

Local Government Audit & Risk Management

Prepared for Local Government New Zealand
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Biography Philip Jones Principal

Philip Jones has over 20 years of financial experience in the local government sector and brings a wealth of practical experience and knowledge. He is the Principal of PJ & Associates Financial and Asset Management Solutions and has been consulting to a variety of local government related organisations since June 2007 including advising management and governance. Between 1993–2007 Philip was the Chief Financial Officer and Group Manager Revenue and Finance for Western Bay of Plenty District Council (WBOPDC), Tauranga. Prior to joining WBOPDC he was a Business Services & Audit Manager with Coopers & Lybrand (now PricewaterhouseCoopers) in London, Tauranga and Hamilton. He is a respected trainer of elected members through Local Government New Zealand KnowHow courses.

Equip, LGNZ's Centre of Excellence, has developed this guide specifically for the local government sector. The Office of the Auditor General supports this initiative and has been consulted in the preparation of the guide.

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Local Government Act 2002

This guide provides a brief overview of the purpose, form and function of an audit and risk committee. A template Audit & Risk Report is available by contacting Equip. Taken together this information is designed to offer guidance and support on the establishment, recruitment and initial operation of an audit and risk committee.

Further services are available from Equip to support the on-going operation of an audit and risk committee, also covering wider aspects of financial excellence. For more information please contact the Equip team.

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Audit and risk management are essential functions of any governance body

An effective audit and risk committee will be based on the following attributes:

- it will have a degree of independence from Council and management which will enable the robust consideration of Council's financial and non-financial risks; and
- the audit and risk committee will consist of both elected and non-elected (external appointee) members who have an enquiring mind and are not afraid to ask the tough questions. The committee will encourage open and effective relationships with external and internal auditors and with management.

The importance of audit and risk from a governance perspective

The role of elected members is to set direction and context within which the administration can operate, to exercise stewardship of the community's assets for today and the future, and to manage risk, promote transparency and strengthen accountability.

It is the role of governance to ensure the integrity and reliability of financial reporting which are cornerstones of transparency and accountability. Auditing does assist in that process.

In all actions there are risks, financial and non-financial. These risks must be identified, mitigated and then managed. This is the role of management. The role for governance is to gain an assurance that there is a robust process to manage risks appropriately.

< One of the roles of an audit and risk committee is to ensure that debt and investments are correctly managed within appropriate policy limits. >

Why audit and risk committees are necessary

The Local Government Act 2002 (LGA) requires¹ a local authority to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

The LGA also states that a local authority should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region.

Whenever local government undertakes action to support their intended outcomes, there will always be risk. These risks cannot be avoided but must be identified and managed. The role of an audit and risk committee is to use good governance skills to gain an assurance that the risks have been identified and where possible have been mitigated. An audit and risk committee is the ideal structure to achieve this.

Monitoring of risk management can be an onerous task for some individual Councillors, and while some of these activities can be delegated to the Chief Executive, particularly where these relate to the actions supporting the Council's direction, it is the Council's role to ensure that there are effective controls in place to ensure that the Council meets both legislative requirements and community expectations.



¹ Section 101 (1) Local Government Act 2002.

Audit and risk committees have a valuable contribution to make in improving the governance, performance and accountability of all local authorities. They can play an important role in examining the Council's policies, processes, systems, and controls to improve its financial management.

Large projects or projects that are not part of 'business as usual' can increase the risk to Council. Local authorities have a number of complex and sometimes technically challenging areas to consider. Audit and risk committees² provide a process in which those challenging areas can be given due attention by competent people.

It is important the audit and risk committee is not just focused on one area of risk, but considers all Councils risks both financial and non-financial.

As an example of financial risk, a significant number of Councils have debt and investments which can expose them to additional risk if not correctly managed. One of the roles of an audit and risk committee is to ensure that debt and investments are correctly managed within appropriate policy limits.

