

# **DEPARTMENT OF FINANCE AND PERSONNEL**

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**DAO(DFP) 5/01**

**5 April 2001**

**Dear Accounting Officer**

## **CORPORATE GOVERNANCE: STATEMENT ON INTERNAL CONTROL**

### **Purpose of this DAO letter**

1. The purpose of this letter is to
  - (a) draw attention to changes, **for the 2000 -2001 financial year accounts**, to the wording of the model statement on the system of internal financial control, as the first stage of a process of moving towards a wider statement on internal control.
  - (b) set out the process of moving from the requirement for a Statement on Internal Financial Control (SIFC) to a Statement on Internal Control (SIC).

Both these statements are to be included in the accounts of

- a. departments
- b. executive agencies
- c. trading funds
- d. executive Non-Departmental Public Bodies, and
- e. any other accounts that are laid before the NI Assembly

2. Included below is a timetable with key stages up to the financial year 2003-04 for which the final version of the Statement on Internal Control will be mandatory. A transitional statement on internal control which is indicative of further work to be done, may be adopted in years 2001-02, and 2002-03.

### **Cancelled DAOs**

3. This letter supersedes the requirements of DAO(DFP) 2/98 and DAO(DFP) 5/99 which are now cancelled.

### **Background**

4. DAO(DFP) 2/98 introduced a Statement on Internal Financial Control (SIFC) to the accounting requirements in central government. Since then best practice in the private sector has developed with the introduction of the Stock Exchange's "Combined Code" of requirements for listed companies and publication of "Internal Control: Guidance for Directors on the Combined Code" (the "Turnbull Report")<sup>1</sup> which examines how specific requirements within the Combined Code should be implemented. These requirements are:

Provision D.2 "The Board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets

Provision D2.1 "The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management."

Provision D2.2 "Companies which do not have an internal audit function should from time to time review the need for one".

5. Following the general principle that best practice in accounting requirements in the private sector should be reflected in central government<sup>2</sup>, consideration has been given to how the provisions of the Turnbull Report can be adapted to the sector. Following consultations with Principal Finance Officers, this letter promulgates the requirements.

### **Timetable**

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<sup>1</sup> Internal Control: Guidance for Directors on the Combined Code can be found at <http://www.icaew.co.uk/intnalcontrol>

<sup>2</sup> Foreword to Accounting Standards (Accounting Board)

6. A timetable detailing the key steps in moving from the Statement of Internal Financial Control to the Statement of Internal Control for each financial year is set out in the table below:

YEAR	TIMETABLE FOR IMPLEMENTATION
1999-2000 <input type="checkbox"/>	SIFC
2000-2001 <input type="checkbox"/>	SIFC plus; A paragraph stating the Accounting Officers awareness of the requirement for a SIC.
2001-2002 <input type="checkbox"/>	SIC if possible - transitional statement allowed.
2002-2003 <input type="checkbox"/>	SIC if possible - transitional statement allowed.
2003-2004 <input type="checkbox"/>	SIC

7. Paragraph 8 below provides wording for an additional paragraph for inclusion in the statement of internal financial control, for the year ended 31 March 2001, to indicate awareness of the need for a wider Statement of Internal Control and to provide assurance that steps are being taken to meet the DFP requirements in respect of that wider statement.
8. The additional paragraph, to be inserted at the end of the existing statement, reads as follows:

**“Implementation of a Statement of Internal Control**

“As Accounting Officer, I am aware of the recommendation for departments to produce a Statement of Internal Control, and am taking reasonable steps to comply with DFP's requirement for this statement to be prepared for the year ended 31 March 2002, in accordance with guidance issued by DFP.”

9. The full text of the amended statement of internal financial control for 2000-2001 is set out at Annex A1 for use by Departments in Appropriation Accounts, and at Annex A2 for use by Executive Agencies, Trading Funds, and Executive NDPBs, and other accounts laid before the Assembly.

