June 2004/**27**

Accountability and Audit: HEFCE Code of Practice

Annexes

Contents

Annex C

Audit committee: model terms of reference

Introduction

HEFCE has certain mandatory requirements which must be included in the audit committee's terms of reference. However, the other elements of the model terms of reference will often need to be modified to suit local circumstances. The key question for audit committees is whether the arrangements within the institution meet the intentions behind these guidelines. These are that the audit committee is independent; that it has sufficient authority and resources to form an opinion and report on the risk management, control and governance arrangements of the institution; and that it can satisfy itself that the institution has adequate arrangements for ensuring economy, efficiency and effectiveness. The terms of reference should be formally approved by the governing body.

Model terms of reference

Constitution

1. The governing body has established a committee of the governing body known as the audit committee.

Membership

2. The committee and its chair shall be appointed by the governing body, from among its own members, and must consist of members with no executive responsibility for the management of the institution. There shall be no fewer than three members; a quorum shall be at least two members. The chair of the governing body should not be a member of the committee. Members should not have significant interests in the institution.

3. At least one member should have recent and relevant experience in finance, accounting or auditing. The committee may, if it considers it necessary or desirable, co-opt members with particular expertise. No member of the committee may also be a member of the finance committee (or equivalent), unless specifically authorised by the Higher Education Funding Council for England (HEFCE) under the terms of paragraph 73 of the Code.

Attendance at meetings

4. The head of finance (or equivalent), the head of internal audit, and a representative of the external auditors shall normally attend meetings where business relevant to them is to be discussed. However, at least once a year the committee should meet with the external and internal auditors without any officers present.

Frequency of meetings

5. Meetings shall normally be held at least three times each financial year. The external auditors or head of internal audit may request a meeting if they consider it necessary.

Authority

6. The committee is authorised by the governing body to investigate any activity within its terms of reference. It is authorised to seek any information it requires from any employee, and all employees are directed to co-operate with any request made by the committee.

7. The committee is authorised by the governing body to obtain outside legal or other independent professional advice and to secure the attendance of non-members with relevant experience and expertise if it considers this necessary, normally in consultation with the designated officer and/or chairman of the governing body. However, it may not incur direct expenditure in this respect in excess of £xx, without the prior approval of the governing body.

8. The audit committee will review the audit aspects of the draft annual financial statements. These aspects will include the external audit opinion, the statement of members' responsibilities, the statement of internal control and any relevant issue raised in the external auditors' management letter. The committee should, where appropriate, confirm with the internal and external auditors that the effectiveness of the internal control system has been reviewed, and comment on this in its annual report to the governing body.

Duties

9. The duties of the committee shall be:

a. To advise the governing body on the appointment of the external auditors, the audit fee, the provision of any non-audit services by the external auditors and any questions of resignation or dismissal of the external auditors.

b. To discuss if necessary with the external auditors, before the audit begins, the nature and scope of the audit.

c. To discuss with the external auditors problems and reservations arising from the interim and final audits, including a review of the management letter incorporating management responses, and any other matters the external auditors may wish to discuss (in the absence of management where necessary).

d. To consider and advise the governing body on the appointment and terms of engagement of the internal audit service (and the head of internal audit, if applicable), the audit fee, the provision of any non-audit services by the internal auditors and any questions of resignation or dismissal of the internal auditors.

e. To review the internal auditors' audit risk assessment and strategy; to consider major findings of internal audit investigations and management's response; and to promote co-ordination between the internal and external auditors. The committee will ensure that the resources made available for internal audit are sufficient to meet the institution's needs (or make a recommendation to the governing body as appropriate).

f. To keep under review the effectiveness of the risk management, control and governance arrangements, and in particular to review the external auditors' management letter, the internal auditors' annual report, and management responses.

g. To monitor the implementation of agreed audit-based recommendations, from whatever source.

h. To ensure that all significant losses have been properly investigated and that the internal and external auditors, and where appropriate the HEFCE accounting officer, have been informed.

i. To oversee the institution's policy on fraud and irregularity, including being notified of any action taken under that policy.

j. To satisfy itself that satisfactory arrangements are in place to promote economy, efficiency and effectiveness.

k. To receive any relevant reports from the National Audit Office, HEFCE and other organisations.

l. To monitor annually the performance and effectiveness of external and internal auditors, including any matters affecting their objectivity, and to make recommendations to the governing body concerning their reappointment, where appropriate.

m. To consider elements of the annual financial statements in the presence of the external auditors, including the auditors' formal opinion, the statement of members' responsibilities and the statement of internal control, in accordance with HEFCE's Accounts Directions.

n. In the event of the merger or dissolution of the institution, to ensure that the necessary actions are completed, including arranging for a final set of financial statements to be completed and signed.

