accounting officer or Board but to help them 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.'*

2.3 Were the Council to adopt an audit committee it is likely that its terms of reference would include the following:

a) A statement of purpose – along the lines set out below

The purpose of an audit committee is to provide independent assurance of the adequacy of the risk management framework and the associated control environment, 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 to oversee the financial reporting process.

b) Core Functions

- Approve (but not direct) internal audit's strategy, plan and performance
- Review summary internal audit reports and the main issues arising, and seek assurance that action has been taken where necessary
- Receive the annual report of the Head of Internal Audit
- Consider the reports of external audit
- Consider the effectiveness of the authority's risk management arrangements, the control environment and associated anti-fraud and anti-corruption arrangements. Seek assurances that action is being taken on risk related issues identified by auditors and inspectors
- Be satisfied that the authority's assurance statements, including the Statement on Internal Control, properly reflect the risk environment and any actions required to improve it

- Ensure that there are effective relationships between external and internal audit, inspection agencies and other relevant bodies, and that the value of the audit process is actively promoted
- Review the financial statements, external auditor's opinion and reports to members, and monitor management action in response to the issues raised by external audit
- Oversee the Council's Code of Corporate Governance.

However, CIPFA is expected to publish further guidelines on the terms of reference of audit committees in local government and it would be sensible to see these before firming up proposed terms of reference.

3. Structure and Administration

- 3.1 A Committee would be expected to be formally independent of both the Executive and Scrutiny functions and would need clear reporting lines as a Council committee. It would probably meet at least four times a year. It would be expected to meet the external auditor at least once a year and (to meet CPA highest level standards) to report annually to the full Council. A workable minimum size is likely to be four Members.
- 3.2 If implemented it may be desirable for the Committee to be instituted in time to receive the external and internal audit plans for 2006/07, which would be presented before the start of the new financial year.

4. Options

4.1 Option 1.

Members of the OSC currently review the regular audit reports with care and constructive challenge. The Council can continue to operate its current arrangements through the OSC, with the advantage of continuity. After 2005/06 this is unlikely to meet the more stringent requirements of the CPA at the levels of higher performing criteria.

4.2 Option 2.

The Council can set up a new audit committee. This will involve:

- Changes to the Constitution
- Set-up and induction
- Servicing a new Committee – although internal audit can take some of the functions in relation to agenda preparation.

It would be unlikely to require a change to Members' allowances, but this would need to be confirmed.

The transfer of regular and long reports to another forum might create further capacity within the OSC agenda.

4.3 Option 3

The Council could adopt a mid-way point – e.g. a specific sub-committee of the OSC, or attaching the audit terms of reference to the existing Administration Committee. This could appear to have some of the disadvantages of both options without their advantage of addressing more stringent levels of best practice head on. The Administration Committee chairmanship is not currently independent of the Executive.

Either of the last two options could involve one or possibly two external members, to provide an additional level of independence and challenge.

5. Consultation

5.1 The Council's external auditors have commented that they would be very supportive of a decision to establish an Audit Committee and have drawn attention to guidance on the desirable qualities for committee members.

5.2 The Director of Law and Administration comments that there is no legal requirement to establish a separate Audit Committee.

6. Financial implications

6.1 There could be some cost to new arrangements. On other committees that have a somewhat similar format and frequency of meetings, such as the Standards and Investment Committees, independent members are eligible for allowances of around £500 each. Chairmen of these committees would receive a special responsibility allowance unless the member already receives one. Additional allowances should be considered in the context of the overall guidance on total allowances.

6.2 Although this function alone might not increase the cost of governance arrangements, it would represent an additional workload in an area of rising demand.

7. Recommendations

Members are invited to comment on the paper, in the light of their current audit responsibilities, and consider what recommendations

they would make to the Cabinet, Administration Committee and, in due course, to Council.

Sue Beauchamp

**Executive Director of
Finance, Information Systems and Property**

Background papers –

Audit Commission Annual Review, Driving Improvement and Value for Money. – July 2005

Audit Commission - Comprehensive Performance Assessment Use of Resources 2005

CIPFA - Audit Committee Principles in Local Government consultative position statement –March 2005

CIPFA in Scotland – Audit committee principles in Local Authorities in Scotland 2004

Institute of Chartered secretaries and Administrators Guidance Note: Terms of Reference – Audit Committee - October 2003.