

Corporate governance in central government departments: Code of good practice

July 2005



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This code of good practice for corporate governance in central government departments is issued by the Treasury. It was drawn up under the oversight of a steering group chaired by Professor Sir Andrew Likierman. The Treasury is grateful for the assistance of the members of the group, who were:

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INTRODUCTION

The role of corporate governance

- i. Corporate governance is the way in which organisations are directed and controlled. It defines the distribution of rights and responsibilities among the different stakeholders and participants in the organisation, determines the rules and procedures for making decisions on corporate affairs including the process through which the organisation's objectives are set, and provides the means of attaining those objectives and monitoring performance.
- ii. There is already a great deal of guidance on a variety of aspects of corporate governance, for example in *Government Accounting*, the *Ministerial Code*, the *Civil Service Code* and the *Cabinet Office Toolkit for Boards*. But none provides an overview of the processes and responsibilities within departments. This code is intended to fill that gap.

About this code

- iii. Much of the content of the code will be familiar to those working in or with central government. In particular, nothing in the code is intended to disturb the existing roles and responsibilities of ministers. Ministers lead departments and are responsible for and accountable to Parliament for the actions and policies of their departments. Boards are there to support Ministers in the leadership and running of departments. The material on the operation of boards and the role of non-executive members is largely new, reflecting an agenda which has developed rapidly in recent years and will continue to do so.
- iv. The code has been assembled to guide central government departments, focussing on the role of departmental management boards and how they can support ministers and heads of departments. It does not spell out in detail how departments should approach every aspect of their governance since it is more appropriate for them to make pragmatic decisions against a principled framework to suit their own responsibilities and circumstances. In particular, the code is not intended to cut across any legal obligations or constitutional requirements of departments, nor the special position of the devolved administrations. Some provisions are also different for non-ministerial departments.
- v. The principles and techniques outlined in the code will also prove useful for other parts of central government, other central government bodies and lower tiers of control and management, and in executive agencies. In these cases the code should be applied with adjustments to suit their scale, responsibilities and accountability chains.
- vi. The code is guidance on good practice, building on existing constitutional and statutory practice. Departments should apply its principles flexibly in the context of their own circumstances. As set out in the code (provisions 2.14, 4.2, 5.3 and 6.6), the board of each department should give a clear account of how far it has complied with key aspects of the code, including an explanation of why any alternative approaches have been chosen, such as, overriding legal constraints. This report on the department's corporate governance should form

part of the material accompanying its annual resource accounts. Much of this material is already covered in departments' publications.

Looking ahead

vii. The code is intended to be a living document. It will evolve as practice develops, with the first set of adjustments likely to cover:

- lessons from the financial management reviews which follow the 2004 Spending Review;
- the implications of the efficiency agenda in the 2004 Gershon report;
- the approach to professional skills in the civil service, launched in October 2004.

viii. Looking further ahead, there could be scope for more radical developments in corporate governance practice and in the code. In the meantime departments should consider experimenting with alternative approaches, which could provide useful pointers to future changes to the code. A note on some possible developments is annexed.

ix. The most up to date version of the code will be kept electronically on the Treasury's website, www.hm-treasury.gov.uk.

PARLIAMENTARY ACCOUNTABILITY

PRINCIPLES

1A. The minister in charge of the department is responsible and answerable to Parliament for the exercise of the powers on which the administration of that department depends. He or she has a duty to Parliament to account, and to be held to account, for all the policies, decisions and actions of the department including its executive agencies.

1B. Under the minister, the head of the department, as its Accounting Officer, is also personally responsible and accountable to Parliament for the management and organisation of the department, including the use of public money and the stewardship of its assets.

Supporting provisions

1.1 The minister in charge of the department may devolve to his or her junior ministers responsibility for a defined range of departmental work, including Parliamentary business. When ministers devolve such responsibility to other ministers, that delegation should be made in writing.

1.2 In non-ministerial departments, there should be a documented agreement as to which minister(s) should answer for the department's affairs in Parliament, depending on the matter in question. Non-ministerial departments may also be bound by their own specific legislation.

1.3 Where a minister delegates authority to departmental officials or to officials in any agency through which the department operates, there should be a clear definition in writing of the delegation of those responsibilities. Where ministers delegate powers to officials, the decisions taken using these powers remain decisions for which ministers are accountable to Parliament.

1.4 The official at the head of the department is normally appointed as its Accounting Officer (AO). The Accounting Officer should establish and document a clear allocation of responsibilities amongst officials in the department, but he or she retains personal responsibility and accountability to Parliament for:

- propriety and regularity;
- prudent and economical administration;
- avoidance of waste and extravagance;
- efficient and effective use of available resources; and
- the organisation, staffing and management of the department.

1.5 The Accounting Officer is also responsible to Parliament, in respect of the deployment of public money, to consider value for money from the point of view of the wider Exchequer.