10. Organisations are encouraged and should aim to prepare a Statement on Internal Control for 2001/02 wherever possible. However, it is recognised that some bodies may need to do further work before all relevant risk management and review processes are fully in place. In such cases it would be permissible to prepare a transitional statement which would include a description of planned work. An illustrative example of the transitional statement is at Annex A3. The facility to produce a SIC which is indicative of further work to be done may be adopted for each of the financial periods which begin on dates on or after 1 January 2001 up to 31 December 2001, and on or after 1 January 2002 up to 31 December 2002. Bodies which anticipate having to prepare such a statement for the second of these years will be asked to verify that they will be able to produce a statement of internal control in accordance with Annex A4 in respect of the financial period beginning on or after 1 January 2003. That will mean that by the beginning of that financial period all development work should be complete and all the required processes should be in place.

### **Format of the Statement of Internal Control**

11. The SIC should be developed in accordance with the pro-forma format at Annex A4 to this letter. The detail of the parts of the pro-forma that are in bold italic text should be drafted to provide a brief but comprehensive summary of the actual processes in place in the body, including a description of how current initiatives (whether centrally or locally driven) are being taken forward. In particular, the narrative description of the processes in place should be used for reporting on progress or compliance with particular central initiatives which have a reporting requirement.<sup>3</sup>
12. Accounting Officers may need to amend the opening paragraph of the pro-forma SIC to give a meaningful description of the boundaries of their accountabilities. In particular, Agencies may need to reflect more fully the relationship with their department, and NDPBs may need to reflect the relationship with the sponsoring department and the role of the NDPB's Board. Whilst all SICs must encompass at least the responsibilities of the Accounting Officer, those bodies which have governance arrangements involving a wider base may consider preparing an SIC which encompasses those wider arrangements. The inter-relationship between the SIC for a sponsoring department and those of related bodies, and the manner of their presentation in the departmental resource account will be for the

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<sup>3</sup> An example of such a requirement at the time of production of this letter would be reporting on compliance with the principal recommendations in the Cabinet Office report "Successful IT: Modernising Government in Action").

departmental Accounting Officer to determine in the context of the actual structures of control.

### **Status and auditability of Statements on Internal Control**

13. The SIC is an integral part of the annual reporting of the body, to be presented alongside the accounts. It should be prepared by the Accounting Officer along with the accounts and passed to the external auditors for review. A summary of the NIAO's approach to the review of Statements on Internal Control is at Annex B.

### **Risk management**

14. The Turnbull report states that a sound system of internal control "depends on a thorough and regular evaluation of the nature and extent of the risks to which the company is exposed". It further states that the purpose of internal control "is to help manage and control risk rather than to eliminate it". The SIC should therefore be the end result of a process of management that is embedded in the planning, operational, monitoring and review activities of the body<sup>4</sup>, these activities being the critical elements of the statement. Production of the SIC should not be conducted as an "add-on" end of year activity. The Statement on Internal Control should explain the nature of control, and any material changes in control, exercised through the whole of the accounting period.

### **Internal Audit**

15. The Turnbull Report referred to the need for internal audit or other monitoring processes to assure management and the board that the system of internal control is functioning as intended. Accounting Officers are already required to make provision for internal audit under the provisions of Government Accounting Northern Ireland. Accounting Officers should, as part of their annual review of the system of internal control, ensure that their internal audit provision is adequately resourced to deliver a service in accordance with the standards in the Government Internal Audit Manual.

### **Enquiries**

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<sup>4</sup> Draft guidance on risk management was produced by Treasury in February 2000 in "Management of Risk – A Strategic Overview" (The "Orange Book"). The final version of this will be issued shortly after this letter. A version of this guidance, developed to be especially appropriate to smaller organisations ("Management of Risk – Guide for Smaller Bodies") has been produced. These documents are advisory, and each body should identify for itself the methodology for embedded risk management that is most appropriate for its business and circumstances.

16. Any enquiries on the content and application of this letter should be addressed in the first instance to

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### **Further Action**

17. Departments should ensure that their executive agencies, trading funds, executive Non-Departmental Public Bodies, and other sponsored bodies are aware of the requirements of this letter.

Yours sincerely

Andrew McCormick

**ANDREW MCCORMICK**  
Treasury Officer of Account

**MODEL WORDING FOR THE STATEMENT ON THE SYSTEM OF INTERNAL FINANCIAL CONTROL FOR THE FINANCIAL YEAR 2000-2001: VERSION 1 - FOR USE BY DEPARTMENTS IN APPROPRIATION ACCOUNTS**

This statement is given in respect of the appropriation account for Vote 00. As Accounting Officer for this Vote, I acknowledge my responsibility for ensuring that an effective system of internal financial control is maintained and operated in connection with the resources concerned. [I carry out this responsibility in conjunction with the department's principal Accounting Officer, the relationship between us being set out in a written statement.]

