AUDIT COMMITTEES IN THE PUBLIC SECTOR

A DISCUSSION PAPER

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by

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Executive summary

This discussion paper aims to achieve a better understanding of the role of audit committees in the public sector and the purposes for which they have been or are to be established. Audit committees are a common feature in the private sector and may be established for public sector owned enterprises but are much less a feature of non-market public sector organisations such as ministries and local governments. When established in the non-market public sector the term "audit committee" appears to describe a committee with a variety of different purposes and reporting lines, often quite limited in scope and in this respect quite different in many countries from their equivalent in the private sector. Independent membership (regarded as crucial to the success of an audit committee in the private sector) is often missing from public sector audit committees.

There are no international standards or recommendations for audit committees, whether in the private or public sector. Some countries have set up working groups to recommend improvements to corporate governance in companies and each of these group's recommendations have been applied to the companies operating in those countries. Mostly the recommendations apply to listed companies only and one element of these recommended improvements has been concerned with the appointment of an audit committee, its membership and responsibilities. The European Commission has also made proposals for improving the corporate governance of companies in Europe; the Eighth Directive (Article 41) requires that public interest entities (listed companies) appoint an audit committee. In general, the approach advocated in the individual countries and the European Commission follows a similar pattern and they have formed the basis for the development of a company audit committee standard for that specific country. This paper has adopted the approach of taking the private sector model and then suggesting how such a model could be applied to the circumstances of the public sector (but not taking into account individual country circumstances).

A key driving force for improvements to corporate governance in the private sector has been the national accountancy profession. However, in only a relatively few countries does the accountancy profession have any real impact on the public sector. Indeed, sometimes it is perceived as having only a very narrow role of external audit with its contribution to improving financial management being either non-existent or very limited. In some countries members of the professional accountancy bodies are even positively discouraged from working within the public sector because of the restrictive conditions imposed by professional bodies. Therefore the accountancy profession is in no position, in general, to promote a debate within a country public sector about the quality of corporate governance. But in those countries that do have a strong accountancy profession, the development of public sector audit committees is not uniform. For example, Sweden has a strong accountancy profession with a highly advanced level of democracy and transparency, but sector audit committees have not been established. The main reason in Sweden for this lack of development appears to be that the existence of such a committee would detract from the responsibilities of top management to ensure that internal control and internal audit were effective.

In other countries with a similar advanced approach to democracy and transparency (the United Kingdom and New Zealand, for example) the exact opposite has been the result. The existence of the audit committee has caused top management to focus on risk and internal control and the existence of the audit committee has given the internal auditor a focus at the very top of the organisation. However, what can also be critical in whether or not audit committees become established are the operational conditions and traditional organisation of the public sector. For example, the appointment of non executives (a key requirement for a successful audit committee) also means that the head of the organisation is required to listen to advice from outsiders and in some countries there is no tradition or recognition that such “outside” advice is either necessary or desirable.

Public sector audit committee arrangements that do exist (at least in Europe or in the surrounding areas) may range from full "governance audit committees" (i.e. similar to those in the private sector) to "central audit advisory boards" to "internal audit management committees", attached to one ministry or municipality. The choice of role for an audit committee in the public sector seems to depend upon a number of factors including the degree of sophistication of financial reporting, the management and financial management and control arrangements, and also the extent to which managerial accountability has developed (including the distance between the political and the administrative decision making processes and the understanding and application of risk management techniques). Other factors (conditions) are favourable support from the highest management levels to reform, the availability of truly independent and expert persons to become members of audit committees, and the willingness to nominate such persons, other than executive managers, to the committee.

Audit committees, whether governance or of other types, are at present an unusual feature in the EU member states, with only four countries having established extensive “governance” audit committees[1], or very close variations thereof[2]. Reasons for this may include the existence of traditional highly politicised administrative arrangements with the decision-making vested in one individual, the minister or mayor, and the reluctance to accept the need for external or even internal “challenge”.

In the new member states (EU-12)[3] there is little experience with audit committees. Poland established them in 2010, focussing mainly on internal audit; the experience of their effectiveness is currently being analysed. In other EU-12 countries audit committees can be set up on a voluntary basis (e.g., Bulgaria, Estonia, Latvia, Malta and Slovakia) but again their principle concern seems to be only with internal audit. There seems to be little appetite for establishing governance audit committees. Overall, audit committees of whatever type seem to have been rejected largely on the ground that they represent another layer of bureaucracy for no apparent added value[4].

Private sector audit committees focus on the reliability and assurance of both internal and external reporting and hence on internal and external audit; on the quality of the internal control systems and the risk management processes. However, for many developing and transition economy countries, applying this form of audit committee in the public sector can be too sophisticated as the preconditions for the existence of such a committee do not exist. But there are derivatives of the audit committee idea that can be very helpful to developing and transition economy countries such as "central advisory audit boards" (CABs) that give advice on and support the introduction of international internal control standards in the public sector and "internal audit management committees" (IAMCs) that primarily focus only on the quality of internal audit and on the willingness of management to implement audit recommendations.

Very importantly, in developing and transition economy countries before embarking on the introduction of audit committees in whatever form, the first step should be to establish a central

[1] The United Kingdom (UK), the Netherlands, Ireland and latterly France

[2] Audit committees have been established at Belgian Federal and Flemish Government levels and In seven other European countries audit committees are mentioned in the relevant laws, but apart from this there appears to be little experience of audit committees (of whatever type) and the appetite for such committees does not seem to be widespread

[3] The 12 most recent states joining the EU were: Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia

[4] The authors are aware that Kosovo, a potential candidate country, has established over 20 audit committees. However, these focus on internal audit only.

harmonisation unit (CHU) for formulating and implementing standards and policies for financial management and control, internal audit and risk management. Should audit committees then be introduced, the CHU or a similar organisation should become the driving force behind whatever types of audit committee is established and monitor their effectiveness. The CHU has an entirely different role from an audit committee because it is concerned with overall policy, is part of the formal administrative arrangements and is concerned to monitor the effectiveness of these arrangements on a regular basis. By contrast, the audit committee lies outside the administrative machine. Its role is to offer advice and to 'challenge' existing arrangements. A CHU is also unlikely to engage with financial reporting policy, whereas an audit committee should.

The authors support the establishment of "governance" audit committees in the public sector based on the model of the private sector, but subject to conditions. Readers should be aware of the dangers involved in doing so where conditions are inappropriate, as they are in many countries, and certainly in most developing and transition economy countries. In these two latter groups of countries the focus should be initially on introducing the foundations of financial management and control and internal audit by establishing CHUs. CHUs can be helped by central advisory boards (CABs) but only if those boards can bring an independent perspective to the work of the CHU. IAMCs may also be helpful but their role and responsibilities should be specified by the CHU and the CHU should also monitor their effectiveness. Ideally IAMCs should also have a degree of independent membership even though there are no examples of this in developing and transition economy countries that the authors are aware of. Overall the message is that the establishment of audit committees is a complicated matter; the evidence is that their role can be easily misunderstood and their capacity to offer independent advice to management is in many countries quite limited. As a result the risk is that they become superficial, political and another cosmetic bureaucratic level. They should not be introduced unless the conditions are right. This would induce a false sense of security with a result that could be wholly counter-productive, adding to expense with no real benefit.

The existence of audit committees does not automatically mean that the organisations that have established them necessarily run well and have no problems with governance, internal control or external reporting. For example, all government ministries in the UK are required to appoint audit committees but their appointment has not prevented either the UK National Audit Office or the Parliamentary Public Accounts Committee from publishing critical reports on the functioning of some of these ministries. Therefore they cannot be regarded as a panacea that will resolve all problems. However, there is no doubt that they have been of positive benefit in improving the quality of public financial management and governance.

I. Audit committees and good governance

"Governance" audit committees (GACs) are a well-established feature in private companies. They form a key element in the governance process by providing an independent expert assessment of the activities of top management, the quality of the risk management, financial reporting, financial management and internal audit, to the board of directors or a supervisory board. Another important role is to ensure that external audit recommendations are fully addressed, that the quality of internal audit is of an appropriate standard and that line management has full regard to internal audit recommendations. Properly exercised their role is vital in being the watchdog for the independence of internal audit and in ensuring that the information made available to the owners (the shareholders) is reliable thereby enabling them to make judgements about the quality of the management and the future prospects for the company.

GACs in the non-market public sector are much less common[1] (although in some countries they have been established in some public enterprises). They only exist where there is a strong focus on financial management and external reporting, where the influence of the accountancy profession is strong and the private sector is regarded as providing an appropriate model for the public sector. This tends to be the case in countries that have an Anglo-Saxon tradition and where the public administration is not so heavily geared to detailed compliance with the law and where the external audit focus is much more on ensuring that the accounts fairly present the financial position of the organisation. Such committees exist at both central and local government levels. Audit committees in law-based countries and in developing and transition economy countries are rare, but there is an increasing interest in developing the concept. However, to be effective the right conditions should exist and without them this interest can lead to false expectations on the part of the authorities or to ineffective audit committees that would do more harm than good. The purpose of this paper is to explore these conditions and to warn of the dangers.

Audit committees have not been established in all countries with a highly developed accountancy profession, democracy and transparency in government arrangements. Indeed, in some countries, such as Sweden, audit committees have been regarded as detracting from the responsibility of top management for the effectiveness of internal audit and internal control and have not been developed in the non market public sector.

There is a close link between good governance and a successful democracy. Effective GACs contribute to the development of democracy. Democracy is about informed political choice – but informed choice depends upon the availability of reliable and impartial information. It also depends upon effective accountability. Reliability, impartiality and accountability together equal transparency and are central to good governance. The role of an audit committee is to ensure that the published financial and related performance information is reliable and impartial and that it presents a true picture of the operations of the organisation. This means that the financial and related performance information available to management needs to be reliable and impartial as well. Impartiality in the provision of information and the accountability for the quality of that information, in the private sector, enable the owners of a company to make decisions about the success or otherwise of the management of a company. Likewise in the public sector impartiality and accountability enable first, the national assembly and subsequently the electorate to make informed judgements about the success or otherwise of government activities.

[1] See note 1 on page 5.

Good governance is so critical to the audit committees' work that a full understanding of the meaning of "good governance" is essential[1].

In the 2008 edition of the OECD Glossary of Statistical Terms corporate governance (for companies) was defined as the "Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making."