1.6 At the request of the departmental Accounting Officer, other senior officials in the department may be appointed as Additional Accounting Officers for certain accounts, Requests for Resources (RfRs), or distinct parts of an Estimate. It is best practice for at least one Additional Accounting Officer to be appointed in larger departments. However, the departmental Accounting Officer retains overall responsibility to Parliament for ensuring a high standard of financial management in the department as a whole.

2

THE BOARD

PRINCIPLE

2. Each department should be managed by an effective board which, within the strategic framework set by the minister (or, in the case of a non-ministerial department, by legislation), supports the head of the department by advising ministers and taking ownership of the department's performance.

Supporting provisions

2.1 Chaired by, under the direction of or with the agreement of the minister, and consistent with the requirements of 1.4, the board should collectively provide leadership in the department and:

- take forward the department's agreed strategic aims and objectives;
- advise on the allocation of its financial and human resources to achieve those aims;
- manage departmental resources, monitoring the achievement of performance objectives;
- set the department's standards and values;
- maintain a transparent system of prudent and effective controls (including internal controls);
- assess and manage risk; and
- lead and oversee the process of change, encouraging innovation, and where appropriate enterprise, to enhance the department's capacity to deliver.

2.2 Board members should take decisions both corporately and objectively, acting in the public interest in keeping with the Nolan principles of public life.

2.3 The board should meet sufficiently regularly to discharge its duties effectively. It should agree a formal schedule of matters reserved for board decision, i.e. those which should not be delegated within the department.

2.4 The board's decisions should be recorded and made available to the department's management. Boards may consider whether members of their own department should be invited to observe all or part of board meetings.

2.5 If the board decides to delegate certain matters for consideration by committees of the board, each of those committees should be chaired by a board member. The board should ensure that it receives adequate feedback on the work of those committees and is able to consider their decisions formally.

2.6 Ministers should consider the best way to run their departments. For example, ministers might chair or sit on the department's board (or special advisers on behalf of ministers might attend board meetings). The appropriate

mechanism will depend on the work of the department and the degree of delegation from ministers to officials.

2.7 Where members of the board have concerns which cannot be resolved about the running of the department or a proposed action, they should ensure that their concerns are recorded in the minutes. This might occur, for example, in the rare circumstance in which the Chair of the board considers it necessary to depart from the collective view of the board.

2.8 There should be a formal, rigorous and transparent procedure for appointing new members of the board (both officials and non-executives). Appointments should be made on merit and against objective criteria. On joining the board, new members should receive appropriate induction in the board's responsibilities and procedures.

2.9 The board should consider appointing as members of the departmental board one or more senior officials from significant agencies or any non-departmental public bodies (NDPBs) through which it conducts its business.

2.10 The board should satisfy itself that it is supplied in a timely manner with information in a form and quality appropriate to enable it to discharge its duties in respect of all the activities of the department, including the work of executive agencies and arms' length bodies (see section 6). Such information will depend on the matters which it has determined should be reserved for board decision, but should include reports of:

- monthly management accounting information relating to the actual use of financial and human resource as well as periodic in-year forecasts of the expected out-turn against financial budgets of resource and capital expenditure, of income and of salient balance sheet information;
- progress in relation to outputs and outcomes (performance targets); and
- the identification and management of risk.

2.11 Board members should have access to the advice and services of a dedicated board secretariat, which should be responsible for ensuring compliance with board procedures.

2.12 Board members should be required to notify and register with the board secretariat (for example in a register of interests) any issues on which they might have a conflict of interest. The board as a whole should consider how it should discuss the matter(s) on which a member may have a conflict.

2.13 The board should undertake an annual evaluation of its performance. At least every two years, it should formally consider its remit, constitution and operating procedures.

2.14 The department should report annually on how the board operates, including a high level statement of which types of decision are to be taken by the board and which may be delegated. This report should refer, if relevant, to the existence, responsibilities and work of any committees of the board.

PRINCIPLE**3. The board's membership should have a balance of skills and experience appropriate to directing the business of the department.****Supporting provisions**

3.1 The board should be a team providing corporate leadership to the organisation as a whole, not merely a collection of individuals responsible for separate parts of the business.

3.2 Depending on the department's strategic aims, there should be amongst the board team an appropriate balance, which should be periodically reviewed, of:

- people skilled in leadership and management of change;
- policy experts with in-depth knowledge of the department's areas of policy, including expertise in strategy formulation, development, evaluation and communication;
- people with skills in operational delivery, and process excellence; and
- people with corporate services skills, including human resources management, information systems and technology, and communications.

3.3 In addition, the board should include members with skills in the measurement and management of performance and financial resources. By December 2006, the board should include a professional Finance Director, whose responsibilities should include advising the head of the department and all members of the board in the financial management of the department's operations.

