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**DAO(DFP)25/03**

**30 July 2003**

Dear Accounting Officer

## **STATEMENT OF INTERNAL CONTROL**

### ***Purpose***

1. The purpose of this letter is to:
  - Remind Accounting Officers what they were expected to have achieved by the end of March 2003 to comply with DAO(DFP)5/01<sup>1</sup> and advise on the actions to be taken if this has not been achieved;
  - Provide a revised proforma “Statement on Internal Control” (SIC) applicable from 2003/4 (some bodies which have met the requirements of DAO(DFP)5/01 for 2002/3 may have to develop their processes further to comply with this letter for 2003/4). The new proforma includes:
    - a. requirement for the SIC, from 2003/4 and subsequently, to confirm that the results of the Accounting Officer review of the effectiveness of

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<sup>1</sup>DAO(DFP)5/01 introduced the requirement for a Statement of Internal Control to be made alongside the accounts of central government bodies.

internal control has been discussed with the Board, Audit Committee (and the Risk Committee, where applicable) [paras 15-16];

- b. an expectation for a reference in the SIC to ongoing maintenance and development of risk management and review processes [para 9]; and
  - c. advises on the interpretation of a “significant internal control problem” which requires commentary in the SIC on the actions taken, or proposed, to deal with it [para 10-11].
2. The Northern Ireland Audit Office’s (NIAO) approach to the review of the SIC remains unchanged from that outlined in DAO(DFP)5/01 [see Annex A to this letter].
  3. There are four annexes attached to this letter:
    - **Annex A** – NIAO’s approach to the review of Statements on Internal Control;
    - **Annex B** – elements relevant in considering whether appropriate risk management, control and review processes are in place to support the SIC;
    - **Annex C** – provisions for those bodies not able to make a SIC for 2002/3 recording that all processes are in place by the end of the year; and
    - **Annex D** – new proforma Statement on Internal Control from 2003/4.

### ***Background***

4. The subject of risk management in central government has developed considerably since the issue of DAO(DFP)5/01. That letter was primarily concerned with adapting private sector requirements into the central government sector. Since then there has been a Westminster Public Accounts Committee report on risk (following the hearing on the 2000 National Audit Office report “Supporting innovation: Managing risk in government departments” available at [www.nao.gov.uk/publications/nao\\_reports/9900864.pdf](http://www.nao.gov.uk/publications/nao_reports/9900864.pdf)).

More recently in GB the Strategy Unit published their report “Risk: Improving government’s capability to handle risk and uncertainty”, available at [www.number-10.gov.uk/SU/RISK/REPORT/downloads/su-risk.pdf](http://www.number-10.gov.uk/SU/RISK/REPORT/downloads/su-risk.pdf), which has led to a programme of work, called “The Risk Programme”. This is being steered by a sub-group of the Civil Service Management Board.

5. Risk management is now firmly at the heart of the management of the business of government bodies. In particular risk is being embedded into the highest level delivery planning mechanisms. As risk sets the context for internal control, it is important that the SIC should reflect these developments and the provisions of this letter aim to ensure that the SIC process is firmly and clearly linked to the continuing development of risk management in central government.

***Expectations under the provisions of DAO(DFP)5/01***

6. Achievement of the deadline set in DAO(DFP)5/01 required that “all relevant risk management and review processes” be in place by the end of March 2003. Annex B of this letter offers a range of elements which are relevant in a body’s consideration of whether it has the relevant processes in place. It is based on the risk management guidance set out in the Orange Book (“Management of Risk – A Strategic Overview”, HM Treasury, 2001) issued under cover of a Dear Principal Finance Officer letter dated 30 April 2001 and the Annex itself provides further guidance on the way in which it may be used.
7. Bodies which did not have the required processes in place by March 2003 should take the actions set out in Annex C to this letter.
8. When drafting the SIC for 2002/3, those bodies which will have completed the implementation of appropriate risk management and review processes during the year 2002/3 should follow the model of the proforma SIC at Annex A4 of

DAO(DFP)5/01<sup>2</sup> They should record at what stage in the year key elements of the processes were implemented if they have not been in place for the full year.