HM Treasury (the Ministry of Finance) in the United Kingdom (UK) uses the term corporate governance instead of 'good governance' and defines it as follows: "Corporate governance is the way in which organisations are directed, controlled and led. It defines relationships and the distribution of rights and responsibilities among those who work with and in the organisation, determines the rules and procedures through which the organisation's objectives are set, and provides the means of attaining those objectives and monitoring performance. Importantly, it defines where accountability lies throughout the organisation.[2]

In 2000 the Netherlands used the term "Government governance" rather than either "good governance" or "corporate governance" and its definition puts the same elements contained in the previously quoted definitions in a slightly different way[3]:

> "Government governance is defined as safeguarding the interrelationship between management, control and supervision by government organisations and by organisations set up by the government authorities, aiming at realising policy objectives efficiently and effectively, as well as communicating openly thereon and providing an account thereof for the benefit of stakeholders."
>
> "The difference between the business sector and the government sector is best exemplified by the published documents attracting public attention. Companies publish their financial statements, on the basis of which the profit is appropriated and the directors are held accountable to the stakeholders. Government publishes its budget, whereby the discussion focuses on policy proposals. In both the government and business sectors, there is a trend towards increasing transparency…"
>
> "The objective of government governance is to create safeguards for achieving policy objectives. The design and operation of governance is important at various levels, from government minister to implementing organisations. Central government is concerned with policy objectives set by the national assembly. The minister is responsible and also accountable for achieving those objectives. The essence of sound governance, from the perspective of ministerial responsibility, is that there are enough safeguards enabling the minister to bear ministerial responsibility".

> "These safeguards should exist within a policy area, which may extend over an entire policy chain, through a well-designed cycle of the management, (internal) control, supervision and accountability processes."

[1] In the private sector the term 'governance' is usually described as "corporate governance". In the public sector in some countries this term is used and in others the term 'government governance'
[2] HM Treasury: Corporate governance in central government departments: Code of good practice 2011
[3] Government Governance – Corporate governance in the public sector, why and how? Ministry of Finance 2000 (Netherlands)

A properly functioning audit committee could be one of those safeguards that the Netherlands suggested but it can only operate effectively given the appropriate conditions, which (for both the private and public sectors) depend essentially upon an effectively functioning management willing to accept independent advice and to effect consequential reform.

II. Standards in the private sector

A. Standards for the audit committee

The private sector provides the model for governance audit committees, defining the objectives, environment, pre-conditions and membership rules. There are various definitions of the role of an audit committee in companies, but they all have the same basic characteristics. An example can be found in the definition drawn from the United Kingdom Code on Corporate Governance[1] (hereafter called "Code") i.e.

“The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company’s internal control and risk management systems;
- to monitor and review the effectiveness of the company’s internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;[2]
- to review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements[3];
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.”

The Code also specifies that: “The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.
“The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the

[1] Published by the UK Financial Reporting Council (FRC) June 2010: The UK Corporate Governance Code
[2] Not relevant to the public sector where the external auditor (the SAI) is generally appointed by the parliament (national assembly).
[3] See note 2 above

reasons for the absence of such a function should be explained in the relevant section of the annual report."

Crucial in this definition is the requirement to review the company's internal control and risk management systems. The Code specifically requires that the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems. To fulfil this responsibility the Code specifies that "the board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls."[1]

B. Standards for the internal control system

One of the main sources of internal control standards in the private sector is the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and this is particularly relevant to the public sector because the recommendations of COSO have been developed by INTOSAI[2] for application in the public sector.

The COSO framework defines internal control as a process effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.

The COSO internal control framework consists of five interrelated components derived from the way management runs a business. The five components are the following: control environment: risk assessment: control activities: information and communication: and, monitoring.

An underlying assumption in the private sector and this applies to COSO, is that the company has clear, definable and measurable objectives. Without these objectives the management structure will not function well or even not at all. Company failures or poor performance are most frequently ascribed to poor management performance. When that occurs, the person(s) most responsible (the chief executive and possibly also the chairman) are blamed and are likely to lose their jobs. The chief executive carries all responsibility but needs an adequate management structure to support him. Indeed, the chief executive would be severely criticised, not least by the audit committee, if that structure did not exist or was deficient in some way. Therefore another characteristic in the private sector is that management is open and prepared to accept independent challenge to its assumptions and policies.

"Tone at the top" is therefore also an essential element in good governance. If the top manager, the chief executive, refuses to accept independent advice or seeks to manipulate membership of the audit committee to ensure that it does what the top manager requires and/or to suit personal interests (bonus payments, for example), then the audit committee will fail in its duty and the only recourse of members is to resign. That is the final weapon that they have.

[1] The public sector reader should bear in mind in looking at private sector comparators that in the public sector the budget has far more significance than in the private sector (see pages 19 and 29)
[2] The International organisation of Supreme Audit Institutions

Compare this to the public sector in many countries where objectives are not always well defined, do not have easily measurable impacts, where standards of performance can be equally difficult to measure and where management structures can be defined for political rather than managerial reasons. Also where the responsibility for delivering an objective and for all the actions of the organisation (e.g. a ministry) rests solely upon a single top manager (the minister) with no power to or tradition of delegation to other junior managers within the organisation and who can be expected to sign personally all documents leaving the organisation, then the practical application (as opposed to the nominal application) of the COSO standards is extremely difficult. In addition if the top manager is unwilling to accept that operationally independent persons should be appointed to comment upon how the organisation is managed and whether or not the organisation is fairly presenting information about its activities then the principles of good governance are extremely difficult to apply and as a consequence a governance audit committee is unlikely to be effective. In other words, the idea of a 'challenge' function, which is what the role of a governance audit committee basically is, is frequently not acceptable or is perceived in political terms rather than in managerial terms and this occurs because the 'top manager' is responsible for all decisions and as a political appointee, inevitably regards criticism or comments in these terms.

III. An analysis of the different types of public sector audit committee – the types most common in the post 2004 member states of the European Union

This section describes in more detail the different types of audit committee that have existed in the post 2004 entrants to the European Union and in many candidate or applicant countries and their strengths and weaknesses. The evidence from discussions with public sector officials in different countries and from debates at international meetings shows that there is a high degree of confusion about what is meant by an audit committee. These most common types are the Central Advisory Boards (CABs) and the Internal Audit Management Committees (IAMCs). In section IV there is then a discussion about the type of audit committee that is most similar to a private sector audit committee, i.e. governance audit committees.

A. Central advisory boards (CABs) and central harmonisation units (CHUs)

Where Central Advisory Boards (CABs)[1] have been established their role has been to give advice to the cabinet of ministers or to the minister of finance on developing and implementing the concepts of PIFC or more narrowly of functionally independent decentralised internal audit in the public sector. Occasionally they may have a policy making role. Their focus is on government-wide internal audit and/or internal financial control policies and their overall implementation. In the EU nine out of twenty-seven member states (six in the EU-12) have currently organisations that could be defined as Central Advisory Boards. They usually do not have the high degree of independence that is an essential characteristic of audit committees concerned with 'good governance', indeed, 'good governance' is in no case that we are aware of included within their terms of reference. They usually

[1] Other names are PIFC Council (Bulgaria), Internal Audit Board, (Cyprus), Audit Board (Estonia), Consultative Inter-Ministerial Committee for PIFC, (Hungary), Consultative Internal Audit Council (Latvia), Standard Inter-departmental Commission for Internal Audit (Lithuania), Internal audit and investigations Board (Moldova), Committee for Public Internal Audit (Romania) and the Internal Audit Co-ordination Board (Turkey)

are attached in one way or another to the ministry of finance or to the prime minister. Membership includes government officials (political and civil service) and sometimes one or two independent members with academic or private sector expertise.

Usually these CABs work closely with the CHU. The primary role of the CHU (sometimes there is a single CHU covering both internal audit and financial management and control and sometimes these responsibilities are divided between two separate CHUs) is to develop and implement the policy and objectives of PIFC throughout the public sector. For most of the recent members of the EU and candidate countries the concepts of financial management and control and internal audit in the public sector were entirely new and had to be developed. The CHU is responsible for drafting a strategy for implementing PIFC as well as drafting or amending primary and secondary legislation as well as regulations and decrees, relating to both internal audit and financial management and control. The CHU is expected to be the main champion for developing the profession of public internal audit as well as that of financial management. Where a CAB has been established, the CHU usually will discuss with the CAB its implementation strategy, key policy changes affecting the entire internal control system and annual reports on the state of development.

The annual reports to the CAB are usually based on annual reports from the different internal audit services and upon annual surveys undertaken by the CHU across ministries and local governments of the state of development of financial management and control. In the main these surveys appear so far to have been concerned with whether or not arrangements for financial management and control and internal audit actually exist, rather than with their quality. To move to quality assessments would be a major step forward, but essential if internal audit is to provide the assurance required by top management and external stakeholders.

The effectiveness of a CAB depends heavily upon the quality of the CHU and the content of the reports made to it by the individual public organisations. However, in reality, little is known about the working and added value of these boards, whether advisory or policy making. The high degree of political membership of most of these boards does tend to mean that the political agenda drives the meeting arrangements. In other words, the demands upon ministers' time tend to determine the timing of meetings and may even affect the content. Even so, a greater proportion of independent and external experts as members should increase the likely benefit from such a board and ought to help encourage a shift to quality assessment. If membership consists only of ministers along with senior civil servants, then the benefits will be limited because of the narrowness of experience of the members and their different interests. Such boards are also likely to have difficulty in making dispassionate criticism of the existing arrangements, especially bearing in mind the limited experience in these countries with internal audit and modern approaches to financial management.

In terms of setting the "tone at the top", there can be merit in establishing a CAB supported by the CHU at an overall governmental level. After all, a CAB provides the opportunity to develop a broad constituency of support within government. They could be particularly helpful in countries where the professions of internal audit (whether private or public) and financial management have only recently become established and where the function of financial management is not well understood other than being seen as a control function with no recognition of its wider role as a major contributor to improving value for money. However, the role and responsibilities of a CAB cannot be regarded as capable of providing the independent and comprehensive assurance that would be expected from an audit committee based upon the private sector model described above.

