Supplement A

to Circular 03/04

Interim Audit Code of Practice

Learning+Skills Council

Contents

Further information

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Interim Audit Code of Practice

Part 1 Introduction

Introduction

1 This interim audit code of practice ('the Code') sets out:

- the broad accountability framework in which the Learning and Skills Council (the LSC) and the providers it funds operate (part 2);
- the mandatory audit requirements on further education (FE) colleges the LSC funds (part 3);
- for information, a summary of the audit arrangements for local authority providers (part 4) and other funding streams and provider types the LSC funds (part 5); and
- information on other relevant review and audit activities within and outside the LSC that other providers may be subject to.

2 The Code will be of interest to management, governors and auditors of organisations within the post-16 education and training sector that is funded by the LSC. Within this sector, the LSC primarily funds by value further education, school sixth forms, work-based learning and adult and community learning. The LSC funds organisations drawn effectively from across the whole of the economy, including FE colleges, higher education institutions, central government bodies, local authorities and voluntary and commercial organisations of very varied sizes and legal forms.

Further education colleges

3 The requirements of part 3 of the Code form part of the LSC's conditions of funding of FE colleges under its financial memorandum, with effect from 1 August 2002. From that date, the requirements in part 3 of the Code replace those set out in the audit code of practice issued by the Further Education Funding Council in 1998.

Other providers

4 For all other providers, parts 2, 4 and 5 of the Code summarise the LSC's audit requirements. The LSC's full terms and conditions of funding of other providers since 1 April 2001, including audit requirements, are formally set out in the LSC's funding agreements (that is financial memoranda, contracts or grant letters) with these other providers. Other providers should continue to refer to their funding agreements for the LSC's terms and conditions relating to its audit requirements.

Observance

5 In part 3 of the Code relating to FE colleges, the terms 'must' and 'will' indicate mandatory requirements included in the Code. For ease of reference, mandatory requirements for FE colleges are summarised at Annex A of this Code. The annexes also include a number of model documents relevant to FE colleges. FE colleges must adopt these documents, or require their auditors to adopt these documents, in order to comply with the requirements of the Code.

6 Parts 4 and 5 of the Code are for information and do not set out mandatory requirements for other providers. The LSC's audit requirements of other providers are given in their individual funding agreements with the LSC. Other providers must refer to these funding agreements for the LSC's mandatory audit requirements.

7 The LSC will look for compliance with the mandatory requirements of the Code or of funding agreements when considering providers' financial management, governance, internal control and application of LSC funds.

Applicability

8 The Code should be read in conjunction with the relevant publications of the Auditing Practices Board and other sources of relevant statute. These are principally the *Learning and Skills Act 2000* for all providers and the statutory instrument and articles of government for FE colleges. The Code is not intended to be a manual. FE colleges, other providers and their auditors should develop their own management procedures and manuals appropriate for them, taking account of this Code.

Scope of the Code

9 The Code summarises the LSC's audit requirements for all the providers it funds. It is not intended to cover the audit requirements of any other body. Others also have an interest in audit arrangements at providers. The Code includes a brief description of the work of some of these other interested parties, as this work is an important part of the accountability framework within which providers operate.

Part 2 General Accountability in the Sector

Introduction

10 The LSC and its providers operate in a complex funding and accountability framework. This part of the Code is for information and sets out the broad context of this framework.

Parliament, the Comptroller and Auditor General and the National Audit Office

11 Parliament's interest is to see that public funds are properly accounted for and used economically, efficiently and effectively by recipients. The comptroller and auditor general (C&AG), who is the head of the National Audit Office (NAO), is the auditor of the LSC's accounts. He has the right to inspect the accounts of any learning provider that receives LSC funding and has the right to carry out examinations of the economy, efficiency and effectiveness with which the LSC or the other providers have used their resources in discharging their functions. The NAO is highly selective in its use of inspection rights; its investigations into economy, efficiency and effectiveness normally involve only a sample of providers.

The Department for Education and Skills

12 The funds distributed by the LSC to providers are received from the Department for Education and Skills (the DfES). The permanent secretary of the DfES is the accounting officer of the DfES and is responsible and accountable to parliament for the resources made available to the LSC. He has to satisfy himself that proper arrangements are being made within his own department and within the LSC to safeguard public funds. To help provide the DfES's accounting officer with assurance on the LSC's arrangements, the DfES's internal audit division (IAD) may make unaccompanied visits to providers, and undertake such enquiries as they reasonably require.

The Learning and Skills Council

13 The LSC is a non-departmental public body funded by grant-in-aid by the DfES under a financial memorandum. The financial memorandum defines the mandatory terms and conditions under which the secretary of state makes funds available to the LSC. These terms and conditions include making the LSC's chief executive its accounting officer, with similar responsibilities to the DfES's permanent secretary. Specifically, the LSC's chief executive must ensure that providers receiving LSC funds:

- have appropriate arrangements for financial management and accounting; and
- use the funds in a way consistent with the purposes for which they have been given and comply with the conditions attached to them.

14 The LSC's chief executive has arranged to provide himself with assurance in relation to these responsibilities. These arrangements include the work of the LSC's IAD and its provider financial assurance (PFA) functions.

15 The LSC's IAD gives annual assurance to the chief executive on the overall adequacy and effectiveness of the LSC's risk management, control and governance processes. Part of the LSC's IAD work will be to review the adequacy and effectiveness of the LSC's PFA functions, as one of the LSC's management controls over risk. As part of their review work, the LSC's IAD may occasionally visit providers, in conjunction with the PFA functions' own review programmes.

16 The national LSC and local LSCs have established audit committees, which advise

respectively the chief executive and local executive directors on the scope and objectives of the work of the PFA teams and on the adequacy and effectiveness of the operation of internal control.

17 The LSC's national and local PFA functions are responsible for assurance on the LSC's funding of providers by:

- formulating the LSC's audit requirements for providers;
- receiving, analysing and acting on the results of the work of providers' auditors, where the LSC intends to place reliance upon these results for assurance;
- local PFA functions carrying out direct assurance work on certain providers' internal control and their application of LSC funds; the frequency and extent of the work depends on risk and materiality;
- directly reviewing, through joint national–local PFA teams, the financial management and governance of FE colleges and other significant providers. These reviews are currently on a four-yearly cycle. The reviews usually take place in parallel with the work of the Office for Standards in Education and the Adult Learning Inspectorate; and
- monitoring the appointment and the quality of the work of auditors appointed by providers under the LSC's requirements.