<u>Reporting procedures</u>

10. The minutes (or a report) of meetings of the committee will be circulated to all members of the governing body.

11. The committee will prepare an annual report covering the institution's financial year and any significant issues up to the date of preparing the report. The report will be addressed to the

governing body and designated officer, summarising the activity for the year. It will give the committee's opinion on the adequacy and effectiveness of the institution's arrangements for the following:

- risk management, control and governance (the risk management element includes the accuracy of the statement of internal control included with the annual statement of accounts)

- economy, efficiency and effectiveness (value for money).

This opinion should be based on the information presented to the committee. The audit committee annual report should normally be submitted to the governing body before the members' responsibility statement in the annual financial statements is signed.

Clerking arrangements

12. The clerk to the audit committee will be the clerk to the governing body (or other appropriate independent individual).

Annex D

Combined Code extract – Audit Committee and Auditors

This is an extract from the Combined Code on Corporate Governance, July 2003 (available at http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf), incorporating recommendations from the Smith and Higgs Reports.

C.3 Audit Committee and Auditors[1]

Main Principle

> **The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.**

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies[2] two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

[1] The Smith guidance suggests means of applying this part of the Code
[2] See footnote 7

- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.[3] A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

[3] See footnote 8

Annex E

Audit committee annual report: a model format

The Code requires each HEI's audit committee to prepare an annual report for submission to its own governing body and subsequently to HEFCE. The audit committee annual report should be supported by the internal audit annual report which would therefore normally accompany it. The annual report should be prepared as early as possible after the end of each financial year, with the aim of it being available before the annual financial statements are signed. The report should be signed and dated by the chair of the committee. This model indicates what could be included in the report. Paragraphs 85 to 88 of the Code indicate the core information requirements.

Title	Full name of institution, Audit Committee Annual Report, financial year. Addressed to governing body and designated officer.
Introduction	Period covered; this should specifically relate to the audit committee's work on the relevant financial year. However, any additional issues should be covered where appropriate, particularly if they affect the opinion. For example where the previous year's annual report could not include something due to timing, or issues have arisen after the year end.
Membership	Names; details of changes and dates thereof; terms of office; identify chair; also separately give details of the clerk to the committee.
Meetings	Dates of meetings and note of attendees.
Terms of reference	If applicable, details of changes and their effect on the work of the committee.
Internal audit	• Name of provider; details of any changes made or due; fee basis; audit committee's assessment of performance for the year (including the use of performance measures and obtaining the views of the external auditors). • Review of appointment; when market testing is due for consideration. • Review of the internal audit annual report (which may be attached to the audit committee annual report); achievement of planned work; consideration of and comment on internal auditors' overall opinion on risk management, control and governance arrangements, and VFM arrangements, as necessary. • Review of audit risk assessment and strategy as appropriate. Number of audit days last year/next year (compare); inclusion of value for money studies. Details of any restrictions placed on the work of the internal auditors. • Review of audit reports (this may appropriately focus on only the more significant issues); audit committee's view of management responses to the findings and recommendations; details of any significant recommendations outstanding. • Review of unplanned or special reports; audit committee's view of management responses to the findings and recommendations; details of any significant recommendations outstanding.

	• Review of VFM studies; summary of important findings and recommendations.
External audit	• Name of provider; details of any changes made or due; fee basis; audit committee's assessment of performance for the year (for example, audit planning, timetable set and met); confirmation to governing body of recommendation of annual re-appointment (or defer this to next meeting); when market testing is due for consideration. • Details of any non-audit services provided. • Review of the external auditors' management letter (draft and final versions where appropriate); significant points arising; audit committee's view of management responses to the findings and recommendations.
Other work done	• Where undertaken, review of specific parts of the annual accounts (preferably between finance committee and the board/council) including members' responsibility and statement of internal control, any relevant issue raised in the management letter and the external auditors' formal annual opinion. • Review of the risk management strategy of the institution. • Other work, including Funding Council reports, letters and other requirements (such as the HEFCE Assurance Service report, student number audit if undertaken, VFM studies; review or changes to the HEFCE Code of Practice); special reports or investigations arising not dealt with elsewhere (for example on fraud or irregularity); review of relevant NAO and other reports; other formal certificates or returns seen; review of Financial Regulations including amendments, communication or recommendations made; issues arising on trusts, joint ventures, subsidiary or associated companies; other VFM work such as a review of VFM strategy. Recommendations made not dealt with elsewhere.
Other	Issues not relevant to the reporting year, such as forthcoming events and issues relating to prior years.
Opinion	The audit committee's opinion on the adequacy and effectiveness of the institution's arrangements for the following: • risk management, control and governance (the risk management element includes the accuracy of the statement of internal control included with the annual statement of accounts) • economy, efficiency and effectiveness (value for money). These opinions should be based on the information presented to the committee.
Circulation	Copy to the HEFCE Assurance Service once approved by the governing body.

