



Supplementary Document
Defence Audit Committee Annual Report 2006-2007

DEFENCE AUDIT COMMITTEE

ANNUAL REPORT 2006-2007

(A paper by the Chair of the Defence Audit Committee)

Introduction

1. Under its terms of reference the Defence Audit Committee is required to report annually to the Accounting Officer in advising him on the Statement on Internal Control he is required to sign as part of the Departmental Resource Accounts. Additionally, the *Corporate Governance Code of Good Practice* mandates central Government departments to report annually on the work of the Audit Committee. This report sets out the Committee's main activities over the year.

2. In reviewing the Department's control and assurance arrangements for 2006-2007 The Committee met 5 times during the year, in November 2006 and January, March, May and June 2007. Copies of the minutes of its meetings were sent to Defence Management Board members, Top Level Budget Command Secretaries and the non-executive Chairs of their audit committees. A number of papers were also considered out-of-committee.

Review of Internal Control Systems 2006-2007

3. The Committee reviewed a number of items in the course of the year in order to assure itself of the adequacy of the Department's internal control arrangements, taking account of its advice to the Accounting Officer in the context of the 2005/06 SIC. These included:

- **Departmental risk and assurance arrangements**, including:
 - the Defence Management Board's approach to Strategic risk management;
 - the Departmental assurance matrix;
 - information assurance processes;
 - Top Level Budget Holders' Risk Management processes, including a review by the Director of Internal Audit of the integrity and effectiveness of risk management processes in place across the Department;
 - the Director of Economic and Statistical Advice's review of Investment Appraisal and Project Evaluation performance across the Department;
 - the results of the Capability Review, and the Defence Management Board's subsequent actions plans; and
 - progress on implementing the Defence Acquisition Change Programme;
- **Internal and external audit of the Department**, including:
 - the Defence Internal Audit Programme and National Audit Office strategy for 2006-2007;
 - an update from the Director of Internal Audit on 'No Assurance' audit findings during the year; and
 - a progress report on implementing the recommendations made as a result of the National Audit Office's review of the management of losses and special payments;
- **Internal reviews of Corporate Governance practice**, in particular the Annual Report setting out the Department's corporate governance arrangements in relation to the Treasury's Code of good practice;
- **Annual stewardship and process owner reports** from:
 - the 2nd Permanent Under Secretary, as the Chair of the Defence Environment and Safety Board (including Scientific risks);

- the Chief of Defence Material (formerly the Chief of Defence Logistics) for the logistics process;
 - the Finance Director for Departmental financial and planning systems;
 - the Deputy Chief of the Defence Staff (Personnel) for Service personnel processes;
 - the Personnel Director for civilian personnel processes;
 - the Director General Media and Communication for the Strategic communications processes;
 - the Director General Security and Safety as the Departmental Security Officer, for security and business continuity;
 - the Director General of Defence Acquisition Policy for acquisition processes;
 - Directors of Operational Capability and of Internal Audit on their programmes and findings over the previous year (including the Defence Fraud Analysis Unit);
 - the Director of Internal Management Consultancy; and
 - from the Director of Performance and Analysis setting out the main conclusions from the review of Top Level Budget Holders' Annual Assurance Reports.
- **The programme for production of the Departmental Resource Accounts for 2006-2007, the Statement on Internal Control for 2006-07 and the Accounts themselves**, in particular the losses statement, to consider whether they contained anything indicative of any systemic control failures.

The Statement on Internal Control Process

4. The Department continued its previous practice to collect information for the Departmental Statement on Internal Control from Top Level Budget organisations. Under this Top Level Budget Holders were asked to provide a brief report, approved by their Audit Committee, to the Accounting Officer, that assured him as appropriate that their management systems were working adequately, and which drew to his attention to any concerns about the operation of governance arrangements, particularly any failures of control that their Audit Committee judged to be significant at Top Level Budget level. They were also asked to provide a table setting out how their Audit Committee addressed specific areas of governance and stewardship to assure itself of the adequacy of the Top Level Budgets' internal control arrangements, and the conclusions it reached. This again ensured a more detailed and transparent central scrutiny of the risk management and assurance arrangement in place across the Department by the Director of Performance and Analysis in cooperation with Defence Internal Audit, including the cross-checking of issues identified in the annual process and stewardship reports against Top Level Budgets' information. This enabled the Committee to take an independent view of the adequacy of risk management and assurance arrangements across the Department and offer substantive advice to the Accounting Officer on the Department's Statement on Internal Control. The current process had been successfully running for two years; the Department will aim to undertake a lessons learnt exercise in the autumn.

