



National Audit Office

FINANCIAL
MANAGEMENT
AND GOVERNANCE
PRACTICE

JANUARY 2010

The Statement on Internal Control: A Guide for Audit Committees



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The Statement on Internal Control: A Guide for Audit Committees

FINANCIAL MANAGEMENT AND GOVERNANCE PRACTICE

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Introduction

In the current climate of fiscal restraint and declining availability of resources, it is important that central government bodies can demonstrate the resources that they are responsible for are appropriately managed and controlled. High quality and proportionate internal control systems will help organisations achieve their aims. The Statement on Internal Control (SIC) is a public accountability document that describes the effectiveness of internal controls in an organisation.

This guide sets out the NAO's approach to considering the SIC as part of our annual audit of the financial statements. In particular, it provides guidance to Audit Committee members on how they can add value to the risk management, governance and internal control processes within their organisation through effective challenge of the disclosures made in the SIC.

As part of our audit approach, the NAO engages with senior executives early on in the reporting period and subsequently challenges the disclosures made in the SIC if these do not provide transparent information to Parliament, or the underlying processes are inadequate. Where we do not see appropriate disclosures in the SIC, we may make use of our powers to report to Parliament.

A wide variety of governance models exist within the central government sector and, although the principles detailed in this guide are intended to apply throughout, some flexibility in their interpretation will be necessary.

I hope you will find this guide useful and informative.

Andrew Baigent
Director General, Financial Audit

Part One

The purpose and content of the SIC

What does the SIC tell us?

The Statement on Internal Control (SIC) is the means by which the Accounting Officer declares his or her approach to, and responsibility for, risk management, internal control and corporate governance.¹ It is also the vehicle for highlighting weaknesses which exist in the internal control system within the organisation. It forms part of the Annual Report and Accounts.

Why do we have a SIC?

Public bodies must provide assurance that they are appropriately managing and controlling the resources for which they are responsible. The SIC is an important accountability document in communicating these assurances to Parliament and citizens.

The SIC is a mandatory disclosure for all central government entities that comply with the Financial Reporting Manual (FRoM). It is a primary accountability document. The external auditors do not provide an explicit audit opinion on the content, but it is subject to external audit review to ensure that it has been prepared in accordance with Government guidance and that it is consistent with the auditors' knowledge of the entity.

What does a SIC disclose?

The Financial Reporting Manual sets out the expected form and content of the SIC. This is a mix of prescribed text and sections where Accounting Officers are expected to describe the particular arrangements in their organisations.

¹ The Accounting Officer usually holds the post of Permanent Secretary or Chief Executive. The Accounting Officer is the senior official in the organisation and he or she may be called to account in Parliament for the stewardship of the resources within the organisation's control.

The SIC should contain disclosures under the following headings:

- Scope of responsibility;
- The purpose of the system of internal control;
- Capacity to handle risk;
- The risk and control framework; and
- Review of effectiveness.

More detail on the information to be disclosed under each heading is set out at Appendix One.

What are the roles and responsibilities?

The Audit Committee plays a key role in the production of the SIC. It supports the board and Accounting Officer by reviewing the comprehensiveness of assurances in meeting the board and Accounting Officer's assurance needs, and reviewing the reliability and integrity of the assurances. The Audit Committee also advises the board and Accounting Officer of any control issues that could be considered significant and are therefore appropriate for disclosure in the SIC. Fuller information on the roles and responsibilities involved in the production of the SIC is set out at Appendix Two.

Part Two

The NAO's approach to the audit of the SIC

To provide assurance to Parliament that public bodies are appropriately managing and controlling the resources for which they are responsible, the NAO reviews SICs to ensure they are supported by robust evidence and the underlying controls are sufficiently reliable.

Although we also have a professional responsibility to review the SIC under ISA 720 as it is information published with the audited accounts, our engagement will begin much earlier in the reporting period.² Assignment Directors and Managers will engage with senior executives, including the Accounting Officer, to discuss the risks facing the organisation, the adequacy of the underlying controls and the transparency of reporting in the prior year. We will also consider the governance processes in place over the production of the SIC.