***Maintenance and development of risk management and review processes***

9. Once a body has the appropriate risk management and review processes in place, it is important that they are maintained and developed to ensure their continuing effectiveness. The SIC should record the key elements of the way in which this is done, whether as part of a “planned maintenance” programme or in response to problems or significant external developments (for example, machinery of government changes). It is also expected that bodies will continue to develop and improve their existing risk management capability as a consequence of the risk improvement programme resulting from the Strategy Unit’s risk report. However, ability to make a SIC compliant with the provisions of this DAO is not dependent on further improvements arising from the Risk Improvement Programme.

***“Significant internal control problems”***

10. The proforma SIC promulgated with DAO(DFP)5/01 includes a requirement to disclose “details of actions taken, or proposed, to deal with material internal control aspects of any significant problems disclosed in the annual report and accounts”.
11. The proforma SIC attached at Annex D to this letter now refers to “significant internal control problems”. This change is intended to clarify the expectation that the SIC only need make reference to significant problems arising from internal control issues. A “significant internal control problem” cannot be centrally defined; the same essential problem may or may not be significant depending on circumstances. The following indicators (which are not exhaustive) may be

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<sup>2</sup> Alternatively, bodies may, and are encouraged to, adopt the new proforma SIC when preparing their SIC for 2002/03 (see paragraph 13)

helpful in considering whether or not an internal control problem is significant enough to be reported in the SIC:

- it seriously prejudiced or prevented achievement of a PSA target;
- it has resulted in a need to seek additional funding from DFP / the sponsoring department to allow it to be resolved, or has resulted in significant diversion of resources from another aspect of the business;
- the external auditor would regard it as having a material impact on the accounts;
- the Audit Committee advises it should be considered significant;
- the Head of Internal Audit reports on it as significant in their annual opinion on the whole of risk, control and governance.

### ***Revised proforma SIC***

12. The proforma SIC to be used from 2003/4 has been revised. It has been approved in principle by the Financial Reporting Advisory Board (FRAB) and is attached at Annex D. There are two reasons for the revisions:
  - Reviews of the 2001/2 SICs indicated a high level of “boiler plating”, reproducing the example SICs at Annexes A3 and A4 of DAO(DFP)5/01 rather than providing a tailored portrayal of the actual processes in the particular body;
  - It is intended to align the processes underpinning the SIC as closely as possible with the work being carried out in GB to implement the recommendations of the Strategy Unit’s 2002 report “Risk: Improving government’s capability to handle risk and uncertainty”.
13. Whilst the new proforma format is required for 2003/4, bodies are encouraged to adopt it for their SIC for 2002/3 (if

doing so, the last sentence of the wording in the section headed “Review of effectiveness” [*“I have been advised on the implications .....continuous improvement of the system is in place”*] is optional for this year).

14. The mandatory elements of wording are not materially changed from those required by DAO(DFP)5/01. However the “freeform” elements are now specified by rubrics requiring bodies to “describe *an aspect of risk management*”. These aspects of risk management pick up both the “Orange Book” stages of the risk management lifecycle and the risk management themes emerging from the Strategy Unit report in GB.

### ***Effectiveness of internal control***

15. It is implicit in the provisions of DAO(DFP)5/01 that the process of reviewing the effectiveness of internal control generates in some shape or form a documented assessment of effectiveness. Given the complexity of most government bodies this may well consist of a number of documents resulting from the review process, including the Head of Internal Audit’s annual assurance, the sequence of stewardship reports (where such a process is implemented), documentation surrounding the maintenance of the risk register and notes from meetings of the Board / Audit Committee / Risk Committee on risk and control issues.
16. A criticism of SICs is that they inform the reader that a review of effectiveness has been undertaken but do not give any assurance that action is taken in response to the assessment of effectiveness generated by the review. To increase the assurance delivered by the SIC the new proforma includes a requirement to record that the Accounting Officer has taken advice on the implications of the assessment of effectiveness from the Board and the Audit Committee (and the Risk Committee, where applicable) and, if appropriate, action has been taken or is planned to address issues arising from it.

