EUROSAI-ECIIA COOPERATION

AUDIT COMMITTEES IN THE EUROPEAN PUBLIC SECTOR – EUROSAI-ECIIA COOPERATION COMMITTEE PAPER (19/05/2017)

EUROSAI

ECIIA

EUROPEAN CONFEDERATION OF INSTITUTES OF INTERNAL AUDITING

This paper is a product of the EUROSAI-ECIIA Cooperation Committee (2014-2017), that consisted of:

EUROSAI

SAI Belgium	Wim François	project co-lead
	Philip Mariscal	
SAI Germany	Axel Böcher	
SAI Lithuania	Audronė Vaitkevičiūtė	
SAI Moldova	Natalia Balaban-Uncu	
SAI Turkey	Semih Zencirkiran	
EUROSAI Secretariat	Karen Ortiz Finnemore	

ECIIA

IIA UK & Ireland	Melvyn Neate	project co-lead
IIA Spain	Juan Ignacio Ruiz Zorrilla	
	Soledad Llamas	

Introduction

In June 2014, EUROSAI and the ECIIA renewed a Cooperation Agreement, first signed in March 2011. The purpose of this cooperation is to facilitate the exchange of information, develop a common understanding in relation to public sector accountability and auditing, share experiences in implementing the existing professional practices' framework and standards and to consult on issues of common interest. Both organisations are committed to promoting good governance[1] across the public sector in Europe.

This paper examines the role of the Audit Committee (AC) as a potentially or an effectively important contributor to the governance process. The first part provides background information on ACs and the second part examines the current situation in the UK government sector, explaining the role, purpose and composition of the AC together with the benefits it can bring. The third part sets out the attributes of effective ACs together with the benefits and some potential difficulties to establishing ACs in the public sector. The fourth part (survey results) examines the AC situation in the wider European area and detail both current practice and obstacles to the widespread deployment of audit committees.

[1] Governance involves the combination of processes and structures implemented by the board to inform, direct, manage and monitor the activities of the organisation toward the achievement of its objectives (Chartered Institute of Internal Auditors – Glossary to the International Standards)

Part 1 – Background

Governance failures in both the public and private sectors have highlighted the need for boards, or in general those charged with governance, to be better informed, more proactive and accountable. Comprehensive international frameworks and guidance on internal control and enterprise/ entity risk management designed to improve organizational performance and governance were developed by COSO (private sector) and INTOSAI (public sector).

The global financial crisis in 2008 triggered a series of regulatory responses. In Europe this paved the way for a system of financial supervision in the banking, insurance and financial markets sectors which included changes to the scope and expectations of ACs. The development and repositioning of ACs in the financial services sector led to a reappraisal of ACs in other sectors. In the UK, ACs are now recognised as key contributors to good corporate governance and the public sector has fully embraced their use and has developed guidelines and good practice for their operation across both central and local government.

Whilst the private sector is profit driven and focuses on increasing shareholder value, the public sector's main aim is to deliver public services. Despite these differences, both shareholders and taxpayers are similar in their quest for more information and greater accountability whilst at the same time becoming increasingly less trusting. Consequently, both corporate directors and leaders of public sector bodies must understand and be fully focused on governance, risk management, the control environment and the organisation's ethics and culture. The consequences of corporate governance failures can be severe and, in order to meet the growing challenge, boards are increasingly seeking assurances to help them to discharge their responsibilities.

Whilst the Board, or equivalent public sector governing body**,** are ultimately responsible for governance, the establishment of an AC can significantly support the Board by providing oversight of financial reporting, risk management, internal control, compliance, ethics, leadership, internal audit, external audit and other assurance providers.

The Institute of Internal Auditors defines the AC in the private sector as, 'the governance body that is charged with oversight of the organisation's audit and control functions'.

