Circular **04/07**

For Information

Audit

Audit Code of Practice

Summary

This circular introduces the Audit Code of Practice (the code) for the post-16 education and training sector. The code is effective until further notice and supersedes the Interim Audit Code of Practice set out in Learning and Skills Council (LSC) Circular 03/04. This circular also reports on the outcomes of the consultation on changes to the audit requirements for further education (FE) colleges set out in a letter dated 28 June 2004.

This circular is of interest to management, governors and auditors of FE colleges and providers within the post-16 education and training sector that are funded by the LSC, to Executive Directors and Finance Directors at local Learning and Skills Councils (local LSCs), and to LSC provider financial assurance staff.

In this circular, the date style 2003-04 indicates a financial year, and 2003/04 indicates the academic year.

Supersedes

This circular supersedes Circular 03/04.

December 2004

Learning+Skills Council

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A Membership of Working Groups

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Executive Summary

Date: December 2004

Subject: The purpose of this circular is to introduce the revised Audit Code of Practice (the code) that applies to the post-16 education and training sector until further notice. The code includes the mandatory audit arrangements for further education (FE) colleges as well as summarizing the audit arrangements for the LSC's principal funding of other providers.

This circular also reports on the outcome of consultation set out in a letter to FE colleges dated 28 June 2004. That letter consulted on changes to the mandatory audit requirements for FE colleges resulting from the introduction of plan-led funding and regularity audit. Some minor changes to the code have also arisen as a result of the internal reorganization of the Learning and Skills Council (LSC). The code reflects the majority of the comments received and is effective from 1 August 2004.

Intended recipients: This circular and the code will be of interest to all providers of education and training in the post-16 sector, including those working in FE colleges and sixth form colleges, and those providing work- based learning and adult and community learning (ACL) provision.
The code is recommended for senior management, members of management teams and governors and auditors of learning providers that receive LSC funding.
Other recipients include Executive Directors and Finance Directors at local Learning and Skills Councils (local LSCs), LSC provider financial assurance staff and other bodies with an interest in audit such as the Higher Education Funding Council for England (HEFCE).

Status: For information and action.

Audit Code of Practice

Introduction

1 This circular introduces the revised Audit Code of Practice (the code) and reports the outcomes of the consultation with further education (FE) colleges set out in a letter to all college principals dated 28 June 2004.

2 Two working groups have been liaising with the Learning and Skills Council (LSC) on the code and considering the proposals for further developments. The Audit Code of Practice Working Group included representatives from the Association of Colleges (AoC) and the Association of College Registrars and Administrators (ACRA), the Department for Education and Skills (DfES), the National Audit Office (NAO) and auditing firms. The Internal Audit Working Group included representatives of FE college internal audit services.

3 The Audit Code of Practice Working Group and the Internal Audit Working Group each met on two occasions. Both groups considered the consultation proposals and responses, and the views expressed have influenced the code. Membership of the two groups is given in Annex A. The LSC thanks both working groups for their contribution. The LSC has also worked with the AoC in presenting these changes to FE colleges at recent seminars and has gained further views from colleges at these and other events.

Structure

4 The main body of this circular provides an introduction and background to the code and the consultation that preceded it.

5 Supplement A contains the code. Supplement B includes model documents for adoption under the code by FE college audit committees, their internal audit service and financial statements auditors (also known as "external" auditors).

Guidance on changes

6 As with the Interim Audit Code of Practice (the interim code), this code focuses on mandatory audit requirements for FE colleges and those model documents needed to meet these mandatory requirements. Supplementary guidance notes to the interim code, which are also applicable to this version of the code, were published jointly with the AoC and ACRA in October 2003. The major changes in this version of the code relate to the introduction of plan-led funding from 2004/05 and the resultant effects on the assurance regime.

7 The other changes to the code have resulted from the internal reorganization of the LSC. The Provider Financial Assurance (PFA) Service Centre is now organized into nine regions. Where audit reports were previously submitted to the heads of PFA of local LSCs, these should now be sent to Regional Audit Managers. This is detailed in the body of the code.

8 FE colleges and providers with queries on how to apply the code may also wish to consult their auditors or the LSC.
The LSC can be contacted by email at audit.code@lsc.gov.uk or by telephone to the Regional Audit Manager of the PFA Service Centre. Contact details for Regional Audit Managers are detailed on the LSC's website (www.lsc.gov.uk/National/Documents/SubjectListing/FundingLearning/ProviderFinance/ProviderFinancialAssurance/Contactdetails.htm).

Future developments

9 The LSC intends to keep the operation of the code under review and will consult interested parties before making any significant amendments.