## **Action**

17. The provisions of this letter apply to Departments, Executive Agencies, Trading Funds, Executive NDPBs, white paper accounts and accounts produced by departments relating to transactions with public corporations and the Northern Ireland Consolidated Fund (i.e. the Public Income and Expenditure Account). Departments should ensure that their Executive Agencies, Trading Funds and Executive Non-Departmental Public Bodies are aware of the requirements of this letter.

## **Contacts**

18. For general queries about this DAO letter please contact: Mark McNaughten on (028) 91858112 (GTN 68112) or e-mail: [mark.mcnaughten@dfpni.gov.uk](mailto:mark.mcnaughten@dfpni.gov.uk), or Karen Beattie on (028) 91858133 (GTN 68133) or e-mail: [karen.beattie@dfpni.gov.uk](mailto:karen.beattie@dfpni.gov.uk)

Yours sincerely

Derek Lynn

**DEREK LYNN**  
**Deputy Treasury Officer of Accounts**

**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 remains unchanged from that detailed in DAO(DFP)5/01. 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 involves:

- 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 to actively search for mis-statements 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 have stated that they will support well thought through risk taking and innovation.

### **ELEMENTS RELEVANT IN CONSIDERING WHETHER APPROPRIATE RISK MANAGEMENT, CONTROL, AND REVIEW PROCESSES ARE IN PLACE TO SUPPORT THE SIC**

A body should have risk management, control and review processes in place, appropriate to the circumstances and business of the body. The detail of these processes will vary from one body to another depending on circumstances such as the size the body and the complexity of the risks which it faces.

This Annex offers a summary of detailed characteristics (*italic text*) under six high level elements (**bold text**) to help with consideration of the completeness of the processes which have been put in place in a particular body.

In respect of the 2002/3 SIC, this Annex is provided as a tool which bodies may adopt in the preparation of their SIC. For 2003/4, these characteristics are included in a “Risk Management Assessment Framework” which is being developed by the Treasury Risk Support Team. Whilst the use of that particular tool will not be mandatory, bodies should ensure that they have evidence which they deem sufficient to demonstrate that they have implemented processes appropriate to their circumstances under each of the high level elements to support their SIC for 2003/4.

#### **1. LEADERSHIP AND STRATEGY**

**There should be a risk management strategy.**

- 1.1 *There should be a risk management strategy which:*
- *Is endorsed by the Accounting Officer / Board / Audit Committee / Risk Committee*
  - *Sets out the organisation’s attitudes to risk*
  - *Defines the structures for the management and ownership of risk and for the management of situations in which control failure leads to material realisation of risks*
  - *Specifies the way in which risk issues are to be considered at each level of business planning*

*ranging from the corporate process to the setting of individual staff's objectives*

- *Specifies how new activities will be assessed for risk and incorporated into risk management structures*
- *Ensures common understanding of terminology used in relation to risk issues*
- *Defines the structures for gaining assurance about the management of risk*
- *Defines the criteria which will inform assessment of risk and the definition of specific risks as "key"*
- *Defines the way in which the risk register and risk evaluation criteria will be regularly reviewed*

- 1.2 *Whether the strategy is set out in a single document or in a series of related documents or resources, it should be easily available to all staff and reviewed at least annually to ensure it remains appropriate and current.*

## **2. CONTEXT FOR RISK MANAGEMENT**

**The context in which risk has to be managed should be identified:**

*Identifying the context for risk management should include consideration of:*

- *Stakeholders, including*
  - *Ministerial interests*
  - *Public interests*
  - *Service user interests*
  - *Wider societal interests*
- *Risk aspects of relationships inside and outside of government (including key suppliers of goods and services), including:*
  - *Ways in which the behaviour of "partners" affects the organisation*
  - *Ways in which the behaviour of the organisation affects the "partners"*
  - *The risk priorities of "partners"*

