

## **Briefing Note**

1. The Public Accounts Committee is currently taking evidence on a Report in the Public Interest issued by the Appointed Auditor (the auditor) in October 2012. On 11 June 2013 the Committee is due to take further evidence from the Wales Audit Office. This briefing note forms part of that evidence and supports the oral evidence to be provided.
2. The Report in the Public Interest draws attention to a number of failures in the governance arrangements, management and internal control at Caldicot and Wentlooge Levels Internal Drainage Board (the Drainage Board).

## **Responsibilities**

3. The Accounts and Audit (Wales) Regulations 2005 (the Regulations) set out the responsibilities of both audited bodies and auditors. Provisions 4 -6 of the Regulation highlight the responsibilities of audited bodies in respect of:
  - putting in place and ensuring that there is a sound system of internal control which facilitates the effective exercise of that body's functions. This includes the body's arrangements for the management of risk and adequate and effective financial management;
  - their accounting records and control systems; and
  - maintaining an adequate and effective system of internal audit of its accounting records and of its system of internal control
4. The Drainage Board therefore has a statutory responsibility for establishing robust and effective governance arrangements.
5. The Regulations also require internal drainage boards in Wales to prepare their annual accounts in accordance with proper practices as defined by "Governance and Accountability in Internal Drainage Boards in England: A Practitioners' Guide 2006" (the Practitioners' Guide). The Practitioners' Guide is published jointly by the Association of Drainage Authorities (ADA) and DEFRA and contains guidance on governance and accounting issues.
6. The Auditor General for Wales appoints the external auditor of the Board (the Appointed Auditor). The Appointed Auditor has responsibility for providing an opinion on an annual basis on the truth and fairness of the financial statements of the Board, but is not required to provide a separate regularity opinion. Since 2005-06 the Auditor General has appointed a member of the Wales Audit Office to undertake this function. Prior to the 2005-06 financial year, responsibility for the appointment of the auditor rested with the Audit Commission in Wales.
7. The overall objective of an audit of financial statements is to obtain reasonable assurance that the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such work is undertaken within a framework of auditing standards and quality control.

8. Misstatements and omissions in financial statements are considered material if individually or in aggregate they could reasonably be expected to influence the decisions of users of the financial statements. Judgements about materiality are affected by both the size and nature of transactions.
9. In common with the external audits of all other bodies, the annual audit of the Drainage Board does not involve:
  - the examination of all financial transactions;
  - the audit of every system and process;
  - the endorsement of management decisions;
  - a determination of whether an audited body has achieved value for money in the use of its resources.
10. The external auditor is not permitted (under professional auditing standards) to act as a consultant or advisor to the audited body, as this would compromise the auditor's independence and create risks of self-audit.
11. Each year the Appointed Auditor prepares an Audit Strategy which sets out the work which he needs to undertake. This Strategy takes into account a number of considerations:
  - the materiality of transactions and balances;
  - verbal and written management representations;
  - the size and complexity of the audited body;
  - specific risk factors; and
  - the extent upon which reliance can be placed on the work of others, for example, Internal Audit.

### **The exercise of audit responsibilities in respect of the Board between 2005 and 2013**

12. A number of issues highlighted in the Appointed Auditor's Report in the Public Interest relate to matters that have arisen from the 2010/2011 financial year onwards, for example, the issues in relation to the sea defences legal case. It is important to note that the Appointed Auditor has not yet issued his audit opinions on the 2010/2011, 2011/2012 and 2012/2013 accounts of the Drainage Board, due to his audit concerns (including those set out in the Report in the Public Interest). The Appointed Auditor will be taking these matters into account in considering the form of his audit opinions for these years of account. The Appointed Auditor is due to conclude his work and issue his report in respect of the 2010-11 financial statements during the next few weeks, following which audit work on the 2011-12 and 2012-13 financial statements will commence.
13. In his evidence to the Committee on 16 May 2013, Mr Jackson Johns (the former Clerk and Engineer of the Drainage Board) informed the Committee that no issues were ever raised as a result of the external audit and that *'the board had a clean slate, practically every year'*.
14. This statement is incorrect. During the period 2005/2006 to 2009/2010, the Appointed Auditor raised concerns in respect of a number of issues relating to the internal governance of the Drainage Board. For example, the Appointed Auditor's previous reports to the members of the Board in nearly every year since 2005-06 have collectively highlighted that the Board had not formalised:

- Standing Orders;
- Standing Financial Instructions;
- a corporate strategy or business plan;
- policies and procedures for Budgetary Control, Human Resources and Information Technology;
- internal audit arrangements; and
- a medium term financial strategy.

15. In addition to raising these significant governance weaknesses in writing with the members of the Board, the Appointed Auditor also had to modify his published audit opinion on the Drainage Board's 2006-07 accounts as these did not include the required Statement on Internal Control and the Board did not have appropriate internal control arrangements to enable it to include a Statement on Internal Control in its financial statements.