CABs are only effective if working with a CHU. The advantages of such a board include that they:

- Provide a ‘sounding board’ for the development of policy towards financial management and control and internal audit to the CHU;

- Can give advice/comments to the minister of finance or prime minister about the practical development of financial management and control and internal audit across the public sector: can help set the 'tone' for such developments;
- Can act as a stimulus to the CHU and can also review the quality of the work of the CHU;
- Can act as a stimulus to the application of financial management and control and internal audit in particular organisations;
- An annual report can highlight key developments or failings.

The disadvantages are that:

- The effectiveness of a CAB depends heavily upon the quality of the CHU and the content of the reports made to it by the individual public organisations.
- Usually the interest of the CAB focuses upon actual activity in financial management and control and internal audit which is regarded as a proxy for quality, when it is not.
- The high degree (usually) of political membership tends to mean that a political agenda drives meetings.
- The CAB cannot be regarded as capable of providing the independent and comprehensive assurance that would be expected from a governance audit committee.

B. Internal audit management committees (IAMCs)

Internal Audit Management Committees (IAMCs) where they have been established, as opposed to CABs, have been attached to a (line) ministry or other budget spending agency, depending generally on the size, relevance or number of financial transactions taking place in that organisation. These committees comment on the internal audit plan and on the internal audit recommendations and report to the head of the organisation. Their members are generally organisation officials (line managers) and usually do not include any external non-executive members, although there are exceptions as in Belgium.

The usual arrangement for internal audit in countries without IAMCs is that the internal auditor discusses directly with the top manager (minister or mayor) his/her audit plans, internal audit findings and recommendations. However, this arrangement may in practice create a number of problems:

- The top manager has little time to effectively manage the internal audit process;
- The top manager lacks the operational knowledge to identify significant internal control weaknesses (the minister or mayor is not appointed for their administrative experience or capability; they may also have too short a tenure in the post to obtain that operational experience of the organisation);
- The top manager may use internal audit to 'settle old scores';
- The internal auditor is seen as the 'spy' of the minister or mayor, does not have the independence required and is not regarded as a provider of support to line management (i.e. as a tool of management);
- The internal auditor can become isolated from the real needs of management;
- The internal auditor has no incentive to take an independent view of the way in which the organisation is organised and run and therefore is unable to contribute to more strategic policy development;
- Top management may regard the recommendations as too trivial from its point of view to enforce, even though they may be important to the auditor;
- Top management may not wish to consider wider governance issues with a material effect upon the adequacy of the internal audit arrangements.

A particular reason to experiment with IAMCs has indeed been to protect/promote the role of the internal auditor and to make management aware of the usefulness of internal audit. The driver of this approach very often has been consultants that come from countries with highly sophisticated internal control systems and where governance audit committees of the type established for private companies, have already been successfully introduced. The usual arrangement where this type of IAMC has been established is for the internal auditor to discuss the strategic and annual audit programme with this committee which may also receive copies of internal audit reports with information about the extent to which management has adopted audit recommendations. This committee would under normal circumstances report to top management although it may be chaired by the top manager (minister or mayor).

An IAMC of this type is limited to agreeing the internal audit programme and receiving internal audit reports and it may also have a role in ensuring that recommendations in internal audit reports are implemented or that managers provide good reasons for not doing so. Such committees are unlikely to have any role in assessing the competence or technical capacity of the internal auditor and given the 'official' membership it is difficult to see how they could in fact do so.

A committee of this type is not capable of providing the independent and comprehensive assurance that would be expected from an audit committee based upon the private sector model. There would be some advantages with this kind of committee although there are disadvantages as well.

The advantages:

The main advantages of the IAMC are:

- Line managers, at least those that are members of the committee, have the opportunity to provide an input into the audit plan and the collegiate nature of the consideration of the programme does provide an opportunity for a balanced decision;
- Sole reliance on top management interest and time is avoided;
- 'Peer pressure' from other managers in the committee may cause actions to be taken on recommendations that might otherwise be ignored;
- Overall the independence of the internal auditor is strengthened and the internal auditor has the possibility to develop a constituency of support for improvements in resources where needed.

The disadvantages:

The main disadvantages of the IAMC stem from the lack of external members (where this is the case) and a lack of technical expertise. In particular:

- The committee has no capacity to offer an independent expert opinion on either the content of the annual audit plan, the risk assessment or the actual audit recommendations;
- Effective consideration of the internal audit activity depends heavily on the relative authority of one manager against others and in hierarchical organisations dispassionate debate is unlikely to occur;
- There is no challenge to the financial management and financial reporting arrangements because these usually lie outside the agenda of such committees and it is difficult to see how it could be otherwise given their membership;
- There is no challenge to the internal management in terms of attitudes, structures and management arrangements;

- The likelihood of any discussion of the adequacy or otherwise of the governance arrangements is remote;
- The existence of such a committee may complicate relationships between the internal auditor and the central harmonisation unit.

To what extent this committee could effectively defend the independence of the internal audit, promote improvements in the quality and support any need for additional audit resources is at best uncertain. Success will heavily depend on individual circumstances and sometimes the opposite effects could occur in that management priorities or interests may well override audit recommendations. The best way of effectively adding to internal audit independence and quality would be by securing an independent expert membership to the committee. However, in most of the target countries a general shortage of expert professionals, even in the private sector, means that this is, in the early stages of developing the public internal audit, not a realistic option. Such a committee would also not have the capacity to address the governance, financial management, accounting and financial reporting issues that are essential to achieving reliable internal control arrangements.

Countries with a CHU for internal audit may consider establishing IAMCs if only to achieve the advantages described above. In that case though, some important questions will have to be addressed, such as the respective roles and relationship between the CHU and the IAMC in terms of interpreting internal audit rules, audit responsibilities, audit manual, audit charter, the right (or sometimes duty) of the internal auditor to resort/report to the CHU, reporting requirements, relationships with the external auditor. Competition or overlap of responsibilities for the general direction of internal audit between a CHU and such a committee could be confusing and should be avoided.

C. An IAMC covering several organisations

A variant of audit committee practice is an IAMC covering a group of organisations, e.g. a group of regions or municipalities. This obviously implies that regions or municipalities have already established internal audit services and sometimes a single joint internal audit unit covering several organisations (as is the case in Romania). The reasons for such a development appear to include obtaining the benefits of scale and to avoid the problem of trying to find sufficient independent experts who could provide the input essential for the effective working of an audit committee. This variant has recently been suggested as a possible way of improving the quality of governance, because it could add strength to the internal audit arrangements in particularly municipalities by providing an additional reporting route to a committee which would not be solely the appointee of a particular mayor. This variant could be helpful to those countries seeking membership of the European Union because, if effective, it will increase transparency and accountability.[1]

Such a development could be also an important contributor to the development of civil society but such committees would also raise quite a few of challenges. One is how to make such a committee genuinely independent of mayoral control and to ensure that full regard is paid to its recommendations. Another important issue is the choice of the persons to fulfil the functions of chairman and secretary of the IAMC. Both persons would need to have the confidence of each mayor involved and the capacity to deliver critical assessments. The organisation of the IAMC should be such that it guarantees a workable balance between independent non-executive members and

[1] PIFC: Key challenges in the implementation of PIFC: European Commission, DG Budget: SIGMA Conference, Portoroz, September 2011.

representatives of the municipalities in the IAMC. Furthermore, the "public" nature of the audit reports and recommendations could be subject to various interpretations. The hosting of the IAMC (its location) as well as the financing of its logistical support would need careful attention as would the need to ensure that audit standards are the same for government funds spent by municipalities and for the funds raised and dispensed by municipalities under their own authority and legislation. Again, the risk of such a committee becoming simply a cosmetic exercise would need to be guarded against.

Other key questions would be to whom the internal auditor should be loyal and report: to the mayor or to the centralised IAMC and whether the IAMC would have the power to require line managers in municipalities to attend and discuss audit recommendations as well as the follow-up of those.

These are difficult questions to answer and especially where individual municipalities are controlled by different political parties or see themselves as in competitive relations with their neighbours. Both are characteristics of many municipalities. An experiment which sought to address these difficult questions could however be useful but countries wishing to undertake such an experiment would need to carefully select the municipalities to be involved and then monitor the outcomes to ensure that there was genuine benefit emerging. Ideally the SAI should be involved in that monitoring process to ensure that there was an independent element involved.

However, the authors are not aware of any such joint IAMCs being established.

IV. Good governance audit committees (GACs)

This section explores the issues that ought to be addressed in considering the establishment of governance audit committees. This type of committee has the most potential to support the development of high quality financial management, internal control, risk management and financial reporting and in turn through that aid the development of more open and better informed democracies. However, in order to fulfil these high ambitions a number of important preconditions and essential criteria that do need to be met.

A. Preconditions for good governance in the public sector

How could the public sector benefit from the principles and standards for the establishment and practice of GACs in the private sector?

Putting ‘good governance’ into practice in many developed countries as well as in developing and transition economy countries will most likely involve changing the traditional way in which public organisations are organised and managed. The person who is most critical to the effective introduction of good governance is the most senior official (the minister or mayor in ministries or municipal authorities or in other organisations, 'those charged with governance').

This senior official sets the tone for the whole organisation. Good governance in the public sector can easily fail unless the safeguards exist that the Netherlands referred to[1]. There are many risks: corruption, management which is partial to the interests of one community or group to the exclusion of others, incompetent management, ineffective management arrangements, lack of

[1] See pages 8 and 9

clarity about objectives and the identification of the client, focus on the interests of the organisation and not on the interests of the user of the goods/services provided, bureaucracy being an end in itself and not a means to an end, concentration of too much power in the hands of one person or a small group of persons, ineffective internal control and internal audit arrangements; failure to manage services efficiently (many levels of 'control' do not equal efficiency or efficient management: they usually mean the opposite), inadequate reporting and failure of accountability, manipulation of financial information to show the best results from the point of view of the top manager, inadequate oversight/external audit.