An audit and risk committee can provide expertise in meeting these requirements by bringing a clarity of purpose by focusing a selected group including existing Councillors on the relevant risks.



Areas of focus for an audit and risk committee

An audit and risk committee in a local government setting has four key areas of focus:

1. Financial reporting including the following
 - I. long term planning including the financial strategy;
 - II. appropriateness of accounting policies;
 - III. annual report; and
 - IV. internal report (monthly and/or quarterly).
2. Risk management and the system of internal controls
 - I. setting the Council's appetite for risk;
 - II. understanding the key risk areas including likelihood and consequences;
 - III. effectiveness of internal controls; and
 - IV. fraud risk and procurement risk.
3. External audit³
 - I. relationship with auditor;
 - II. understanding scope and engagement;
 - III. review significant audit findings/recommendations; and
 - IV. monitor progress on recommendations.
4. Internal audit⁴
 - I. appointment and relationship with internal auditor;
 - II. scope of work; and
 - III. responses to internal audit recommendations.

An audit and risk committee will also be responsible for maintaining and considering its own effectiveness. It must ensure that there are robust processes in place to ensure effective communication with both the full Council and management.

An effective audit and risk committee will ensure that there are adequate internal policies in place that are implemented for compliance with all legislative requirements local authorities face.

Setting up the audit and risk committee

When deciding to form an audit and risk committee there are a number of considerations that need to be considered by Council. The committee or subcommittee can only be established by the Council.

The first step is to establish the role and responsibility of the audit and risk committee.

Once the roles and responsibilities of the audit and risk committee have been established then the form and function of the committee must be agreed by the full Council. For example, is it a committee reporting directly to Council or is it a subcommittee of the finance committee?

The next step is to select the membership of the committee. Considerations will include the number of elected members and external appointees. Having an external appointee not only brings additional skill to the committee that would not normally be available but also brings a degree of independence. The skills required are set out later in this paper. The appointment of external people needs to be made by full Council.

If it is decided that an external appointee(s) will be made then consideration must be given to how Council will select its external appointees. While a local chartered accountant may be well known in the community does that person have the appropriate skills in local governance matters?

What delegations will be given to the committee? Will they be able to appoint internal⁵ auditors without reference to full Council? A sample of delegations are set out later in this paper.

Managing risk

The management of risk is the process of identifying, mitigating where possible and monitoring all risks whether financial or non-financial. Good risk management also means effective communication with those who are managing and monitoring risks.

Risk management is important in helping managers to achieve objectives by addressing any threats to the achievement of these objectives. It assists in decision-making and in identifying opportunities for continuous improvement. Risk management is integral to public sector management and sound corporate governance and improves accountability for decision-making. Although it is only one of an audit and risk committee's wider functions, effective risk management is a vital responsibility that audit committees should always consider.

Risk management processes need to be ongoing and embedded in the culture. There should be the potential to re-adjust the organisation around performance improvement.

The governance responsibilities with respect to risk management and internal control can be summarised as follows:

- establish a 'tone at the top' that promotes a risk-aware culture;
- set the Council's risk approach;
- be informed as to the measures that management is taking in relation to significant risks;
- ensure that the Council has appropriate processes for identifying, assessing and responding to risks in accordance with the Council's risk approach, and that those processes are operating effectively; and
- ensure that the Council's activities are effectively controlled so that management's risk responses and policies are carried out as planned towards the achievement of the Council's objectives.

While establishing an appropriate 'tone at the top', setting the Council's approach to risk and monitoring the strategic risks facing the Council are responsibilities that is with Council, many of the other responsibilities with respect to risk management and internal control can be delegated to the audit and risk committee.

² As authorised by Schedule 7 Local Government Act 2002.

³ The external auditor is appointed by the Office of the Auditor General, therefore the appointment of the external auditor is not a function of the audit and risk committee.

⁴ Internal audit is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation.

⁵ Internal Auditors.