The Learning and Skills Council's Funding Agreements and Its Assurance Responses

18 Many of the LSC's current assurance arrangements for its funding of providers are inherited. The Further Education Funding Council (FEFC) obtained almost all of its assurance from the results of the work of auditors appointed by FEFC or by institutions to FEFC's requirements. The Training and Enterprise Councils sought direct assurance through the work of their own in-house or contracted audit team. This inheritance has led to assurance arrangements that are based on one or more of the following:

- the type of providers funded;
- the form of funding agreement in use; or
- the LSC funding stream the provider receives.

19 Under the LSC's financial memorandum with the DfES, the LSC must comply with *Government Accounting* published by HM Treasury. In accordance with *Government Accounting*, the LSC uses three types of funding agreement with its providers. These are grant-in-aid, grant, and contract. Each type of funding agreement itself confers different requirements, through *Government Accounting*, on the LSC to obtain assurance.

20 The LSC gives grant-in-aid to FE colleges under a financial memorandum. Grant-in-aid funding is assumed to be in perpetuity and is not time-limited, although supporting schedules giving the funds payable are renewed annually. The financial memorandum requires the FE college to appoint an accounting officer (with responsibilities as in paragraph 12 above). The FE college must only use LSC funds for the purposes granted and all FE college funds, from whatever source, must be used with propriety and regularity, as defined in HM Treasury guidance. Where the FE college holds unspent funding, it may not be distributed outside the FE college. The FE college is restricted in its arrangements for borrowing and acquisition and disposal of significant assets. The FE college must have accounting and audit arrangements that conform with central government norms, including an interest in all aspects of internal control. A simplified financial memorandum is also used for the LSC's funding of dance and drama awards at dance and drama schools.

21 The LSC gives grants for specific learning provision. Grants are usually renewed annually, but may be for longer or shorter periods or for the purchase of a specific service. Grant funding confers an interest in the proper use of public funds identical to that for grant-in-aid funding. Depending on the conditions of the grant, unspent funds must be surrendered to the LSC or retained by the provider for future public purposes and in any event not distributed outside the public sector. The terms and conditions of grant agreements are otherwise simpler than a full financial memorandum. The LSC uses various grant agreements with local authorities and independent former external institutions.

22 The LSC contracts for learning provision with learning providers from the public, voluntary and commercial sectors. The larger LSC contracts, for purchase of work-based learning provision, will for 2003/04 usually be for three years' funding. The LSC also uses short-term contracts for specific learning provision. Many FE colleges and other public bodies currently have contracts in addition to their financial memorandum or grant agreements. Public sector organisations funded under contract will usually have an overarching requirement given elsewhere to make proper use of public funds, even if this is not explicit in the LSC's contract. Commercial and voluntary organisations funded under contract are not normally restricted in their use of LSC funds, once the LSC is satisfied that the contracted learning provision has occurred and is in accordance with the qualitative and quantitative measures of the contract.

23 Given the funding agreements the LSC is required to use, the LSC may seek assurance from providers in any or all of four main areas: financial statements, use of funds, internal control, and application of funds. The LSC may require the provider to submit the following.

- Audited true and fair financial statements and related disclosures, including corporate governance statements. For FE colleges, the annual financial statements are essential to their dialogue with the LSC on financial health, forecasting, borrowing and capital projects. For all other providers, the LSC will use financial statements in assessing the providers' financial health and other analyses. The LSC has no other role in determining the legal form or content of other providers' financial statements.
- A statement, usually audited, on the provider's proper use of public funds (the 'use of funds' statement). Alternatively the LSC may seek to obtain this assurance through the work of its own appointed auditors or PFA teams. This assurance, on how LSC funds have been spent, is as described in paragraph 20.
- An audit report on the soundness of the provider's systems of internal control. Alternatively the LSC may seek to obtain this assurance through the work of its own appointed auditors or PFA teams. For FE colleges the scope of this assurance is on risk management, control and governance processes. For other providers it will normally be specifically on those systems that support production of funding claims or spending of LSC funds, or both.
- A funding claim, based on the FE college or provider's individual learner records or other statistical return, with an accompanying audit report by the auditors of the provider's financial statements. Alternatively the LSC may seek to obtain this assurance through the work of its own appointed auditors or PFA teams. The funding claim and audit report demonstrate that the provider has earned the funds allocated to it under the LSC's funding methodology for that provision.

24 The LSC takes as much assurance as possible from the work of providers' existing auditors. The LSC will normally take such assurance where the auditors have been appointed and quality-controlled in accordance with the requirements of the LSC or another

body with a statutory role to secure sound audit arrangements within the public sector (principally the Audit Commission, the NAO or the Higher Education Funding Council for England). Where the LSC cannot ensure the quality of the appointment or the work of providers' existing auditors, it will normally seek to appoint its own auditors. These funding auditors will be either the LSC's PFA teams, or audit firms under contract.

25 The timing of assurances will need to be brought forward in future years to meet HM Treasury's timetable for the signing of the LSC's accounts.

Providers' Accountability to Others

26 Providers are subject to many other reviews, by public and private sector bodies. These reviews may make use of the same information as the LSC, such as the audited financial statements. The LSC will seek to minimise duplication, although the scope and objectives of these reviews are often little related to the LSC's assurance needs and reciprocal or commissioning arrangements are unlikely to be meaningful.

Part 3 Specific Audit Requirements on Further Education Colleges

Introduction

27 This part of the Code applies to FE colleges and specialist designated institutions. FE colleges receive funding from the LSC through grant-in-aid in accordance with the financial memorandum. The term 'FE college' does not include adult education institutions and institutions such as specialist providers or dance and drama schools. These institutions are subject to different arrangements, which are considered elsewhere in this Code. The AoC has agreed and endorses this part of the code.

28 The Code retains many of FEFC's audit requirements on FE colleges. An immediate reason for this is that FE colleges continue to be funded under a financial memorandum that, under HM Treasury guidance, continues to require these audit arrangements. Many of these arrangements are normal (if not universal) requirements and practice for central government funding across the UK public sector. Similar long-standing arrangements for internal auditing, auditing of financial statements and audit committees exist for higher education institutions, central government bodies, local authorities, the National Health Service and Housing Associations. Use of internal audit services (IAS) and audit committees is increasingly seen as best practice in voluntary and commercial organisations.

