



Financial Sustainability Program

Information Paper 3

Audit Committees

July, 2006



Introduction

This information paper is one of a number being developed as a part of the LGA's Financial Sustainability Program. It is designed as a thought starter. Manuals, codes, guidelines, technical definitions, standards and similar documents are also being prepared to provide practical assistance to Councils.

The subject of this information paper is audit committees. Recent amendments to the Local Government Act have introduced three relatively new concepts – a mandated requirement to have an audit committee, specific criteria regarding the appointment of auditors and a specific provision regarding the capacity for a Council to conduct an efficiency and economy audit. These are in addition to statutory responsibilities which Councils have for annual independent auditing of financial statements. This paper is aimed at ensuring a clear understanding of the requirements for the establishment of audit committees.

Establishing an audit committee is only one step in a Council's approach to best practice financial governance and financial sustainability.

It should be noted that Councils are also subject to a range of external legislative requirements and powers in parallel with those applying to other governments including under the Criminal Law Consolidation, Freedom of Information, State Records and Ombudsman Acts.

This paper should be read in conjunction with the information papers on Financial Sustainability which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audits - Audit Specification
- Efficiency & Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Governance in Local Government
- Financial Governance and Management
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- Depreciation
- Local Government Financial Indicators
- Debt Management
- An Approach to Assessing Financial Sustainability for Local Government

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What does the Act now Require?

The Local Government Act has been amended to require Councils to establish audit committees. **The expected date of operation of the amendment is 1 January 2007.** This legislative change was supported by Local Government and also included as a recommendation in the LGA's Independent Inquiry into the Financial Sustainability of Local Government in South Australia.

Audit committees play a critical role in the financial reporting framework of Councils by overseeing and monitoring the participation of management and external auditors in the financial reporting process. They will also address issues such as the approach being adopted by Councils and management to address business risks, corporate and financial governance responsibilities and legal compliance. Councils may also refer issues of a strategic nature to their audit committees.

The principle functions and extent of authority for an audit committee are set out in Section 126 of the Local Government Act (see Attachment 1). In summary the minimum statutory functions of an audit committee include:

- reviewing annual financial statements to ensure that they fairly present the state of affairs of a Council;
- proposing, and contributing relevant information to, a review of a Council's strategic management or annual business plans;
- proposing and reviewing the exercise of powers in relation to "other investigations" as specified under section 130A of the Local Government Act 1999 (e.g. the conduct of efficiency and economy audits - see Information Paper 5: Efficiency and Economy Audits);
- undertaking the functions that would have been undertaken by a (single Council) subsidiary's audit committee in cases where the Council has exempted the subsidiary from having an audit committee. (Note that this function has no application to a regional subsidiary.);
- liaising with the Council's auditors; and
- reviewing the adequacy of the Council's accounting, internal control, reporting and other financial management systems and practices on a regular basis.

Audit committees provide an important independent role between a Council and its management and between a Council and its community. Audit committees have no authority to act independently of Councils and can only act in areas covered by their terms of reference.

One of the primary roles of these committees is to provide suggestions and recommendations to Councils and/or management, about actions to be taken to enhance financial governance, considered to be in the best interests of local communities.

Whilst the establishment and existence of audit committees are mandated by Section 126 of the Local Government Act, they are actually established under Section 41 of the Act just like any other committees of Councils. The establishment of an audit committee must occur on a Council by Council basis because there is no statutory power for a number of Councils to come together to establish a regional audit committee to perform the functions of the audit committee collectively for those Councils. Clearly, a number of Councils may agree to appoint the same persons to their audit committees and their audit committees may meet on the same day (and

possibly in the same place). Careful consideration must be given to audit committees meeting other than within the boundaries of the Council which establishes them as their meetings must be open to the public, except in circumstances provided for under the Act. Audit committees are individual Council committees and have direct accountability and responsibilities to their establishing Councils.

Audit committees are like any other Council committee and are subject to the requirements of the Local Government Act at Section 41 (for example, reporting and accountability, appointment of the Presiding Member), the duties at Section 62 and the obligations of Sections 73 and 74, which apply to its members. Further, consideration needs to be given to the application (or not) of Part 2 of the Local Government (Procedure at Meetings) Regulations and whether it is appropriate to determine discrete meeting procedures given the nature and functions of audit committees.

Committee Membership

To gain the most benefit from having an audit committee, it is important that a Council appoints properly skilled people who have experience in audit practices and understand the business of the Council.

The Act requires that members of audit committees:

- may not include an employee of the Council;
- may include persons who are not members of the Council;
- may include members of an audit committee of another Council (or in fact may have the same membership as the audit committee of another Council); and
- must otherwise be determined in accordance with the requirements of the regulations (if appropriate).

Staff members may attend meetings and provide services but may not be members of the committee.

