

**THE
FURTHER
EDUCATION
FUNDING
COUNCIL**

**Guidance Note
on the
College Audit
Committee**

**Supplement A
to Audit Code
of Practice**

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GUIDANCE NOTE ON THE COLLEGE AUDIT COMMITTEE

Introduction

1 This guidance note supplements the audit code of practice. It gives guidance and good practice to assist colleges and audit committees in meeting the requirements of the code. The word 'should', used in the following paragraphs, denotes the Council's view of good practice. Guidance is given under the headings:

- role of the audit committee
- principal tasks of the audit committee
- membership of the audit committee
- proceedings of the audit committee
- reporting to the governing body
- irregularities, including fraud and corruption
- self-assessment.

Role of the Audit Committee

2 Model terms of reference which the governing body should establish for the audit committee are:

- to advise the governing body on the effectiveness of the college's whole system of internal control, including controls for securing economy, efficiency and effectiveness (value for money)
- to advise the governing body on the appointment, reappointment, dismissal and remuneration of the external auditor and the internal audit service
- to advise the governing body on the scope and objectives of the work of the external auditor and the internal audit service
- to ensure co-ordination between the internal audit service and external auditor
- to consider and advise the governing body on the audit needs assessment and strategic and annual internal audit plans for the internal audit service
- to advise the governing body on internal audit assignment reports and annual reports and on control issues included in the external auditor's management letters, and management's response to these

- to consider and advise the governing body on relevant reports by the NAO and the Council, and where appropriate, management's response to these
- to monitor, within an agreed timescale, the implementation of agreed recommendations relating to internal audit assignment reports, internal audit annual reports and external auditors' management letters
- to establish, in conjunction with college management, relevant performance measures and indicators and to monitor the effectiveness of the internal audit service and external auditor through these measures and indicators
- to produce an annual report for the governing body which includes the committee's advice on the effectiveness of the college's system of internal control. The report should incorporate any significant matters arising from the work of the internal audit service and external auditor.

3 In order to exercise its role the audit committee should have the power to:

- investigate any activity within its terms of reference
- seek any information it requires from the internal audit service, the external auditor, governors, committees and college employees, plus relevant information from subcontractors and other third parties
- obtain external professional advice.

4 The governing body must not add to these terms of reference responsibilities that require the audit committee to adopt an executive role, or its members to offer professional advice to the governing body. Advice should be given only in committee members' capacity as governors, and only within their terms of reference. Rather than adopt an executive role, the audit committee should seek formal professional opinions from the internal audit service, external auditor or other professional advisers to the governing body. The terms of reference should be formally approved by the governing body and this approval should be formally minuted.

5 *The Report of the Committee on the Financial Aspects of Corporate Governance* (the Cadbury committee) recommended that audit committees should review the interim and annual financial statements before submission to the board. This recommendation was made for organisations the structure of which would not normally include a finance committee or equivalent. Almost all colleges do have a finance committee. The existence of a finance committee at colleges presents them with an opportunity to maximise the independence of the audit committee. This is through not involving the audit committee in reviewing and advising the governing body on the financial statements. Audit committees should not adopt the review of financial statements as a term of reference, but should review the financial statements in view of the recommendations made in external audit management letters only. They should not become involved in commenting on accounting policies. When a college does not have a finance committee, the governing body should undertake the detailed review of the financial statements.

6 Similarly, the audit committee should not become involved in the review and provision of advice to the governing body on the approval of the college's financial regulations and procedures. This role should be adopted by the finance committee or by the governing body in the absence of a finance committee. The audit committee's role should be to examine the soundness of, and compliance with, the financial regulations and procedures through the work of the internal audit service and external auditor and to advise the governing body accordingly.

7 There is a clear distinction between the roles of the audit committee and the finance committee, although in practice there may be some confusion. The finance committee monitors the financial position of the college and advises the governing body on the solvency of the college, and other financial aspects, including the budget, management accounts, and statutory financial statements. The finance committee should advise the governing body on the budget, monitor the budget and advise on whether the governing body can approve the annual financial statements. In contrast, the audit committee should advise on the audit plans, monitor the internal audit service's performance against these plans, and then consider the college internal audit service's annual report.

Principal Tasks of the Audit Committee

8 To enable the audit committee to fulfil its terms of reference effectively, it should structure its work in terms of the reports it receives and the timing of certain events.