Therefore, "tone at the top", whilst highly important in the public sector, can be difficult to apply in practice. In countries where all decision making is the responsibility of one person (or a very small group of officials) and where both the top manager and the senior management are appointed for political (as opposed to managerial competence) considerations and where the law requires the top manager to be responsible for all decision-making and signing all documents, it will be very difficult to establish an appropriate "tone at the top" culture. Such arrangements also hinder the development of a questioning and analytical, or 'challenge' culture, an essential characteristic of an audit committee. Civil service laws ought to require that delegated decision making arrangements are introduced (and in some countries they do but in practice are ignored). Good governance arrangements would reinforce the quality of decision making. A challenge culture is only likely to emerge where there is a delegation of authority accompanied by effective accountability arrangements. In these circumstances an audit committee can be a positive asset for the top manager. Therefore just establishing audit committees would not be enough for "setting the tone at the top". Other organisational changes are required and in addition, the top manager also needs to "own" a number of personal attributes, best summarised in these "Seven principles of Public Life"[1]:

1. Selflessness: taking decisions only for the benefit of the public interest;
2. Integrity: avoiding being compromised;
3. Objectivity: making choices on the merit of carrying out public business;
4. Accountability: being accountable to the public and submission to scrutiny;
5. Openness: aiming at full transparency;
6. Honesty: avoiding conflicts of interest and
7. Leadership: promoting the above by leadership and example

The Committee on Standards in Public Life advocates that all public bodies should draw up codes of conduct incorporating these "Seven principles of Public Life" and that the internal systems for maintaining standards should be supported by independent scrutiny. The audit committee would not be responsible for this scrutiny, but it may comment on practices which are inconsistent with these principles.

[1] Committee on Standards in Public Life', which set out seven principles of public life (HMSO: Cm 2850, 1995) (UK). The Committee on Standards in Public Life was established in 1994, initially to deal with concerns about unethical conduct amongst MPs and issues over procedures for appointment to public bodies. Its role though extends to include: Ministers, civil servants and advisers; Members of Parliament and UK Members of the European Parliament; Members and senior officers of all non-departmental public bodies and of national health service bodies; non-ministerial office holders; members and other senior officers of other bodies discharging publicly-funded functions; and elected members and senior officers of local authorities'. It is a "standing" committee and is an advisory non-departmental public body, sponsored by the Cabinet Office

B. Making the GAC effective

This section sets out the necessary basic elements of the operational environment in which the GAC will have to function. It also considers the meaning of "independence", "impartiality", and "integrity" for a GAC and its members and concludes with a definition of four key requirements without which the added value of such a committee will become doubtful.

a) The environmental basics

A GAC can only function effectively in an environment that incorporates the following seven criteria. If they do not exist the initial role of a GAC would be to advise the top management of the changes that ought to be made in order to ensure that they existed. Such a committee should also reflect the operational environment of the organisation that it is advising.[1] Not all these conditions may exist on the establishment of the GAC but they need to be understood as necessary and reforms over time should be made to ensure that these conditions apply because without them the effectiveness of the audit committee is undermined.

1. Clear and measurable strategic objectives

Clear and measurable strategic objectives[2] to be achieved within a defined period provide the framework within which management and hence an audit committee ought to work if they are to function effectively. However, where such objectives exist for public sector organisations both in many developed countries as well as in many developing and transition economy countries, many strategic objectives tend to be cast in too general and vague terms set out in broad strategic plans to be achieved over indeterminate periods. They are not useful for setting managerial targets and for making clear to managers what is expected of them within a prescribed timescale. But those strategic objectives provide the context for the internal control and risk management systems and it is on these that an audit committee would focus in assessing the relevance of the internal control system and the risk management arrangements.

2. Management structure

There should be a management structure designed to achieve the strategic objectives; clearly defined operational objectives and performance measures/indicators followed by appropriate information and relevant reporting systems developed to meet management needs. Again as with

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[1] The Chartered Institute of Public Finance and Accountancy (UK) has published specific guidance about local government audit committees operating within the United Kingdom (Audit Committees – practical guidance for local authorities). This guidance identifies the following as essential: "Good audit committees will be characterised by:

- A strong chairman – displaying a depth of skills and interest.
- Unbiased attitudes – treating auditors, the executive and management equally.
- The ability to challenge the executive (leader/chief executive/mayor or whatever combination) when required.
- A membership that is balanced, objective, independent of mind, and knowledgeable.

The audit committee needs to be recognised as an important body in the council's structure to allow it to provide the essential challenge to the executive when needed. Best practice from the private sector and other parts of the public sector is for an audit committee to report directly to the board, i.e. council, therefore making it independent from the executive and scrutiny functions. This provides status, independence and clarity to the role.
The support and interest of the chief executive and leader of the council is therefore essential."

[2] Many public sector objectives cannot easily be measured and alternative indicators need to be defined as a proxy.

the strategic objectives, these operational objectives and performance measures/indicators also provide the context for the internal control and risk management systems and hence would be a focus of audit committee concern.

3. Risk identification and risk management

Based upon those strategic and operational objectives, risks need to be identified with a risk management strategy and active implementation. An audit committee would want to be satisfied about the effectiveness of that risk management strategy. Risk can be very difficult to define and where financial management is not well developed key risks can easily be missed. These key risks will depend upon the area with which the audit committee is concerned. Common to all governance audit committees should be a concern about strategic financial risk, that is, has a strategic financial plan been prepared for the organisation which can demonstrate whether current policies and activities can be continued into the future, given the level of resources likely to be available, and whether new policies or developments instigated in the current financial year can be afforded in future financial years. But a ministry of finance governance audit committee or where there is a single governance audit committee for a government ought also to include within its purview those risks which would affect the viability of the budgetary assumptions, i.e. the fiscal risks[1], and the steps being taken to mitigate those risks. Examples of fiscal risk include those arising from:

- Unexpected changes in key macroeconomic variables
- The impact of exchange rate depreciations or other international trade shocks
- Changes in commodity prices
- For low-income countries, volatile aid flows and the need to cushion the poor from external shocks
- Contingent liabilities, natural disasters, the financial stability of state owned enterprises and of sub-national governments
- Legal claims
- Guarantees
- Liabilities arising from public/private partnerships.

Governance audit committees established by local governments should also include within their scope, the equivalent financial risks such as the:

- underlying budget assumptions;
- reasonableness of provisions for inflationary pressures;
- budget setting and monitoring processes;
- extent to which known trends and pressures have been provided for;
- achievability of changes built into the budget;
- realism of income targets;
- alignment of resources with the municipal service and organisational priorities;
- the availability of any contingency or un-earmarked reserves to meet unforeseen cost pressures;
- the strength of the financial management and reporting arrangements. (Unlike private sector governance audit committees, this would require a public sector governance audit committee to have an involvement with the budgetary process.)

[1] Fiscal Risks—Sources, Disclosure, and Management - Prepared by the IMF Fiscal Affairs Department May 21, 2008

Both internal and external audit should be concerned with these types of risk and the risk mitigation arrangements and therefore a governance audit committee ought to ensure that audit programmes take these types of risk fully into account.

4. A focus on financial management

The quality of financial management, the financial reporting (internal and external) and the internal financial control arrangements will be heavily dependent upon the quality of the financial management processes. These in turn will depend upon the qualifications, experience and status of the person responsible for financial management and not least how that person develops and provides information, especially about value for money, to the management of the organisation. An audit committee would expect to receive regular reports from this person and would be particularly interested in the application of accounting standards and policies.

5. A comprehensive internal control system

Generally comprehensive internal control systems do not exist in developing and transition economy countries and indeed also in many developed economies. Where they do exist, they usually concentrate on purely internal financial control procedural arrangements focussed solely on ensuring that spending remains in line with the budget. Operational performance is largely ignored and this is because the budgets themselves are not linked to realistic operational performance targets. The audit committee will need to satisfy itself that the internal control system is operating effectively in all its aspects and that managers have reliable and targeted financial and operational information.

6. Transparency and accountability

As part of the process to secure transparency and accountability, the ministry of finance usually produces consolidated annual financial statements. These may only cover the national budget, although if international public sector accounting standards were adopted (whether cash or accrual based) those consolidated financial statements would need to extend beyond budgetary organisations to include all those ‘controlled’ by the Government. The ministry also produces a number of other financial statements which are intended for the benefit of external users, like the IMF and donors. Where an audit committee has government wide responsibilities it ought to ensure that such statements and reports are relevant and consistent with the information available from the overall internal control system. Where the audit committees are decentralised and therefore cover one ministry only, the (decentralised) audit committee should be satisfied that the financial statements of the ministry (or other organisation) are accurate and reflect the true financial position of the ministry. Whatever the arrangements for the preparation of the financial statements, the finance department in the ministry of finance, or in line ministries, normally will prepare the financial statements to be signed by the minister, (or in a line ministry to be sent to the minister of finance) prior to submission to external audit. Review by the audit committee should help to protect the minister from adverse external audit criticism and indeed the audit committee could well be assisted in the formulation of its comments by the internal audit. An example would be that the ‘accounts closing process’ may be inadequate leading to mistakes and for example, differences between the accounts and the notes to the accounts. The audit committee ought to ensure that the internal auditor includes such a process within the annual audit programme.

7. Anti-corruption and anti-fraud processes

Anti-corruption and anti-fraud processes should operate effectively and a high degree of protection and confidentiality should be established for those who wish to disclose inappropriate actions. The audit committee would want to satisfy itself that these policies in fact were operating effectively.

An audit committee can only be efficient if the management arrangements and structures are organised in such a way as to facilitate the achievement of the organisation's objectives. This means that there is a sufficient degree of delegation of both decision making and spending powers to lower management levels, that reporting arrangements are robust and comprehensive enough to provide senior management with the control information they require and that the information reported is reliable whether it be internally to more senior managers or externally to the ministry of finance or to the national assembly. Overall management should be willing to accept challenge, or to accept and listen to justified criticism.

"Challenge" is a fundamental aspect of audit committee behaviour and the benefits of 'challenge' should be fully appreciated by top management. However, "challenge" in many countries as well as in developing and transition economy countries would generally be regarded as a significant change from the traditional view of management which tends to be strictly hierarchical with lower level managers not willing to contest decisions or arguments put forward by higher level managers and certainly not by politicians. The question is whether governments would be prepared to establish a management structure that devolves power and still allows the top manager (the minister or mayor) to take full responsibility through the parallel development of delegation and accountability arrangements. The key role of the internal audit and the audit committee is to provide confidence to the top manager that those delegation arrangements were working effectively and that the information being provided was reliable and internal controls operating effectively. However, the most difficult problem for those top managers is that an effective audit committee should act in a manner that could appear to inhibit their own apparent discretion, even though the reality is that through challenge the opportunity is created to test the robustness of decisions and hence ultimately offer protection from criticism.