29 This part of the Code sets out audit requirements of FE colleges at length, in contrast with the relatively brief sections on other providers and funding streams. This is acknowledged and is a product of the LSC's effective status as 'regulator' of the financial accountability of FE colleges. The other parts of the public sector listed above have their own statutes, codes or equivalent documents, on which the LSC normally relies, setting out their requirements in similar vein. These other codes are not reproduced here. Providers outside the public sector are subject to Companies Acts or Charity Commission requirements or other regulations, none of which are reproduced here.

Sources of Requirement on Further Education Colleges

Further education college articles of government

30 The modified articles of government for FE colleges, effective from 1 April 2001, require governing bodies to:

- establish an audit committee to advise on matters relating to the governing body's audit arrangements and systems of internal control; the committee shall consist of at least three persons and may include employees of the governing body other than those in senior posts, and shall operate in accordance with any requirements of the LSC (clause 5 paragraph 5);
- cooperate with any person authorised by the LSC to audit any returns of numbers of learners or claims for financial assistance and give any such person access to any documents or records held by the corporation (clause 18);
- arrange for the examination and evaluation on its behalf of its systems of internal financial control to ensure that they contribute to the proper, economical, efficient and effective use of the governing body's resources (clause 19 paragraph 1); the persons appointed are referred to as 'internal auditors' (clause 19 paragraph 2);
- appoint for each financial year a financial statements auditor (or external auditor) (clause 20 paragraph 3); and

- not appoint any persons as internal auditors who are appointed as financial statements auditors (clause 20 paragraph 5).

Financial memorandum

31 The LSC's financial memorandum with FE colleges is that inherited from FEFC Circular 99/48, issued in December 1999, and is in the process of being updated. Under the financial memorandum, the governing body has the following obligations.

- It must ensure that funds are used only in accordance with the Act, the financial memorandum, and any other conditions which the LSC may from time to time prescribe (paragraph 9).
- It must ensure that the financial, planning and other management controls, including controls against fraud and theft, applied by the FE college are appropriate and sufficient to safeguard public funds (paragraph 10).
- It must secure the economical, efficient and effective management of all of the FE college's resources and expenditure, capital assets and equipment, and staff so that the investment of public funds in the FE college is not put at risk (paragraph 10).
- It must establish an audit committee. The audit committee must include at least one person, whether a governor or not, with relevant financial/audit expertise (paragraph 10).
- It must require the principal to take personal responsibility for ensuring the proper and effective operation of the financial, planning and management controls and for effecting the governing body's policies for securing the efficient, economical and effective management of all the FE college's income, assets and expenditure (paragraph 12). As the FE college's accounting officer, the principal may be required to appear before the Committee of Public Accounts of the House of Commons, alongside the chief executive of the LSC, on matters relating to the use of funds provided by the LSC (paragraph 14).
- It must arrange the auditing of financial statements and internal audit in accordance with the requirements and guidance of the LSC. In particular, it will not be permissible for FE colleges to appoint the same firm to undertake both internal and financial statement auditing (paragraph 36). The LSC may undertake examination of the FE college's internal financial and management controls and may recommend improvements. These examinations will normally take place as part of the cycle of college inspections (paragraph 37). The books and records of the FE college will be open to inspection by the LSC and by the C&AG. To help in providing an assurance on the adequacy and effectiveness of controls within the FE sector, the DfES's internal auditors may make unaccompanied visits to colleges and undertake such enquiries and review such books and records as they may reasonably require to undertake their work (paragraph 38).
- FE colleges shall report all significant (as defined in the audit code of practice) cases of fraud or irregularity to the LSC (paragraph 41).

32 The public nature of the governing body's role, its financial accountability through the LSC to parliament, its stewardship of public funds, and not least the good name of the FE college and the interests of its learners, all demand high standards of conduct in the exercise of its functions. The existence of a rigorous framework of audit and internal controls can assist governors in this process.

Audit Committee

Role

33 The role of the audit committee is advisory. Each FE college must establish an audit committee to advise on the adequacy and effectiveness of the FE college's systems of internal control and its arrangements for risk management, control and governance processes. This advice is primarily formed through a consideration of the work of the FE college's IAS, its financial statements auditor and funding auditor. Guidance on risk management is provided in the LSC's *A Guide to Risk Management in Further Education*.

34 To establish the role of the audit committee, the governing body must set terms of reference for the audit committee. Minimum terms of reference to be used are detailed in Annex B. Whilst the governing body may add to these terms of reference, it must not add terms that:

- require the audit committee to adopt an executive role;
- require members of the audit committee to offer professional advice to the governing body outside their role as governors; or
- cause the committee to lose its primary focus on the adequacy and effectiveness of the FE college's audit arrangements and risk management, control and governance processes.

35 The governing body's approval of the FE college's annual financial statements must be on the recommendation of the audit committee or the finance committee or both committees. Where the governing body approves the financial statements on the recommendation of the finance committee, the audit committee must also receive the financial statements to inform their review of the management letter of the financial statements auditor and consideration of the statements on Corporate Governance, Responsibilities of Members of the Corporation and the System of Internal Control.

36 The audit committee must have the right of access to obtain all the information it considers necessary from members of the staff and governors, and to consult the IAS, financial statements auditor and funding auditor directly.

Membership and clerking

37 Paragraph 5 of the articles of government and paragraph 10 of the financial memorandum set the requirements for audit committee membership. In order to ensure independence and objectivity, members of the audit committee must not be members of the finance committee (or equivalent) and the chair of the governing body must not be a member of the audit committee.

38 The governing body must determine the membership of the audit committee and the terms on which they are to hold and vacate office. A co-opted external member of the audit committee should not normally be appointed as its chair, since the chair has to be able to attend, as of right, all meetings of the governing body. Subject to this, co-opted external members should be treated as having equivalent status to full members of the governing body.

39 To maximise the independence of the audit committee, the clerk to the governing body should normally be the clerk to the audit committee. Where the clerk to the governing body is a senior manager at the FE college or has significant financial responsibility, another individual should act as clerk to the audit committee so as to protect the independence and objectivity of the audit committee.