9 Continuity of coverage of external and internal audit is essential. Where the college is due to retender for the internal audit service and external auditor, the selection process should be initiated during the spring of the final contract year, to allow the audit committee to make its recommendation to the corporation by the end of the final contract year. For example, if the final contract year is the year to July 1999, the selection process should be initiated by the spring of that year.

10 The audit committee should monitor the performance of the internal audit service and the external auditor each year in time for remedial action to be taken. For example, if the first review of performance of the internal audit service takes place before the end of the calendar year, with a second review in the spring of the following calendar year, this should allow time to rectify the situation, or allow a change of auditors early in the financial year. Appendix 1 of this guidance note provides suggested performance indicators to assist in monitoring the performance of internal audit and appendix 2 provides suggested performance indicators for monitoring the performance of the external auditor.

11 The audit committee should consider and advise the governing body on the internal audit needs assessment and audit plans. The governing body should approve these annually at the start of the year to which they relate, and in any event, before the commencement of work.

12 All internal audit assignment reports should be submitted to the audit committee sufficiently in advance of meetings to allow their proper consideration. The extent to which these should be reviewed is a matter for individual members. Reports should be received in a format that includes the management response. Where any recommendation is accepted by college management, the audit committee should ensure that it is aware of the person responsible for the action and the date by which action is to be completed. The audit committee should seek periodic updates from college management on the implementation of recommendations.

Membership of the Audit Committee

13 Many colleges continue to experience difficulties in securing sufficient attendance of committee members at meetings of the audit committee. The audit committee should consist of three to five members, but no fewer than three. At least one member should have relevant skills and experience. The Council has found that members greatly enhance the effectiveness of audit committees when they have experience in:

- delivering internal audit services, or managing the results of internal audit
- delivering a sound framework of internal control in a business as complex as a college.

14 The majority of the members should be governors but the governing body may co-opt persons to the audit committee who are not governors. Many colleges have found this effective, without the need to divert governors with financial skills from the finance committee, or equivalent, to serve on the audit committee. The chairman of the committee should normally be a governor to allow effective feedback to the governing body. However, if suitable and effective reporting procedures can be devised, a co-opted member may chair the committee. The governing body must determine and minute their approval of the membership of the audit committee. This determination should include a quorum for the committee which, in the Council's opinion, should be a minimum of two members, both of whom should be governors.

15 The audit committee's position within a college's structure of governance is challenging in that it may on occasion examine evidence that is critical of aspects of the college's governance, management and professional advisers. To maximise the audit committee's independence and objectivity, the following persons should not be asked to serve as members of the audit committee:

- governors with significant interests in the college. Examples of financial and personal interests are given in the Council's publication, *College Governance: A guide for clerks*
- those with executive responsibilities for the college at senior level, such as the principal and senior postholders at the college, whether as co-opted members of the committee, staff governors or co-opted

governors. Other members of the college's staff who are governors may serve on the audit committee, provided that they do not have significant executive, management, financial or budgetary responsibilities which would allow them to influence strategy decisions within the college

- employees, partners or those with a significant interest in any of the college's professional advisers or suppliers of other significant goods or services. Professional advisers include the college's internal audit service, its external auditor, solicitors, bankers, insurers and property advisers
- the chairman of the governing body and the members of the finance committee or equivalent.

16 It is for the governing body to decide whether an interest is significant. In doing so, reference might be made to the college's register of interests. The Committee of Public Accounts in its eighth report *The Proper Conduct of Public Business* noted that 'care should be taken to avoid actual, potential, perceived and perceivable conflicts of interest'.

17 Where a member of the audit committee has a perceived interest in any matter to be considered by the committee, similar procedures relating to declarations of interest to those outlined in the college's instrument of government and standing orders should apply.

Proceedings of the Audit Committee

18 The frequency of meetings of the audit committee is a matter for the governing body, but it should normally meet at least termly. For smaller colleges, two meetings a year may be acceptable, depending on the reporting cycle of internal and external audit. In determining its meeting cycle, the audit committee should take account of:

- the need to operate regularly and frequently as part of the governance of the college
- the timing of the work of the college internal audit service and external auditor
- the need to sustain the interest of its members.

19 The head of internal audit should normally attend, as a minimum, all meetings where internal audit plans and reports are to be discussed. The external audit partner should normally attend any meetings where the management letter or other report is being considered. If the head of internal audit or external audit partner is unable to attend, a suitable representative should attend with prior agreement from the chairman of the committee.

