



National Audit Office

**GOOD PRACTICE**

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# Helping your Audit Committee to add value

2nd edition January 2012

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**Financial Management and Reporting**

**Our vision is to help the nation spend wisely.**

**We apply the unique perspective of public audit to help Parliament and government drive lasting improvement in public services.**

The National Audit Office scrutinises public spending on behalf of Parliament. The Comptroller and Auditor General, Amyas Morse, is an Officer of the House of Commons. He is the head of the NAO, which employs some 880 staff. He and the NAO are totally independent of government. He certifies the accounts of all government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources. Our work led to savings and other efficiency gains worth more than £1 billion in 2010-11.



National Audit Office

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# Introduction

## Good Practice to help your Audit Committee add value

The role of the Audit Committee is fundamental to ensuring that organisations function according to good governance and accounting and auditing standards, and adopt appropriate risk management arrangements. The National Audit Office (NAO) regards well functioning Audit Committees as key to helping organisations achieve good corporate governance. To assist Public Sector Audit Committees in this role we have a checklist-based toolkit that Audit Committees can use to facilitate workshops, to assess their performance against best practice.

Our toolkit won the 2004 Chartered Institute of Public Finance and Accountancy award for innovation and excellence in auditing. The toolkit has since been revised and updated<sup>1</sup> and reflects best practice as set out in the Treasury's Audit Committee Handbook (March 2007).

The practical top tips in this booklet are the result of the good practice identified by the NAO in facilitated discussion groups involving non-executive directors from our client organisations and our own directors, where a range of topics were discussed including:

- induction of new non-executives;
- managing the audit committee agenda;
- briefings from business directors;
- financial matters and performance measurement; and
- judging the effectiveness of the audit committee.

This booklet<sup>1</sup> should be used in conjunction with the Treasury's Audit Committee Handbook (March 2007), the updated NAO Audit Committee checklist, which can be found on our website [www.nao.org.uk](http://www.nao.org.uk) and the advice and guidance of your NAO Client Lead.

<sup>1</sup> We have updated our Audit Committee Checklist and this booklet (January 2012) to reflect the requirement for departments, their executive agencies and arm's-length bodies to produce a Governance Statement in place of the Statement on Internal Control in their annual report and accounts for 2011-12 onwards. Guidance on the Governance Statement is set out in the revised Chapter 3 of *Managing Public Money* (HM Treasury, 2011).

# Building a strong foundation

*“The work of an Audit Committee is built on its membership, and the organisation at large, understanding the role and remit of the Audit Committee in the wider governance structure”*

## Understanding the role and remit

**1** Even with a clear role and remit, in practice, it is very easy for the Audit Committee to drift and for the chain of governance to become inefficient and ineffective. Careful attention to detail in forming the terms of reference and the meeting agenda will pay dividends.

**2** To minimise role and remit drift once the terms of reference are agreed, Audit Committees should ensure that the Accounting Officer, or where appropriate the Board, is aware of the responsibilities and activities of the Committee. It is also important to ensure that a balance is struck during meetings between financial and corporate governance items.

## A risk management role

**3** Many Audit Committees also find it difficult to identify where their responsibilities lie in relation to risk management and the role of the Accounting Officer. Many organisations place the responsibility on the Board or equivalent senior governance body, but also require assurance via the Audit Committee. It is essential that the Audit Committee:

- understands the role and activities of the Board (or equivalent senior governance body), in relation to risk;
- discusses with the Board its policies and attitude to risk to ensure management operates within these parameters;
- understands the framework for risk assessment and management and the assignment of responsibilities; and
- critically challenges and reviews the risk register, without second guessing management, to provide assurance that the arrangements are actively working in the organisation.