We expect Accounting Officers to reflect weakness in internal control identified by other reports on their organisation published during the year within the SIC, for example, select committee reports or NAO VFM reports.

At the Audit Committee, we will discuss the disclosures made in the draft SIC and raise any concerns we have over the transparency of reporting or sufficiency of the underlying controls and assurances. In addition, our professional responsibilities require us to consider whether the SIC is:

- Produced in accordance with HM Treasury requirements; and
- Consistent with our understanding of the position based on the information that we are aware of from our work on the financial statements and other work.

In cases of non-compliance with HM Treasury requirements or where we consider that a significant issue has not been adequately reflected in the SIC, we will consider the implications for our audit opinion. In these instances, we modify our audit opinion and/or issue a separate report to Parliament.

To enable change and help audited bodies benefit from our cross-government perspective, we will publish digests of best practice from our work on SICs.

² International Standard on Auditing 720 (Revised) Section A – Other Information in Documents Containing Audited Financial Statements.

Part Three

How can the Audit Committee add value?

To assist Audit Committees in their challenge function we reviewed a wide range of SICs to identify good practice in corporate governance, risk management and internal controls, and the disclosure of these, within the SIC. The results are set out below broken down by key SIC heading. The table is not intended to be a comprehensive list, but a useful tool to help Audit Committee members identify where their organisation's processes and procedures could be strengthened or additional disclosure would be valuable. All good practice areas should be considered in two ways; first to see if there are appropriate policies and procedures in place and secondly to see if this is working in practice. Management should have evidence that these systems and processes are working, and may use internal audit or other assurance providers to give some of this assurance.

Capacity to Handle Risk

Key theme	Area	Good practice
Leadership	Risk management policy	<ul style="list-style-type: none"> • Sets out the commitment, processes and behaviours expected of the Board • Guidance is available on how to implement the policy
	Description of responsibilities	<ul style="list-style-type: none"> • Clear chain of accountability for risk from the Accounting Officer downwards • The responsibilities of the Executive, Board, Audit Committee and any other relevant groups/roles are clearly defined
	Communication	<ul style="list-style-type: none"> • Regular consultation with key stakeholders and partners on risk
Staff training	Risk management tools on intranet	<ul style="list-style-type: none"> • Risk management support and guidance made available to staff via intranet
	Senior management accountability	<ul style="list-style-type: none"> • Management clearly accountable for ensuring that appropriate guidance, support and training is available to their staff
	Risk management training	<ul style="list-style-type: none"> • Ongoing training to embed risk management concepts and tools into everyday business

Key theme	Area	Good practice
Other items	Independent review	<ul style="list-style-type: none"> Periodic review of the capacity to handle risk by internal audit
	Risk management maturity	<ul style="list-style-type: none"> Benchmarking of the organisation against a risk management model, with actions in place to achieve the next maturity level

Evidence of Effectiveness

- Evidence that the organisation has responded to changes in risk profile or specific events in a positive and effective way

Risk and Control Framework

Key theme	Area	Good practice
Risk management framework	Risk management strategy	<ul style="list-style-type: none"> Agreed and specifically signed-off at Executive/Board level Sets clear accountabilities for action Sets out a structured process for identifying, assessing, communicating, escalating and managing risks, which is dynamic and responsive to changing circumstances Staff are held accountable for risk management through the performance management system
	Reporting	<ul style="list-style-type: none"> Regular risk management reporting at various levels within the organisation
Risk identification	Upward reporting	<ul style="list-style-type: none"> Upward identification and reporting of risks
Risk evaluation	Risk registers	<ul style="list-style-type: none"> Clear ownership of risk at Executive/Board level Regular review of the corporate register Risk ranking consistently assigned to all entries
Control of risks	Framework of appropriate controls built into routine processes	<ul style="list-style-type: none"> Procedures in place to ensure appropriately skilled and experienced staff are responsible for business processes Documented procedures for all key business processes Management controls ensure quality processing Management information is available to assess the quality of processing and the level of activity
Risk appetites	Clearly defined risk appetites	<ul style="list-style-type: none"> Risk appetite is defined at a corporate level Risk appetite cascaded down within the organisation Evidence of risk appetite being tailored to reflect different risks