**Reflections on the external audit work performed at the Drainage Board:**

16. In conducting his audit of the Drainage Board, the Appointed Auditor is required to comply with internationally recognised auditing standards. The requirements of these standards are both extensive and prescriptive, but they are also narrowly focused on ensuring that the financial statements of the audited body are true and fair.
17. Whilst the Appointed Auditor did identify governance weaknesses and deficiencies which were reported to the Board (who have responsibility for the governance of the Drainage Board), the main focus of the audit work undertaken was on the accounts of the Drainage Board, in accordance with both the auditing standards and also the legislative requirements. It was the accumulation of the various governance issues, together with the subsequent whistle blowing allegations that provided the basis for the very significant additional audit work that was undertaken to produce the published Report in the Public Interest.
18. Further to the publication of the Report in the Public Interest and other widely publicised failings relating to governance matters at other public sector bodies (which have often been triggered by whistle-blowing disclosures), the Auditor General and the Wales Audit Office have recognised the potential benefits of augmenting our core financial audit approach to provide a greater emphasis on governance-related matters. This increased focus on governance topics features as a core theme in the Auditor's General recently published Corporate Strategy for 2013 to 2016, copies of which have already been provided to the Committee.
19. The investigation leading to the Report in the Public Interest was far more extensive than would be the case in conducting an annual audit of the financial statements. The investigation involved looking at issues which would not normally be considered by the auditor when providing an audit opinion on the financial statements. Examples of these include a range of non-material items such as subscriptions to external bodies, time off in lieu arrangements etc. Such matters would not be examined by the auditor during the normal course of an audit.
20. As part of our normal audit process we have conducted a post-project learning exercise to establish whether there are matters which need to be addressed in the way in which we conduct our audits of smaller bodies, both in terms of our audit approach and our staff training.

21. The Report in the Public Interest identified a fundamental breakdown of the Board's governance arrangements. Whilst the external audit had identified and reported upon various governance deficiencies throughout the period 2005-06 to 2009-10, we have considered whether there was opportunity to have drawn together these issues earlier in a holistic way. We have identified several obstacles that combined to prevent this from occurring:

- the focus of the external audit work primarily on the financial statements, rather than also covering governance matters in depth, as referred to earlier in this note;
- throughout the period from 2005-06, the former Clerk and Engineer had placed significant pressure on the external audit team in respect of audit fees. In hindsight, it raises the question as to whether this was done to limit the extent of the audit that was undertaken, given the deficiencies that existed and which were only identified as part of the Report in the Public Interest work;
- in common with the findings of the Financial Reporting Council in respect of quality reviews of private sector external audit firms throughout the UK, professional auditor scepticism at all levels within audit teams can be improved through staff training and also by providing greater auditor challenge to management representations provided during the course of the audit;
- procedures for following up key issues raised in previous year's audits can be enhanced and more robustly documented. This could include specifying the impact of previously identified weaknesses in our Audit Strategy. For example, where there are concerns in relation to key governance or high level financial controls this is likely to result in a more transactional based audit.
- The implicit assumption that the audits of small bodies are inherently of lower risk is not necessarily the case, and our approach to the audit of small bodies needs to be modified as a result; and
- Our portfolio of smaller audits needs to feature more prominently in future within our 'cold review' quality assurance arrangements.

#### **Report in the Public Interest process:**

22. In April 2011 the Welsh Government passed files of information to the auditor containing issues and allegations which had been raised by members of staff of the Board. Further information was subsequently passed to the auditor by a member of the Board. Whilst a number of the issues raised were relevant to the audit, other issues did not fall within the statutory remit of the auditor, for example, the conduct of internal disciplinary proceedings and alleged breaches of health and safety regulations. Having reviewed all of the information the auditor considered that a number of issues should be investigated as part of his audit. An investigation was commenced and it became apparent that there were a number of issues which needed to be addressed by the Board in short term. In September 2011, the key matters which the Board needed to address were communicated in writing to the Board's Interim General Manager. This was to ensure that timely action could be taken by the Board on these issues prior to the publication of any formal audit report. Verbal updates to Welsh Government officials were also provided throughout the period.

23. The investigation itself was extensive and involved interviewing key individuals and review of numerous Board documents. The auditor sought to ensure that all his conclusions were robust, evidence based and free from bias. In August 2012 the auditor sent a draft consideration document to all relevant parties seeking confirmation of the factual accuracy of its contents. All representations were carefully considered and the document was amended where the Appointed Auditor considered it appropriate.
24. In his evidence to the Committee Mr Jackson Johns presented a letter from himself to the auditor stating that the report was 'superficial, unbalanced, inaccurate and not objective both in contents and conclusions'. As part of the normal reporting process Mr Jackson Johns was provided with a copy of the draft consideration document and invited to identify any factual inaccuracies. In his response to the auditor Mr Jackson Johns did not identify any factual inaccuracies. Appended to this paper is the auditor's response to Mr Jackson Johns.

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