For the government sector, INTOSAI's Internal Control Standards define the AC as, 'A committee of the board of directors whose role typically focuses on aspects of financial reporting and on the entity's processes to manage business and financial risk, and for compliance with significant legal, ethical and regulatory requirements' [INTOSAI GOV 9100, Annex 2 Glossary, 2004]. More recent guidance can be found in the IFAC publication *International Framework: Good Governance in the Public Sector* (2014).

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 sometimes missing from public sector audit committees. (Noel Hepworth and Robert de Koning, Audit committees in the public sector. A discussion paper, 2012)

Public sector audit committee arrangements that do exist in Europe 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. (Hepworth & de Koning)

Mandate, responsibilities and conduct of Audit Committees

The mandate of the audit committee may be derived from legislation, regulation, government policy or best practice.

The responsibilities of the Audit Committee can include the review and the provision of oversight on: (i) the systems and practices management establishes to set and sustain high ethical standards; (ii) governance initiatives established by the Board; (iii) the establishment, implementation, maintenance, and effectiveness of risk assessment, risk management and risk reporting processes; (iv) the organisation's internal control and anti-fraud and corruption framework; (v) the organisation's performance management framework including the setting up, measuring and monitoring of key performance indicators; (vi) the organisation's financial reporting process [Audit Committees should discuss with the Board, senior management and external auditors significant matters (such as significant accounting estimates and adjustments) relating to financial statements and public accountability reporting.]; (vii) the appointment of internal and external auditors and to ensure effective follow up of their work; (viii) the review of regular reports on the implementation status of approved management action plans resulting from the work of internal and external auditors. Appropriate checklists may be developed to facilitate the carrying out of all the above activities (Institute of Internal Auditors - Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations).

The operation of an Audit Committee will be enhanced by: having an effective Chair; the committee being supported with appropriate secretarial arrangements; meetings being well planned (the audit committee may also develop an annual plan of activities) and conducted efficiently; committee members having appropriate access to entity staff and information, and actual and potential conflicts of interest being effectively managed (Australian National Audit Office - Better Practice Guide – Public Sector Audit Committees, Part 5)

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. (Hepworth and de Koning Audit Committees in the Public Sector – A Discussion Paper May 2012)

Audit committees can only function effectively in an environment where clear and measurable strategic objectives to be achieved within a defined period provide the framework within which management and hence an audit committee ought to work; there is the existence of an appropriate management structure designed to achieve the strategic objectives; risks are identified and mitigated with a risk management strategy and its active implementation; there is a focus on financial management; there is a comprehensive internal control system; transparency and accountability are ensured; and anti-corruption and anti-fraud processes have been established. (Hepworth & de Koning)

Part 2 - Audit Committees in the UK

In the UK private sector, companies with a premium listing of equity shares in the UK are required to comply with the UK Corporate Governance Code or to explain to shareholders why they have not done so. The Code requires the establishment of an AC. The AC has a specific role, acting independently of executive management to ensure that shareholders' interests are properly protected in relation to risk management, internal control and financial reporting. The US Sarbanes-Oxley Act 2002 increased AC responsibilities and authority.

In the UK Government sector, boards have clear responsibility for both setting the organisation's risk appetite and for ensuring that controls are in place to manage risks in accordance with this appetite. The AC is key to supporting the Board in fulfilling this responsibility.

The primary purpose of an AC in the UK government sector is to provide the Board and/ or the Accounting Officer[2] with independent assurance on the adequacy and effectiveness of the organisation's risk management framework, internal control environment and the integrity of the governance and financial reporting processes.

HM Treasury guidance, *Corporate governance in central government departments: Code of Good Practice 2017* provides that:

The Board should ensure that there are effective arrangements in place for governance, risk management and internal control. The Board should be supported by an Audit and Risk Assurance Committee (ARC) chaired by a suitably experienced non-executive board member.

The Code of Practice makes a number of supporting provisions which include:

- ✓ The Board and Accounting Officer should be supported by an ARC, comprising at least three members
- ✓ Advising on key risks is a board role. The ARC should support the Board in this role

[2] Each organisation in central government must have an Accounting Officer, which is usually the senior official in the organisation. Accounting Officers must be able to assure Parliament and the public of high standards of probity in the management of public funds.