Terms of Reference

The operations of audit committees are governed under Section 41 of the Local Government Act and relevant other sections regarding open meetings etc.

As referred to above, the provisions of the Act and the 'Meeting Regulations' that apply to any Council Section 41 committee have equal application to audit committees. Consequently, issues such as notification of meetings to the members of the committee and to the public, the calling of special meetings, the keeping and distribution of minutes, the use of the confidentiality provisions at Sections 90 and 91, and the application of meeting procedures (whether Part 2 of the Meeting Regulations or otherwise) all need to be considered and determined in establishing audit committees. Probably the most fundamental point to be aware of in this regard is that an audit committee does not enjoy any special dispensation from the obligation to conduct its meetings in public.

Terms of reference should be prepared for audit committees and should not only meet minimum requirements but be tailored to the specific needs and circumstances

of individual Councils. Audit committees governing smaller Councils, for example, may require fewer meetings per year. However, in large Councils, there is also an argument that an audit committee may need fewer meetings where an internal audit function takes on an oversight role and/or monitors compliance.

Included as Attachment 2 to this paper is a proposed model terms of reference for an audit committee. It is provided to assist Councils in formulating their own terms of reference for their own committees. The model is intended to not only meet the requirements of the Local Government Act but to also embody examples of good practice for the operation of audit committees. It must be adapted to suit individual Council's requirements.

Audit Committees of Subsidiaries

The nature of the relationship between a subsidiary's audit committee and that of an establishing Council differs between single Council subsidiaries and regional subsidiaries.

A Council's audit committee will undertake the functions that would have been undertaken by the audit committee of a single council subsidiary (established under Section 42 of the Local Government Act) where the Council has exempted the subsidiary from the requirement to establish an audit committee. The effect of this provision is that the operations of a single Council subsidiary will either be subject to its own audit committee or to the Council's audit committee.

In the case of regional subsidiaries established by two or more Councils (under Section 43 of the Local Government Act), the individual audit committees of the constituent Councils have no functional role in relation to their regional subsidiary. A regional subsidiary is required by the Local Government Act (Schedule 2, clause 30(2)) to establish an audit committee, unless it is exempted from this requirement by its charter. If exempted, no one Council's audit committee acts on behalf the subsidiary, in comparison to the situation for a single Council subsidiary (as outlined above).

What are the issues for Councils?

It will be a statutory requirement in January 2007 that all Councils establish an audit committee, or if they already have such a committee, that its membership and terms of reference meet the requirements of the Act.

The prime focus for Councils in this area is to ensure that the strategic financial direction of the Council supports sustainability and that their internal controls are kept under review and are appropriate to address risks exposure. Audit committees play a valuable role in facilitating the two way communication between Councils and their independent external auditors resulting in more reliable financial reporting, accountability, transparency and good governance.

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Attachment 1: Local Government Act Provisions Related to Audit Committees

Section 126 of the Local Government Act 1999 provides that:

- (1) A council must have an audit committee.
- (2) The membership of an audit committee—
 - (a) may include persons who are not members of the council; and
 - (b) may not include an employee of the council (although an employee may attend a meeting of the committee if appropriate); and
 - (c) may include, or be comprised of, members of an audit committee for another council; and
 - (d) must otherwise be determined in accordance with the requirements of the regulations.

* * * * *

- (4) The functions of an audit committee include—
 - (a) reviewing annual financial statements to ensure that they present fairly the state of affairs of the council; and
 - (ab) proposing, and providing information relevant to, a review of the council's strategic management plans or annual business plan; and
 - (ac) proposing, and reviewing, the exercise of powers under section 130A; and
 - (ad) if the council has exempted a subsidiary from the requirement to have an audit committee, the functions that would, apart from the exemption, have been performed by the subsidiary's audit committee; and
 - (b) liaising with the council's auditor; and
 - (c) reviewing the adequacy of the accounting, internal control, reporting and other financial management systems and practices of the council on a regular basis.

The timing of bringing the amended provisions into operation is proposed to be on or after 1 January 2007.

Attachment 2: Model Terms of Reference for Audit Committees

Set out in italics (below) are recommendations regarding the direction a Council may wish to take in relation to its audit committee. These are areas for which specific consideration will need to be given prior to the adoption of the terms of reference for its committee.

1 Membership

1.1 Members of the committee are appointed by the Council. The committee shall consist of *{at least one independent member with at least one additional member from the Elected Members of Council – consistent with any Regulations}*. The minimum size of the committee shall be *{three}* members.

[Note that Section 126(2) provides that an audit committee may include persons who are not members of Council.]

1.2 Independent member(s) of the committee shall have *{recent and relevant financial, risk management, internal audit etc}* experience. The Principal Member of the Council shall be a member of the committee (or the Principal Member is an ex officio member of the committee).