### **3. RISK IDENTIFICATION AND EVALUATION**

**Risk should be identified and evaluated in a structured way.**

*There should be documentation which:*

- *Records identified risks in a structured way to*
  - *Record dependencies between risks*
  - *Record linkages between lower level risks and higher level risks*
  - *Identify key risks*
  - *Facilitate assignment of ownership at a level which has authority to assign resources to the management of the relevant risk*
  - *Evaluate risks using defined criteria which are applied consistently*
  - *Provide evaluation of inherent risk (before any control implemented) and residual risk (risk remaining after planned controls are implemented)*
- *Evaluates risk taking account of both:*
  - *The likelihood of the realisation of the risk, and*
  - *The impact of the realisation of the risk*
- *Identifies assigned ownership of the risk at a level or grade with sufficient authority to assign appropriate resources to control the risk*
  - *Records, in as far as it can be defined,*
  - *The acceptable level of exposure in relation to each risk*
  - *Why it is considered that the defined acceptable level of exposure can be justified*

### **4. CRITERIA FOR EVALUATION OF RISK**

**There should be specific criteria for evaluating risk encompassing a range of factors.**

- 4.1 *Criteria for evaluating risk should give consideration to:*
- *Financial / value-for-money issues*
  - *Service delivery / quality of service issues*
  - *Reversibility or otherwise of realisation of the risk*
  - *The quality or reliability of evidence surrounding the risk*
  - *The impact of the risk on the organisation / stakeholders / partners / others*
  - *Defensibility of realisation of the risk*

- 4.2 *The criteria should be applied consistently and methodically across the whole range of risks.*

## **5. RISK CONTROL MECHANISMS**

**Appropriate controls should be in place in relation to each risk:**

- 5.1 *The controls should be:*
- *Based on active consideration of the options for controlling that risk to an acceptable level of residual exposure.*
  - *Promulgated to all those who need to know about the controls.*
  - *Regularly reviewed to consider whether they continue to be*
    - *Effective*
    - *The best value for money response to the risk*
    - *Documented by the relevant managers.*
- 5.2 *In respect of key risks, including those which lie beyond the control of the organisation, plans should be developed and documented contingent against the risk being materially realised despite the controls which are in place.*

## **6. REVIEW AND ASSURANCE MECHANISMS**

**Review and assurance mechanisms should be in place.**

*Review and assurance mechanisms should ensure that:*

- *Each level of management, including the Board, regularly reviews the risks and controls for which it is responsible.*
- *These reviews are monitored by / reported to the next level of management.*
- *Any need to change priorities or controls is clearly recorded and either actioned, or reported to those with authority to take action.*
- *Lessons which can be learned, from both successes and failures, are identified and promulgated to those who can gain from them.*
- *An appropriate level of independent assurance is provided on the whole process of risk identification, evaluation and control.*

- *The methodology for gaining independent assurance is defined with particular reference to the role of internal audit and to the role of any other review bodies working within the organisation.*

## ANNEX C

### **PROVISIONS FOR THOSE NOT ABLE TO MAKE A SIC FOR 2002/3 RECORDING THAT ALL PROCESSES ARE IN PLACE BY THE END OF THE YEAR.**