- ✓ The ARC should not have any executive responsibilities or be charged with making or endorsing any decisions. It should take care to maintain its independence
- ✓ The Board should ensure that the ARC is adequately supported
- ✓ The ARC should lead the assessment of the Board's annual Governance Statement
- ✓ The ARC's Terms of Reference should be made publicly available

In practice this means that all government departments and agencies in the UK **must** establish an Audit and Risk Committee.

Depending on the size and nature of the organisation, consideration should be given to having 2 separate committees, ie:

- An Audit Committee – focusing on assurance over governance, financial reporting, annual report and accounts, etc
- A Risk Assurance Committee – focusing on the adequacy and effectiveness of the organisation's risk management and assurance framework

This separation of responsibilities has historically been adopted by banks and financial services. In the government sector, all aspects can be covered by one committee, unless the workload or complexity are such that one committee is not able to provide sufficient attention.

The Code provides that there should be an annual report on the ARC's work.

The HM Treasury Audit and Risk Assurance Committee Handbook [April 2013] sets out 5 good practice principles for ARCs in UK central government:

1. **ARC should be independent and objective; each member should have a good understanding of the organisation's objectives and priorities**

   - The Board should be supported by an ARC with no executive responsibilities, comprising at least three members
   - The ARC Chair should be a Non Executive Director (NED) with relevant experience
   - Executives of the organisation should not be appointed to the ARC; their role is to attend, provide information and participate in discussions, either for the whole meeting or for particular agenda items as requested

- The Accounting Officer (AO) and Finance Director (FD) should routinely attend ARC.
- Normally the Chief Audit Executive (CAE), Risk Manager and external auditor will attend
- It is good practice for the ARC Chair to meet with each of the attendees outside of the normal committee structure

2. ARC should have appropriate skills to enable it to function effectively

- ARC is responsible for ensuring that the Board and AO receive the assurance they need on governance, risk management, the control environment, the financial statements and the annual report and accounts. To effectively discharge this responsibility the ARC need a wide range of skills and experience in relation to governance, risk management and control. In view of the importance of financial management and reporting, at least one member of the ARC should have recent and relevant financial experience sufficient to allow them to competently analyse the financial statements and management
- In conjunction with the Board, other skills may be identified such as IT or change management skills. Sometimes where more specialist skills are required the ARC should be empowered to co-opt additional members or procure specialist advice
- All ARC members should receive training, be it to understand the workings of government or to help them understand the nature of the organisation's role and operations

3. ARC should support the Board by reviewing the comprehensiveness and reliability of assurances on governance, risk management, the control environment and the integrity of financial statements and the annual report

- ARC should help the Board and AO develop their assurance needs and then consider how well these are being met; this should encompass the organisation's strategic objectives and the associated risks and control mechanisms, the sources of assurance available and the level of confidence and reliability of the various assurances provided. The 3 Lines of Defence model is a useful tool in assisting ARCs with this process.

- ARC should be proactive and commission additional assurance activity from existing or additional sources if it identifies any significant areas that are not being subject to sufficient review
- ARC should also seek assurance that weaknesses identified by assurance reviews have been remedied

4. **The scope of the ARC should be formally defined in Terms of Reference and include all the assurance needs of the Board; the ARC should have particular engagement with the work of Internal Audit, Risk Management, the external auditor, financial management and reporting issues**

- The ARC ToR should be agreed by the Board and made publicly available
- The ARC should have the authority to require any member of the organisation to report on the management of risk or the control environment within their areas of responsibility
- In government in the UK there will always be two significant sources of independent and objective assurance, internal audit and external audit.
- In central government, external audit is primarily conducted by the National Audit Office (NAO). Although the NAO reports to Parliament, its work is of great benefit to the organisation.
- Internal audit work is carried out primarily for the AO and Board and is likely to be the most significant resource used by the ARC. The CAE has a responsibility to provide an annual opinion on the overall adequacy and effectiveness of the organisation's governance, risk management and control processes. There is consequently a major synergy between the CAE and the role of the ARC.
- ARC should also understand the organisation's business strategy, operating environment and the associated risks. It should understand the Board's risk appetite and ensure that executive management operate within this parameter
- ARC should also understand the organisation's risk framework, management and assurance and be able to challenge these