Roles and responsibilities

Set out below are some of the items that could be considered as part of a charter for an audit and risk committee:

- satisfying itself about the existence and quality of cost-effective internal control and risk management systems, and the proper application of processes;
- monitoring existing corporate policies and recommending new corporate policies to prohibit unethical, questionable or illegal activities. This also includes a reviewing/monitoring role of the documentation of all policies and procedures;
- monitoring the Council's external and internal audit process;
- engaging with Council's external auditors regarding the external audit work programme and agreeing the terms and arrangements of the external audit;
- reviewing the effectiveness of the annual audit and 10-year plan audit;
- monitoring management responses to audit reports and the extent to which external audit recommendations concerning internal accounting controls and other matters are implemented;
- reviewing the effectiveness of the risk assessment/management policies and processes;
- ensuring the independence of Council's internal audit processes;
- monitoring the delivery of the internal audit work programme; and
- engaging with internal and external auditors on any specific one-off audit assignments.

Councils can ensure the operation of an effective internal audit function by:

1. identifying areas of risk for an internal audit focus;
2. approving and reviewing internal audit work programmes;
3. ensuring that the internal auditor has adequate resources and skills to undertake the work and is not subject to undue management influence; and
4. approving the appointment of the internal auditor⁶ and internal audit engagement letter and letter of undertaking.

While often the external auditor will have a relationship with management, it is important that the elected members also have a relationship with the external auditor to build confidence that the auditor can raise issues directly with the elected members, ensuring good accountability.

⁶ Only if this is an external appointee, if the internal auditor is an internal employee then there needs to be a protocol allowing the internal auditor to report directly to the audit and risk.

< It's the little details that are vital. Little things make big things happen. >

**Top US basketball coach
John Wooden**



Example of skills required for audit and risk committee

For an 'advisory-oriented' audit and risk committee, particular emphasis should be placed on strategy, performance management and associated risk management disciplines.

In determining the composition of the audit and risk committee, the combined experience, skills, and personal qualities of audit and risk committee members is critical. Members should bring:

- the ability to act independently and objectively;
- the ability to ask relevant and pertinent questions, and evaluate the answers;
- the ability to work constructively with management to achieve improvements;
- an appreciation of the public entity's culture and values, and a determination to uphold these;
- a proactive approach to advising the governing body and Chief Executive of matters that require further attention;
- business acumen; and
- appropriate diligence, time, effort and commitment.

It is recommended that an external appointee have the following experience:

- financial reporting (which should be emphasised in public entities with more complex financial reporting requirements);
- broad governance experience;
- familiarity with risk management disciplines (identification, evaluation and management);
- understanding of internal control and assurance frameworks;
- a good understanding of the roles of internal and external audit;
- industry or sector expertise; and
- the ability to explain technical matters in their field to other members of the audit committee.

Examples of delegations

The audit and risk committee shall have the following delegated powers and be accountable to Council for the exercising of these powers.

In exercising the delegated powers, the audit and risk committee will operate within policies, plans, standards or guidelines that have been established and approved by Council, the overall priorities of Council, the needs of the local communities and the approved budgets for the activity.

The audit and risk committee shall have delegated authority to approve the appointment of the internal auditor of risk management and internal audit programmes, audit engagement letters and letters of undertaking for audit functions and additional services provided by the external auditor.

The audit and risk committee can conduct and monitor special investigations in accordance with Council policy, including engaging expert assistance, legal advisors or external auditors, and, where appropriate, recommend action(s) to Council.

The audit and risk committee can recommend to Council:

- adoption, or non-adoption of completed financial and non-financial performance statements;
- governance policies associated with Council's financial, accounting, risk management, compliance and ethics programmes, and internal control functions;
- accounting treatments, changes in generally accepted accounting practice; and
- new accounting and reporting requirements.

The chairperson of the audit and risk committee shall have delegated authority to approve the letter of engagement for the external appointee to the audit and risk committee.

Power to delegate

The audit and risk committee may not delegate any of its responsibilities, duties or powers.



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