The system of internal financial control can provide only reasonable and not absolute assurance that assets are safeguarded, transactions authorised and properly recorded and that material errors or irregularities are either prevented or would be detected within a timely period.

The system of internal financial control is based on a framework of regular management information, financial regulations, administrative procedures including segregation of duties, and a system of delegation and accountability. In particular, it includes *[see note 3]*:

- comprehensive budgeting systems with an annual budget;
- procedures to review and agree the budgets;
- the preparation of regular financial reports which indicate actual expenditure against the forecasts;
- clearly defined capital investment control guidelines;
- as appropriate, formal project management disciplines.

The department has an internal audit unit, which operates to standards defined in the Government Internal Audit Manual. The work of the internal audit unit is informed by an analysis of the risk to which the department is exposed, and annual internal audit plans are based on this analysis. The analysis of risk and the internal audit plans are endorsed by the department's Audit Committee and approved by me [and the department's principal Accounting Officer]. At least annually, the Head of Internal Audit (HIA) provides me with a report on internal audit activity in the department. The report includes the HIA's independent opinion on the adequacy and effectiveness of the department's system of internal financial control.

My review of the effectiveness of the system of internal financial control is informed by the work of the internal auditors and the executive managers within the department who have responsibility for the development and maintenance of the financial control framework, and comments made by the external auditors in their management letter and other reports.

### ***Implementation of a Statement of Internal Control***

As Accounting Officer, I am aware of the recommendation for departments to produce a Statement of Internal Control, and am taking reasonable steps to comply with DFP's requirement for this statement to be prepared for the year ended 31 March 2002, in accordance with guidance issued by DFP.

[Details of the action taken, or proposed, to correct weaknesses in the system of internal financial control, or an explanation of why corrective action is not considered necessary, should be given here. The wording should be tailored to reflect the circumstances of the case, including where the action taken or proposed is the responsibility of the principal Accounting Officer rather than the Accounting Officer for the Vote.]

### ***Notes***

- 1. Each Accounting Officer must prepare a statement for each Vote for which he or she is responsible.*
- 2. The statement should be included as a separate document normally coming between the "Statement of Accounting Officers' responsibilities" and the Summary of Outturn.*
- 3. Changes to the wording should be kept to a minimum. However, the key areas described in the third paragraph are the minimum features to be expected in the system and Accounting Officers are encouraged to describe any additional features of the system of internal financial control which are relevant to the effectiveness of the system, such as improvements in control procedures or new accounting systems with additional control facilities. Accounting Officers may also wish to mention any special reviews or similar work undertaken within the department to verify or improve the system of internal financial control. Any such information should be given as an additional paragraph. It may also be appropriate to refer to such reviews in*

*the fifth paragraph which comments on the means by which the Accounting Officer satisfies him or herself on the effectiveness of the system.*

**SUGGESTED WORDING FOR THE STATEMENT ON THE SYSTEM OF INTERNAL FINANCIAL CONTROL FOR THE FINANCIAL YEAR 2000-2001: VERSION 2 - FOR USE BY EXECUTIVE AGENCIES, TRADING FUNDS AND EXECUTIVE NDPBs**

As Accounting Officer, I acknowledge my responsibility for ensuring that an effective system of internal financial control is maintained and operated by (name of body).

The system can provide only reasonable and not absolute assurance that assets are safeguarded, transactions authorised and properly recorded, and that material errors or irregularities are either prevented or would be detected within a timely period.

The system of internal financial control is based on a framework of regular management information, administrative procedures including the segregation of duties, and a system of delegation and accountability. In particular, it includes *[see note 3]*:

- comprehensive budgeting systems with an annual budget which is reviewed and agreed by [a committee of] the Management Board [or other appropriate description];
- regular reviews by the Management Board of periodic and annual financial reports which indicate financial performance against the forecasts;
- setting targets to measure financial and other performance;
- clearly defined capital investment control guidelines.
- as appropriate, formal project management disciplines;

(Name of body) has an internal audit unit, which operates to standards defined in the Government Internal Audit Manual. The work of the internal audit unit is informed by an analysis of the risk to which the body is exposed, and annual internal audit plans are based on this analysis. The analysis of risk and the internal audit plans are endorsed by the body's Audit Committee and approved by me. At least annually, the Head of Internal Audit (HIA) provides me with a report on internal audit activity in the body. The report includes the HIA's independent opinion on the adequacy and effectiveness of the body's system of internal financial control.