## Skills and knowledge required

Once there is a clear understanding of the role and remit, the Audit Committee should be able to make an informed decision about the skills and knowledge required in its membership

- 4 The key role of the Audit Committee is to scrutinise and advise on financial and corporate governance issues. The membership of the Committee must therefore be able to scrutinise the accounts so as to enhance accountability and add value.
- 5 The qualifications and expertise of members should be targeted to meet the requirements set out in the Committee's terms of reference. The Committee should have non-executive members with an audit or finance background and, where relevant, with specialist knowledge, for example, of Private Finance Initiative (PFI) and Public Private Partnership (PPP) deals. Some Committees have found it useful to identify four or five key personal qualities and skills/experience that are desirable and have then assessed their members against this. This can help to identify a suitable training programme, or may lead to changes in membership.
- 6 When considering the membership of the Audit Committee, organisations should aim to achieve a mix of individuals, expertise and qualifications relevant to the maturity of the Audit Committee and to the nature of the organisation.
- 7 Non-executives should be appointed for certain key business areas based on their expertise and interests. Examples of key areas include third party assets, accounting and financial reporting, and PFI.
- 8 It is likely that some expert advice will be required during the course of an Audit Committee's business. The ability and authority of the Committee to seek expert advice where necessary to provide independent internal or external assurance on key issues should therefore be agreed with the Accounting Officer.
- 9 It is vital to the effective working of an Audit Committee that there is sufficient business knowledge. If the membership of the Audit Committee is relatively new, a higher proportion of independent executives who know the organisation can initially be helpful. Where a non-executive's involvement with the organisation is only through the Audit Committee, it is essential that processes are established to help familiarisation and keep up to date with new developments.
- 10 As the Audit Committee matures, the skills and knowledge of the members should also develop, enabling them to focus on the key issues facing the organisation. Audit Committee networks or conferences within Departmental boundaries can be a good way to keep up with current developments.

## Improving relationships and communication

**11** It is important for the Audit Committee to have good relationships and communication with those it seeks briefings from, and those it provides assurance to. This ensures that the Committee has appropriate business knowledge and the means through which to fulfil its function.

**12** The effectiveness of internal and external audit, the finance function, and the Audit Committee is increased when the parties work in partnership, providing a highly sound base for governance:



This approach is most effective when the three parties work together in an open environment of communication, and support each other in constructive challenge

### Encouraging good communication

**13** Good, open relationships between the Audit Committee, Finance Director, and Internal and External auditors are also essential to adding value to the organisation. There are a number of ways to encourage this, for example:

- the profile of the Audit Committee can be raised to support and add weight to audit investigations by:
  - promoting audit enquiries internally with the relevant directors to make sure they know the purpose of the audit;
  - holding the organisation to account for the implementation of all audit recommendations (internal and external, including the NAO's Value for Money work); and
  - calling appropriate business heads to meetings to explain how they are delivering their agreed actions or on risks for which they are responsible.
- arranging separate meetings for the Chair, non-executives, and internal and external auditors to help non-executive members establish open working relationships;
- arranging meetings with the Chair, the auditors, and the Finance Director in the weeks leading up to the Committee meeting to discuss areas for the agenda and papers that should be provided; and
- arranging meetings with the auditors directly before the Audit Committee can be particularly valuable to discuss progress, and influence the meeting.

## Relations with others

**14** The Audit Committee can assist the Accounting Officer with the Governance Statement by producing an Audit Committee Annual Report outlining activities, issues and recommendations for the year. An Annual Report can also help the Accounting Officer to better understand the role and remit of the Committee, significant areas of business risk in the organisation, and the value that the committee adds to the organisation. Some suggested areas are:

- list of activities completed in year;
- list of recommendations and resulting actions;
- sources of assurance used; and
- areas to focus on in the coming year.

**15** Where there are departmental and subsidiary Audit Committees, effective communication is vital.

- It is preferable to have separate membership on the main (Departmental) Audit Committee, rather than Chairs of subsidiary committees, to ensure that an independent, questioning perspective is maintained.
- However, effective communication can be achieved by encouraging subsidiary Chairs to attend Departmental Committee meetings on a rotation basis to provide briefings and gain a wider awareness of Departmental audit issues.
- Subsidiary Committees should produce mini-Annual Reports outlining their activities, and these should be circulated to the Departmental Audit Committee.
- Networking events should be arranged for members of all related Audit Committees to raise awareness of common issues and to share good practice tips.

## Adding value to the organisation

**16** As well as providing assurance within the governance and accountability structures of the organisation, it is essential that the Audit Committee is seen to contribute, deliver results and add value to the organisation.