Internal Control Issues

5. During the past year the Armed Forces Personnel Administration Agency (AFPAA) achieved three extremely significant milestones by rolling out the Joint Personnel Administration (JPA) system to the Royal Air Force (RAF) from April 2006, the Royal Navy (RN) from November 2006, and the start of the roll out to the Army from the end of March 2007. Initial teething problems with RAF specialist pay and expenses were overcome and the first RN payroll in November 2006 was successful. There are now no systemic problems with the delivery of RAF and RN pay and allowances. However, following RAF go-live a number of concerns about JPA support to Departmental financial and manpower accounting processes, and some weaknesses in AFPAA internal controls were identified. These have had a temporary impact on the Department's ability to exercise full financial control and increased the risk to the timeliness and quality of the

Departmental Resource Accounts. Following identification of these issues, mitigation plans were put into effect and action taken to resolve them meant that full financial control had been re-established before year end. Despite this, the Defence Audit Committee concluded that the issues represented a significant failure in financial control during the year that would need to be included separately in the Statement on Internal Control. AFPAA (now the Service Personnel Veterans Agency) continues to work with the MoD finance community to resolve the outstanding issues.

6. Other than these issues, the Committee is content that the information it reviewed during the year provided sufficient assurance that effective corporate governance arrangements were in place for all other significant risks facing the Department, and that where areas of weakness had been identified, corrective action was in hand. In reaching this conclusion, the Committee was particularly encouraged by the significant developments in Business Continuity Management, especially the implementation of effective policy and processes to ensure that this is an integral part of the management processes undertaken across all areas of the Department. The Committee also commends the work done to date on implementing the Defence Acquisition Change Programme, particularly the development of new Through Life Capability Management processes, new planning and approvals processes and the merger of the Defence Procurement Agency and Defence Logistics Organisation Top Level Budgets in April 2007 to form the new integrated procurement and support organisation: Defence Equipment and Support. On this basis, the Committee endorsed the draft Statement on Internal Control for the Accounting Officer's signature.

Other Business

7. The Committee conducted the annual review of its operations as called for in its Terms of Reference, which included:

- its composition and Terms of Reference;
- the forward business programme up to and including the review of the Department's Statement on Internal Control;
- a revised approach to the Internal Audit Strategy that will enhance its ability to direct the internal audit programme; and
- a review of the consultation draft Handbook for departmental Audit Committees.

The Audit Committee Handbook

8. In July, the Treasury published the Audit Committee Handbook. This sets out the requirement for departmental level audit committees to be established in accordance with the five principles of the Handbook or to set out in the context of the Committee's annual report any areas where internal procedures differ, and why. Overall, the Committee operates broadly within the context of the principles, save for two areas:

- Para 4.4 "***Executive members of the organisation should not be appointed to the Audit Committee. The role of the Executive is to attend, to provide information, and to participate in discussion, either for the whole duration of a meeting or for particular agenda items***"

The Defence Audit Committee membership seeks to be formed of a majority of non-executives, but given the complex nature of defence business it is also essential to have executive military and civilian members. Executives attend on a personal basis and bring with them a wide range of expertise that is essential in supporting the non-executives so that the Defence Audit Committee is able to successfully fulfil its role.

- Para 4.8 (second bullet) ***“All members of Audit Committees should have a clear understanding of how their individual performance will be appraised, including a clear understanding of what would be regarded as unsatisfactory performance and the criteria which would indicate the termination of Audit Committee membership should be considered.”***

The Department has been reviewing the guidance and process for appraising the performance on non-executives, following which better central guidance will be provided to non-executives and those responsible for appraising their performance. The DAC reviewed this guidance in detail during the year and endorsed the Department’s intentions to roll it out across defence on completion, including to the non-executives members of the DAC.