Operation

40 The audit committee must have the right, whenever it is satisfied that it is appropriate to do so, to go into confidential session and exclude any, or all, participants and observers, except the clerk to the audit committee. When the audit committee exercises this right the rules relating to quoracy must be observed.

41 The internal auditor must be invited to attend all meetings, as must the financial

statements auditor and funding auditor where business relevant to them is being discussed. Senior management should be invited to attend audit committee meetings particularly where their area of responsibility is under discussion.

42 The audit committee must consider all significant audit findings or recommendations but need not be concerned with the more detailed findings unless the audit committee considers it valuable to do so. The governing body, advised by the audit committee, is ultimately responsible for ensuring that management take appropriate action on those reports that call for it, or for recognising and accepting the risks of management not taking action.

Annual cycle of business

43 The audit committee must consider a minimum number of items of business each year for it to be able to function effectively. These are set out in the Table 1 together with indicative timings.

Monitoring performance of funding auditors

44 The audit committee may wish to identify and approve annually appropriate performance indicators for the funding auditor. The LSC is ultimately responsible for monitoring the performance of funding auditors. FE college audit committees should oversee the audit of the FE college's funding claims and the submission of returns to the LSC. The LSC's national assistant director of finance (provider financial support) will seek feedback from FE colleges and their audit committees on the performance of the funding auditors through client satisfaction surveys which include standard questions set by the LSC.

Internal Audit Service

45 Both the articles of government and the financial memorandum require the governing body of each FE college to establish an IAS.

46 Parts of the Code are common to IASs and other FE college auditors. These parts are dealt with at paragraphs 82 to 106 of this Code. The IAS must comply with the requirements of the Code.

Table 1 Minimum Cycle of Audit Committee Business

	Current year item of business	Indicative Timings (✔)						To recommend to the governing body for approval
		Previous year	Current year			Next year		
		Summer	Autumn	Spring	Summer	Autumn	Spring	
1	Appointment and reappointment or dismissal (where applicable) and remuneration of internal auditors	✔ or autumn term	✔ or summer term					Yes
2	Internal audit needs assessment, strategic plan and annual plan		✔					Yes
3	Appointment and reappointment or dismissal (where applicable) and remuneration of financial statements auditors			✔ or summer term	✔ or spring term			Yes
4	Review of performance of the internal audit service and establishment of annual performance indicators for next year				✔ or autumn term	✔ or summer term		No
5	Funding auditor interim opinion and management letter					✔•		Yes∗
6	Internal audit service annual report					✔•		Yes∗
7	Financial statements audit management letter					✔•		Yes∗
8	Annual report of the audit committee					✔		Yes∗
9	Recommendation of approval to the governing body of annual financial statements (may be the role of the finance committee or equivalent)					✔		Yes
10	Funding auditor final opinion and management letter						✔	Yes
11	Review of performance of the financial statements auditors and establishment of annual performance indicators for next year						✔ or summer term	No
12	Internal audit reports on reviews and progress update		Depends on timing of reports					No
			✔	✔	✔			
13	Consideration of funding auditor franchise and partnership spot check reports (where applicable)		Depends on timing of visits					No
			✔	✔	✔			

∗ Governing bodies must have all of these reports (items 5, 6, 7 and 8) available before approving the financial statements and the statements included therein on Corporate Governance, Responsibilities of Members of the Corporation and the System of Internal Control. The governing body must approve the annual financial statements to meet LSC deadlines.

• Items 5, 6 and 7 may be deferred until the spring term but see comment above.

Standards

47 The operation and conduct of the FE college IAS must comply with the standards of internal audit, which have been promulgated by HM Treasury and included in Government Internal Audit Standards (GIAS). These standards are available at the Treasury website (www.hm-treasury.gov.uk) and are supplemented by Good Practice Guides. The major requirements of these standards as applied to the internal audit of FE colleges are detailed below in paragraphs 49 to 69.

Role

48 Internal audit is defined in the GIAS as being 'an independent and objective appraisal service within an organisation.

- The IAS primarily provides an independent and objective opinion to the governing body on risk management, control and governance processes, by measuring and evaluating their effectiveness in achieving the organisation's agreed objectives. In addition, internal audit's findings and recommendations are beneficial to line management in the audited areas. Risk management, control and governance comprise the policies, procedures and operations established to ensure the achievement of objectives, the appropriate assessment of risk, the reliability of internal and external reporting and accountability processes, compliance with applicable laws and regulations, and compliance with the behavioural and ethical standards set for the organisation.
- Internal audit also provides an independent and objective consultancy service specifically to help line management improve the organisation's risk management, control and governance. The service applies the professional skills of internal audit through a systematic and disciplined evaluation of the policies, procedures and operations that management put in place to ensure the achievement of the organisation's objectives, and through recommendations for improvement. Such consultancy work contributes to the opinion which internal audit provides on risk management, control and governance.'

49 The introduction and maintenance of risk management and control processes in FE colleges is a management function. The IAS cannot provide any guarantee against material errors, loss or fraud. The IAS can play a valuable role in helping management to improve risk management, control and governance processes and so reduce the potential effects of any significant risks faced by the FE college.

Scope of internal audit service

50 The IAS must have formal terms of reference, agreed by the governing body on the recommendation of the audit committee. These must include the terms of reference set out in Annex D. FE colleges may accept other terms and conditions of business but these must not compromise or conflict with the terms of reference given as Annex D.

51 The LSC wishes to minimise duplication between the work of the FE college IAS and the LSC-appointed funding auditor. The funding auditor conducts extensive work on the learner numbers systems in undertaking the funding audit. The funding auditor will report the findings of his or her work in annual opinions and management letters to the FE college. The funding auditor's work is based upon standard LSC audit programmes at every FE college, which are available on the LSC website (www.lsc.gov.uk).

52 The LSC has put in place quality-assurance arrangements whereby the work undertaken by the LSC-appointed funding auditors is reviewed and assessed. The results of these reviews along with the use of standard audit programmes and operating guidance ensure that the funding auditor's work is carried out to an appropriate standard. The LSC will offer assurance on the FE college's

learner numbers systems based on the results of these reviews. The FE college's IAS must review the findings set out in the funding auditor's interim opinion and management letter when considering the annual statement on the FE college's risk management, control and governance processes. The FE college's IAS and the audit committee must decide whether to place reasonable reliance on the work of the funding auditor or to conduct work themselves to derive assurance on the FE college's learner numbers system. For those colleges not subject to an annual funding audit, this statement may not be available.