- ARC should also consider significant accounting policies and disclosure and should expect comprehensive reviews of the financial statements by the FD, including comparisons with previous year and budget together with explanations for significant variances.

5. **ARC should communicate effectively with all key stakeholders, eg Board, CAE, external auditor, risk manager and other assurance providers**

- After each meeting the ARC should report to the Board and AO summarising the business undertaken and offering advice on further action
- ARC should also provide an annual report, timed to support the annual governance statement. This should cover the ARC's opinion on governance, risk management and control; the comprehensiveness and reliability of assurances; financial reporting; the quality of internal and external audit; the ARC's view of its own effectiveness and any issues that need attention

Good ACs are characterised by having a strong and independently minded chair, a balance of member's skills, ie independent, knowledgeable and informed, but above all the ability to challenge the executive.

In the UK local government sector, ACs are also viewed as a key component of corporate governance. They provide a high-level focus on assurance and the organisation's arrangements for governance, managing risks, maintaining an effective control environment and reporting on both financial and non-financial performance. In addition, ACs are also seen as playing a role in ensuring value for money (VFM) and countering fraud.

Part 3 – Audit Committees - Attributes, benefits and obstacles

3.1 What are the main attributes of effective Audit Committees?

Several studies, guidelines and regulations have identified and categorized attributes of an effective Audit Committee into individual member attributes and committee related attributes as follows: (a.o. ICPAK, *Audit Committees in the Public Sector*, 2015)

1. Individual Committee Member Attributes:

For effective contribution to the performance of the Audit Committees, the following attributes are key for members:

- Has appropriate technical skills and experience.
- Satisfies requisite independence requirements
- Demonstrates leadership and integrity with a ‘doing the right thing’ attitude
- Is knowledgeable about the entity and its industry

2. Committee Attributes

The following attributes are essential for the collective performance of the committee:

2.1 Clarity of Purpose: An audit committee needs to be clear about its mandate, purpose and role in the organisation and within the governance structure as a whole. (New Zealand Office of the Auditor General Good Practice Guide - Audit Committees in the Public Sector).

2.2 Has appropriate skills mix:

People appointed on audit committees should have financial expertise; knowledge of governance, assurance, and risk management best practice; a good knowledge of the sector or industry in which the public entity operates and good business acumen. They are also to be independent and be prepared to have candid discussions at all levels within the organisation regarding the activities and areas of responsibility of the audit committee. (New Zealand Office of the Auditor General Good Practice Guide - Audit Committees in the Public Sector);

2.3 Its size and composition is commensurate with the mandate of the Institution:

A March 2009 Global Institute of Internal Auditors survey of Chief Audit Executives listed seven organizational characteristics that should be considered when determining the ideal number of Audit Committee members. In order of importance, they listed;

- The complexity of the organization (e.g., decentralized versus centralized, public versus private) and industry.
- The size of the organization.
- The extent of responsibilities and expertise assigned to the audit committee.
- The size of the board of directors and number of board committees.
- The culture of the organization and its needs.
- The assignment of members to other board committees and external commitments.
- The roles and responsibilities of the audit committee as outlined in the charter.

2.4 Effective Communication: The ease and demeanour of communications between the committee members and management; and relationships with other governance committees as well as external and internal auditors.

2.5 Guided by the Audit Committee Charter: There is a mutual understanding of the responsibilities and functions of the committee, and of the activities for which the committee is not responsible

2.6 Chaired by a person who is able to lead discussions, encourage the participation of other members, and conduct meetings in an effective manner.