1. A number of bodies still had work to do after 31 March 2003 before all their risk management and review processes would be in place. This annex makes provision for these bodies to complete implementation of their processes during 2003/4 whilst still being compliant with DFP guidance. It should be noted that this provision is a concession against the requirements of DAO(DFP)5/01, made to recognise the reality of the situation of a number of bodies at this stage.
2. By Friday 29 August 2003 such bodies should notify DFP of their position. This notification should be addressed to Mark McNaughten, Financial Reporting and Accountability Branch, (028) 91858112 (GTN 68112) or e-mail [mark.mcnaughten@dfpni.gov.uk](mailto:mark.mcnaughten@dfpni.gov.uk) and copied to the NIAO Director responsible for the audit of the particular body's financial statements. The notification should include a summary of work remaining to be done along with a proposed timetable for completion of the work. This timetable should not extend beyond March 2004. This will allow DFP to consider ways in which appropriate support can be delivered to the bodies involved; ongoing monitoring procedures will be notified by DFP to all bodies concerned.
3. Executive Agencies and NDPBs should copy their notification to their sponsoring department in order that sponsoring departments can consider the implications of the position of the body for the departmental SIC and what actions they might take to encourage and assist the body to complete the implementation of its risk management and review processes.
4. When preparing their SIC for 2002/3 they should follow the principles of Annex A3 to DAO(DFP)5/01(Transitional Statement), except that they should add a broad timetable to the statements of the actions planned for 2003/4.

## PROFORMA STATEMENT ON INTERNAL CONTROL

(The wording which is not in *italic* script in this proforma SIC should be replicated in every SIC, the words in *italic* script being amended as appropriate to the body in question. ***Bold italic*** script indicates a rubric which should be fulfilled in a way appropriate to the actual processes in place in the body to which the SIC relates.)

### 1. **Scope of responsibility**

As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of *Department Yellow's* policies, aims and objectives, 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 Northern Ireland.<sup>1</sup>

***(Accounting Officers should add to this paragraph to provide an explanation of the accountability arrangements surrounding their role. In particular they should comment on***

- ***Processes in place by which they work with / involve Ministers on managing risk***
- ***Inter-relationship of department /Executive Agency/ NDPB)***

### 2. **The purpose of the system of internal control**

The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all 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 and prioritise the risks to the achievement of *departmental* policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically. The system of internal control has been in place in *Department*

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<sup>1</sup> In NDPBs where responsibility for risk management is shared by the Board and the Accounting Officer, the SIC may be made jointly by the Accounting Officer and the Chair of the Board. Some NDPBs may be required to do this under other provisions by which they are governed.

Yellow for the year ended 31 March 200x and up to the date of approval of the annual report and accounts, and accords with DFP guidance.

### **3. Capacity to handle risk**

*(Describe the key ways in which*

- *leadership is given to the risk management process*
- *staff are trained or equipped to manage risk in a way appropriate to their authority and duties. Include comment on guidance provided to them and ways in which you seek to learn from good practice)*

### **4. The risk and control framework**

*(Describe the key elements of the risk management strategy including the way in which risk (or change in risk) is identified, evaluated, and controlled. Include mention of how risk appetites are determined. <sup>2</sup>)*

*(Describe key ways in which risk management is embedded in the activity of the organisation)*

*[This section should only be inserted by those bodies to which it is relevant.*

*(Describe the key elements of the way in which public stakeholders are involved in managing risks which impact on them)]*

### **5. Review of effectiveness**

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. 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. I have been advised on the implications of the result of my review of the

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<sup>2</sup> It will be helpful if indication can be given here of the generic risk priorities of the body during the period covered by the SIC. For example, a body might indicate that its risk priorities are in the areas of personnel and project management whilst another might indicate that its priorities are IT infrastructure and external economic circumstances.

effectiveness of the system of internal control by the Board, the Audit Committee (*and Risk Committee, if appropriate*) and a plan to address weaknesses and ensure continuous improvement of the system is in place.

***(Describe the process that has been applied in maintaining and reviewing the effectiveness of the system of internal control, including some comment on the role of:***

- ***the Board***
- ***the Audit Committee***
- ***if relevant, the Risk Committee / Risk managers / Risk Improvement Manager***
- ***Internal Audit***
- ***Other explicit review / assurance mechanisms***

**6. Significant internal control problems (*if applicable*)**

***(If there are significant internal control problems, record here an outline of the actions taken, or proposed, to deal with them. The wording should be tailored to reflect the circumstances of the case.)***

*(Signature of Accounting Officer and date of signature)*