10 Audit arrangements are a direct product of the LSC's terms and conditions of funding and the LSC is working to harmonize these arrangements as far as possible. The LSC intends to integrate its harmonized audit arrangements into later versions of the code, so that the code will eventually be a condition of funding for all providers.

11 During 2004-05, the LSC plans to pilot plan-led funding in respect of work-based learning (WBL) provision that takes place at colleges. This would end the need for a year-end reconciliation and recovery process and would therefore have significant implications for both funding and assurance arrangements. In such cases, this funding could be covered totally by the regularity audit and no detailed WBL funding audit would be necessary. The LSC is further seeking to pilot the end of reconciliation and recovery, and associated funding audit, with commercial and charitable providers. This change would require these providers to be funded under grant and hence be subject to regularity audit.

Background

Accountability

12 In issuing the interim code in Circular 03/04, the LSC highlighted that the accountability arrangements expressed in the interim code were changing and would continue to change as the LSC harmonized its terms and conditions of funding. Circular 03/04 also noted the LSC's work to that date in reducing bureaucracy. Since the interim code has been issued, the LSC has made major changes to its FE funding methodology and progress in reducing bureaucracy. These changes permit and require major changes to the LSC's audit requirements of FE colleges. These changes are underpinned by a move from detection and control by the LSC over colleges' financial delivery, to a trust-based relationship of college governors and managers taking responsibility for the open and transparent spending of LSC funds.

Reducing bureaucracy

13 In autumn 2001, the LSC established the Bureaucracy Task Force (BTF) chaired by Sir George Sweeney, a Council member and the principal of Knowsley Community College. The BTF's remit, in its first year of work, was to review the burden of bureaucracy on FE colleges. It reported its findings in November 2002.

14 One area the BTF considered at length was the audit of FE colleges. Its members raised significant concerns about the extent and frequency of audit of colleges, particularly funding audit. Many colleges commented that they were spending significant additional resources that they would not otherwise spend, on servicing the funding audit. The BTF accepted that the extent of FE college funding audit was largely a direct product of the nature of the funding methodology. The LSC was able to make some progress in reducing funding audit even under the funding methodology inherited from the Further Education Funding Council (FEFC). Thus in 2002/03, as a response to the findings of the BTF, 20 pilot colleges were taken out of full funding audit. A further 97 pathfinder colleges were taken out of full funding audit in 2003/04.

15 Further reductions in funding audit depended on the introduction of plan-led funding for the majority of colleges and this has happened in 2004/05. Plan-led funding has meant an end to the automatic year-end reconciliation and clawback process and hence an end to funding audit for most colleges. The cessation of funding audit and the introduction of regularity audit in 2004/05 has

resulted in the lightest touch audit regime that FE colleges have seen since the incorporation of colleges in 1993 (see Table 1). The new audit regime will save significant funds previously spent by the LSC on funding audit work at colleges. The new audit regime will also save the additional resources colleges reported to the BTF, and elsewhere, as being required to service a detailed funding audit. These savings, in terms of time, cost and management distraction, will now be available for learning provision.

Table 1: Significant audit arrangements for FE colleges, 1993 to 2004.

Audit type	Period		
	1993 to 2000	2000 to 2004	2004/5
Internal	Yes, appointed by college	Yes, appointed by college	Yes, appointed by college
Financial statements	Yes, appointed by college	Yes, appointed by college	Yes, appointed by college
Regularity	Yes, appointed by college	Yes, appointed by college	Yes, appointed by college
Funding (Individualized Learner Record)	Yes, appointed by college	Yes, appointed by LSC	Only at colleges not yet in plan-led funding

16 The LSC recognizes that while plan-led funding has changed risks to both the LSC and to colleges as set out below, some risks under the FEFC's funding methodology remain. If these risks, old or new, materialize, control through increased audit may be reintroduced. The LSC sees the BTF's principal recommendation, in its May 2004 report *(Extending Trust: A report of the Bureaucracy Task Force)* that colleges regulate themselves, as the key to preventing such a re-imposition of control. Self-regulation is by definition something that the LSC cannot and should not try to do to colleges; it is for colleges themselves to do this. The LSC can, and will, support self-regulation and will make further reductions in audit in line with its introduction, where these reductions can be justified.

17 The assurance regime for colleges set out in the code is close to that present in other parts of the English education sector. The key elements of the regimes for local education authority (LEA)-maintained education providers, higher education (HE) institutions and FE colleges are set out in Table 2.

Table 2: Key elements of audit regimes at providers.

