

## **AUDIT COMMITTEE**

**5 JULY 2011**

### **ANNUAL REVIEW OF TERMS OF REFERENCE**

Report from: Mick Hayward, Chief Finance Officer

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#### **Summary**

To consider whether any changes are required to this committee's terms of reference.

#### **1. Budget and Policy Framework**

- 1.1 Council is responsible for the establishment of committees and any revisions to the terms of reference of the Audit Committee would need to be referred to Council for approval.

#### **2. Background**

- 2.1 Council approved the establishment and the terms of reference of the Audit Committee on 15 June 2006. This followed consideration of guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).
- 2.2 Since 2006 the terms of reference have been revised to reflect changes such as the requirement to produce an annual governance statement, improved reporting to this committee of whistleblowing occurrences and the submission of an Annual Treasury Outturn Report. The Committee's existing terms of reference, incorporating these changes, are set out in Appendix A for Members' consideration.
- 2.3 The Audit Commission advise that it is considered best practice that the terms of reference are reviewed regularly, to ensure they remain relevant and meet current and expected future needs.

#### **3. Options**

- 3.1 The Committee's terms of reference have been reviewed on an annual basis, in line with the Audit Commission guidance. Review of these on a less frequent basis could result in the terms of reference becoming outdated and no longer relevant to current requirements.

#### **4. Advice and analysis**

- 4.1 The Committee's terms of reference are based on guidance from CIPFA, as shown in Appendix A. There have been no developments or further guidance issued that necessitates a change in the immediate future. Officers are not therefore recommending any changes at this stage.
- 4.2 However, Members are advised that on 30 March 2011 Communities and Local Government issued a consultation on the *Future of local public audit*. This followed the announcement in August 2010 that the Audit Commission is to be disbanded and explores options for local authorities to obtain their own external audit provision. The consultation includes proposed changes to both the structure and role of audit committees, which are reproduced as Appendix B to this report for Members' information.
- 4.3 There are no diversity or sustainability implications.

#### **5. Risk management**

- 5.1 An annual review of the Committee's terms of reference will ensure that they are relevant and meet current and expected future needs. There are, therefore, no significant risks arising from this report.

#### **6. Financial and legal implications**

- 6.1 There are no financial or legal implications arising directly from this report.

#### **7. Recommendations**

- 7.1 Members are asked to consider this Committee's current terms of reference and confirm that they meet current and expected future needs without amendment.

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#### **Background papers**

Chartered Institute of Public Finance and Accountancy's publication "Audit Committees: Practical Guidance for Local Authorities".  
Communities and Local Government consultation "Future of local public audit", March 2011

## Audit Committee Terms of Reference

Terms of Reference	Linkage to CIPFA's publication	
<ul style="list-style-type: none"> <li>To provide independent assurance on the adequacy of the risk management framework and the associated control environment, including consideration of the Council's approach to risk management and the assurance framework, the production of the annual governance statement, arrangements for delivering value for money and the Council's anti-fraud arrangements and anti-corruption measures;</li> <li>To receive reports in line with the Council's whistleblowing policy;</li> <li>To monitor the Council's compliance with its own published standards and to consider any proposals for changes to Financial Rules, Codes of Practice on tenders and contracts;</li> <li>To monitor financial policies and processes, including endorsement of improvement plans to strengthen the control environment;</li> <li>To approve the annual governance statement.</li> </ul>	Regulatory Framework	To maintain an overview of the council's Constitution in respect of contract procedure rules, financial regulations and codes of conduct and behaviour.
		To review the anti-fraud and anti-corruption policies.
		To consider the council's compliance with its own and other published standards and controls.
		To monitor the effective development and operation of risk management and corporate governance in the council.
		To oversee the production of the authority's Annual Governance Statement and to recommend its adoption.
<ul style="list-style-type: none"> <li>To approve the annual accounts and annual treasury outturn report.</li> </ul>	Accounts	To review the annual statement of accounts and annual treasury outturn report. Specifically, to consider whether appropriate accounting policies have been followed and whether there are concerns arising from the financial statements or from the audit that need to be brought to the attention of the council.