An additional problem, and this is especially relevant in developing and transition economy countries, is finding the independent and expert individuals who are able and willing to become members of an audit committee.

b) Independence, impartiality, integrity as applied to an audit committee member

What does "independence" mean in this context and in what way might independence in the public sector differ from independence in the private sector? Independence in this context means "being unwilling to be under an obligation to the executive". For a GAC member it means undertaking the responsibilities in an impartial and independent manner. Independence does not merely mean "not being a member of the executive". Without independence it will be difficult if not impossible for an audit committee member to pursue and give "impartial advice". "Impartial advice" means not just that the advice is accurate but that it is also relevant and appropriate in that context (and is certainly not "political", even though it may be regarded as inappropriate or unwelcome advice to the recipient). Audit committee members should have a reputation for being straightforward and avoiding bias whatever a personal interest may be.

The quality of membership in a GAC is highly relevant as it may make or break the audit committee's effectiveness. The Code[1] requires that in the private sector the membership of the audit committee should be: "of at least three or in the case of smaller companies, two independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience."

[1] See footnote 1, page 9

A GAC is about ensuring that the information that is flowing within and from the organisation is accurate in all material respects and therefore reliable to all concerned. The members of the audit committee must always be able to give independent advice about the quality of this information, whether it flows from weak or robust systems, risk management arrangements, lack of clarity of objectives or from whatever source. They should not be prejudiced by either their relationship with the management (at whatever level) or more widely with the organisation. Their independence and integrity (meaning, avoidance of being compromised) is essential to the effective functioning of such a committee.

The role and nature of a public sector GAC has certain implications for political leadership and in those countries where management structures are relatively undeveloped or where there is no separation of policy and administrative or executive functions, or where there is no tradition of 'challenge' the following ought to be specifically addressed i.e.
1. Is there an explicit political will to create organisational arrangements in which power and responsibilities are delegated and not kept in the hands of one person with responsibility for both policy and the public administrative arrangements?
2. Can a politician accept the appointment of independent members of the audit committee who should owe no political allegiance to that politician, when other senior appointments are being made on a political basis?
3. Would a politician be prepared to accept challenge on the impartiality and accuracy of reporting information?
4. Would a politician, as the top manager, accept that an important role of the audit committee would be to comment on matters affecting internal audit (bearing in mind that in most developing and transition economy countries the internal auditor agrees the audit strategy and submits reports to the top manager) including:

- the audit strategy and periodic audit plans, forming a view on how well those plans address the overall adequacy and effectiveness of the organisation's risk management, control and governance processes;
- the results of internal audit work, and management response to issues raised by that work;
- the resourcing of internal audit;
- the terms of reference (or equivalent) for internal audit[1].

A properly functioning GAC can therefore as one of its functions, not only provide independent expert support to the activity of internal audit but it can also ensure that even at the highest levels of management internal audit has an effective voice. In other circumstances where the law may require that the internal auditor should report directly to top management, the internal audit 'voice' may be 'drowned out' by other, especially political, considerations. (However, the existence of an audit committee should not prevent the internal auditor from going directly to the head of the organisation should that person feel the need to do so.)

If any of the replies to the four questions mentioned above would be "no", then there is a high risk of clash between a GAC and management and hence of failure for the role of the audit committee. The integrity issue is the fundamental reason why the membership of the audit committee has to be independent of the executive.

In the private sector the objectivity and independence of the audit committee is achieved through the appointment of non-executive members with a particular emphasis upon the independent role of the chairman. In some developed countries, but most notably in developing and transition

[1] These impacts upon internal audit are taken from the Audit Committee Handbook published by the UK Treasury.

economy countries, the notion of independent non executives having any sort of a role (in what can be highly politicised civil services) can be very problematic and one difficult to appreciate by politically committed politicians operating in hierarchical organisational structures with little or no understanding of the concept of 'challenge'.

The public sector, especially in developing and transition economy countries, will experience difficulties in fulfilling the requirements for independent membership for a variety of reasons:

- The specific tasks and responsibilities of a GAC require <u>appropriate skills</u> of its members. Those skills can be very hard to find especially in countries where there are professional skill shortages anyway.
- The <u>role of chairman</u> is particularly difficult because not only has the chairman to lead the committee but the chairman has also to deliver the committee judgements to the executive in a way that makes the points firmly but also constructively, without any form of political bias and in a manner that will not lose the respect of the executive.
- The <u>issue of independence</u> also raises very difficult questions for political organisations where even senior civil service and municipal appointments can be made for political reasons. These questions may have to be solved in the context of civil service reform.
- Where there is a tradition to put all powers in the hand of one individual and where the internal auditor reports directly to that person, this will not only lead to difficulties over developing effective management structures but any <u>comment or criticisms</u> made by an audit committee could be seen as direct criticisms of the minister or mayor personally causing the issue to become political with the effect of destroying the intended independence of the audit committee.

There is little point in nominating 'friends or favourites' of the minister or mayor as members of audit committees as they lack the required degree of independence. Independence is crucial because the whole purpose of the audit committee is to ensure that the executive is not misleading the top management, and that top management is not misleading external stakeholders.

Benchmarking the scope and membership of a GAC against the criteria mentioned above will show whether or not the audit committee has been established for the benefit of the organisation and its stakeholders. Top management as well as stakeholders like the national assembly, the external auditor, donors and other stakeholders such as service users and tax payers should receive the right signal.

One concern expressed by some is about the cost of establishing audit committees. The assumption is that audit committee members have to be paid. But that is not the experience of all countries and the motivations for serving as an audit committee member are often much wider that a mere consideration of payment. Expenses incurred in the course of audit committee business should be reimbursed, but fees for service are not always needed and should not be regarded as necessary as a matter of course.

In countries that have become member states of the European Union in recent years, the relationships in the public sector between any audit committee on the one hand and the persons responsible for financial management and control within an organisation, internal audit, the external auditor and the central harmonisation units (CHUs) that have been established to develop PIFC, on the other, will have to be considered carefully. The internal auditor should work closely with the audit committee which ought to offer advice on risk and risk management, the audit plan, and the effectiveness of internal control and the quality of the financial statements. The external auditor also ought to have discussions with the audit committee especially about the annual financial statements and relationships with internal audit. The CHU could also take on the key role of secretary where only one audit committee exists for the whole government sector. Attending decentralised audit committee meetings will not be a feasible option for the CHU because of the usual lack of staff. Overall though, in all of its work, the audit committee must not become part of the executive: it is a non-executive body and should always remain so. In this a GAC would differ significantly from an internal audit management committee.

In summary, the currently existing organisational structures in some developed as well as in developing and transition economy countries would seem to be incompatible with the requirements that are necessary for the operation of a fully developed GAC of a type which has been developed to provide independent assurance in the private sector. Functional or operational independence based on professional integrity is a concept not yet well explored and even less developed in the public sector in many countries. Unless this is recognised from the outset any audit committee with robust independent members will immediately have difficulty with the organisation which it is supposed to be serving. In other words, establishing a GAC brings no benefits unless accompanied or even better, is preceded by, other reforms. Yet these conditions for the successful introduction of a GAC are wholly consistent with the building of strong and transparent public sector institutions.

c) Key requirements.

Should all conditions for the GAC based on the private sector model be in place before the public audit committee can become an asset to the organisation? Certainly not, but much will depend on the presence of four key requirements:

1. the substantive support and acceptance from top management of the desirability of independent opinion and sometimes painful advice even in the circumstances of changes in political control which would also mean that non-executive membership should not change on a change of political control;
2. an independent chairman intellectually equipped to pursue improvements in the quality of public finance management and capable of delivering advice in a manner acceptable to the top manager;
3. two (at least) other independent non executive members external to the organisation and unwilling to be under any obligation to the organisation other than a willingness to provide impartial advice, and
4. a willingness by the organisation (top manager as well as senior civil service) to embark on and support a process to reform to financial management that the audit committee should be expected to stimulate. (Without this fourth condition the audit committee will become frustrated and feel that its role is pointless. Top management should recognise that the audit committee is essentially about the financial and managerial integrity of the organisation and thus deserves the highest respect from all management levels.)

If these requirements cannot be fulfilled, the value of such an audit committee is more likely to be cosmetic than substantive; worse, the end result could even be counter-productive because there would be an ‘illusion’ of independent review rather than substance and this could mislead independent observers about the quality of the governance arrangements.

From a practical point of view, the GAC should be supported by effective secretarial arrangements (see Annex 1). It should also be provided with an appropriate budget so that if necessary it can commission independent advice. There should be regular review procedures of the successes or failures of the committee as well as systematic reporting on each meeting to the head of the organisation. An annual report should give an overview of the strengths and weaknesses of the risk management arrangements, the internal control system, comments given about the effectiveness of internal audit, set out its views on the accounting and financial reporting processes, including the annual financial statements and any discussions with the external auditor.

Officials should be required to attend committee meetings as necessary, although the internal auditor should always attend the meetings. Where a single audit committee has terms of reference that cover several ministries it may be more appropriate for the head of the CHU to attend with heads of individual internal audit units only attending for matters that specifically concern them. The external auditor whether the SAI or a private audit firm should also be invited to attend committee meetings as observers and to answer questions as appropriate. However the non executive committee members should always have the opportunity to meet separately from executive members if they feel necessary.

It is not enough that the GAC just considers the internal audit plans and the audit recommendations. The role of such a committee is far wider given its concern for the overall financial and managerial integrity of the organisation not just for the benefit of top management but also for the benefit of external stakeholders. Annex 2 summarises the main advantages and disadvantages of this type of audit committee and Annex 3 provides a sample list of agenda items that should be covered by a GAC. In Annex 4 we set out some examples of where countries have introduced GACs based on the private sector model.

V. Current practice with public sector audit committees

Of the member states of the European Union who joined prior to 2004, France, Ireland, the Netherlands and the United Kingdom have established governance or governance type audit committees.

In France the new Organic Budget Law of 2001 moved away from ex ante financial control towards internal audit performed by the inspection services of the ministries in co-operation with the "Inspection de Finance" in the Ministry of Economy and Finance. In 2008 'Ministerial audit committees' were established in some ministries. These committees only have civil servants as members and there is no external membership. The French ministerial audit committees were to consider the effectiveness and efficiency of the internal financial control arrangements make recommendations for improvement, review the quality of accounting, financial management and risk control and ensure that information systems are sufficient to meet proposed reforms to accounting and internal control. However, in June 2011 the Ministry of Economy and Finance issued a decree establishing a control and internal audit body to be attached to each ministry. Also, each ministry has to establish in 2012 an audit committee, responsible for defining audit policy, ensuring the internal control quality, managing risks, approving the internal audit plan and following up on the audit recommendations. To harmonise the introduction of audit and audit committees the decree also established a central harmonisation unit under the Minister for State Reform. The decree refers to the composition of the audit committees in the sense that its members should be professional and independent with its majority being external members with non-operational responsibilities.