The role of the chair is critical to the effective operation of audit committees. The chair has particular responsibility for ensuring that the committee is appropriately resourced and that it is maintaining effective communication with stakeholders.

2.7 Periodically assesses the performance of its members and collectively as a committee.

2.8 Monitors the implementation of recommendations made by internal and external audit and other review activities.

2.9 Receives an appropriate level of support and provides committee members sufficient opportunities to keep abreast of key developments in the entity and the public sector generally.

2.10 The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time. (Audit Committee Institute - Audit Committee Handbook)

3.2 What are the potential main benefits of an effective Audit and Risk Committee/ Audit Committee?

Although the role and form of ACs may vary, all should act as the principal non-executive adviser to the Board. They can provide independent challenge and can support and promote a strong ethical culture, corporate governance and financial management, better decision making and effective and efficient use of resources.

ACs can help organisations to succeed by providing the Board with information, advice and assurance. There are four main assurance benefits from operating an audit committee: increased scrutiny; efficient use of resources; increased focus on internal assurance; and increased focus on accountability. There are two main advisory benefits from operating an effective audit committee. They are: a fresh perspective at an organisation wide level, drawing attention to possible threats, opportunities, and emerging issues that the organisation might otherwise miss; and a range of experience and expertise. (New Zealand Good Practice Guide Audit Commit-tees in the Public Sector Part 2 - Public sector context, and benefits of audit committees)

In the UK, ACs are viewed as a key component of corporate governance with the potential to make a real difference to the way public services are provided. They help the Board fulfil its responsibilities by paying attention to the organisation's strategy and operations together with the associated risks. They provide the Board with assurance and insight by examining the effectiveness of risk management as well as other assurance providers such as external and internal audit.

Regarding Internal Audit, the AC can help to ensure IA independence by providing the CAE with a reporting line independent of the executive, especially in cases when internal audit (being functionally independent and directly subordinate to the head of institution) still reports to the administrative head of the same institution, who, at the same time, for example, approves the strategic and annual audit plan. The AC will normally assess and approve the IA Charter, consider IA reports, monitor the quality and effectiveness of IA work, assess the adequacy of IA resourcing and evaluate and approve the IA Plan.

Unlike IA, which is part of the organisation and reports within the organisation, the UK NAO scrutinises public spending on behalf of/ and reports to Parliament. It is totally independent of the government departments and public bodies which it audits. So whilst the AC cannot control the work of the NAO it can nevertheless consider and inform the

NAO's Strategy by making suggestions regarding risk and problem areas. It can also consider NAO reports and how management responds.

Typically, ACs will review the work of both the internal and external auditors to ensure that their recommendations are actioned promptly and effectively by executive management.

At their best, ACs consider the overall assurance situation and support and promote effective relationships between external audit, internal audit and other assurance providers. AC scrutiny and challenge can result in improvements to governance, risk management and internal controls as well as financial reporting and management. All of these factors facilitate better decision making and ensure enhanced accountability.

Finally, an effective AC can inspire public confidence that the organisation is being independently scrutinised.

3.3 What are the main hurdles to overcome when setting up Audit Committees in the public sector?

There may be several challenges when setting up Audit Committees in the public sector (European Commission, *Role of Audit Committees for Internal Audit in the public sector. Discussion Paper No. 4*, 2014)

Clarifying the powers and responsibilities of audit committees

In the absence of clear guidance on audit committees in the public sector and without specific legal anchorage, it may be difficult to define the scope, powers and responsibilities of such committees. These might be limited and their tasks might be interpreted as focusing mainly on advising or on supervising. The same issue may arise when determining the relationship between the audit committee and the internal audit service.

Integrating audit committees in public governance

In most EU Member States, internal audit is linked to and reports directly to the top/higher levels of their public entities. Depending on the entity, internal audit may report to the (deputy) minister, the general secretary, the general director or the mayor.