Terms of Reference	Linkage to CIPFA's publication	
		To consider the external auditor's report to those charged with governance on issues arising from the audit of the accounts.
<ul style="list-style-type: none"> <li>• To discuss with the external auditor new accounting standards, changes to the reporting framework and the basis of the annual audit, including the content of performance work;</li> <li>• To receive all reports by the external auditor including all performance reports and the annual audit and inspection letter;</li> <li>• To oversee Internal Audit activity;</li> <li>• To provide an independent review of the Council's financial and non-financial performance.</li> </ul>	Audit Activity	To comment on the scope and depth of external audit work and to ensure it gives value for money.
		To consider the external auditor's annual letter, relevant reports, and where appropriate to request further reports for full council.
		To consider specific reports as agreed with the external auditor.
		To consider the head of internal audit's annual report and opinion, and a summary of internal audit activity (actual and proposed) and the level of assurance it can give over the council's corporate governance arrangements.
		To consider specific internal audits reports as requested.
		To consider a report from internal audit on agreed recommendations not implemented within a reasonable timescale.
		To commission work from internal and external audit, as appropriate.

## Extracts from CLG consultation “Future of local public audit”

### 3. Commissioning local public audit services

- 3.1 Government believes that a localist approach, without an independent central body having a role in appointing an auditor, is an important element of driving accountability to local people rather than to central government. However, maintaining the independence of the auditor in the new system is central to the principles of public audit. Our proposals therefore need to include measures to safeguard the independence of the auditor.

#### Duty to appoint an auditor

##### CURRENT SYSTEM

- 3.2 Under the current system, the Audit Commission appoints all auditors of local public bodies included in Schedule 2 of the Audit Commission Act. Before making appointments of auditors to local government bodies, the Commission has a statutory duty to consult the body. The Commission has voluntarily extended this practice to health bodies.

##### OUR PROPOSALS

- 3.5 We propose that all larger local public bodies (those with income/expenditure over £6.5m) will be under a duty to appoint an auditor. The auditor would need to be on the register of local public statutory auditors, which should help to ensure that the quality of auditors is maintained.
- 3.6 It is equally important as it is in other sectors that those to whom audit is directed have influence but that the independence of the auditor remains paramount. Therefore, for larger public bodies, we propose an approach whereby appointment is made by full council or equivalent, on the advice of an audit committee with opportunities for the electorate to make an input.
- 3.7 We consider that local public bodies will wish to co-operate to ensure that there is wide competition for external audit contracts, and that local public bodies will want to work together to procure an external auditor. We propose to ensure that legislation provides for both joint procurement and joint audit committees.
- 3.8 Lord Sharman, in his report, *Holding to Account: the Review of Audit and Accountability in Central Government*, was clear that, to maintain confidence, auditors must be independent to avoid improper influence and allow work to be carried out freely. Independence includes the way auditors are appointed. We consider that, as part of a new local audit regime, each larger local public body should have an audit committee with a majority of members independent of the local public body and, with some elected members to strike a balance between objectivity and in-depth understanding of the issues.
- 3.9 A possible structure is set out below. However, there could be alternative arrangements, for example:
- a) only the chair and perhaps a minority of members are independent of the local public body

- b) a chair and a majority of members independent of the local public body, as described below
  - c) as for (b), but with independent selection of the members independent of the local authorities
- 3.10 We are keen to ensure that local public bodies have flexibility in the way that they constitute and run audit committees. But we need to balance this with ensuring that the minimum requirements for an audit committee set out in legislation provide for an independent audit appointment. We set out below a possible structure and role for the audit committee, some of which may be prescribed in legislation and some of which we would put forward as best practice.

### **Structure of audit committees**

We envisage that in the new system, an audit committee could be structured in the following way:

- The chair should be independent of the local public body. The vice-chair would also be independent, to allow for the possible absence of the chair.
- The elected members on the audit committee should be non-executive, non-cabinet members, sourced from the audited body and at least one should have recent and relevant financial experience (it is recommended that a third of members have recent and relevant financial experience where possible).
- There would be a majority of members of the committee who were independent of the local public body.