53 Each FE college must devote sufficient resources to the IAS, taking into account the advice given by the head of the IAS. If the head of the IAS or the audit committee consider the level of audit resources limits the scope of the IAS or prejudices the ability of the IAS to deliver a service consistent with the definition of internal auditing, they must draw this matter to the attention of the governing body. Where agreement cannot be reached on the level of IAS resources, the FE college must report this to the head of PFA at their local LSC.

Independence

54 The IAS must be sufficiently independent of the activities it audits to allow auditors to form impartial and effective professional judgements and recommendations. The IAS must be separate from FE college management, even if provided in house, and without any executive, management or operational responsibilities outside the IAS.

55 Individual internal auditors must not be assigned to assurance work in areas where they have had an executive or other involvement for at least two years after such involvement.

Relationships with management, other auditors and other review bodies

56 The head of the IAS must coordinate IAS plans and activities with FE college managers, financial statements auditors and funding auditors to ensure the most effective audit cooperation is achieved and duplication of effort is minimised. The IAS must offer the financial statements auditors the opportunity to place reliance on their work, provided this does not prejudice the IAS's independence.

Staffing, training and development

57 The IAS must demonstrate compliance with the four principles of the Code of Ethics for Internal Auditors set out in the GIAS. The principles cover integrity, objectivity, competency and confidentiality.

58 The IAS must be appropriately staffed in terms of numbers, grades, qualification levels and experience to fulfil its objectives in accordance with the GIAS. All internal auditors must be properly trained to carry out their responsibilities and must undertake a programme of continuing professional development. The head of the IAS must either hold the Government Internal Audit Certificate (GIAC) or be able to demonstrate skills, knowledge and experience consistent with the requirements needed for the GIAC, as must the person leading the IAS work.

Audit strategy

59 The head of the IAS must develop and maintain a strategy for providing the governing body with an objective evaluation of the FE college's risk management, control and governance processes, and opinions on their effectiveness.

60 The strategy must be developed to meet the audit needs of the FE college as assessed by the head of the IAS, using the FE college's objectives and risk management as a primary resource. The IAS must develop, as a minimum, a strategic audit approach that over the cycle of the strategy covers all the areas listed in Annex C. FE colleges will be able to commission audit work from their IAS to cover other risk areas identified by the IAS at the planning stage or by the FE college's own risk assessment process.

61 The IAS must prepare annual audit plans designed to implement the audit strategy. The FE college must receive from its IAS timely strategic and annual plans formulated according to the service's own priorities. The plans must be approved, before the commencement of work, by the governing body on the recommendation of the audit committee, and must cover the whole year.

Management of audit assignments

62 For each audit assignment, a detailed plan must be prepared. The IAS must seek a sponsor for each assignment. This will normally be the FE college manager with overall responsibility for the area to be audited. Assignment plans must be agreed with the sponsor before any work is done.

63 The IAS must adopt a risk-based systematic approach, as set out in GIAS, for all audit assignments intended to provide an opinion. This approach will enable the IAS to reach the conclusions necessary to form an opinion on the area being reviewed. Such opinions must be clearly stated in assignment reports. Audit opinion can also be derived by the use of supplementary audit techniques and approaches.

64 The IAS must follow up assignments by reviewing the effectiveness of the response of the FE college's management to the findings of and recommendations of assignments. The follow-up findings must be reviewed with the sponsor before being reported. The head of the IAS must report to the audit committee any management responses which they judge to be inadequate for the identified risk.

Reporting

65 A written audit report must be issued at the close of each audit assignment. It is the head of the IAS's responsibility to alert the audit committee how far the governing body could be exposed by any shortcomings in the area under review. The degree of control must be related to the risks involved, but it is management's role to exercise judgement in establishing the balance between risk and control.

66 The IAS must produce an annual report on their opinion of the overall adequacy and effectiveness of the FE college's risk management, control and governance processes, within the scope of their review. The minimum content for a FE college IAS annual report, which must be followed by the IAS, is set out in Annex E. Each FE college must promptly provide a copy of the approved annual IAS report to the head of PFA at its local LSC, following its consideration by the audit committee.

Quality assurance

67 The work of the IAS must be controlled at each level of operation to ensure that a continuously effective level of performance, complying with the GIAS, is being maintained. The head of the IAS must develop a quality-assurance programme designed to give assurance that the work of the IAS complies with the GIAS.

68 The head of IAS must make provision for internal quality reviews of the work at the FE college to be undertaken periodically by appropriately experienced or qualified individuals. These reviews must be undertaken at least every other year.

Financial Statements Auditor

Role

69 The basic objective of the FE college financial statements auditor is to report on the truth and fairness of the income and expenditure for the year, and the financial position of the FE college and any subsidiary companies shown in the financial statements. The financial statements auditor must form an opinion as to whether proper accounting records have been kept and whether the accounts are in agreement with those records, and to state that the accounts have been properly prepared in accordance with the

Statement of Recommended Practice: Accounting for Further and Higher Education Institutions.

70 The financial statements auditor must also be concerned with the requirements of the LSC to report on the regularity and propriety of transactions. The financial statements auditor must report, in all material respects, whether monies expended out of funds from whatever source administered by the FE college for specific purposes have been properly applied for those purposes and that monies expended out of funds provided by the LSC (and the Higher Education Funding Council for England (HEFCE) if applicable) have been applied in accordance with the financial memorandum (and the funding agreement with HEFCE if applicable) and any other terms and conditions attached to the funding. The LSC intends in due course to issue clarification of its expectations of financial statements auditors in providing an opinion on the regularity and propriety of transactions.

71 Financial statements auditors in their audit report must report on the FE college's compliance with the principles set out in section 1 of the Combined Code on Corporate Governance issued by the London Stock Exchange. The financial statements auditors are not required to consider whether the principal's statement on the system of internal control covers all risks and controls or to form an opinion on the effectiveness of the FE college's corporate governance procedures or its risk and control procedures.