Key theme	Area	Good practice
Embedding risk management	Culture of risk management throughout organisation	<ul style="list-style-type: none"> • Every significant risk is assessed and ranked • A risk owner is assigned to each risk and has the authority to allocate risk management tasks to specific officers • Every employee is aware of their own responsibilities for managing risk • Executive decision papers contain a section on key risks

Evidence of Effectiveness

- No significant internal control failures occurred in year
- Evidence that the risk and control framework identified and managed changes in the risk environment effectively during the year

Review of effectiveness

Key theme	Area	Good practice
Review of Effectiveness	Executive/Board	<ul style="list-style-type: none"> • Considers the top risks faced by each part of the organisation • Discusses the effectiveness of internal controls related to key risks
	Audit Committee	<ul style="list-style-type: none"> • Regularly considers the effectiveness of internal controls • Considers the coverage of the Internal Audit programme • Reviews progress on implementing Internal Audit and External Audit recommendations
	Risk Manager/Committee (if applicable)	<ul style="list-style-type: none"> • Periodically reports on progress made and further improvements necessary
	Internal audit	<ul style="list-style-type: none"> • Annual work programme is risk-based. Progress and amendments are reported to the Audit Committee • Annual assurance statement provided to the Accounting Officer

Key theme	Area	Good practice
Other assurance mechanisms	Management Accounts	<ul style="list-style-type: none"> Monthly review by budget holders Quarterly re-forecasts Individual approval of capital expenditure projects
	Management assurance statements	<ul style="list-style-type: none"> Set out the governance, risk and control arrangements in each directorate/business area and any weaknesses identified The statements are collectively reviewed and challenged by the Audit Committee
	Capability Review	<ul style="list-style-type: none"> Review of progress in implementing recommendations

Evidence of Effectiveness

- Evidenced-based assurances over the effectiveness of internal controls and their coverage of risks (provided by senior management to support the SIC)
- The annual internal audit plan is flexed to address risks arising

Significant Internal Control Issues

Key theme	Area	Good practice
Significant Internal Control Issues	Current year issues	<ul style="list-style-type: none"> Full disclosure of all significant internal control issues and their impact on the organisation Includes action being taken to prevent recurrence and the timescales involved Anticipated future risks and actions to mitigate these are reported
	Prior year issues	<ul style="list-style-type: none"> Follow up reporting on all prior year significant internal control issues Includes explanations for any slippage against the original timescales

Evidence of Effectiveness

- Significant internal control issues have not arisen in subsequent years

Appendix One

Contents of the SIC

Based on the 2009-10 Financial Reporting Manual (FReM), Annex 2 (http://www.financial-reporting.gov.uk/documents/2009/2009_10_frem_full_version.pdf)

Scope of responsibility

- Reports the Accounting Officer's responsibility for maintaining a sound system of internal control. The Accounting Officer is required to sign the SIC in recognition of this.

NAO comment

It is essential that the Accounting Officer clearly identifies their responsibilities, and the interaction with any statutory board, where this applies.

The purpose of the system of internal control

- Explains that the system of internal control is designed to manage the risk of failure; it cannot eliminate all risk and therefore only provides a reasonable and not absolute assurance of effectiveness.
- Confirms whether the system of internal control was in place for the whole of year and accords with HM Treasury guidance. Material changes or the absence of an element of the risk management process for a material period should be disclosed.

NAO comment

It is important that this section includes a transparent consideration of areas where the system may not have been fully in place during the period. This would include where processes were temporarily suspended.

Capacity to handle risk

- Describes how leadership is given to the risk management process, how staff are equipped to manage risk and how the organisation learns from good practice.

NAO Comment

This section should provide details of how the organisation has adapted to changes in the risk environment.