### ***Independent members of the committee***

When choosing an independent member of the committee, a person can only be considered for the position if:

- he or she has not been a member nor an officer of the local authority/ public body within five years before the date of the appointment
- is not a member nor an officer of that or any other relevant authority
- is not a relative nor a close friend of a member or an officer of the body/ authority
- has applied for the appointment
- has been approved by a majority of the members of the council
- the position has been advertised in at least one newspaper distributed in the local area and in other similar publications or websites that the body/ local authority considered appropriate

## **Role of the Audit Committee**

### **CURRENT SYSTEM**

- 3.11 As auditors are currently appointed by the Audit Commission there is no role for an audit committee in the appointment of auditors, although the Audit Commission always consults local public bodies before it confirms an audit appointment. However, some local public bodies do have Audit Committees (some of which are independent) with roles in relation to both internal and external audit.

- 3.12 Health bodies currently have their own form of audit committees following the Financial Reporting Council best practice guidance, comprising of independently appointed non-executive directors governed by their own rules and requirements.

## **OTHER SECTORS**

- 3.13 The Financial Reporting Council currently produces guidance for the establishment of audit committees for companies, stating that they should be made up of at least three, or in the case of smaller companies two, independent non-executive directors.
- 3.14 The main role and responsibilities of a company's audit committee are set out in written terms of reference and can include a number of roles, including: providing advice to the board in relation to the appointment of external auditors
- approving the remuneration and terms of engagement of the external auditor
  - reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process
  - developing and implementing policy on the engagement of the external auditor to supply non-audit services

## **OUR PROPOSALS**

- 3.16 It is likely that we would want to specify in legislation some responsibilities that the audit committee should have in relation to the engagement of an auditor and monitoring the independence and quality of the external audit. However, we would not wish to limit the scope of an audit committee so that a local body had no flexibility in designing its role.
- 3.17 The expanded role of the audit committee would include the provision of advice and guidance to the full council or equivalent (the audit committee may wish to have regard to advice from the section 151 officer) on appropriate criteria for engaging an auditor and advice as to how these criteria could be weighted. The audit committee would be given copies of the bids to evaluate in order that they may advise the full council or equivalent on the selection process and may, if they wish, indicate which auditor, in their view, presents the best choice.
- 3.18 The full council or equivalent would need to have regard to the advice of the audit committee but would not need to follow its advice. The full council or equivalent would be responsible for selecting an auditor and engaging that auditor on a contractual basis.
- 3.19 Advice provided by the audit committee to the full council or equivalent would be published, although consideration will need to be given to the treatment of commercially confidential material.
- 3.20 If the full council or equivalent did not follow the advice of the audit committee, then it would need to publish on its website a statement from the audit committee explaining its advice and a statement from the full council or equivalent setting out the reasons why the council or equivalent has taken a different position.

### **Option 1**

- 3.21 We could specify only one mandatory duty for the local public body's audit committee, i.e. to provide advice to the local public body on the engagement of the auditor and the resignation or removal of an auditor.
- 3.22 It would then be left up to the local public body and the audit committee to decide whether the audit committee should have a wider role in other issues, e.g. setting a policy on the provision of non-audit services by the statutory auditor or reviewing the relationship between the auditor and the audited body.
- 3.23 This option would ensure that the audit committee provided advice to the local public body at crucial moments, but would allow the local public body and the audit committee flexibility to decide on any other functions it may carry out. However, if only the minimum was followed, this may not provide an adequate check on ongoing independence through the auditor's term.

### **Option 2**

- 3.24 We could specify a much more detailed mandatory role for the audit committee which could include, but may not be restricted to the following:
- providing advice to the full council on the procurement and selection of their external auditor
  - setting a policy on the provision of non-audit work by the statutory auditor
  - overseeing issues around the possible resignation or removal of the auditor
  - seeking assurances that action is being taken on issues identified at audit
  - considering auditors' reports
  - ensuring that there is an effective relationship between internal and external audit
  - reviewing the financial statements, external auditor's opinions/conclusions and reports to members and monitor management action in response to the issues raised by external audit
  - providing advice to the full council on the quality of service they are receiving
  - reporting annually to the full council on its activities for the previous year
- 3.25 This option would provide more assurance about the independence of the relationship between the audited body and its auditor, it would also ensure that the audit committee had a wider role in reviewing the financial arrangements of the local public body.