Letter of engagement

72 The governing body must appoint the financial statements auditor. The appointment will be subject to annual review and reappointment. The duties of the financial statements auditor must be clearly presented in an engagement letter.

73 The duty of care owed by financial statements auditors is not yet resolved. The model engagement letter which must be followed by the financial statements auditors will be issued separately. The LSC will review the wording of the letter of engagement every year. FE colleges may accept terms and conditions of business as part of the letter of engagement but these must not compromise or conflict with the terms of reference given in the model engagement letter.

Reporting arrangements

74 The financial statements auditor has no responsibility for auditing or undertaking any other work on the FE college's funding claims. This responsibility rests with the funding auditor. The sequence of events for reporting on the FE college's funding claims is described in Annex F.

75 The financial statements auditor must not sign off his or her audit report until a recovery and tolerance statement has been provided by the LSC confirming the FE college's funding and an assurance letter has been received from the executive director of the local LSC. Audit work on the financial statements must not be delayed until receipt of the recovery and tolerance statement. To avoid delay, financial statements auditors must undertake their work on the basis of interim figures provided by the FE college and use the figures confirmed in the funding auditors' interim opinion copied to the FE college.

Audit report

76 In making their annual report the financial statements auditor must use the wording of the audit report as prescribed by the LSC. The LSC will review the wording of this report each year.

77 Financial statements auditors are reminded that where they are unable to express an unqualified opinion on the FE college's financial statements or wish to use alternative wording to the audit report prescribed by the LSC, they must immediately communicate this to the principal, the chair of the corporation and the chair of the audit committee. They must also inform the executive director and head of PFA at the local LSC.

Management letter

78 The FE college must promptly send a copy of the approved management letters of the financial statements auditor including those arising from interim audits, with the FE college response, to the head of PFA at its local LSC.

Eligibility

79 The criteria required for eligibility as financial statements auditors of FE corporations are set out in paragraph 5b of schedule 8 of the *Further and Higher Education Act 1992* and included in the list of key definitions.

80 A number of financial statements auditors have transferred their business into a limited liability partnership formed under the *Limited Liability Partnership Act 2000*. Under the previous partnership arrangements the partnership did not have a separate legal status from that of its individual members. The effect of the transfer to limited liability partnerships is to establish corporate bodies which constitute a separate legal entity from their members. In practice this will make no difference to the FE college as the rights and the liability of the new corporate body will remain the same.

Funding Auditor

81 The arrangements for the funding audit are described in Annex F.

Areas Common to the Internal Audit Service and Financial Statements Auditor

Selection criteria and procedures

82 On joining the FE sector, or when mergers occur, FE colleges must have in place an IAS and financial statements auditor with effect from the first day of operation of their financial memorandum with the LSC. FE colleges already funded by the LSC have in place both sets of auditors, and can periodically seek to confirm or change their audit service providers. If the audit service provider is changed, the contract with the incoming provider must start on the day after expiry of the contract with the outgoing provider to ensure continuity of provision. Where continuity is not possible, for example, due to the immediate resignation of the incumbent auditors, the FE college must institute interim arrangements before commencing the formal appointment process. Such a period should not normally exceed three months. If the FE college believes that a gap is unavoidable, they must contact the head of PFA at their local LSC.

83 Each governing body must, in accordance with the financial memorandum with the LSC, appoint an IAS and a financial statements auditor in accordance with the LSC's requirements. FE colleges must promptly send to the head of PFA at the local LSC the tender proposal and draft letter of engagement for the audit provider the FE college intends to appoint so that the LSC can ensure that the appointment is in accordance with its requirements. The head of PFA at the local LSC will advise FE colleges on audit appointments in advance of the FE college's selection process, on request.

84 An audit service provider proposing to accept the appointment as internal auditor or financial statements auditor must obtain the FE college's permission to communicate with the outgoing auditors. Outgoing auditors must obtain permission from the FE college to discuss its affairs freely with the proposed auditors, and must disclose all information required by the proposed auditors that is relevant to the appointment.

85 Where the IAS is contracted to an external provider, the head of the IAS must be rotated every seven years. The partner responsible for the financial statements audit must also be rotated every seven years. The IAS must annually ensure that appropriate arrangements are in place to guarantee the independence of internal audit.

86 FE colleges must promptly send details to the head of PFA in the local LSC of a significant change of audit service provider, whether by merger, demerger, takeover or other significant reorganisation.

Auditors' liability

87 FE colleges must not appoint a financial statements auditor whose letter of engagement includes any limitation of liability in respect of external audit work. The limitation might be through an explicit clause or by other limitation of liability. This principle matches that of section 310 of the *Companies Act 1985*, which prohibits any capping of the auditors' liability in respect of audit opinions given under the Act.

88 For internal audit work FE colleges can negotiate over any proposal by the internal audit service to restrict or cap their liability. The governing body must specifically consider and approve any request for a liability restriction. This limit must not be under £1 million.

89 For categories of work other than the certification of financial statements, or internal audit work, FE colleges may negotiate with their audit service provider over any proposal by them to restrict or cap their liability as long as the eventual outcome represents the best value for money and takes into account the wider interests of the FE college, the LSC, the DfES and taxpayers. It should also take into account the risks and likely consequences of any loss suffered as a result of negligence, the effect of the terms of any restriction of liability and the level of professional indemnity held. The governing body must specifically consider and approve any request for a liability restriction.

Removal or resignation of auditors

90 Where the IAS or the financial statements auditor cease to hold office for any reason, they must provide the governing body with either a statement of any circumstances connected with the removal or resignation which they consider should be brought to the governing body's attention, or a statement that there are no such circumstances. The FE college must copy this statement to the head of PFA at their local LSC without delay.

Access to further education colleges and audit working papers

91 FE colleges must allow the LSC, the DfES's internal auditors and the NAO unrestricted access to all records, information and assets which the they consider necessary to fulfil their responsibilities, including, through the FE college's contract with the IAS, IAS working papers and key IAS personnel.

92 Internal audit working papers may be the property of the FE college. The Institute of Chartered Accountants in England and Wales has issued a technical release Audit 2/98 *Access to the Working Papers on Internal and Financial Statements Auditors of FE Colleges* which provides guidance on access to working papers and examples of hold harmless letters. The example hold harmless letters allow the LSC or the financial statements auditors or the FE college's new IAS access to the IAS working papers.