Such a reporting line is necessary to ensure adequate organisational independence for internal audit and to demonstrate its effectiveness and needs to be formally established, particularly with a view to avoiding conflicts of interest.

Existing governance structures could be an alternative to audit committees as a functional reporting line for internal audit, depending on the administrative organisation and the administrative culture of the country and of public entities (ministry, institutions, local community). If the governance structures cover the entire scope of responsibilities of the entity, such structures could actually take the role of oversight body.

In such cases, it may be a challenge to integrate the specificities of overseeing internal audit activity into the governance structures, while fulfilling the preconditions assigned to audit committees. Moreover, it is important to ensure that the members of the governance body responsible for functional organisational independence have the required level of knowledge, skills and qualifications.

Composition of audit committees

It can be difficult to find members with the right kind of experience, skills and independence for audit committees.

The qualifications and independence of the members of an audit committee are crucial because the committee’s collective composition will determine its credibility, and therefore its acceptance by top and operational management and external stakeholders. The same factors determine a committee’s capacity to deliver added value.

Some basic criteria apply to the composition of an internal audit oversight body or an audit committee. As well as finding the right people, there has to be the right balance among members. The optimal audit committee has sufficient knowledge of the entity, its businesses, functions and environment, as well as technical know-how in the field of auditing and risk management. Moreover, some members should be external to the entity or at least not have any executive responsibilities within it. Yet another challenge is to avoid conflicts of interests between a member and the activities of the public entity.

Administrative burden and cost of audit committees

The effectiveness and independence of internal audit may be jeopardised if a functional reporting line for internal audit is not clearly established or inadequate, or the composition/ functioning of the audit committee is not credible. Such weaknesses would make it very unlikely that the committee could offer added value. Instead, audit committees might be perceived as an unwelcome added layer of bureaucracy and be rejected by managers and other stakeholders. Moreover, the time-consuming nature of such committees and the costs of operating them might be controversial, especially in times of public spending cuts. It may be too costly for small entities to set up and staff an audit committee. To address this specific problem, the EU Commission (DG Budget) has recommended the setting up **of** regional audit committees with ‘exception only reporting’ responsibilities as a cost-friendly option.

Committing Officers and governance bodies on audit committees

Officers and governance bodies in public entities may see it as unnecessary or even undesirable to set up an audit committee. They may, for instance, see the tasks of an audit committee as being part of their own oversight responsibilities, and perceive a newly-created audit committee as a blurring of responsibilities. In countries where audit committees are not mandatory, some might argue that they are not obliged to establish such committees.

Other obstacles might be:

(a) The roles of the audit committees and other committees, such as the finance committee, risk committee (where separate), and performance committee, should be clarified to minimise overlap and promote the effective use of these structures. (Public Sector Audit Committee Forum – Challenges facing Public Sector Audit Committees);

(b) Adequate dedication and commitment on the part of members and proper preparation for meetings, reading documents prior to meetings, follow-up procedures and attendance of and participation in meetings may not be receiving sufficient attention by audit committee members. (Public Sector Audit Committee Forum – Challenges facing Public Sector Audit Commit-tees);

(c) The audit committee may sometimes be unable to evaluate situations due to the absence of quality information which should be made available by management. The audit committee therefore cannot fulfil all its responsibilities. (Public Sector Audit Committee Forum – Challenges facing Public Sector Audit Committees);

(d) Lack of adequate resources assigned to the audit committee;

(e) There may be an expectation gap between the audit committee and management:

The audit committee's expectation from management – to have a positive attitude to the findings and recommendations; to have a constructive approach to interacting with the audit committee; to be supportive in identifying potential areas of risk; and to keep the audit committee informed of the entity's strategic plans, any investigations or any probity issues.

The management's expectation from the audit committee – to communicate about its activities and reports; to be able to identify high risk areas; to focus on the main areas of risk and business improvement opportunities; to make recommendations by considering the cost and reality to implementation; and to create a continuous improvement culture. (Australian Office of the Auditor General Presentation: Audit Committees in the Public Sector)