[Note that a person would not be considered independent if he or she was an Elected Member of that Council. Subject to any codes of conduct adopted by Councils, this does not preclude an Elected Member or an employee of a Council from being a member of an audit committee of another Council.]

1.3 Only members of the committee are entitled to vote in committee meetings. Unless otherwise required by the Act not to vote, each member must vote on every matter that is before the committee for decision. However *{other individuals such as the Chief Executive Officer, Finance Manager and if applicable the heads of risk, compliance and internal audit and representatives from the finance function}* may attend any meeting as observers or be responsible for preparing papers for the committee. In accordance with the principles of open, transparent and informed decision making, committee meetings must be conducted in a place open to the public. The agenda and minutes of the committee meetings, subject to any items that are discussed in confidence under Section 90 of the Local Government Act 1999 and subsequently retained as confidential under Section 91 of the Act, are also required to be made available to the public.

1.4 *{Council's external auditors and internal auditors}* may be invited to attend meetings of the committee.

1.5 Appointments to the committee shall be for a period of *{up to four years, or until the end of the term of the Council}*. Appointees may be reappointed by Council.

1.6 The Council shall appoint the Presiding Member of the committee.

[Note that the Principal Member of the Council may be the Presiding Member of the committee or an independent person may take this role]

2 Secretarial resources

2.1 *{The Chief Executive Officer shall provide sufficient administrative resources to the committee to enable it to adequately carry out its functions}.*

3 Quorum

3.1 The quorum necessary for the transaction of business shall be *{50% of the number of members of the committee plus one or a specified number}*. A duly convened meeting of the committee at which a quorum is present shall be competent to exercise all or any of the authorities, powers and discretions vested in or exercisable by the committee.

4 Frequency of meetings

4.1 The committee shall meet *{at least four times a year at appropriate times in the reporting and audit cycle}* and otherwise as required.

5 Notice of meetings

5.1 Ordinary meetings of the committee will be held at times and places determined by Council or, subject to a decision of Council, the committee. A special meeting of the committee may be called in accordance with the Act.

5.2 Notice of each meeting confirming the venue, time and date, together with an agenda of items to be discussed, shall be forwarded to each member of the committee and observers, no later than 3 clear days before the date of the meeting. Supporting papers shall be sent to committee members (and to other attendees as appropriate) at the same time.

6 Minutes of meetings

6.1 The Chief Executive Officer shall ensure that the proceedings and resolutions of all meetings of the committee, *{including recording the names of those present and in attendance}* are minuted and that the minutes otherwise comply with the requirements of the Local Government (Procedure at Meetings) Regulations 2000.

6.2 Minutes of committee meetings shall be circulated within five days after a meeting to all members of the committee and to all members of the Council and will (as appropriate) be available to the public.

7 Role of the committee

7.1 Financial reporting

- 7.1.1 *{The committee shall monitor the integrity of the financial statements of the Council, including its annual report, reviewing significant financial reporting issues and judgements which they contain.}*
- 7.1.2 *{The committee shall review and challenge where necessary:}*
 - 7.1.2.1 *{the consistency of, and/or any changes to, accounting policies;}*
 - 7.1.2.2 *{the methods used to account for significant or unusual transactions where different approaches are possible;}*
 - 7.1.2.3 *{whether the Council has followed appropriate accounting standards and made appropriate estimates and judgements, taking into account the views of the external auditor;}*
 - 7.1.2.4 *{the clarity of disclosure in the Council's financial reports and the context in which statements are made;}* and
 - 7.1.2.5 *{all material information presented with the financial statements, such as the operating and financial review and the corporate governance statement (insofar as it relates to the audit and risk management).}*

7.2 Internal controls and risk management systems

The committee shall:

- 7.2.1 *{keep under review the effectiveness of the Council's internal controls and risk management systems;}* and
- 7.2.2 *{review and recommend the approval, where appropriate, of statements to be included in the annual report concerning internal controls and risk management.}*

[Note that it is important that the audit committee understand the business of the Council to appreciate the risks it manages on a daily basis, and to ensure that there are appropriate management plans to manage and mitigate this business risk. This will include insurance matters, financial reporting, legal and regulatory compliance, business continuity, and statutory compliance. This can be facilitated by discussions with the internal and external auditors and by presentations by management on how business risks are identified and managed.]