## Increasing meeting efficiency

**17** The Treasury's Audit Committee handbook suggests that committee meetings should be held quarterly. On average, each committee meeting is likely to take between two and three hours. When added to the likely preparation time between each meeting, Committee Chairs have around 20-25 hours each year to carry out the wide-ranging functions of the Committee. It is therefore essential that meetings are efficient.

**18** Meeting time should be optimised by having executive summaries provided on each agenda paper outlining the key points, cross referred to the risk and business agenda and stating what action the Committee is required to take. Meeting schedules should be organised so that all necessary issues and key events are addressed throughout the year at the appropriate time. A seasonal, standing agenda, as recommended in the Treasury handbook, can help to ensure efficiency and effectiveness.



**19** Attendance at Committee meetings should be managed by limiting the number of executives attending, and by inviting attendance for relevant agenda items.

### **Using members' expertise**

**20** The review of risk registers and the Governance Statement is a key part of the Committee's role, and this can often be dependent on members' knowledge of the business. Proper induction and opportunities to meet people from within the organisation are therefore key.

**21** The Committee should provide advice to the Accounting Officer on the annual financial statements. Ideally, the Audit Committee should expect a comprehensive overview of the financial statements by the Finance Director, including comparisons with the prior year and current year budget, and an explanation of any issues arising.

**22** The Audit Committee should consider the draft financial statements before they are presented for audit, and where appropriate suggest where external audit can bring additional focus. The Committee should take a commonsense approach to reviewing the financial statements and add value to the quality of financial reporting by asking:

- what are the similarities or differences from last year's financial statements;
- which are the most critical accounting policies;
- what has been taken off balance sheet;
- for a summary of the accounting implications of any PFI deals;
- whether there have been any significant changes in accounting treatment and policies;
- whether there have been any changes in financial reporting standards which impact on the accounts;
- whether there are any points of difference between the auditors and finance function;
- if there are any matters of significant judgement in the financial statements;
- what the key points are in the Foreword/Management Commentary;
- if there were any changes between the first draft presented for audit and the final draft and why;
- to meet with the external auditor to discuss matters arising from the audit to supplement the Committee's formal review;
- if there are any issues of materiality to the financial statements; and
- if there are any issues in the financial statements which would be of interest to those outside the body, and check that the issues are appropriately described.

## How the NAO can help you

**23** The NAO has updated its self-assessment checklist to reflect the introduction of the Governance Statement from April 2012 to replace the existing Statement on Internal Control.

**24** The self-assessment checklist is designed to help Audit Committees consider whether they are meeting best practice. The checklist includes a series of Good Practice Questions using the five principles outlined in HM Treasury's Audit Committee Handbook (March 2007).

**25** Also, as part of our programme to develop and promote best practice, we offer facilitated workshops to help apply a tailored version of the toolkit and draw conclusions as to an Audit Committee's effectiveness. Each workshop is followed up with an action plan that includes the decisions made and the actions agreed. This action plan should be owned by the Audit Committee and used to monitor the implementation of agreed actions.

**26** If you would like the NAO to facilitate a workshop for your Audit Committee, please ask your usual NAO contact or Client Lead.

**27** Finally, if you have any queries or would like more information on any topic in this booklet, please contact us on: Z5-FMGP@nao.gsi.gov.uk, 0207 798 7000 or your usual NAO contact or Client Lead.



# Where to find out more

The National Audit Office website is

[www.nao.org.uk](http://www.nao.org.uk)

Links to other websites:

[www.hm-treasury.gov.uk/audit\\_committee\\_handbook.htm](http://www.hm-treasury.gov.uk/audit_committee_handbook.htm)

[www.hm-treasury.gov.uk/d/mpm\\_annex3.1.pdf](http://www.hm-treasury.gov.uk/d/mpm_annex3.1.pdf)

If you would like to know more about the NAO's work in this area please email

[Z5-FMGP@nao.gsi.gov.uk](mailto:Z5-FMGP@nao.gsi.gov.uk)

[www.nao.org.uk/financial-management](http://www.nao.org.uk/financial-management)

Twitter: @NAOorguk



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