In Ireland following a report recommending their introduction in 2002, audit committees have been established in ministries. Audit committees can perform the following functions:

- "Act as another source of independent advice to Accounting Officers.

- Review the plans and reports of the internal audit unit and quality assure the service provided by the unit.
- Assess whether appropriate action is taken to deal with key issues identified by the internal audit unit and by external audit.
- Examine and monitor the implementation of the Department's risk management strategy.
- Provided they have representatives external to the Department, they can facilitate improvements in internal audit and internal control through the exchange of information between (i) Departments/Offices and (ii) between the private and public sectors."

Membership of audit committees includes a significant external representation (at least 2 members), including, in the normal course, representatives from the private sector with appropriate expertise. The chairperson of the Committee should come from outside the Department or Office. The Comptroller and Auditor General, or his nominee, should be invited to meet the Committee at least once a year.

In the Netherlands, audit committees have been established since the 1980s. However in 2012 the Ministry of Finance, following a review which concluded that these committees added value, proposed a new regulation on ministerial public sector audit committees aiming at:

- strengthening the position of audit committees;
- strengthening the role of external members;
- clarifying the responsibilities and competences of the Committees, and
- standardising roles and responsibilities.

Audit committees include external independent members and the number of such members is increasing. The main tasks of an audit committee are to:

- review the quality of organisational processes, including financial reporting, management statements and reports;
- comment on the internal audit policy, and review the annual audit plan;
- reviewing the risk management policy and results;
- comment on the management control, system and the results of policy evaluation.

More tasks may also be added to this core agenda.

The regulations require that the audit committee of a ministry should have at least 2 independent external members. The minister appoints all members. There is no requirement that the chair of the audit committee should be an external member. The chief financial officer and the internal auditor of the ministry are expected to provide support to the committee and the external members have access to other civil service officials.

The Court of Auditors is sent a copy of the agenda.

An important current question is whether audit committee responsibilities should be limited to an advisory role to the ministerial top management, or should they also have some form of supervisory responsibility?

In regional and local governments audit committees are not widespread. Committees of elected representatives from the respective local government council are expected to cover the functions of an audit committee.

In the United Kingdom, audit committees have been established in ministries (and also across the public sector, including in local government) for a considerable time. These are full governance type audit committees. There is a significant external independent membership, although in local government membership consists mainly of elected representatives, sometimes though with an external adviser[1]. The Treasury published the latest 'handbook' of advice[2] covering the role of the audit committee; membership, independence, objectivity and understanding; skills, scope of work; and communications. Membership includes non executives one of whom should be chairman. The responsibilities of the Committee should include:

- "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;
- anti-fraud policies, whistle-blowing processes, and arrangements for special investigations;
- The Audit Committee will also periodically review its own effectiveness and report the results of that review to the Board."

Of the member states that acceded to the EU in 2004 and later none has introduced governance type audit committees in the non market sector. Seven EU-12 member states have laws that allow for establishing audit committees on a voluntary basis, but have little or no experience with them, and the definition in these laws seem to focus on the role of internal audit only[3]. The same applies to the remaining and potential candidate countries[4]. The main reason for this appears to be that the second pillar of the Public Internal Financial Control (PIFC[5]) policy - introducing internal audit - initially received more attention than its first pillar: financial management and control. Also because the concept of "management" has been difficult to introduce for historical traditional reasons, financial management has also been a difficult concept to introduce. A further tradition, again difficult to change, is that budgeting has often not been perceived of as part of financial management.

Of the countries, both within and outside the European Union, that have introduced "governance" type audit committees with a broad remit of responsibilities, the main driving force has been the ministry of finance, usually supported by the supreme audit institution (SAI) both of which have been willing generally to offer advice on roles and responsibilities and membership arrangements. (See examples in Annex 4).

However, outside the European Union but within the group of countries/territories classed as European neighbourhood countries, one[6] has established a single "governance" audit committee. (This committee has been established covering the whole public sector, apart from local government and government business enterprises. The committee is attached to the ministry of finance which was also the driving force for its establishment.) This approach of a single audit committee attached to the ministry of finance, may provide a model for other developing and transition economy countries particularly those which have difficulty in finding sufficient skilled persons to exercise non

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1 Audit Committees: practical guidance for local authorities, 2005 CIPFA
2 2007: http://www.hm-treasury.gov.uk/audit_committee_handbook.htm
3 Only Poland seems to have gone further recently by establishing audit committees in all ministries in 2011
4 With the exception of Kosovo that has established over 20 audit committees in its public sector
5 **PIfC** Public Internal financial Control, publication by Robert de Koning 2007 on the EC policy developed around 2000 to help candidate and potential **candidate** countries preparing for the accession negotiations in the field of financial control (Chapter 28, now 32)
6 The Palestine National Authority

executive roles. This arrangement can provide the ministry of finance with a better opportunity to explore the overall standards of risk management, internal financial control and internal audit without necessarily damaging the integrity of individual ministerial internal audit units. Another benefit is that it can reinforce internal audit units because the audit committee rather than the internal auditor would have the authority to require the senior civil servant (other than a minister) to explain how the ministry has responded to the internal audit reports. The location of an audit committee within the ministry of finance also provides the opportunity to comment on the financial statements of the government and on the accounting policies supporting those statements and to liaise with the SAI.

VI. Introducing audit committees

Administrative reform in the area of PIFC should take into account individual country circumstances and current understanding of the subject. There is therefore no clear answer to the question of when and what type of audit committee to start with. Only general indications and timeframes can be suggested.

However, if PIFC is at the very early stages of development and if the idea of introducing independent non executive persons into the administrative arrangements would at this period of administrative reform be unacceptable, then aiming to introduce a GAC so early would be inappropriate and unsuccessful. Therefore the types of committee that might be considered would be the CAB and the IAMC.

Where a country is proposing to implement PIFC and the idea of a functionally independent internal audit is non-existing or new and the perception of financial management is limited primarily to control of spending against the budget then the most appropriate form of committee to be established would be normally a CAB but with some measure of membership drawn from outside the public administration. A CAB with this type of membership would not only be an expression of serious public commitment for the development of PIFC policy but it would also provide an opportunity for non government advisors to provide an input into a policy development where the experience of the government itself, by definition, is very limited. The technical contribution of such a board to improvements in financial management and internal audit including outside advisers, would provide for alternative views to be put forward contrasting with those of politicians. Such outside advisers would not need to have the high degree of independence that should be expected of members of a GAC and neither would they dominate a CAB in the way that they would a GAC. Such a central advisory board would also provide a valuable 'sounding board' for any newly established CHU and would facilitate support for the harmonised and co-ordinated introduction of PIFC across the public sector.

In addition to the CAB and once the internal audit function in the public sector has become established and is well aware of its role and comfortably supported by the CHU and the CAB (which could take up to 4-5 years), then the possibility arises of establishing IAMCs. These would only deal with one aspect of PIFC, namely internal audit. The effectiveness of these committees would depend very much on the existence of an independent and expert membership and ideally also the appointment of an effective and committed independent chairman. Anything less than this would raise doubts about the real effectiveness of such a committee! (To introduce such a committee too early would not allow for any practical experience (either on the part of internal auditors or of the administration) to be gained and it would be unclear in practice what role the independent members would be expected to play.)

In previous sections we have explained that the GAC based on the private sector model fulfils the complete requirements of an audit committee. Governments adopting PIFC would want to develop strong democratic institutions and strong accountability. A GAC could be a significant factor in helping them do so. However, where the public administration is characterised by a highly politicised structure with all or most responsibilities for managerial decisions vested in one or a small group of persons, the opportunities for independent persons to make their views known would be relatively small. Therefore in these circumstances a GAC would be unlikely to be effective because of the critical conditions that ought to apply, namely, an independent and experienced membership (that is experienced in an understanding of the role of financial management and audit), an effective chairman and a willingness on the part of the executive to work with the committee. Without these conditions applying, the establishment of an audit committee risks creating the illusion of an independent assessment of quality and that would do more harm than good. If a government, nevertheless wishes to take some action, it would be best to introduce GACs into those areas that are not central to the government process: e.g. state enterprises where there are clear private sector models that can be followed. To help success, this reform should be actively and publicly promoted by the prime minister and the minister of finance while making sure that the independent members of the audit committee are <u>not</u> appointed by the current board of the enterprise. This reform should be undertaken with the support of the <u>external</u> auditor, often the SAI. The external auditor should be tasked with reviewing how the audit committee was working, with the audit report going directly to the government and not to the board.

Based on the experience of this model (say after 2 or 3 years) the next step could be to introduce a similar approach into selected central government agencies, again asking the external auditor to review the working of the process. The introduction of GACs into core line ministries depends on important changes to the organisational structures of line ministries which would affect the role of the minister and the decision making processes. The minister would still retain overall ministerial responsibility but would need to delegate responsibility for <u>operational and</u> <u>service delivery to lower management levels.</u> Such administrative reforms would in any event improve the quality of both public administration and financial management.

Given these changes a GAC could become effective provided that the other relevant conditions could be met. Probably the independent members of the GAC, and certainly the Chairman, should be appointed jointly by the minister of finance and the relevant minister. The role of the GAC in a ministry would be to ensure that effective arrangements were in place to provide assurance on risk management, governance, financial performance and internal control. The GAC would review the financial reports of the ministry and the quality of the risk management arrangements. The internal auditor would discuss the audit programme with the audit committee and provide his/her reports to the committee. The most senior permanent official (the secretary general of the ministry, for example) and the person responsible for the day to day financial management arrangements should be expected to attend audit committee meetings, but not as members. The committee would expect to discuss with the secretary general the committee views and comments and the secretary general should be required to ensure that audit committee views and recommendations were properly responded to. The audit committee would report annually to the minister. The committee should also have a responsibility to liaise with the external auditor. In addition the head of the CHU or his representative ought to attend GAC meetings as an observer.

Where the audit committee was responsible to the minister of finance or there was a single audit committee covering all of government then the committee ought to have a specific concern for fiscal risks as well as strategic financial risks. This would require the audit committee to become involved in the elements of the budget process to satisfy itself as far as possible about how far such risks were identified, taken into account in the budget process and then the actions being taken to mitigate them.