Type of audit	LEA maintained education providers	Higher education institutions	Further education colleges
Financial statements	Through work of Audit Commission	Yes, appointed by HE institution	Yes, appointed by college
Regularity	Through work of Audit Commission	Yes, appointed by HE institution	Yes, appointed by college
Internal	Through the local authority	Yes, appointed by HE institution	Yes, appointed by college
Funding	May be part of internal audit. LSC commissions for schools with sixth forms	Yes, on risk-based cycle performed by HEFCE ("data audit")	For colleges not yet in plan-led funding. Risk-based cycle performed by LSC for remainder

Changes to risk under plan-led funding

18 Between 1994/95 and 2003/04, colleges were funded under a methodology in which money very closely followed the learner. The FEFC, and then the LSC, gave colleges a funding allocation that was the best joint estimate of what activity the college would deliver. Colleges would then deliver learning, and collect data on what they delivered. The LSC paid colleges a monthly profile on account against the total allocation for the year. Colleges converted that part of the data that had funding implications into a money value, using the LSC's national rates for each element of learning. The total money value of delivery was then reconciled to the total allocation paid on account.

19 Colleges submitted a funding claim to the LSC and this funding claim was audited in depth every year. Where a college under-performed against its allocation, the LSC sought to recover unearned funds through clawback. Where a college over-performed against its allocation, the LSC may have funded this over-delivery.

20 This funding relationship meant that the LSC's expenditure figure in its own financial statements varied according to how much colleges delivered. Also, the LSC had a debtor figure in its accounts for the clawback due from colleges, and a creditor figure for over-performance that the LSC intended to fund. The expenditure and debtor figures were material figures in the LSC's financial disclosures, both by nature and by value.

21 The LSC must demonstrate to its external stakeholders, and in particular the National Audit Office (NAO), that it has sufficient assurance that the figures in the financial statements are true and fair. The LSC therefore required all colleges' funding claims to be audited in depth every year, to prove the accuracy of key figures in the LSC's own financial statements.

22 Plan-led funding breaks the automatic link between funding and performance. The LSC assumes a college's total allocation for a year to be fixed. The LSC will change the allocation, by negotiated agreement, where a college is performing at a different level

from the allocation. These negotiations are informed, but not dictated by, the value of earnings calculated by actual delivery through data with funding implications. The LSC therefore no longer requires an annual funding audit of every college's funding claim, as the LSC's own financial statements are subject to less uncertainty. It is sufficient for the LSC to gain most of its financial assurance over the value of colleges' spending of LSC funds, through colleges' own assurances to the LSC and through regularity audit. In respect of colleges' internal control, the LSC again gains assurance from colleges direct and through the work of college internal audit services.

The importance of the regularity audit

23 Regularity audit has been in place for all FE colleges since 1993/94, and previously, when colleges were under local government control. Regularity audit is not a new requirement for colleges. Both colleges and the LSC did see regularity audit as having lower importance in informing evidence of the use of public funds, since both had the more significant evidence of the funding audit available to them. In other words, with the funding audit in place, the LSC did not consider it necessary to set out its expectations of regularity audit.

24 With funding audit discontinued for most colleges, the LSC does now need to be sure that regularity audit is performed to a good common standard across all colleges. Regularity audit is now the LSC's key source of assurance over the use of funds.

25 For those colleges where regularity audit has always been of a good standard, the extent of regularity audit is not expected to change significantly. For those colleges where regularity audits may have been done less well in the past, the extent of these audits will increase. Financial statements auditors will also seek to rely on the work on key financial systems carried out by internal auditors and other auditors. This would reduce the level of regularity audit work.

26 Many colleges are now compensating for the end of funding audit and the assurance it gave colleges and managers on the college's main income line, LSC funding. In particular, funding audit is now acknowledged by many colleges to have given them a high standard of assurance on their internal control over their key learner numbers systems. Understandably, colleges are now looking to their internal auditors, their financial statements auditors or other consultants, to give them this assurance.

Colleges' management of risk

27 The LSC considers that this properly allows colleges to manage risk by reviewing all controls and sources of assurance available to them, and adding assurance where risks are not managed. Colleges will make their own decisions to appoint additional audit or other consultancy work to this end. The extent and cost of this work will be for colleges and not the LSC to decide. Under funding audit, the LSC effectively made this decision for colleges.