Annex F

Procedures for market testing of externally provided internal and external audit

Introduction

1. External testing can be conducted in a number of ways. The most common method is a full tendering exercise. This should be considered for the provision of all externally provided audit services, although it may depend on the institution's financial regulations. Additionally, the GIAS standards say that there should be external quality reviews of internal audit, however it is provided, by appropriately qualified and independent reviewers, at least once every five years. Such an external review might in turn inform the approach to a tendering exercise.

2. Guidance on how tendering could be conducted is set out below. However, institutions may find it appropriate to develop alternative models, for example comparison of current costs and coverage with that provided to a number of similar institutions. Whatever approach is adopted it should be fair, reasonable and well documented. The frequency of such testing is a matter for individual institutions, but it should normally take place at least every seven years. Institutions may contact the HEFCE Assurance Service for advice on all aspects of external testing.

3. However external testing is undertaken, and whatever the result, no partner in a firm of auditors should be responsible for an institution's external audit for more than seven continuous years. After that period, the partner concerned should not resume responsibility for the external audit of the institution for five years.

4. External testing should be conducted in accordance with an institution's own purchasing procedures. European Community procurement requirements should be taken into account where the likely audit and related fees over the proposed contract period exceed the relevant threshold. External testing should take place as far in advance of the start date of the contract as possible, to provide continuity of service and so that the new auditors have enough time to prepare properly.

Tendering procedures

5. The audit committee should establish an evaluation committee which could consist of members of the governing body, management and representatives of the audit committee. This committee should agree on its selection criteria and the scope of the audit work required, and should identify suitable providers. This should normally include the institution's present auditor. Information should be sought on each provider's track record and relevant experience. Factors such as the size, location and nature of the audit should be taken into account when the audit committee decides which providers to invite. The tender documentation could include or refer to the proposed terms of reference the institution will find acceptable. For external audit this will normally be based on the model letter of engagement shown at Annex H. For internal audit this will normally be based on the model terms of reference shown at Annex G. Providers should be asked to indicate what

material changes to the model terms they would like the evaluation committee to consider.

6. The evaluation committee should then seek detailed proposals from at least three providers. The proposals should be evaluated using pre-determined assessment criteria. The evaluation committee should draw up a short-list of at least three candidates and invite each of them to make an oral presentation. The institution may send a copy of their written proposals to the HEFCE Head of Assurance and Audit for comments at least two weeks before the interviews. Following the interviews, a recommendation on which provider to accept should be made to the governing body, or the audit committee where it has been given delegated authority in this respect.

7. The provider should be required to:

a. Operate in accordance with published audit and accounting standards.

b. Meet professional, ethical and quality standards in completing its work.

c. Comply with terms of reference approved by the governing body.

d. Provide suitably qualified and experienced staff.

e. Endeavour to promote continuity of staffing.

f. Ensure that the staff employed will receive appropriate ongoing training.

g. Provide the HEFCE Assurance Service with access to relevant working papers and correspondence in accordance with this Code.

h. Set out proposals for liaison with other auditors.

i. In respect of internal audit, set out the firm's position on the restriction of liability. Where a restriction is sought, the level should be stated, together with the firm's explanation of why liability should be restricted and why the level proposed is both reasonable and appropriate. When comparing different proposals, the institution's evaluation committee should take account of any differences in liability restriction. In particular, this evaluation should consider the risks and likely consequences of any loss suffered as a result of negligence, the level of professional indemnity held, and the wider interest of the institution's responsibility for public funds, as described in the financial memorandum with HEFCE. See also paragraph 121 of this Code.

j. For non-statutory audit work conducted by the external auditors, the same principles in sub-paragraph i above should be applied by management. Where an agreement to restrict liability is reached, the governing body should be notified through the audit committee.

8. The same firm must not be appointed as both internal and external auditors as this compromises the required objectivity and independence of the two services.

Qualifications of external providers

9. The provider should ideally be able to demonstrate a record in providing audit services which goes wider than the HE sector. It should not be assumed that audit firms are qualified to provide internal audit services simply because they undertake external audit, or vice versa. Auditors should be qualified and registered in accordance with the relevant legislation.

Change of external provider

10. When any appointment is agreed by the governing body, institutions should inform the HEFCE Head of Assurance and Audit of their selection and provide a statement outlining the procedure adopted in making appointments.

Annex G

Internal audit: model terms of reference

1. The internal audit service is responsible for providing an objective and independent appraisal of all the institution's activities, financial and otherwise. It should provide a service to the whole organisation, including the governing body and all levels of management. It is not an extension of, nor a substitute for, good management, although it can have a role in advising management. The internal audit service is responsible for evaluating and reporting to the institution's governing body and designated officer, and thereby providing them with assurance on the arrangements for risk management, control and governance, and VFM. It remains the duty of management, not the internal auditor, to operate these arrangements.