My review of the effectiveness of the system of internal financial control is informed by the work of the internal auditors, the Audit Committee which oversees the work of the internal auditor, the executive managers within the body who have responsibility for the development and maintenance of the financial control framework, and comments made by the external auditors in their management letter and other reports.

### ***Implementation of a Statement of Internal Control***

As Accounting Officer, I am aware of the recommendation for departments to produce a Statement of Internal Control, and am taking reasonable steps to comply with DFPs requirement for this statement to be prepared for the year ended 31 March 2002, in accordance with guidance issued by DFP.

[Details of the action taken, or proposed, to correct weaknesses in the system of internal financial control, or an explanation of why corrective action is not considered necessary, should be given here. The wording should be tailored to reflect the circumstances of the case. If, in the case of an executive agency, the action taken or proposed involves an Accounting Officer in the parent department, that should be explained.]

### ***Notes:***

1. *The statement should be signed by the appointed or designated Accounting Officer.*
2. *The statement should follow the statement of the Accounting Officer's responsibilities. If the latter is included as part of the Foreword, so may the new statement.*
3. *Changes to the wording should be kept to the minimum. However, the key areas described in the third paragraph are the minimum features to be expected in the system and Accounting Officers are encouraged to describe any additional features of the system of internal financial control which are relevant to the effectiveness of the system, such as improvements in control procedures or new accounting systems with additional control facilities. Accounting Officers may also wish to mention any special reviews or similar work undertaken within the department to verify or improve the system of internal financial control. Any such information should be given as an additional paragraph. It may also be appropriate to refer to such reviews*

*in the fifth paragraph which comments on the means by which the Accounting Officer satisfies him or herself on the effectiveness of the system.*

**Statement on Internal Control – Transitional Statement**

*[ The Transitional Statement provides an illustration for a body that is developing its internal control processes but considers that further elements are required to be introduced together with a continued period of trial and assessment prior to the preparation of a full statement on the system of internal control as illustrated in Annex A4. ]*

*As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of departmental policies, aims and objectives, set by the department's Ministers, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.*

The system of internal control is designed to manage rather than eliminate the risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness.

The system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of departmental policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically. I expect to have the procedures in place in March 2002 necessary to implement DFP guidance. This takes account of the time needed to fully embed the processes which the department has agreed should be established and improve their robustness.

We have carried out appropriate procedures to ensure that we have identified the department's objectives and risks and determined a control strategy for each of the significant risks. As a result, risk ownership has been allocated to the appropriate staff and the department has set out its attitude to risk to the achievement of the departmental objectives.

The management board has ensured that procedures are in place for verifying that aspects of risk management and internal control are regularly reviewed and reported on. There will be a full risk and control assessment before reporting on the year ending 31 March 2003. Risk management has been incorporated more fully into the corporate planning and decision making processes of the department.

The board receives periodic reports concerning internal control. The appropriate steps are being taken to manage risks in significant areas of responsibility and monitor progress on key projects.

Following the identification of the department's key objectives and risks, further work has been done to bring about more consistency in the way in which the department treats risks.

In addition to the actions mentioned above, in the coming year the department plans to:

- Regularly review and update the record of risks facing the organisation;
- set up a system of key performance and risk indicators;
- develop and maintain an organisation-wide risk register; and
- arrange for reports from the chief executives of the department's agencies on internal control activities.

*The department has an Internal Audit Unit, which operates to standards defined in the Government Internal Audit Manual. They submit regular reports which include the HIA's independent opinion on the adequacy and effectiveness of the department's system of internal control together with recommendations for improvement.*

*My review of the effectiveness of the system of internal control is informed by the work of the internal auditors and the executive managers within the department who have responsibility for the development and maintenance of the internal control framework, and comments made by the external auditors in their management letter and other reports.*

**Statement on Internal control – PROFORMA**

As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of departmental policies, aims and objectives, set by the department's Ministers, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting. *(Accounting Officers may wish to amend this paragraph to provide a comprehensive explanation of the accountability arrangements surrounding their organisation.)*

The system of internal control is designed to manage rather than eliminate the risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness.