The application of audit committees to local government is more problematic. Elected members of local government are responsible for checking independently upon the executive but this is complicated by the political nature of local government. Local governments would probably expect that the audit committee should be comprised of elected members. However, to achieve independence they should not be members of any executive or finance committees and the committee should have the ability to co-opt into its membership independent experts. The local authority members would probably require special training and should have the authority to meet with the external auditor. Crucially the terms of reference of this audit committee should exclude any discussion of political policy.

We have suggested that CABs and IAMCs are significantly different from GACs. The transformation from the first into the last should not be seen as an evolutionary step, but should rather be based on a new paradigm introducing appropriate concepts of managerial accountability and transparency as well as full operational independence of the internal audit function.

Conclusions

A. Governance audit committees (GACs)

Can GACs that are based on the private sector model be a useful aid to improving public financial management? The answer is not straightforward and some countries appear to have considered their introduction but have rejected the proposal seemingly on the grounds that they do not add value. In Section IV B a (page 18 onwards), 'the environmental basics' we set out seven criteria we regard as important. The degree of importance that countries may attach to each of these criteria is very likely to be different. In a country with an inflexible bureaucracy and legal system where the role of the audit committee may need to be described in great detail (and hence be subject to attack if the committee appears to step beyond its legal competence) and where a hierarchical and perhaps politically dominated civil service exists, an audit committee may seem to be an added encumbrance. An audit committee will work best where it has a degree of flexibility to challenge existing practice recognising that the nature of that challenge may change as circumstances change. Certainly where the four key requirements identified on page 24 do not exist, along with a modernised and devolved management structure, their value is more likely to be cosmetic than substantive with the end result that their existence could be counter-productive. The only standards that have been developed for such audit committees are those that apply to the private sector and these have been developed on an individual country basis. Therefore any country wishing to introduce a requirement for the establishment of audit committees in the public sector and wanting to refer to international models can only look to either private sector company models developed for application in particular countries or should look at how audit committees have been developed by certain countries (such as the examples given in Annex 4) for application to the public sector. Those models would though only apply to the "governance" type audit committee. In our view, the existence of a "governance" audit committee could provide potentially a significant benefit to the dominant role of the "top manager" provided that that top manager was prepared to accept challenge and encourage the development of devolved management. This does not mean that the top manager's responsibility would be weakened, but rather that the power of such a manager would be tempered by a strengthened system of accountability and by appropriate checks and balances. Such a development may be too premature for most developing and transition economy countries as it is highly unlikely that the four key requirements can be fulfilled.

With time it may be expected that conditions will develop in such a way as to allow for the establishment of a “governance” audit committee based on the private sector model, but establishing “governance” audit committees without serious efforts to change management arrangements and culture and involve non-executive members should be discouraged. Indeed until such changes occur and the appropriate quality of independent non-executive members can be found (and this will require a real determination on the part of the most senior officials, that is the prime minister and/or the minister of finance, to achieve reform), “governance” audit committees should not be established because the results could be counter-productive.

Another key player in assessing the level of governance, transparency and accountability is the (SAI). This obviously requires that the SAI is well equipped (in human resources and experience) to do so. We have referred to the need for the external auditor to become involved in the work of a “governance” audit committee. The audit programme of the external auditor would also need to focus on the quality of the public internal control systems of government and more in particular, on the quality of public internal audit, rather than just on compliance. This would have the benefit of linking all actors in the public audit field together (CHU, external auditor, audit committee, internal audit units) in enhancing and promoting the development of financial management and control and the internal audit function.

B. Central advisory boards (CABs)

In our view the establishment of an effective CAB could be potentially a useful first step in moving towards a GAC approach. However, this is not necessarily easy to do. Some of the difficulties are: biased or limited agendas, neglect of the internal audit role or a focus on internal audit to the exclusion of financial management, political chairmanship, inappropriate membership and inadequate support from the CHU or alternatively taking over from the CHU the role of "executive" body. As a support to the CHU the establishment of a CAB could be useful under the right conditions. But to go the further step of converting the CAB into a “governance” audit committee would require, as a minimum that the 4 key conditions referred to on page 24 were met. (The critical requirement in the evolution of a CAB would be the degree of independent membership, including chairmanship. Without that, even as an adviser to a CHU, existing attitudes and approaches to public financial management will tend to remain, and even be reinforced. CABs with external members have the opportunity to develop a broader reform agenda than would normally be possible by a CHU acting alone because of the possibilities for persons outside the system to question why traditional approaches, such as the minister or mayor being responsible for “everything” and why budgets are not devolved, are sustained in modern circumstances. They also have the opportunity to introduce ideas about “good governance”.)

C. Internal audit management committees (IAMCs)

The relevance and appropriateness of IAMCs is more difficult to judge. The need for such a committee clearly arises from the situation where the internal auditor reports only to the head of the organisation, the minister or mayor. Whilst this may have theoretical advantages in practice this is not always a sustainable policy. The top official's dominant concern should be for policy and strategic issues with internal audit likely to come fairly low down the list of priorities. In any event what should be of prime importance is the overall quality of financial management, a factor that is not well recognised by either the IAMC or by causing the top managers to focus on internal audit. An IAMC can provide support to the internal auditor but without external expert membership the effectiveness of such a committee will be limited and in practice may be counter-productive because it could create a sense of complacency. Policy makers who have introduced such committees ought to be well aware of the potential limitations and of the effects that such a narrow agenda and a wholly executive membership would have.

Provided these limitations are fully recognised, IAMCs may provide benefits, mostly by giving support to the internal auditor. The IAMC is not capable of replicating the role of a "governance" audit committee. Therefore the significant governance, transparency and accountability weaknesses that exist will not be remedied. One added risk is that its existence may in fact mislead top management (and external stakeholders) about what it is actually capable of achieving. The IAMC also completely ignores the fact that an effective financial management and control system is crucial. The internal audit can support the operation of such a system through providing an independent assurance that the organisation's risk management, governance, financial management and internal control processes are operating effectively. But the system has to be there in the first place!

The case for IAMCs for groups of budget handling entities (like a group of municipalities) is also difficult to judge. There are many problems to be addressed and the answers to these problems will depend very much on local circumstances. However, there is a real risk that such committees may become cosmetic and merely another layer of bureaucracy. Such joint committees could only have benefits in limited circumstances and where the problems we have identified can be easily addressed. But if they can be addressed an experiment may provide useful results that could be then be applied elsewhere.

D. Final remarks

Countries that have established or are considering establishing some form of advisory audit committee should have a proper understanding of what they really wish to achieve and then determine the type of committee required. The confusing use of the same term 'audit committee' to describe what are in fact very different types of committee is misleading and is particularly unfortunate. Most developing and transition economy countries seem to misinterpret or misunderstand the "governance" functions, scope and responsibilities of an audit committee. Committees that have been established are not 'audit committees' of the type that would be compatible with the concept of the "governance audit committee". They certainly do not have the most appropriate type of membership or agenda. The committees that have been established cannot be expected to deliver the benefits that "governance" audit committees are capable of doing.

In most developing and transition economy countries (and some other countries too) the senior ranks of the civil service mainly consist largely of political appointees. The top manager (minister or mayor) is responsible for 'everything'. The potential for governance failure is serious because that single source of power and responsibility contradicts a key principle of effective governance, namely that by one means or another there should be a check on the exercise of power by any one individual or small group of individuals. This check can be provided in a variety of ways. For example, by requiring the separation of powers (thus of the roles of the minister or mayor and chief executive or chief management official), or by giving independent legal powers to the chief executive (or management official) that act as a break or check on the unfettered power of the minister or mayor. Or that non executives play a key role in decision making and/or that audit committees are established (again either wholly or mainly consisting of non-executives) to provide an independent assurance that the internal control system in all its facets is working effectively.

However, as countries gradually develop their public sector management arrangements by more clearly defining the roles of the politician and the civil service and introducing managerial accountability in substance rather than form, then in our view GACs have a potentially valuable contribution to make. Indeed their role can become essential in the process of ensuring that the top manager is fully and independently informed about the reliability and effectiveness of key reporting, risk management, financial management and internal audit activity. The crucial elements in all of this are the independence and expertise of the membership (including the chairman) and the willingness of the senior management to recognise the value of and to accept impartial advice.

A determined 'top management' with a commitment to reform could do much to overcome the problems, but the effective sustainability of such a committee depends very much on a stable political approach to public sector management in government, a continuous commitment to reform and "tone of the top". The top manager has to realise and accept the benefits and need for such a committee from the point of view of external stakeholders (the council of ministers, the national assembly, donors and other external stakeholders) and see that the benefits can reach beyond immediate political considerations.

Although laws in many countries are the basis for reforms, laws alone cannot fulfil all conditions. The conditions required for the development of GACs represent an attitude of mind which would perhaps be better stated as a change of culture. Therefore inevitably, as with most reform, they are likely to take time to evolve. Experimentation with pilot organisations may be the best way to proceed.

Our advice to a country that has traditional managerial arrangements with a focus on one individual and no, or only recent, experience of financial management and control and a functionally independent, decentralised internal audit is to put all available energy and resources into the building up of a central harmonisation unit for developing public sector wide financial management and control and internal audit. This unit, preferably attached to the ministry of finance could significantly benefit from the existence of a central advisory board. External members could encourage the shift of focus from structures to quality of the outputs of those structures. Ideally the chairman of the board should be one of the independent members. The success of such a board depends very heavily upon the effectiveness of the CHU and its relationship with the board. Ignoring the operational environment and the capacity for independent assessment would make the approach simplistic and then potentially counterproductive.

Annexes

Annex 1: The secretarial arrangements supporting an audit committee.

The role of the secretary of the audit committee[1] should be to ensure that:

- There is close engagement with the chairman so that the chairman is fully informed about any development that might affect the work of the committee and is able to make decisions about which the committee need to be informed (the chairman being a non executive will not be familiar with the internal workings, developments and thinking of the organisation or indeed internal politics, and the secretary should therefore provide the intelligence that would ensure that the decisions of the committee were relevant to current circumstances within the organisation);
- A forward programme of meetings is established;
- The agenda is agreed with the chairman;
- Papers are prepared for the meeting in sufficient time to enable the members to be properly prepared (only in the most exceptional circumstances should verbal presentations be made, other than to explain or develop a previously circulated written paper);
- Significant changes in the risk register are reported to the committee;
- The relevant civil servants attend the meetings;
- The decisions and comments of the committee are properly recorded, agreed with the chairman and acted upon, and that following each meeting a report to the head of the organisation is prepared summarising the business that the committee has addressed, and communicating to the head those main issues about which the head should be informed;
- The committee is fully informed about actions taken or not taken arising from decisions made at previous meetings;
- Bilateral meetings are arranged as necessary between the chairman and key executives including the head of the organisation.