The risk and control framework

- Describes the key elements in the risk management strategy, including how risk is identified, evaluated and controlled. **This section must explicitly include the management and control of information risk.**
- Describes how risk appetites are determined.
- Explains how risk management is embedded within the organisation.
- Describes how public stakeholders are involved in managing risks which affect them (where appropriate).

NAO Comment

Changes to the risk and control framework in year should be highlighted. Disclosure should cover how quickly and effectively the organisation embedded these changes within the day to day operations of the organisation.

Review of effectiveness

- Confirms that the Accounting Officer has responsibility for reviewing the effectiveness of the system of internal control.
- Provides assurance that the review is informed by the work of internal audit, executive managers and external audit.
- Provides assurance that the board and Audit Committee (and risk committee, if appropriate) have advised the Accounting Officer on the implications of the results of the review.
- Confirms a plan is in place to address weaknesses and ensure continuous improvement.
- Comments on the role of the board, Audit Committee, risk committee/managers (if relevant), internal audit and other explicit review/assurance mechanisms.
- Outlines actions taken or proposed to deal with any significant internal control issues.

NAO Comment

Organisations should demonstrate how they have been responsive in reacting to risks and that they are not tied to a process-driven mentality.

Significant internal control issues

As part of the review of effectiveness, Accounting Officers must disclose the actions taken/proposed to deal with any significant internal control issues. While it is for Accounting Officers to judge whether a matter is significant, *Managing Public Money*, suggests the following tests that might indicate a significant internal control weakness:³

- Might the issues seriously prejudice or prevent achievement of a PSA target?
- Could the issue have a material impact on the accounts?
- Could the issue divert resources from another important aspect of the business?
- Does the Audit Committee advise it is significant?
- Does internal or external audit regard it as significant?
- Could the issue, or its impact, attract significant public interest, or seriously damage the reputation of the organisation?

NAO Comment

Disclosure of significant internal control issues should be full and frank, covering how the issue arose and the remedial actions taken and planned. Progress against planned actions should be updated in subsequent years.

³ *Managing Public Money*, annex 4.15, http://www.hm-treasury.gov.uk/d/mpm_annex4.15.pdf

Appendix Two

Roles and responsibilities in preparing the SIC

The key roles and responsibilities surrounding the production of the SIC are as follows:

Accounting Officer

The Accounting Officer is responsible for maintaining a sound system of internal control, reviewing the effectiveness of the system and the preparation of the SIC. He/she must sign and date the SIC in acknowledgement of this.

Executive

Prepare and 'own' the SIC prior to submission to the Audit Committee.

Often senior executives are responsible for preparing assurance statements for the AO to support his/her review of the effectiveness of controls.

Internal Audit

Internal audit provides the Accounting Officer with an objective evaluation of, and opinion on, the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control.⁴ The Head of Internal Audit usually provides this in an annual assurance statement.

Some IA functions do more than this, for example, conducting an evidenced-based review of the assurance statements received by the AO to support their review of effectiveness of the SIC.

External Audit

We engage with senior executives early to raise the issues we would expect to be reported in the SIC. We review the preparation and content of the SIC to ensure the disclosures are in line with HM Treasury guidance and consistent with our understanding of the organisation. Where reporting is not transparent or the underlying processes and controls are inadequate, we will draw this to the attention of the Audit Committee and Accounting Officer for amendment. If the SIC remains unadjusted, we may modify our audit opinion.

⁴ Taken from Government *Internal Audit Standards*, part 4 standards, attribute standards.

Audit Committee

The Audit Committee should support the board and Accounting Officer by reviewing the comprehensiveness of assurances in meeting the board's and Accounting Officer's assurance needs and reviewing the reliability and integrity of these assurances.⁵

The Audit Committee should also advise the board and AO of any control issues that it considers are significant and are therefore appropriate for disclosure in the SIC.

Audit Committees may rely on a variety of sources, e.g. internal audit, to support them in this work.

Board

The board supports the Accounting Officer in drawing up the SIC.

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