7.3 Whistle blowing

{The committee shall review the Council's arrangements for its employees to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters. The committee shall ensure these arrangements allow independent investigation of such matters and appropriate follow-up action.}

7.4 Internal audit (if applicable, where a Council does not have a separate internal audit function)

The committee shall:

7.4.1 *{monitor and review the effectiveness of the Council's internal audit function in the context of the Council's overall risk management system;}*

7.4.2 *{consider and make recommendation on the program of the internal audit function and the adequacy of its resources and access to information to enable it to perform its function effectively and in accordance with the relevant professional standards.}*

[Note that this may include the review of the areas that have been identified for review and the frequency of review. The committee should also monitor whether the function of internal audit has adequate standing and is free from management or other restrictions. Whilst internal audit focuses on a Council's systems and procedures, it is important that audit retains its independence and is not subject to any influence from management or Council that impedes its ability to report objectively.]

7.4.3 *{review all reports on the Council's operations from the internal auditors;}*

[Note that the reports to the audit committee need not be the detailed reports that are presented to management for their review. Ordinarily a high level review report is all that is required detailing the work undertaken, the findings and management response.]

7.4.4 *{review and monitor management's responsiveness to the findings and recommendations of the internal auditor;}* and

7.4.5 *{where appropriate, meet the "head" of internal audit (internal or outsourced) at least once a year, without management being present, to discuss any issues arising from the internal audits carried out. In addition, the head of internal audit shall be given the right of direct access to the Principal Member of the Council and to the Presiding Member of the committee}.*

7.5 External audit

The committee shall:

- 7.5.1 *{develop and implement a policy on the supply of non-audit services by the external auditor, taking into account any relevant ethical guidance on the matter};*
- 7.5.2 *consider and make recommendations to the Council, in relation to the appointment, re-appointment and removal of the Council's external auditor. {The committee shall oversee the selection process for new auditors and if an auditor resigns the committee shall investigate the issues leading to this and decide whether any action is required};*
- 7.5.3 *{oversee Council's relationship with the external auditor including, but not limited to:*
 - 7.5.3.1 *recommending the approval of the external auditor's remuneration, whether fees for audit or non-audit services, and recommending whether the level of fees is appropriate to enable an adequate audit to be conducted;*
 - 7.5.3.2 *recommending the approval of the external auditor's terms of engagement, including any engagement letter issued at the commencement of each audit and the scope of the audit;*
 - 7.5.3.3 *assessing the external auditor's independence and objectivity taking into account relevant professional and regulatory requirements and the extent of Council's relationship with the auditor, including the provision of any non-audit services;*
 - 7.5.3.4 *satisfying itself that there are no relationships (such as family, employment, investment, financial or business) between the external auditor and the Council (other than in the ordinary course of business);*
 - 7.5.3.5 *monitoring the external auditor's compliance with legislative requirements on the rotation of audit partners; and*
 - 7.5.3.6 *assessing the external auditor's qualifications, expertise and resources and the effectiveness of the audit process (which shall include a report from the external auditor on the audit committee's own internal quality procedures)};*
- 7.5.4 *{meet as needed with the external auditor. The committee shall meet the external auditor at least once a year, without management being present; to discuss the external auditor's report and any issues arising from the audit};*
- 7.5.5 *{review and make recommendations on the annual audit plan, and in particular its consistency with the scope of the external audit engagement};*

- 7.5.6 *{review the findings of the audit with the external auditor. This shall include, but not be limited to, the following;*
- 7.5.6.1 *a discussion of any major issues which arose during the external audit;*
- 7.5.6.2 *any accounting and audit judgements; and*
- 7.5.6.3 *levels of errors identified during the external audit.*
- The committee shall also review the effectiveness of the external audit.}*
- 7.5.7 *{review any representation letter(s) requested by the external auditor before they are signed by management};*
- [Note that these representation letters are a standard practice of any audit and provide the auditor confirmation from management, (in particular the Chief Financial Officer) that, amongst other matters, accounting standards have been consistently applied, that all matters that need to be disclosed have been so disclosed and that the valuation of assets has been consistently applied.];*
- 7.5.8 *{review the management letter and management's response to the external auditor's findings and recommendations}.*

8 Reporting responsibilities

- 8.1 *{The committee shall make whatever recommendations to the Council it deems appropriate on any area within its terms of reference where in its view action or improvement is needed.}*

9 Other matters

The committee shall:

- 9.1 *{have access to reasonable resources in order to carry out its duties};*
- [Note that this is subject to any budget allocation being approved by Council];*
- 9.2 *{be provided with appropriate and timely training, both in the form of an induction programme for new members and on an ongoing basis for all members};*
- 9.3 *give due consideration to laws and regulations of the Local Government Act, 1999;*
- 9.4 *{make recommendations on co-ordination of the internal and external auditors};*
- 9.5 *{oversee any investigation of activities which are within its terms of reference}; and*

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- 9.6 *{oversee action to follow up on matters raised by the external auditors};*
- 9.7 *{at least once a year, review its own performance, constitution and terms of reference to ensure it is operating at maximum effectiveness and recommend changes it considers necessary to the Council for approval}.*