Scope

2. All the institution's activities, funded from whatever source, fall within the remit of the internal audit service. The internal audit service will consider the adequacy of controls necessary to secure propriety, economy, efficiency and effectiveness in all areas. It will seek to confirm that management have taken the necessary steps to achieve these objectives and manage the associated risks.

3. The scope of internal audit work should cover all operational and management controls and should not be restricted to the audit of systems and controls necessary to form an opinion on the financial statements. This does not imply that all systems will be subject to review, but that all will be included in the audit risk assessment and hence considered for review following the assessment of risk. It follows that if internal audit is to give an opinion on the whole system then that will include academic operations. The role of internal audit in this area is to confirm that there are adequate systems for the management of teaching and learning and research. For example, internal audit could confirm that the examination system is operating effectively and meeting its objectives, but this does not mean that internal audit should form academic judgements. Similarly, internal audit might review a research grant to ensure that the requirements of the grant have been met, but it should not form a view on the merit of the research undertaken.

4. It is not within the remit of the internal audit service to question the appropriateness of policy decisions. However, internal audit is required to examine the arrangements by which such decisions are made, monitored and reviewed.

5. The internal audit service may also conduct any special reviews requested by the governing body, audit committee or designated officer, provided such reviews do not compromise its objectivity or independence, or achievement of the approved audit plan.

Responsibilities

6. The head of the internal audit service is required to give an annual opinion to the governing body and designated officer, through the audit committee, on the adequacy and effectiveness of the

arrangements for risk management, control and governance; and for economy, efficiency and effectiveness (value for money) within the institution; and the extent to which the governing body can rely on these. He or she should also comment on other activities for which the governing body is responsible, and to which the internal audit service has access.

7. To provide the required assurance, the internal audit service will undertake a programme of work, based on a strategy authorised by the governing body on the advice of the audit committee. The programme will evaluate the arrangements in place:

a. To establish and monitor the achievement of organisational objectives.

b. To identify, assess and manage risks to those objectives.

c. To advise on, formulate and evaluate policy within the responsibilities of the designated officer.

d. To ensure compliance with policies, laws and regulations.

e. To ascertain the integrity and reliability of financial and other information provided to management and stakeholders, including that used in decision making.

f. To ascertain that systems of control are laid down and operate to promote the economic, efficient and effective use of resources and to safeguard assets.

Standards and approach

8. The internal audit service's work will be performed with due professional care, in accordance with appropriate professional auditing practice. It will have regard to Treasury and IIA standards and will comply with the HEFCE Code of Practice.

9. In achieving its objectives the internal audit service will develop and implement an audit strategy that assesses the institution’s arrangements for risk management, control and governance and for achieving value for money.

10. The head of internal audit will implement measures to monitor the effectiveness of the service and compliance with standards. The audit committee will consider and approve these performance measures and may also ask the external auditor to provide an independent assessment of internal audit's effectiveness.

Independence

11. The internal audit service has no executive role, nor does it have any responsibility for the development, implementation or operation of systems. However, it may provide independent and objective advice on risk management, control and governance, value for money and related matters, subject to resource constraints. For day to day administrative purposes only, the head of

internal audit should report to a senior officer within the institution, such as the institution's clerk or secretary. (The reporting arrangements should take account of the nature of audit work undertaken.) The head of internal audit shall have right of access to the institution's designated officer.

12. Within the institution, responsibility for risk management, control and governance arrangements and the achievement of value for money rests with the governing body and management, who should ensure that appropriate and adequate arrangements exist without reliance on the institution's internal audit service. To preserve the objectivity of the internal auditors' professional judgement, it is for management to determine whether or not to accept audit recommendations, to recognise and accept the risks of not taking action, and to implement recommendations.

Access

13. The internal audit service has rights of access to all the institution's records, information and assets which it considers necessary to fulfil its responsibilities. Rights of access to other bodies funded by the institution should be set out in the conditions of funding. The head of internal audit has a right of direct access to the chair of the governing body, the chair of the audit committee and the designated officer. In turn, the internal audit service agrees to comply with any requests from the external auditors and HEFCE Assurance Service for access to any information, files or working papers obtained or prepared during audit work that they need to discharge their responsibilities.

Reporting

14. The head of the internal audit service must submit an annual report to the governing body and designated officer through the audit committee. The report must relate to the institution's financial year, and include any significant issues up to the date of preparing the report which affect the opinion. The report should give an opinion on the adequacy and effectiveness of the institution's arrangements for:

- risk management, control and governance, and
- economy, efficiency and effectiveness

and the extent to which the governing body can rely on them. The auditor should also prepare, before the beginning of the year, an audit risk assessment and strategy supported by an assessment of resource needs. These should be submitted to the governing body for approval following consultation with relevant managers and the designated officer, and after consideration by the audit committee.