20 Governors who are not members of the committee should have the right of attendance at meetings, save that the committee may, when it is satisfied that it is appropriate, go into confidential session and exclude any, or all, participants and observers.

21 Senior managers of the college should be invited to attend meetings of the audit committee as required to provide information and to give their views. This attendance should not be limited to the director of finance or equivalent, but should include senior managers from any part of the college's system of internal control under examination.

22 The governing body, through the audit committee, is ultimately responsible for ensuring that prompt and effective action is taken on those audit reports that call for it, and for recognising and accepting the risks resulting from not taking action. The audit committee should advise the governing body where, without good reason, action is not being taken on audit reports. The governing body should consider this as an item of business at its next meeting.

23 The clerk to the committee may find the Council's publication, *College Governance: A guide for clerks* useful in administering the committee's business. The meetings of the audit committee should be minuted. The minutes should form part of the papers presented to the governing body at its next meeting. The audit committee should be clear in its advice to the governing body. The clerk to the governing body should normally service the audit committee and help its chairman to plan future business. However, where the clerk also has financial responsibilities at senior management level within the college, the governing body should consider the need for audit committee meetings to be serviced by another person to ensure the independence of the clerk to the audit committee.

Reporting to the Governing Body

24 The internal audit annual report should be received by the audit committee in time to allow the audit committee to report formally to the governing body on the state of the whole system of internal control within the college, before the governing body approves the college's financial statements.

25 The audit committee's annual report to the governing body should include its advice on the effectiveness of the college's whole system of internal control and be based on the internal audit annual report and external audit management letter. The report should incorporate any significant matters arising from the work of the internal audit service or external auditor. Model contents of an audit committee annual report which the committee may wish to adopt is at appendix 3 to this supplement.

Irregularities, Including Fraud and Corruption

26 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. This may be set out in the college's financial regulations or specified separately in a 'fraud policy statement'. Such a statement, which also contributes to an anti-fraud culture, may include some or all of the following areas:

- allocation of responsibilities for the overall management of fraud
- the procedures which staff should follow if a fraud is discovered, including referral to the audit committee and the commissioning by the audit committee of special investigations by the internal audit service or others
- guidance on training for the prevention and detection of fraud
- reference to the response plans that have been devised to deal with and minimise the damage caused by any fraudulent act.

27 Colleges may also find it useful to formulate a fraud response plan in order to clarify the action to be taken in the event of a fraud, and to act without delay. A fraud response plan may include the following areas:

- to whom the fraud or suspicion of fraud should be reported in the first instance
- how the college should investigate the fraud
- how to secure the evidence in a legally admissible form
- when and how to contact the police, if appropriate
- how to initiate recovery action
- who else to contact for advice
- how to disseminate the lessons learned from the experience in cases where there may be implications for the college as a whole.

28 The Council's audit service can provide advice to colleges on dealing with fraud and irregularity, particularly when notified at an early stage.

Self-assessment

29 Appendix 4 to this supplement is a checklist which is offered to audit committees to assist them in assessing their performance. It is not part of the audit framework.

SUGGESTED PERFORMANCE INDICATORS FOR THE COLLEGE INTERNAL AUDIT SERVICE

1 The audit committee should devise suitable performance indicators for the work of the internal audit service and monitor its achievement against these. The achievement should form part of the basis for the governing body's decision on the annual reappointment of the internal audit service.

2 An ideal set of performance indicators is difficult to devise. Many indicators are either spurious or intermediate measures of performance. Some invite attempts to inflate apparent success by subdividing units of achievement in order to increase their number. In many cases, the most successful indicators necessarily contain a large degree of subjective opinion.

3 Table 1 contains suggested indicators. These are not exhaustive nor necessarily appropriate to all colleges. An appropriate set of performance indicators may consist of four to six of those listed below. Each indicator is given a suggested frequency of monitoring.