3.4 Building on their experience, board members should undertake continuous professional development to ensure that they maintain the necessary level of skill and expertise, both as individuals and as a group.

3.5 The board should consider succession management and talent development. This should include how to harness talent from outside government to bring in wider experience and broader perspectives.

3.6 The board should satisfy itself that plans are in place for orderly succession to the board and to senior management positions, so as to maintain an appropriate balance of skills and experience within the department and the board. These arrangements should also ensure that board members, both executive and non-executive, are periodically considered for reappointment, normally every four years.

4

INDEPENDENT NON-EXECUTIVES

PRINCIPLE

4. The board should include independent non-executive members to ensure that executive members are supported and constructively challenged in their role.

Supporting provisions

4.1 It is important to ensure that no individual or small group of individuals can dominate the board's decision-making and that the board can draw upon a wide range of experience. There should therefore be a reasonable balance on the board of both executive members and independent non-executive members. There should be a minimum of two independent non-executive members, ideally more.

4.2 The board should identify in the annual report each non-executive member it considers to be independent. The board should determine whether the member is independent in character and judgement and whether there are relationships which could affect the member's judgement. The board should state its reasons if it determines that a member is independent notwithstanding the existence of relationships or circumstances which may make it appear to the contrary. For example, in certain circumstances, it may be possible for the board to determine that a senior executive of a department's NDPB (see provision 2.9) in fact operates in an independent capacity on the department board.

4.3 Independent non-executive members should be prepared to offer constructive challenge across all the board's business with a view to ensuring that all aspects of strategy and delivery of policy are scrutinised for effectiveness and efficiency. They should in particular:

- be involved in the monitoring of performance and progress of the department, including the use of human and financial resource;
- maintain a critical overview of the department's financial controls and procedures for assessing and managing risk, drawing on their wider experience; and
- depending on the responsibilities of the department, challenge the quality of the policy formulation process.

4.4 As for all board members, independent non-executive members should be selected through a rigorous, open and transparent recruitment process. They should be appointed by the head of department, to whom they are accountable for their performance, following ratification of the selection by the board as a whole. Other than in non-ministerial departments, these appointments should be made in consultation and agreement with the minister in charge of the department.

4.5 On appointment an independent non-executive should be:

- provided with written terms of reference including the specification of his or her role, line of accountability and terms of appointment;
- informed how his or her performance will be appraised; and
- given an induction programme covering not only the organisation but also the government environment as a whole.

4.6 The head of department should hold meetings periodically with the independent non-executive members as a group, without the executives present. Non-executive members may propose that they should have the opportunity to meet ministers periodically, without executive members present, to discuss the work of the board.

4.7 Independent non-executive board members should ensure that appropriate arrangements are in place to allow staff in the department a channel to raise concerns outside the normal line management chain.

5

INTERNAL CONTROLS

PRINCIPLE

5. The board should ensure that effective arrangements are in place to provide assurance on risk management, governance and internal control. In this respect, the board should be independently advised by:

- **an audit committee chaired by an independent non-executive member;**
- **an internal audit service operating in accordance with Government Internal Audit Standards.**

Supporting provisions

5.1 The board should assure itself on the effectiveness of the department's internal control and risk management. The board should establish:

- a proper framework of prudent and effective controls, so that risks can be assessed, managed and taken prudently;
- clear accountability for managing risks; and
- that managers are equipped with relevant skills and guidance.

5.2 The board should establish an audit committee, of at least three members. The chairman of the committee should be an independent non-executive member of the board and at least one of the committee members should have recent and relevant financial experience. The audit committee should be established and function in accordance with the Audit Committee Handbook.

5.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available publicly. The department should report annually on the work of the committee in discharging those responsibilities.

6

ARM'S LENGTH BODIES

PRINCIPLE

6. Where part of the business of the department is conducted with and through arm's length bodies¹ (ALBs), the department's board should ensure that there are robust governance arrangements with each ALB board, setting out the terms of their relationship, in order to promote high performance and safeguard propriety and regularity.

Supporting provisions

6.1 The board should ensure that the department has a written agreement with each of the department's ALBs, setting out a clear definition of how their relationship should work. These documents should reflect the increased emphasis on departments conducting business with and through partnership organisations. Each departmental agreement with an ALB should be drawn up to suit the ALB's legal standing and the environment in which it operates.

6.2 The agreement document should be reviewed and updated periodically. It should include clear information about:

- shared aims and performance targets;
- arrangements for reporting and consultation in order to ensure that the department board receives information enabling it to monitor the areas specified in paragraph 2.10; and
- where relevant, the process of board and senior management appointments in the ALB.

6.3 Departments may adopt a variety of supplementary arrangements in practice to manage these relationships. For example, senior members of ALBs may be members of, or observers on, departmental boards in their capacity as stakeholders; similarly, departmental board members may be members of the boards of ALBs.