15. The head of the internal audit service is accountable to the designated officer and the governing body through the audit committee for the performance of the service. He or she should also report audit findings to relevant managers (including the designated officer) and draw the attention of the audit committee to key issues and recommendations. This may be done by providing the committee with copies of all reports, or by reporting on an exception basis, or by

providing a summary of key issues.

16. The internal audit service should usually produce its reports, in writing, within one month of completing each audit, giving an opinion on the system reviewed and making recommendations to improve systems where appropriate. Such reports should be copied to the designated officer and may be copied to the audit committee and the external auditor. Managers will be required to respond to each audit report, usually within one month of issue, stating their proposed action with a timetable for implementing agreed recommendations. Material recommendations will usually be followed up some 6-12 months later. In addition the audit committee will monitor the implementation of audit recommendations.

17. The head of the internal audit service should report to the designated officer any serious weaknesses, significant fraud or major accounting breakdown discovered during the normal course of audit work. If the designated officer refuses to report the matter to the HEFCE accounting officer, the chair of the audit committee and the chair of the governing body, then the auditor must report to them directly.

Liaison

18. The internal audit service will liaise with the external auditors and the HEFCE Assurance Service to optimise the audit services provided to the institution.

Annex H

External audit: model terms of reference

The HEFCE Assurance Service should be notified of any material difference between this model letter and the auditors' letter.

To the members of the governing body of ....

Appointment and qualification

1. As appointed auditors of .... we agree to the following basis on which we shall perform our duties.

2. We understand that the governing body (this will require modification where the governing body does not appoint the auditor) will assess the auditors' work in each year and undertake a detailed review of the appointment at least every seven years. Remuneration will be fixed by the governing body on the advice of the audit committee.

3. We confirm that we are qualified as auditors in accordance with relevant legislation.

Responsibilities of the institution

4. We recognise that the governing body is responsible on behalf of the institution for:

   a. Establishing and maintaining a system of controls, financial and otherwise, in order to carry on the operation of the institution in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure, as far as possible, the completeness and accuracy of the records.

   b. Preparing financial statements that:

      i. Comply with the institution's charter and statutes, all statutory requirements relating to the institution's financial affairs, the financial memorandum (dated ....) with the Higher Education Funding Council for England (HEFCE), any requirements of the Learning and Skills Council or the Teacher Training Agency (if appropriate), and other regulations relating to the constitution and activities of the institution and which are relevant to its financial affairs.

      ii. Show a true and fair view of the state of the institution's affairs at 31 July, and of the cashflows and income and expenditure for the year then ended, taking into account where relevant and appropriate all required statutory and other disclosure requirements and the Statement of Recommended Practice (SORP) on Accounting for Further and Higher Education Institutions.

c. Preparing the Finance Record (or its successor) in accordance with instructions from the Higher Education Statistics Agency (HESA).

Standards of audit

5. We will undertake the audit of the institution's financial statements and such other matters as the governing body requires in accordance with auditing standards, having regard to relevant Auditing Guidelines and Auditing Standards issued by the Auditing Standards Board.

Reporting

6. We as auditors:

a. Are responsible for making a report to the governing body on the financial statements which are to be laid before the governing body during our tenure of office.

b. May be required to provide an audit report on the HESA Finance Record (or its successor) which should be consistent with our audit report on the institution's financial statements.

7. Our report will state whether in our opinion the financial statements show a true and fair view of the institution’s affairs at 31 July, and of the cashflow and income and expenditure for the year then ended.

8. In arriving at our opinion we are required to consider the following matters and to report on any aspect where we are not satisfied, namely whether:

a. Proper records are being kept by the institution.

b. The financial statements agree with the accounting records.

c. We have obtained all the information and explanations we think are necessary for the purpose of our audit.

d. The financial statements comply with the Companies Act 1985 (where the institution is incorporated under the Companies Act) and, where appropriate, with the Statement of Recommended Practice on Accounting in Higher Education Institutions (SORP) or other legislative or regulatory requirements.

9. We will also report to the governing body whether, in all material respects, monies expended out of all non-recurrent grants and other funds from whatever source, administered by the institution for specific purposes, have been properly applied to those purposes and, if appropriate, managed in compliance with any relevant legislation.

10. We have agreed with the institution the wording of an unqualified audit report at the time of our appointment. Any subsequent modifications or qualifications will then be based on our professional judgement, but comply with the Auditing Practices Board's Auditing Standard: Audit Reports on Financial Statements (May 1993).