93 The college financial statements auditors must comply with any requests from the LSC, the DfES's internal auditors and the NAO for access to any information which they consider necessary to fulfil their responsibilities. The working papers are the property of the financial statements auditor.

Areas Common to the Internal Audit Service, Financial Statements Auditor and Funding Auditor

94 These general principles for auditors are intended to supplement, not replace, those

issued by the accountancy bodies. This is necessary because there is a public interest in the use of the LSC's funds and auditors are also concerned with the LSC's requirements.

Due care and professional care

95 Auditors must exercise both due care and professional care in their work, but the concepts can be explained separately. 'Due care' means working with competence and diligence, not infallibility or extraordinary performance. Auditors are not expected to give absolute assurance. 'Professional care' means using audit skills and judgement based upon appropriate experience, training, ability, integrity and objectivity. 'Professional care' must be appropriate to the objectives, complexity and materiality of the audit being performed.

96 In exercising due professional care auditors must:

- take reasonable steps to obtain information relevant to the audit; auditors should take into account information from the FE college, the LSC, any changes in legislation and the results of previous audit work;
- keep up to date with developments in professional matters;
- look out for and take into account any unusual circumstances;
- consider audit objectives and plan work to adhere to them;
- document the conclusions arising from the planning process, and detail a budget for staff and time;
- discuss the main features of the audit with the FE college;
- ensure that audits are staffed with suitably qualified and experienced personnel, and that work is properly controlled and reviewed;
- ensure that conclusions are adequately supported by reliable evidence; this evidence should be sufficient for an experienced auditor with no previous connection with the audit to ascertain what work was done and how the conclusions were reached;
- control costs of audit, and weigh costs and likely benefits; and
- preserve confidentiality where appropriate.

Access

97 The IAS, the financial statements auditor and the funding auditor must have unrestricted access to all documents, records, assets, personnel and premises and be authorised to obtain such information and explanations as they consider necessary for their work.

98 Each FE college must grant the head of internal audit, the financial statements auditor and the funding auditor, the right of access to the chair of the audit committee and also the right to ask the chair to convene a meeting, if necessary with, or without, other participants. The head of the IAS must have direct access to the principal and to the governing body, normally through the chair of the audit committee.

Additional services

99 The governing body must approve additional services beyond the scope of the auditors terms of reference, where the cumulative value of this work by any of the audit service providers exceeds £20,000 in any 12-month period. The governing body may choose to adopt a lower threshold for their approval. The audit committee must be informed of all work undertaken by FE college auditors.

100 The governing body and the auditors must ensure that additional services do not compromise the audit service providers' objectivity, independence or ability to achieve audit plans. All work, regardless of value, where

there is a possible conflict of interest must be referred to the governing body to enable them to formulate a view on it.

101 Under their contract with the LSC, funding auditors are permitted to perform only certain additional services at FE colleges that they audit. These services are set out in *Guidance for Audit Committees on the Audit of Individualised Student Record (ISR) Data and Final Funding Unit Claims at Colleges of Further Education* issued in September 2001. Any doubt about the permissibility of services additional to the funding audit must be referred to the LSC's national assistant director of finance (provider financial support), who will advise on what is acceptable.

Fraud and irregularity

102 The financial statements auditor of each FE college has a duty to plan and conduct the audit so that there is a reasonable expectation of detecting material misstatements in the accounts arising from irregularities, including fraud, or breaches of regulations. The financial statements auditor does not have a duty to search specifically for irregularities and fraud and their audit should not be relied upon to disclose them. Where the financial statements auditor identifies a serious weakness or an accounting or other control breakdown it must be reported to the principal, the chair of the governing body and the chair of the audit committee without delay.

103 The head of the IAS must issue written procedures to auditors on the action to be taken if they suspect or discover fraud or irregularity and must arrange to be informed by the FE college, as soon as possible, of all suspected or discovered fraud, whether internal or external. The principal and chair of the audit committee must also be informed. Where the audit committee feels there is evidence of irregularity, fraud, corruption or any impropriety, the chair of the audit committee must notify the chair of the governing body, who must raise the matter at the next meeting of the governing body. Where the matter is considered significant, the governors must consider holding a special meeting.

104 All FE colleges must have a written policy on the process to be followed when evidence of potential irregularity, including fraud, corruption or any impropriety, is discovered. The policy must include referral to the audit committee and the commissioning by the audit committee of special investigations by the IAS or others. This must be set out in the FE college's financial regulations or specified separately in a fraud policy statement. The head of the IAS must also be informed so that he or she can consider the adequacy of the relevant controls, evaluate the implication of the fraud on the risk management, control and governance processes and consider making recommendations as appropriate.

105 The FE college, and where appropriate, its funding auditor, its financial statements auditor or its IAS must report to the LSC's chief executive, and copy to the local LSC's executive director, without delay, serious weaknesses, significant frauds, major accounting and other control breakdowns of which they are aware. A serious weakness would be one which may result in a significant fraud or irregularity, and may include cases of irregularities in expenditure which could lead to suspicions of fraud. Significant fraud is usually where one or more of the following factors are involved.

- The sums of money are in excess of £10,000.
- The particulars of the fraud are novel, unusual or complex.
- There is likely to be great public interest because of the nature of the fraud or the people involved.

106 There may be circumstances that do not fit this definition. In these cases or any others, advice or clarification can be sought from the local LSC's head of PFA.

Part 4 Local Authorities

Introduction

107 This part sets out for information the LSC's general approach to assurance for its funding of learning provision delivered through local authorities.

108 The LSC's assurance arrangements do not affect the statutory requirements of local authorities in respect of the audit of their financial statements or the internal audit of their internal control. These requirements are not within the LSC's remit. The overarching requirements on local authorities and the role of the Audit Commission in certifying the auditors they appoint are set out at Annex G. The LSC's assurance arrangements are currently organised by funding stream.