6.4 The department's relationship with ALBs should reflect the department board's assessment of the ALB's ability to manage its risks, including those relating to delivery and financial management. The aim should be to ensure that the department's monitoring of and intervention with its ALBs is targeted on the most significant risks.

6.5 In the case of companies or other entities in which the department has a controlling shareholding, the departmental board will need to distinguish between the department's role as a shareholder and any other business relationship it or other departments may have with the company (for example as customer). This can prove an effective method of making subsidies transparent and clarifying conflicting policy objectives.

¹ The term "arm's length bodies" is taken to include a department's NDPBs and public corporations. There may also be value in considering the department's relationship with, for example, PPP and PFI partners.

6.6 The department should report annually on the overall arrangements it has in place for promoting sound working relationships with its ALBs.

A

DEVELOPING THE CORPORATE GOVERNANCE AGENDA IN CENTRAL GOVERNMENT

A.1 This annex discusses some possible developments in corporate governance in central government departments. These were briefly considered by the steering group in its deliberations, but the conclusion was reached that further work was necessary before the ideas could be included in a code of governance.

A.2 The following discussion is offered to help departments consider how further to develop their own corporate governance arrangements and potentially take some of these forward on a trial basis.

Role of the Board

A.3 The role of the Accounting Officer originates from the Gladstonian reforms of the 1860's. It provides for accountability to Parliament for every aspect of the Accounting Officer's responsibilities. The principle of clear Parliamentary accountability is not in question, but departments are now of a complexity little imagined over a century ago. As management becomes increasingly professional and departmental boards assume greater responsibilities, the question of whether accountability to Parliament is best served through an unchanged Accounting Officer role deserves continuing discussion.

A.4 Most radically, it is for discussion whether, under the direction of the minister, the board collectively could take responsibility for the day to day management of the department. The responsibility of the head of department to report to the Public Accounts Committee might be as the board's chair/representative. This approach would require some changes in the terms of appointment of heads of departments as Accounting Officers, consistent with the legal requirements (s7 of the Government Resources and Accounts Act 2000) to be responsible for the preparation of the department's resource accounts and their transmission to the Comptroller and Auditor General. This arrangement of responsibilities would not of course supplant the authority of ministers.

A.5 Another option to explore would be to vary the balance and composition of the board. Thus the board might have fewer executives and more non-executive members. There might also be a limit on the number of non-executives who are direct stakeholders (i.e. who have other responsibilities such as management of agencies or NDPBs supporting the department's work). The code could also specify an optimum size for a department's board, to help prevent unwieldy arrangements which may impede efficient decision-making.

A.6 Another potential future development, in the interests of openness and transparency, would be for departments to report annually on the number of meetings of the board and its subcommittees, and board members' attendance at each.

Executive Board members

A.7 Departments could make a number of specific functional appointments in addition to the finance director. These might include a chief operating officer and certain heads of profession. This approach might be a way of reinforcing the professionalisation of the civil service.

A.8 Departments could go further and specify that some of these executive appointments should be AAOs. At the moment AAOs are appointed with responsibility for named sections of the department's work, with only the head of department as Principal Accounting Officer being answerable to Parliament for the whole of the department's remit. But there is also a case for recognising the specialised department wide responsibilities of some executive appointments.

Non-executive Board members

A.9 The code sets a fairly liberal definition of independence for non-executives. Departments could draw it more stringently, adapting the definitions of independence in the Higgs report, and in the *Combined Code* for listed companies.

A.10 The procedure for appointing non-executives could also become even more transparent. One possibility would be for an appointments sub-committee to make recommendations to ministers, considering only candidates selected through open advertisement or by using a headhunter.

A.11 Consistent with strengthening the position of the non-executives, there could be a senior independent director tasked with specific responsibilities. Among these could be leading the other non-executive members in reporting to ministers, say annually, on the effectiveness of the board, and possibly the effectiveness of individual members of the board. These reports could be copied both to the head of department and to the Cabinet Secretary.

A.12 Board appraisal is covered in more detail in Lynton Barker's report on Board effectiveness in NDPBs. This could be taken forward by the audit committee. The department could report annually on how this appraisal has been done, and there could be external validation.

A.13 Some or all of the other non-executives could have specific responsibilities either jointly or severally. These could include liaison with the department's stakeholders, including the department's staff (and their representatives), as appropriate, to build confidence and enhance the department's credibility. The feedback mechanism from different stakeholders could also be specified, for example by requiring regular meetings between non-executives and staff, and/or inviting the department's external stakeholders to provide input direct to the non-executives about the department's performance.

A.14 This annex is not intended to restrict departments in developing their corporate governance. It may be appropriate and valuable to experiment with other models of corporate governance in central government departments within the guiding principles established in the code.