Table 1. Suggested performance indicators

<i>Indicator</i>	<i>Timing</i>
Provision of service	
<ul style="list-style-type: none"> cost of service year-on-year within contract. Competition will prove a powerful indicator at the time of renewal of contract 	annual
<ul style="list-style-type: none"> external comparisons with other colleges, although such comparisons may be difficult 	as possible
<ul style="list-style-type: none"> percentage of work undertaken by qualified and experienced personnel 	annual
<ul style="list-style-type: none"> percentage staff turnover rates 	annual
<ul style="list-style-type: none"> planned and out-turn percentages of time employed on audit of systems within the annual plan 	annual

<i>Indicator</i>	<i>Timing</i>
<ul style="list-style-type: none"> actual time spent on individual audit assignments against that planned* 	after each assignment and at time of annual report
Planning	
<ul style="list-style-type: none"> observance of Council guidance in preparation and content of the audit needs assessment (ANA) and strategic and annual audit plans 	annual, at time of planning
<ul style="list-style-type: none"> submission of ANA and plans to the audit committee in time for agreement by the governing body at the start of the year to which they relate, and in any event, before the commencement of work 	annual, at time of planning
Approach	
<ul style="list-style-type: none"> observance of Council guidance on performance of assignments, especially in agreement of scope and timing of each assignment, identification of systems objectives and control objectives with management* 	after each assignment
<ul style="list-style-type: none"> management's perceptions of depth and impact of recommendations including systems weaknesses not identified by the audit* 	after each assignment
<ul style="list-style-type: none"> performance of follow-up work within an agreed timescale following finalisation of assignment report 	annual
Reporting	
<ul style="list-style-type: none"> completion of every assignment in the annual plan, subject to variations agreed by the audit committee, and if appropriate, the head of internal audit 	at time of annual report
<ul style="list-style-type: none"> fulfilment of the scope and objectives of each assignment in the annual plan* 	after each assignment
<ul style="list-style-type: none"> evaluation of all systems objectives and control objectives identified for each system reviewed* 	after each assignment

Indicator	Timing	Indicator	Timing
<ul style="list-style-type: none"> observance of Council guidance on assignment reports, especially the existence of a clear opinion on the adequacy and effectiveness of operation of internal control in each system audited in the assignment, an action plan of prioritised recommendations and management response, person responsible and date for completion of action 	after each assignment	<ul style="list-style-type: none"> results of review of the work of the internal audit service by the Council's audit service 	as appropriate
<ul style="list-style-type: none"> issue of draft and final reports within the period specified in the internal audit service's terms of reference 	after each assignment	<ul style="list-style-type: none"> savings generated as a result of internal audit work. Apart from the realisation of such indicators being often difficult to prove, the generation of savings is not a principal objective of the core assurance provided by the internal audit service. Savings will be relevant where the internal audit service has been tasked with value-for-money reviews over and above the core assurance* 	annual
<ul style="list-style-type: none"> the number of agreed findings or recommendations made by the internal audit service. Regard should be paid to the quality of findings, not simply the quantity. The subdivision of broad findings and recommendations and comment on trivial matters should be avoided. The condition of the system under audit will also influence the number of recommendations made⁺ 	after each assignment	<p>* indicators which might be evaluated through a written performance survey conducted by internal audit after each assignment, the results of which should be presented to the audit committee. An example is provided as an addendum to this appendix. See paragraph 4 for further discussion</p> <p>+ indicators which should be treated with particular caution. See paragraph 4 for further discussion</p>	
<ul style="list-style-type: none"> the number of assignments completed, systems audited, or reports issued without regard for quality⁺ 	annual	<p>4 Structured questionnaires permit easier evaluation by assigning scores to the response for each aspect of the audit. Bias can be reduced by sending questionnaires on the same audit to various levels of management. Such indicators should be used with caution as results will be subjective. A better appraisal may be achieved by aggregating a number of audits over time. Also, care should be taken to avoid creating conditions that inhibit the reporting of controversial recommendations.</p>	
Relationships			
<ul style="list-style-type: none"> evidence of co-ordination between the internal audit service and the external auditor 	annual		
<ul style="list-style-type: none"> attendance at audit committee 	each audit committee meeting invited to		
Other			
<ul style="list-style-type: none"> results of review of the work of the internal audit service by the external auditor if they intend to rely on it 	annual		

EXAMPLE OF SURVEY OF PERFORMANCE

[] College Internal Audit Service: Satisfaction Survey

Audit:

Completed by:

Our service to the governing body and management of the college is enhanced by our understanding of the usefulness of our work for you. Please complete the following survey and return it to me direct. The survey will form part of our reporting to the audit committee of our performance in the year.