The system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of departmental policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically. This process has been in place [for the year ended 31 March 200x/since XX] and up to the date of approval of the annual report and accounts and accords with DFP guidance.

As Accounting Officer, I also have responsibility for reviewing the effectiveness of the system of internal control.

***Summarise here the process that has been applied in reviewing the effectiveness of the system of internal control as appropriate to the circumstances of the reporting body.***

***Examples of some of the types of processes are:***

- ***procedures for identifying the body's objectives and key risks;***
- ***the development of the control strategy and risk management policy;***
- ***the allocation of risk ownership;***
- ***the role of the Audit Committee or other relevant committee;***
- ***involvement and role of internal audit;***
- ***procedures for ensuring that aspects of risk management and internal control are regularly reviewed and reported on;***
- ***systems used to ensure compliance with specific regulations or procedures laid down by central departments;***
- ***details of monitoring procedures for subsidiary bodies;***
- ***monitoring of progress with current initiatives and compliance and extant external requirements.***

My review of the effectiveness of the system of internal control is informed by the work of the internal auditors and the executive managers within the department who have responsibility for the development and maintenance of the internal control framework, and commitments made by the external auditors in their management letter and other reports.

***Record here details of actions taken, or proposed, to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts. The wording should be tailored to reflect the circumstances of the case.***

## NIAO's APPROACH TO THE REVIEW OF STATEMENTS ON INTERNAL CONTROL

### Review procedures

1. The NIAO's approach to the review of internal control statements will, in essence, be the same as that for statements on the system of internal financial controls. The relevant part of the Comptroller and Auditor General's certificate will read along the following lines:-

*'I review whether the statement on page – reflects the [name of audited body]'s compliance with DFP's guidance, "Corporate Governance: Statement of Internal Control". I report if it does not meet the requirements for disclosure specified by DFP, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements'.*

2. *The NIAO review procedures draw on the relevant section of the Auditing Practices Board's guidance, Bulletin 5/99 'The Combined Code: Requirements of Auditors under the Listing Rules of the London Stock Exchange', tailored as appropriate for a central government context. The objective of the review is to assess whether the audited body's description of the processes adopted in reviewing the effectiveness of the system of internal control appropriately reflects that process. This will be substantively covered by:*

- *Consideration of whether the disclosures are consistent with the NIAO's review of board and committee minutes and their knowledge of the audited body obtained during the audit of the financial statements;*
- *NIAO attendance at audit committee meetings at which corporate governance, internal control and risk management matters are considered;*
- *Consideration of the process adopted by the Accounting officer for his/her effectiveness review, and of the documentation prepared to support the statement.*

3. *The NIAO's work on internal control will not be sufficient to enable them to express any assurance on whether the audited body's controls are effective. In addition, the financial statement audit should not be relied upon to draw to the Accounting Officer's attention all matters that may be relevant to their consideration as to whether or not the system of internal control is effective.*

*Auditors are not expected actively to search for misstatements or inconsistencies, but if they become aware of such a matter they will discuss it with senior management to establish the significance of the lack of proper disclosure.*

### ***The NIAO's work on understanding the business and controls***

- 4. As noted above, the auditor's work on the financial statements audit is not driven by the requirement for an internal control statement and cannot be relied upon to indicate that controls are effective. Nevertheless the NIAO audit approach, 'Audit 21', is a risk based approach based upon obtaining a good understanding of the business, the risks that it faces and how those risks are managed. Although the emphasis remains to an extent on financial risks and controls, this work should provide a sound base for the auditor's consideration of the Accounting Officer's internal control statement. It should also provide opportunities to make recommendations for improvements to internal controls.*
- 5. Risk management and internal control issues are often a feature of the NIAO's wider Value-for-Money audit role. The NIAO recognise that risk-taking is essential if public bodies are to innovate and improve and, as a member of the Public Audit Forum, have stated that they will support well thought through risk taking and innovation.*