11. We undertake to report to the governing body (by way of a management letter which should be forwarded to the HEFCE Assurance Service by 28 February the following year at the latest), any significant matters arising from the audit which might lead to material errors or have an impact on future audits. This could include areas where economies could be made or resources could be used more effectively, with advice for improvement. The management letter could include:

a. Weaknesses in the structure of accounting systems and internal control.

b. Deficiencies in the operation of accounting systems and internal control, including internal audit.

c. (i) That the work of the internal auditors has been assessed, and
(ii) The extent to which reliance can be placed on the work of the internal auditors in support of external audit work.

d. Inappropriate accounting practices and regulations.

e. Non-compliance with legislation, accounting standards, Funding Council requirements or other regulations.

Irregularities including fraud

12. The governing body is responsible for ensuring the establishment and maintenance of adequate risk management, control and governance arrangements. It is also responsible for ensuring compliance with statutory, taxation and other regulations, and for the prevention and detection of irregularities, including fraud. We are not required to search specifically for such matters and our audit should not therefore be relied on to disclose them. However, we shall plan and conduct our audit so that we have a reasonable expectation of detecting material mis-statements in the accounts resulting from irregularities, including fraud, or breach of regulations.

13. We will report in writing to the designated officer any serious weaknesses, fraud, irregularities or accounting breakdowns we come across in the normal course of our duties, and, where the designated officer refuses to make a report, to the governing body and to HEFCE's accounting officer without delay.

Other work

14. We may be asked from time to time to provide additional services beyond the scope of the audit described above. This could involve investigation work and value for money reviews. Precise requirements will be agreed between the governing body and ourselves in a separate engagement

letter before any work is undertaken. Any systems development or consultancy work will be the responsibility of separate staff.

Access

15. We shall have rights of access at all times to the books, accounts and vouchers of the institution and to such information and explanations as we think necessary to perform our duties. We also expect to have access to internal audit files and working papers. We, in turn, agree to comply with any requests from the internal auditors and the HEFCE Assurance Service for access to any information, files or working papers obtained or prepared during our audit that they need to discharge their responsibilities. The HEFCE Assurance Service will exchange letters where necessary with both parties which deal with confidentiality and the terms under which access is given.

16. We shall have the right of access to the chair of the audit committee, the right to ask the chair to convene a meeting of the audit committee if necessary, and the right to attend audit committee meetings where relevant business is to be discussed.

Annual meetings

17. We will be entitled to attend the meeting of the governing body to which the institution's annual reports and financial statements of accounts are presented. We will also be entitled to receive all notices of and other communications relating to that meeting which any member of the governing body is entitled to receive, and to be heard at any such meeting, on any part of the business which concerns us as auditors.

Termination of appointment

18. We understand that if there are serious shortcomings on our part the governing body may pass a resolution to remove us before the expiry of our term of office, notwithstanding any agreement between us and the institution.

Fees

19. [A paragraph setting out the auditor's terms for charging and collecting fees should be included.]

Other terms

20. [Auditors may include certain additional paragraphs for internal purposes, for example on confidentiality, conflicts of interest, quality of service, complaints procedure and legal jurisdiction.]

Agreement of terms

21. If the contents of this letter are not in accordance with your understanding of the arrangements made, we shall be pleased to receive your observations and to give you any further information you require. Otherwise we shall be grateful if you would confirm in writing your agreement to the terms of this letter by signing the enclosed copy and returning it to us. Once agreed, this letter will remain effective from one audit appointment to another until it is replaced.

Yours sincerely

[Signed by auditors]

On behalf of the governing body of ...., I confirm that the above terms are satisfactory.

Signed

Position

Date

Annex I

External audit report: suggested wording

The suggested form of the wording of the unqualified report (if appropriate) should be:

Report of the independent auditors to the governing body of ....

We have audited the financial statements on pages ...... to ...... which have been prepared under the historical cost convention (as modified by the revaluation of certain fixed assets) and in accordance with the accounting policies set out on pages …. to ….

Respective responsibilities of the governing body and auditors

As described on page …., the governing body is responsible for preparing the financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board and the HEFCE Code of Practice. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the governing body in the preparation of the financial statements, and of whether the accounting policies are appropriate to the institution's [group's] circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material mis-statement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

i. The financial statements give a true and fair view of the state of affairs of the institution [and the group (if appropriate)] at 31 July 20xx, and of the surplus of income over expenditure, recognised gains and losses and cashflows of the institution [and the group (include where the institution is incorporated under the Companies Act)] for the year then ended; and the statements have been properly prepared in accordance with [the Companies Act (include where the institution is incorporated under the Companies Act) and] the Statement of Recommended Practice on Accounting in Higher Education Institutions.

ii. In all material respects, income from the Higher Education Funding Council for England, [the Learning and Skills Council and the Teacher Training Agency (if appropriate)] grants and income for specific purposes and from other restricted funds administered by the institution have been applied only for the purposes for which they were received.

iii. In all material respects, income has been applied in accordance with the institution's statutes (or equivalent) and where appropriate in accordance with the financial memorandum with the Higher Education Funding Council for England.