<i>Indicator</i>	<i>Good</i>	<i>Adequate</i>	<i>Inadequate</i>	<i>Poor</i>
Planning				
Did the scope of the audit cover the system being audited?				
Did you agree the systems and control objectives for the system?				
How useful were the planning discussions?				
Delivery				
Did the audit take place at the agreed times and locations?				
Was the audit for the agreed duration?				
Were the personnel those expected?				
Quality				
How well did the auditors appear to understand the law and know the Council's requirements?				
How well did the auditors know the college and the system?				
Did the audit identify all the main strengths and weaknesses of the system?				
Reporting				
Was the report issued promptly?				
Did it reflect the closure meeting?				
How useful were the recommendations?				
Were the report and the opinion given easily understood?				
Was the report in the agreed format?				

SUGGESTED PERFORMANCE INDICATORS FOR THE COLLEGE EXTERNAL AUDITOR

1 Concepts of measurement of the effectiveness of the external auditor are less developed. For colleges, duties of external auditors are rigidly defined by statute and professional standards, supplemented by Council requirements. Relevant questions in relation to the duties of the external auditor might centre on:

- the external auditor's understanding of their duties and the college's business
- the likelihood that the work has been planned and conducted in a way that will discharge the duties
- the actual discharge of the duties.

2 The outputs of the external auditor are limited in extent to an opinion and management letter. The consideration of these outputs and the operation of external audit are largely the same as for the internal audit service. An appropriate set of performance indicators may consist of four to six indicators. They might centre on:

- the adequacy of the work done to produce the management letter
- the depth, impact and usefulness of recommendations in the management letter
- the degree of acceptance of recommendations and their actual implementation
- the make-up, skills and stability of the external audit team against expectations
- whether any subsequent material errors within the financial statements or final funding unit claim were detected
- the level of liaison with the internal audit service
- the auditor's performance at audit committee meetings
- continuity of staff.

Use of a client satisfaction survey similar to the example provided at the addendum to appendix 1 to this supplement may also be appropriate.

MODEL CONTENTS OF AN AUDIT COMMITTEE ANNUAL REPORT

The annual report should be prepared as early as possible in respect of each year with the aim of it being available to the governing body by the time the annual financial statements are signed. It is suggested that the report could contain (as appropriate) the following:

- introduction (period covered, and so on)
- membership of audit committee, highlighting changes
- summary of when meetings were held
- terms of reference of committee, highlighting changes
- review of reports of internal audit service
- review of management letter of external auditor
- review of other work done, for example, Council reports, NAO reports, VFM work
- any other relevant matters
- audit committee's opinion to the governing body on the adequacy and effectiveness of the college's internal control system and the extent to which they can rely on it.

SELF-ASSESSMENT CHECKLIST FOR AUDIT COMMITTEE

Membership

- there is an audit committee
- the committee has three to five members
- the governing body has determined the numbers of members of the committee and terms on which they are to hold and vacate office
- the majority of members are from the governing body
- members, including co-opted members, do not have interests in the college
- membership excludes the chairman of the governing body, principal and members of the finance committee or equivalent
- membership excludes college personnel and staff governors, where these have executive responsibilities for the college at senior level
- a quorum has been set and is observed in practice
- the committee has sufficient, relevant expertise
- appropriate clerking arrangements have been established which ensure that the clerk to the committee does not have financial responsibilities at senior management level within the college.

Terms of Reference

- the terms of reference reflect the model in paragraph 2 of this supplement
- the terms of reference make clear the responsibilities and levels of authority of the committee
- the terms of reference of the committee have been approved by the governing body
- the committee's agendas and minutes indicate completeness of coverage of its terms of reference

- the committee confines itself to an advisory role on matters beyond its powers
- discussions by the committee and its recommendations are adequately reported to the governing body
- members are aware of the committee's terms of reference.

Operation

- the committee normally meets at least termly
- committee meetings are timed to report to the governing body's meetings
- the timing and content of the committee meetings match the internal and external audit planning and reporting cycles
- minutes are prepared for meetings of the committee
- the head of internal audit normally attends committee meetings
- the external auditor attends committee meetings as appropriate
- senior managers are invited to attend meetings of the committee as required
- the committee annually assesses its performance against the requirements set out in its terms of reference
- the committee reviews the college's arrangements for ensuring VFM
- the committee prepares an annual report to the governing body.