Specific Assurance Arrangements

109 Local authorities are principally funded by the LSC through grant for the following.

- School sixth form funding, delivered principally through schools maintained by the local education authority (LEA). Some learning provision for pupils with special educational needs is subcontracted by the LEA to independent schools. The LSC is considering its assurance arrangements for its funding of school sixth forms.
- Adult and community learning, delivered by local authorities direct, by assignment to adult education institutions or schools maintained by the local authority, or by subcontract to other organisations. For the 2001/02 funding period, the LSC required LEAs as a condition of grant to make a return to the LSC on their use of LSC adult and community learning funds, as set out in Circular 02/10. The 2001 to 2002 return will be accompanied by a certificate on it by the LEA's auditors appointed by the Audit Commission. It is anticipated that this assurance arrangement will be retained for 2002/03.
- Further education participation and learner support, delivered principally by LEA-maintained FE institutions (FEIs). The LSC's assurance arrangements for LEA-maintained FEIs are set out in circular 02/25. The LSC requires all FEIs to make final funding claims and statements on the use of funds to the LSC. The claim and statement on use of funds must be accompanied by a certificate by the auditor appointed by the Audit Commission to audit the accounts of the local authority, as described in Annex G.
- Excellence Challenge, under a funding agreement devised by the DfES, delivered by schools. Assurance arrangements for these funds are under consideration.

110 Local authorities may be funded by the LSC under contract for work-based learning, local initiative funding, life skills, workforce development and adult information, advice and guidance. This learning provision is delivered by LEAs and institutions maintained by them. Assurance arrangements for funding paid under contract are described in part 5.

Part 5 Other Providers and Funding Streams

Introduction

111 This part sets out for information the LSC's general approach to assurance on its funding of learning provision delivered by providers other than FE colleges or local authorities. The LSC's accountability and audit requirements for the learning provision described below are set out in the schedules of the funding agreement for that learning provision. This part considers the following audit arrangements.

- Funding agreement. Many of the LSC's funding streams are delivered by a wide range of organisations under funding agreements specific to the funding stream. In 2002/03 some providers' could have more than one funding agreement.
- Provider type. Some providers, other than FE colleges or local authorities, have main funding agreements with the LSC covering a number of funding streams and are subject to a common audit arrangement for these funding streams.

Audit Arrangements Led by Funding Agreement

Work-based learning

112 The LSC funds this significant area of learning provision at all types of organisation, including commercial organisations, voluntary organisations, FE colleges, local authorities and other central government bodies. The LSC's funding agreement for work-based learning sets out the returns to the LSC required of providers and evidence that must be retained to support these returns.

113 The LSC's PFA teams give assurance on the funding of work-based learning at all other, non-FE college, providers. The PFA teams review and report to the provider on the soundness of internal control and the application of LSC funds for the purposes intended.

Other contract-based funding

114 The LSC funds significant values of learning provision through funding streams including local initiatives funding, workforce development, adult information, advice and guidance and education business links. There are also many other funding streams, with lower financial values, not listed here. Each of these funding streams is subject in 2002/03 to a separate funding agreement that each provider receives. Each funding agreement, as for work-based learning, sets out the audit arrangements required of the provider. The LSC's PFA teams will give assurance on these funding agreements as for work-based learning. Where possible the LSC's PFA teams will plan their work to cover all of a provider's contract-based funding as part of one review.

115 The LSC is the final beneficiary of a significant amount of European Social Funding (ESF) in 2002 to 2003. It is seeking to match most of this funding as co-financing of learning provision at both existing and new learning providers. The LSC will seek to perform assurance work on matched ESF as part of its normal assurance work on these providers' other funding. In some cases where the principles of co-financing do not apply, the LSC may require an audit of the costs of ESF provision.

Audit Arrangements Led by Provider Type

Higher education institutions

116 The LSC has inherited from FEFC reciprocal arrangements for its funding of higher education institutions (HEIs). Under these arrangements HEFCE, through its own audit code of practice, require HEIs to appoint auditors of their internal control, their financial statements and use of funds for the purposes

intended. These auditors report the results of their work to HEFCE. HEFCE's audit service carries out at HEIs a role parallel to the LSC's PFA teams in examining financial management and governance.

Specialist providers

117 The LSC funds learners with learning difficulties through individual placement, under schedule and purchase order, at specialist providers. Under these arrangements, the specialist provider's financial statements auditor must provide a statement on the use of LSC funds to the LSC within six months of the end of their financial year. The LSC's assurance arrangements for this funding are being redeveloped in association with the Association of National Specialist Colleges (NATSPEC) on behalf of its member specialist providers. The LSC will be seeking agreement in 2002/03 with individual specialist providers, whether members of NATSPEC or otherwise, that in future the LSC's PFA teams will provide the LSC with assurance on the use of its funds. Those specialist providers where this agreement is reached will no longer be required to commission their financial statements auditor to provide a statement on the use of LSC funds.

Independent former education institutions

118 The LSC funds further education participation and related funds at a small number of independent former education institutions. These institutions will until further notice be subject to the same assurance arrangements as LEA-maintained former education institutions. Audit reports on the independent former education institutions' funding claims and statement on use of funds are, however, provided by the institutions' financial statements auditors.

Learndirect hubs

119 The LSC directly funds further education participation at a number of **learndirect** hubs. The LSC will contract with its funding auditors to audit the hubs' funding claims and individual learner record (ILR) data returns. Where a hub makes returns to the LSC through a recipient FE college, audit of this funding will be performed by the LSC's appointed funding auditor, as part of the FE college audit. Starting from 2003/04 all **learndirect** hubs will be funded directly by the LSC.

Dance and drama schools

120 The LSC funds a number of dance and drama awards for individual learners at dance and drama schools. The funding is subject to a financial memorandum between the LSC and the dance and drama schools. Under the financial memorandum, the dance and drama school's financial statements auditor is required to report to the LSC within five months of the end of the dance and drama schools' financial year end on:

- the accuracy of data returns; and
- compliance with the requirements of the Education (Grant) (Dance and Drama) (England) Regulations 2001.

Central government bodies

121 The LSC is funding a number of central government bodies in 2002/03, mainly for work-based learning. The LSC will be exploring whether reciprocal assurance arrangements can be established for this funding with the other bodies. Where such arrangements are not established, the LSC's PFA teams will provide assurance. As described in paragraph 22 above, public sector bodies receiving LSC funding under contract will be subject to an overarching requirement set out elsewhere to make proper use of these public funds. The LSC's PFA teams will not review the proper use of public funds by central government bodies receiving work-based learning funding.

Notes

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Publication enquiries: 0870 900 6800

Reference CIRC/0659/03