28 Where colleges are making decisions about the need for additional assurance, it should be recognized that the risk to colleges' income lines has changed and that levels of assurance based on matching the past regime may no longer be needed. The LSC does not intend to automatically claw back for under-performance for colleges in plan-led funding in 2004/05 onwards. The uncertainty, and hence immediate risk, to colleges' main income line of the chain of accountability from individual learner events, through data, conversion into funding, precise reconciliation, audit and automatic clawback, is no longer present. Colleges should therefore consider the changed nature of risk in their LSC income line and whether, and to what extent, it is necessary to appoint auditors or consultants to address financial risks present before plan-led funding.

Addressing residual risks

29 Although the LSC will no longer require reconciliation and audit against its detailed funding methodology, it does not have the power to waive its legal responsibilities, and nor can it ignore commonsense tests of existence. The LSC has to continue to address risks of misapplication of funds against these two tests.

30 To tackle these residual risks of learner non-existence and ineligibility, the LSC will devise a programme of work that is in direct and marked proportion to risk. Under plan-led funding, those colleges that manage their provision well will only need minimal and infrequent coverage of residual risks to existence and eligibility. HEFCE practice suggests that this might be on a cycle of several years. Where the LSC identifies higher risk provision at a college, this provision will be subject to more frequent audit, possibly as frequently as annually for the highest risk provision.

31 Such reviews of funding data are not assumed to lead automatically to financial recovery by the LSC from colleges. The key test will be, as for regularity audit, whether there has been any actual loss to the public purse through the mis-spending of LSC funds. Again, the LSC does not normally intend to extrapolate the results of its reviews retrospectively to all the years between those reviews, unless there is exceptional evidence of deliberate irregularity and impropriety.

Regularity audit

32 The introduction of regularity audit has implications for all college auditors. The work will be carried out by financial statements auditors, based on a self-assessment questionnaire. Regularity audit will be carried out in two stages, interim (reporting to 31 March) and final (reporting to 31 July). The LSC is seeking a duty of care over this work through a three-way relationship, although colleges should note that the LSC does not wish to become involved in any other part of the audit assignment, for example, discussions over numbers of audit days or audit fees. The LSC is working with audit firms and the Institute of Chartered Accountants in England and Wales to produce a model letter of engagement for auditors to use. This will be published as soon as it is finalized. There will be a letter of engagement between the college and the financial statements auditor that will refer to the duty of care owed to the LSC by the auditor in respect of regularity audit. There will be a second letter between the financial statements auditor and the LSC, giving a formal duty of care over the regularity audit work at all of their client colleges.

33 The LSC is in the process of finalizing the regularity audit framework within which financial statements auditors will be expected to operate. Five regularity audit pilots have taken place and these were completed in November 2004. Following the completion of these pilots, the LSC will finalize and publish the regularity audit framework.

34 Historically, there have been very few instances of college financial statements auditors reporting irregularity or impropriety in the use of public funds. The LSC does not expect a significant increase in the reporting of irregularity as a result of these changes, although the need to report continues to be a matter of judgement by regularity auditors.

Charitable status of colleges

35 The draft Charities Bill (the Bill), published in May 2004, potentially places further requirements on the LSC as primary regulator of exempt charities in the FE sector. In particular, the Bill highlights the requirement for colleges, and the LSC as regulator, to be concerned with the application of their assets regardless of their source. This reflects the ethos that there should be no distinction in the sources of

income when considering how a college spends its funds. This is unlikely, therefore, to have a significant impact on the scope of regularity audit work as the proposals cover all expenditure, regardless of the source. If the draft Bill progresses to statute, the LSC will be formally concerned that the regulatory framework embraces college funds from all sources and that colleges comply with all aspects of charity law.

Responses to Consultation

36 The LSC received 151 responses to the consultation letter dated 28 June 2004. The LSC thanks respondents for contributing to the consultation process. Responses were received from:

- the AoC
- ACRA London Region
- the DfES
- the Higher Education Funding Council for Wales (HEFCW) and Education and Learning Wales (ELWa)
- 130 FE colleges, including governing bodies, audit committees, clerks to the governing bodies, principals and finance directors
- one HE institution
- 15 accountancy firms and internal audit providers
- the Chartered Institute of Public Finance and Accountability (CIPFA).

37 A summary of the responses to the consultation and the response from the LSC is attached at Annex B.

38 The code incorporates changes arising from responses to the consultation, most of which relate to the changes resulting from the introduction of plan-led funding.