Annex J

Guidance on value for money arrangements

[Paragraphs 3 and 4 updated 3 March 2005]

Introduction

1. In the HE sector there is an underlying duty of care to ensure that public funds are spent on the purposes for which they are intended, and that good value for money (VFM) is sought. This duty is included as a condition of grant in the financial memorandum between the DfES and HEFCE. HEFCE is responsible for promoting VFM across the HE sector. This has been achieved in a number of ways, including commissioning VFM studies, the Good Management Practice Programme (www.gmp.ac.uk), our strategy for leadership, governance and management (see HEFCE 2004/26), formation of the Leadership Foundation (www.leadership-he.com) and assessment of HEIs' VFM arrangements by the HEFCE Assurance Service.

2. HEIs are autonomous bodies and the onus is on them to pursue and achieve VFM. This is basic good practice. It is included as a requirement in the model financial memorandum between HEFCE and institutions (2003/54) which states:

> 'The governing body is responsible for delivering value for money from public funds. It should keep under review its arrangements for managing all the resources under its control, taking into account guidance on good practice issued from time to time by the Council, the NAO or the Public Accounts Committee.'

HEIs' governing bodies and heads of institution are usually similarly charged in HEIs' instruments and articles of government or equivalent.

3. The governing body will discharge much of the detailed responsibility for VFM through its audit committee.

4. The audit committee will be the main channel for reporting on the arrangements for securing VFM to the governing body. In addition to the audit committee, committees dealing with finance, resources and property are likely to most obviously encounter VFM considerations. However, all committees of the governing body should have regard to VFM and should draw any significant VFM related issues to the attention of the audit committee or the governing body.

5. Executive responsibility for VFM resides with the head of institution, with the responsibility ideally cascading down through senior management to all levels of the organisation.

What VFM is

6. VFM may be referred to as the ’three Es’ – economy, efficiency and effectiveness, which flow in this logical sequence:

- economy – obtaining resources (human, material, and so on) at best value, taking both price and quality into account (‘doing things at best price’)
- efficiency – the efficiency of converting resources (inputs) into outputs (‘doing things the right way’)
- effectiveness – application of outputs to achieve the organisation’s objectives (‘doing the right things’).

For VFM arrangements to work well, they will need to address all these three elements.

7. The adoption of recognised good practices, adapted to the institution’s circumstances as appropriate, is usually seen as evidence that an institution has sought VFM. In order to be effective, VFM awareness and good practice needs to permeate to all levels of an organisation. This should cover all capital and revenue expenditure, including staff costs, and extending beyond the purely financial to consider quality and effectiveness. VFM should be an integral element of everything, not a separate process operating in parallel to other things. It is good practice for VFM arrangements to be clearly articulated, and applied, and there should be clear reporting arrangements.

VFM arrangements

8. There is no single ideal approach to seeking VFM, and HEFCE is not prescriptive about the approach to be adopted. But we do require institutions to demonstrate that suitable arrangements are in place.

9. It is good practice to have a VFM policy and a VFM strategy. A policy will make overarching statements about the organisation’s VFM approach, principles and philosophy, steering the VFM arrangements. These arrangements can be described in a VFM strategy document. A strategy will incorporate specific actions, targets and dates. The formulation of a strategy, and adherence to it, will help to ensure co-ordination of effort across the institution and sharing of good practice and help to avoid gaps and overlaps.

10. It should be clear who is responsible for VFM, including the focus of responsibility at senior level. VFM might typically be the responsibility of the senior management team or equivalent group, or there might be a specific VFM group. One example of an arrangement found to work well in practice is for a member of the senior management team to be the nominated sponsor for each VFM exercise or project. This arrangement helps to ensure that VFM work receives appropriately senior sanction, support and follow-through. Whatever arrangements are in place, the responsibility and reporting lines should be clear. As noted above, the responsibility lies ultimately with the

governing body, usually channelled mainly, but not exclusively, through the audit committee.

11. In practice, most VFM work is likely to be carried out by HEI managers and staff using their detailed knowledge of operations. Some of this will take place as an integral part of routine operations. For example, in the budget setting process it should be usual to question the need for the continuing level of spend on activities. In zero-based budgeting this questioning approach is applied consistently to whole areas of spend. Some VFM work may consist of specific topics or projects, for instance the way in which a particular commodity is procured and consumed across the organisation. It is likely that many VFM projects or activities will be taking place across an organisation at any one time. The existence of a VFM strategy and a VFM group will help to monitor and co-ordinate these.

12. Those responsible for procurement should be continuously addressing VFM issues, and a procurement strategy and annual procurement report will help to demonstrate the institution's approach to VFM.

13. VFM work may also be carried out by external consultants providing the additional resource or expertise required. For instance, specialist energy consultants, VAT and tax advisers.