The secretary should also support the chairman of the audit committee in the preparation of an annual report (and other reports) about the work of the audit committee and its conclusions. In addition the secretary should ensure that appropriate records are maintained of audit committee member's terms of appointment, that arrangements are made to replace members (or reappoint them) as necessary and that new members are provided with appropriate induction training. As the audit committee ought to have a budget enabling it to function efficiently, the secretary should also be responsible for managing that budget. The secretary should also aim to ensure that the work of the audit committee is not biased in one particular direction, for example in considering only internal audit issues at the expense of financial management and control or accounting issues.

Annex 2: The main advantages and disadvantages of a governance audit committee

Advantages:

- A rigorous review of whole internal control and financial management process should occur;
- A stringent assessment of the quality of the risk management process;
- A critical assessment of the quality of the accounting, financial management and internal audit would exist;

[1] Based upon the advice contained in HM Treasury Audit Committee Handbook (2007)

- A capacity for close monitoring of the management response to internal audit reports and internal audit follow up would exist;
- An independent review of the accounting policies and the external financial reports adds to confidence in the quality of those reports;
- An assessment of the external audit activity and a dialogue with the external auditor adds to management discipline and ensures that proper regard is had to the comments contained within the management letter;
- Provides a platform for debate about improvements to governance arrangements;
- Overall provides an independent assessment to the top manager of the operational and financial health of the organisation and to external stakeholders.

Disadvantages:
- Potentially the committee could be directly critical both of line management and top management and that could be therefore politically embarrassing;
- The effectiveness of the committee depends entirely upon the personalities and experience of the independent members;
- Finding members with experience of and sensitivity to a political situation (private sector experts with no experience of the public sector often require particular training if they are to make good committee members) is extremely difficult in countries where there is an acute shortage of professional skills;
- Similarly, finding external members who are expert in public financial management adds to the difficulty, although the required expertise could be spread over one or two members, or as an alternative, the Committee should have access to that type of advice, e.g. over the application of accounting policies and standards, and that may be equally difficult;
- Finding a chairman who has the sensitivity and status and who is able to deliver critical messages to top management can be difficult.

Annex 3: A governance audit committee agenda

The Audit Committee is expected to drive the organisation - to which it is attached - towards the implementation of several important reforms. During its initial period of operation the agenda of the audit committee should aim to cover the following (and avoid getting the committee too much involved in detail):

- The adequacy of the internal control system including the quality of the cash management arrangements;
- The risk identification and management arrangements;
- The internal audit risk assessment arrangements and their link with organisational objectives and risk identification and mitigation arrangements;
- The key internal audit reports (i.e. not all), the recommendations and their implementation;
- The relationship between the internal audit and the external auditor;
- Any statement of internal control prepared by the organisation;
- The external financial reports and the accounting basis for those reports along with the underlying accounting policies, satisfying itself that those reports are consistent with the relevant laws and regulations;
- Any other financial reports published in the name of the organisation, whether to donors, other stakeholders or multi-national organisations;

- The external audit strategy for auditing the organisation, even though the external audit will make its own decisions about the approach and scope of the audit, the external audit management letter and management responses as well as the external audit report;
- The anti-fraud and corruption strategy, including ‘whistle blowing’ arrangements.

In subsequent agendas should be covered:

- The strategic planning arrangements and the objectives that have been defined;
- The managerial operational objectives and the availability of appropriate managerial structures, information systems and reporting arrangements;
- Operational risk management arrangements;
- Strategic financial risks (including where appropriate fiscal risks)
- Performance reporting arrangements;
- Proposals for financial management reforms to allow the committee the opportunity to comment on the appropriateness, in terms of priority and the effects upon internal control arrangements.
- The development of good governance arrangements.

In those subsequent agendas there should be a schedule of standing items including consideration of the internal audit risk planning, consideration of the financial accounts and the external audit management letter and opinion and the annual assessment by the CHU of the quality of the internal audit and financial management arrangements.

Annex 4: Country examples based on the private sector model.

Audit committees based on the private sector model have mainly been developed in countries that have strong accountancy professions (with accountancy being defined as including both financial management and external audit) and where those professions have played a prominent role in the public sector. That profession often provides a source of expertise although that is not the only source. Some examples of audit committee reports and advice are set out below. These are mainly drawn from the UK, Australia and Canada (which all have strong accountancy professions) and whilst the emphasis of advice or the coverage of audit committee activity may differ, fundamentally all have the same objective that is the improvement of the governance, internal control and external reporting arrangements.

United Kingdom

The National Audit Office (NAO) advises[1] that the role of the audit committee is fundamental to ensuring that organisations function according to good governance and accounting and auditing standards, and that appropriate risk management arrangements are adopted. The NAO regards well functioning as a key to helping organisations achieve good corporate governance.

The Scottish Government has also published an Audit Committee Handbook[2]. The HM Treasury and CIPFA publications on audit committees have been referred to earlier (see for example pages 18 and 26).

The Audit Committee of the Ministry of Defence provides a good example of what an audit committee should cover. It discusses the internal control systems, reviewing a number of items in the course of the previous year in order to assure itself of the adequacy of the internal control

[1] NAO: Helping your Audit Committee add value: November 2009
[2] Scottish Government Audit Committee Handbook, July 2008

arrangements and it provides advice to the Accounting Officer (the chief civil servant in the Ministry). This advice included:

- Ministerial risk and assurance arrangements,
- Internal and external audit of the Ministry, including:
- the Defence Internal Audit Programme and National Audit Office strategy;
- an update from the Director of Internal Audit on 'No Assurance' audit findings during the year; and
- the progress report on implementing the recommendations made as a result of the National Audit Office's review of the management of losses and special payments;
- Internal reviews of corporate governance practice, in particular the annual report setting out the Ministry's corporate governance arrangements in relation to the Treasury's Code of good practice (the Treasury is the UK Ministry of Finance);
- Annual stewardship and process owner reports from a variety of Ministry sources.

Australia

The Australian National Audit Office (ANAO) advises that audit committees can be a forum for communication between management and internal and external auditors as well as bringing a degree of independence and expertise to an entity's corporate governance arrangements. This includes reviewing the entity's risk management framework; reviewing the entity's financial statements and recommending their signature by the chief executive; approving the internal audit programme; and reviewing fraud control plans.[1] The ANAO defines the broad functions of the audit committee as:

- enhance the control framework;
- improve the objectivity and reliability of externally published financial and other information and
- assist the Auditor-General to comply with all legislative and other organisational objectives. [2]

The audit committee of the Australian Treasury (the Ministry of Finance) e.g. functions as a forum of review of audit issues by supporting and enhancing the control framework; ensuring the objectivity and reliability of published financial information and by assisting the Secretary (the chief official) to comply with all legislative and other obligations. The audit committee reviews internal and external audits relating to the Treasury and follows the recommended best practice guidelines issued by the ANAO.

The ANAO also attends Treasury audit committee meetings as an observer.[3]

Canada

The Office of the Auditor General of Canada has published best practice advice for audit committees. This includes:

"The audit committee should ensure financial oversight by

- critically reviewing the interim and annual financial statements, the auditor's report, and the management discussion and analysis section of the annual report;

[1] Annual Report 2006-7
[2] Annual Report 2008-9
[3] Treasury Annual Report 2003-4

- ensuring that presentation of financial statements is fair, appropriate, and clear, and that it meets generally accepted accounting principles and
- actively soliciting the external auditor's judgments about the acceptability and the quality of the corporation's accounting principles as applied in its financial reporting. This discussion should include such issues as the clarity of financial disclosure and the aggressiveness or conservatism of the corporation's accounting principles and estimates.

The audit committee should ensure oversight of corporate books, records, financial and management control and information systems, and management practices by

- reviewing the special examination plan and report prepared by the external examiner;
- actively soliciting information about significant risks and exposures and reviewing the adequacy of internal controls to manage those risks;
- reviewing the integrity and effectiveness of the management information systems;
- reviewing internal audit plans and reports and management's subsequent actions and
- reviewing significant findings and recommendations made by the external auditor and examiner and following up on management's subsequent actions.

The audit committee should

- ensure ethical oversight through the annual review of management's compliance with the corporate code of conduct;
- actively solicit all sensitive information (for example, senior management expenses, significant litigation, non-compliance with laws and regulations, misuse of corporate assets, illegal activities);
- oversee the resolution and investigation of complaints of wrongdoing (audit committee mandates should include the requirement for a process to investigate and resolve all complaints, including those made anonymously);
- ensure that internal audit is adequately resourced and that it has adequately covered the major risks and activities of the corporation; and
- recommend external auditors and their compensation, and pre-approve all non-audit services by external auditors to ensure that their objectivity and independence are preserved.

Membership and competencies:

- Audit committees should be composed of at least three members. Each member should be an independent director, who should not be an officer or an employee of the corporation.
- Although a variety of skills and experience is beneficial to an effective and balanced audit committee, all members should be financially literate and at least one member should have accounting or related financial management expertise. Financial "literacy" signifies the ability to read and understand fundamental financial statements, including a balance sheet, income statement and cash flow statement, and the ability to ask probing questions about the corporation's financial risks and accounting. "Expertise" signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication (experience as a chief executive officer, for example, or other senior officer with financial oversight responsibilities).

Operating procedures

a. Terms of reference. Audit committees should have clear, written terms of reference and operating procedures that specify the scope of the committee's responsibilities and how it carries them out, including its structure, processes, and membership requirements.

b. Meetings. The frequency of audit committee meetings should be tailored to the responsibilities assigned, but should be at least quarterly. The audit committee should also meet periodically with management, the external auditor, and the head of internal audit, in separate private sessions.

c. Disclosure requirements. Audit committees should publicly disclose their charter, composition, recommendations not adopted by the board, and nature and amounts of auditor's fees, in audit and non-audit services."