Mark Haysom
Chief Executive, LSC

Annex A: Membership of Working Groups

Audit Code of Practice Working Group

David Coates*	Clerk to the Corporation, The People's College Nottingham, West Nottinghamshire College and East Riding College; member of the Association of Colleges and Association of College Registrars and Administrators Steering Committee
Patrick Green	Partner, Bentley Jennison
Karen Hagan*	Finance Director, Somerset College of Arts and Technology; Vice-chair, Colleges Finance Directors Group
Russell Harrod	Audit Manager, National Audit Office
Ian Mason	Audit Policy Manager, Learning and Skills Council
Louise Mellor	Director, Assurance Policy, Learning and Skills Council
Peter Newson	Director, External Assurance, Learning and Skills Council
Steve Passmore	Regional Audit Manager, Learning and Skills Council
Mike Rowley	Director, KPMG LLP
Adrian Rutter	Director, Risk and Assurance Services Tenon Ltd; Director, Public Sector Services Blueprint Audit Ltd
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Matthew Hodge	Senior Manager, PricewaterhouseCoopers
David Morris	Manager, MacIntyre Hudson
Robin Pritchard	Partner, Pritchard Wood
Adrian Rutter	Director, Risk and Assurance Services Tenon Ltd Director, Public Sector Services Blueprint Audit Ltd
Karen Shaw	Manager, Hampshire Audit Services
Ian Stafford	Principal Auditor, Learning and Skills Council
Rob Turton	Partner, BDO Stoy Hayward

Annex B: Responses to Consultation

Consultation area	Supportive %	Not supportive %	Other/no view %	Comments
Learner existence and eligibility				
1 The LSC intends to cover the risks of learner non-existence and ineligibility through a risk-based programme of work. Please comment on the implementation of this approach.	89	2	9	*Supportive responses recognized that residual risks flagged up by funding audit need to be covered. Some respondents wished to see further details of the proposed programme of work, and were concerned at the possible duplication of internal audit work.* The LSC is still developing its approach to learner existence and eligibility work and will keep colleges informed. It will be designed to minimize any duplication of work.
Regularity audit				
2 Do you agree that regularity audit should be based on a college self-assessment process that can then be used to contribute to other audit work, minimizing the duplication of audit work and associated costs?.	92	3	5	*This was strongly supported. Respondents commented that the self-assessment process should not create extra burdens on colleges and guidance should be provided to ensure that self-assessment is consistent across colleges.* The LSC will bear these points in mind as it develops the regularity audit framework. In particular, it will aim to eliminate duplication between the regularity audit and the financial management and governance reviews undertaken by the Provider Financial Assurance Service Centre alongside inspections.

Consultation area	Supportive %	Not supportive %	Other/no view %	Comments
3 Do you agree that colleges should, as part of their corporate governance responsibility statements, give the LSC assurances on the colleges' proper and regular use of funds based on all evidence available to the college (including the regularity audit self-assessment)?	90	7	3	*This was strongly supported*
4 Do you agree that college financial statements auditors should deliver annual independent assurance on colleges' regular and proper use of LSC and other funds? If not, which is your preferred option?	90	7	3	This approach was strongly supported, with some comments that the duty of care issue needs to be resolved so that the financial statements auditors are able to provide assurance to the LSC. This has been adopted in the code.

Consultation area	Supportive %	Not supportive %	Other/no view %	Comments
5 Do you agree that the LSC should secure its duty of care for regularity audit opinions by becoming a party to the letter of engagement between colleges and their financial statements auditors?	68	24	8	*This proposal was largely supported. Some respondents queried the necessity for it; others asked whether audit firms would be willing to enter such a tripartite arrangement. Others expressed concern that the auditors' accountability would be blurred and a precedent would be set for the LSC to instruct colleges' advisers. Most of the "not supportive" responses were concerned that the LSC would be taking away some of colleges' independence.* The LSC is working with audit firms and the Institute of Chartered Accountants in England and Wales to develop some mutually acceptable wording for the letter of engagement. The LSC is not seeking to reduce colleges' independence: it does not seek to become involved in discussions over audit days and fees.
Internal audit				
6 Do you think that the LSC should prescribe the level of coverage of colleges' learner numbers systems by college internal auditors?	22	71	7	*This proposal was in general not supported. Respondents commented that colleges are not all the same and the level of coverage is best left to internal auditors who are able to plan according to colleges' individual circumstances.* This proposal has not been adopted in the code. The level of coverage of internal audit work should be a matter for discussion between the college and the internal auditors.
7 Do you think the LSC should require annual coverage of learner numbers by internal auditors?	42	54	4	*Respondents made similar comments in their responses to this question as they did to question 6. Many comments noted that it would in any case be unusual for annual coverage of learner numbers not to be the norm.* This proposal has not been adopted in the code. The internal audit of learner numbers systems should be risk-based rather than an automatic annual process and should be a matter for discussion between the college and the internal auditors.

Notes

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