Internal auditors and VFM

14. The Code states (in paragraph 108) that an HEI's internal auditors should include an opinion on the adequacy and effectiveness of the institution's VFM arrangements in their annual report to the audit committee, governing body and designated officer. This should be based on the auditors' knowledge and experience of the HEI's arrangements.

15. VFM considerations should be an integral part of the routine work of the internal auditors. It is good practice for internal auditors to give an opinion in relation to each assignment carried out, and this can include an opinion on VFM aspects and indication of areas which might benefit from VFM review. Internal auditors may also be asked to carry out specific VFM studies. They are often regarded as particularly suited to conducting or assisting with VFM studies because of their objectivity and professional expertise in review, analysis and investigative work. It is for HEI management to decide what part their internal auditors should play in this.

16. The internal audit service's terms of reference should separately identify any responsibility it may have in initiating, conducting or participating in VFM studies. The emphasis of such work should be to help management meet its responsibility for securing the economic, efficient and effective use of resources.

VFM reporting

17. It is mandatory under this Code for an HEI's audit committee to report its opinion on the HEI's VFM arrangements annually to the governing body. Also the HEI's internal auditors should report an opinion on VFM arrangements annually to the audit committee, governing body and designated officer. The audit committee should base its opinion on the information supplied to it by the internal

auditors, by management and from any other sources.

18. These opinions relate to the **arrangements** in place to secure VFM. This is distinct from the actual results, outputs or **achievement** of VFM. So if proper steps are taken to achieve good VFM but, for whatever reason, the best outcome is not achieved, then the correct opinion will still be that proper arrangements are in place. Many projects or arrangements will be complex and subject to circumstances which cannot be predicted with certainty. If the risks are well managed then the range of possible outcomes will have been anticipated and allowed for. Proper arrangements will maximise the chance of an optimum outcome in the prevailing circumstances, as distinct from guaranteeing the best outcome.

19. The following forms of reporting are useful sources of information on VFM arrangements. They are not listed in order of importance:

- opinions on VFM issues included in internal audit assignment reports and in the internal audit annual report
- annual report on procurement
- reports on VFM studies/projects/other forms of management review
- annual report by the head of institution/senior management to the audit committee and/or governing body on VFM arrangements and achievements. This could include reference to ongoing or routine activities which contribute to good VFM as well as specific VFM projects.

Reference

20. There is VFM guidance on the web at www.hefce.ac.uk under Good practice/Value for money and under Good practice/Audit/Guidance. This provides examples and other material in relation to VFM, but it is not intended to be exhaustive. There are numerous other sources of relevant information.

Annex K

Annual assurance return from institutions

To be submitted with audit committee annual report.

This return is designed to remind designated officers of the returns and information to be supplied under the financial memorandum and HEFCE Code of Practice, and to seek other information that can inform the risk assessment by the HEFCE Assurance Service. In order to minimise the frequency of HEFCE audit work, this return is necessary to demonstrate continuing contact with institutions. HEFCE auditors will respond to each institution by providing the designated officer with an annual audit summary that demonstrates the HEFCE Assurance Service risk assessment of the institution. The assessment is based on any audit work undertaken in the year and on returns and information supplied by the institution.

Institution	
Period	
Return completed by designated officer (enter name of head of institution)	
Have you submitted the audit and other returns to HEFCE as required under the financial memorandum and HEFCE Code of Practice, including the financial statements, external audit management letter and internal audit annual report?	
Have there been any changes of senior postholder in the period, such as the designated officer or deputy, or finance director or other head of service? (If so, please provide details.)	
Has there been a change of external auditor in the period? (If so please provide details.)	
If your internal audit is provided under contract, has there been a change of provider, partner or manager in the period? (If so please provide details.)	
If your internal audit is provided in-house, has there been a change of head of internal audit in the period? (If so please provide details.)	
Was the internal audit plan for the period completed? (If not please give details.)	
Has there been a change of chair of the governing body?	

Have there been any changes to the membership of the audit committee?	
Has the audit committee been quorate throughout the year?	
Have you completed a review of institutional and/or governance effectiveness during this period? (See the Report of the National Committee of Inquiry into HE – the Dearing Report.) If so, please forward a copy of the report or action plan.	
Have you completed a review of effective financial management in this period? (See HEFCE 98/29.) If so, please advise us of the outcome or provide a copy of the report or action plan.	
Has there been any confirmed instance of serious weakness, such as fraud, that should have been notified as required under the HEFCE Code of Practice (Annex A)?	
Can you confirm that the requirements of the financial memorandum have been satisfied during the year, including that: • public funds have been applied for the purposes intended • there are sound arrangements for risk management, control and governance • the institution remains solvent and is forecast to remain solvent • the institution has complied with borrowing requirements • value for money has been pursued.	

Signed……………………………………………..

Dated………………………………………………