

**THE
FURTHER
EDUCATION
FUNDING
COUNCIL**

**Guidance Note
on Areas
Common to the
College
Internal Audit
Service and
External
Auditor**

**Supplement D
to Audit Code
of Practice**

CONTENTS

	Paragraph
Introduction	1
Selection of the college internal audit service and external auditor	2
Terms of engagement	7
Independence	8
Additional services	9
Reappointment of auditors	11
Removal or resignation of auditors	14
Relationship with other auditors	19
Auditors' liability	22
How to assess limitation of liability in practice	26
Appendix: Selection of the college internal audit service and external auditor	

GUIDANCE NOTE ON AREAS COMMON TO THE COLLEGE INTERNAL AUDIT SERVICE AND EXTERNAL AUDITOR

Introduction

1 This guidance note supplements the audit code of practice. It gives guidance and good practice on areas common to the college internal audit service and external auditor, and covers the selection of auditors. Guidance is intended to assist with compliance with the code, and is given under the headings:

- selection of college internal audit service and external auditor
- terms of engagement
- independence
- additional services
- reappointment of auditors
- removal or resignation of auditors
- relationship with other auditors
- auditors' liability
- how to assess limitation of liability in practice.

Selection of the College Internal Audit Service and External Auditor

2 The selection of the college internal audit service should be subject to the same procedures as for the external auditor. This is in response to the Council's experience of the first five years of internal audit service provision at colleges. The Council has not been able to place reliance upon the work of a significant proportion of internal audit service providers in each of those years. This has been due mainly to internal auditors not fully complying with the standards set out in the *Government Internal Audit Manual* (GIAM). The inability to place reliance on this work strikes at the heart of the Council's 'arm's length' relationship to the internal audit of colleges. It has also caused considerable problems to colleges. It is necessary for the Council to assure itself that colleges' internal audit services being put in place are likely to give a service on which it can rely.

3 The college is required to subject its internal audit service and the external auditor to competition for both quality and price at least every five years.

The college's financial regulations may require full tendering or a more limited competition, depending on the value of the contract.

4 The governing body, advised by its audit committee, is responsible for appointing the college internal audit service and the external auditor. The audit committee should determine selection criteria in advance of receiving proposals. Key selection criteria include:

- the relevant experience of the internal audit service provider or external audit firm and in particular the relevant experience of the partner and audit manager responsible for the audit
- the audit fee, including a clear basis and commitment on future fee increases.

5 The tender process will include receipt of proposals for an audit service. The college must consult the Council's audit service on its shortlist of providers tendering for its internal audit service and external auditor. The college must send copies of the audit proposals to the Council, to assist in the consultation process. The audit service will make every effort to respond to this consultation promptly, but would ask that two weeks' notice is given. The reason behind the consultation is that the Council's chief executive, as accounting officer, will rely, to a large extent, on audit work carried out at colleges in order to fulfil the following responsibilities of his accountability to parliament:

- ensuring that public funds are safeguarded
- securing value for money from public funds
- monitoring colleges' compliance with any terms and conditions attached to their funding.

The Council therefore has an interest in the selection process by which auditors are appointed, and the appointments themselves.

6 Guidance on the selection of an internal audit service and external auditor is given in the appendix to this supplement.

Terms of Engagement

7 The duties of colleges and their internal audit service and external auditor should be clearly presented in agreed terms of engagement. Model terms of reference for use by the college internal

audit service are at appendix 2 to supplement B, and a model letter of engagement for external auditors is at appendix 1 to supplement C. The letters of engagement prepared by the auditors should incorporate these model terms. Copies of letters of engagement should be sent to the chief auditor.

Independence

8 The following should be avoided by the college internal audit service and external auditor:

- official, business, professional and personal relationships with college staff or governors which might cause, or be perceived to cause, either auditor to limit the scope or character of the audit
- any financial interest, direct or indirect, in the college (other than the normal contractor – provider relationship).

Additional Services

9 Whether the college internal audit service and external auditor provide additional services beyond the scope of their audits is generally a matter for the college. Both the governors and the auditors must ensure that the undertaking of additional work does not impair the objectivity of the college internal audit service and external auditor when forming their audit opinions. Particular care needs to be taken if the external auditor is also appointed to provide the college internal audit service. It is good practice for the extent and nature of other work to be approved by the governing body in advance of that work taking place. If other work accounts for more than 50 per cent of the external audit or internal audit annual fee, that work should be approved by the governing body before it is undertaken. Other work below this limit may be approved with delegated authority. All additional work should be reported to and considered for the impact on audit independence by the governing body.

10 In order to judge the relationship between the college and its internal audit service and external auditor, the college should disclose separately, by way of a note to its financial statements, the fees paid to:

- its external auditor for the audit of the college's financial statements and statistical returns required by the Council
- its internal audit service
- its internal audit service and external auditor for additional services.

Reappointment of Auditors

11 The governing body should reappoint the college internal audit service and the external auditor formally each year, on the advice of the audit committee. The audit committee should review the college internal audit service's work and the external auditor's work at the end of each year to ensure that the college is receiving sufficient work of a high standard at a reasonable price. Where the governing body is satisfied with the work of the college internal audit service and the external auditor, it should reappoint them. It will not then be necessary to repeat the full selection process each year. New letters of engagement need only be agreed at the end of the contract period.

12 Many colleges have experienced changes to their external auditor and internal audit service due to circumstances beyond their control. These might be due to mergers, demergers, takeovers or other reorganisations, or withdrawal of service by the service provider.

13 Depending on the extent of the change, there might be a considerable reduction in the pool of skills and experience available to the college internal audit service and external auditor. Where a demerger or other reorganisation has taken place, the staffing of the local office of the service provider may appear to be unaffected. Where a local office breaks away from a national organisation, the quality control systems and specialised technical support provided by the larger organisation will not necessarily be available to the new provider. In these circumstances, the college should consider retendering the appointment. If in any doubt the matter should be referred to the Council's chief auditor. If the change is notified by its service provider to the college:

- four months or more before the college's year-end, the retender should be for the coming year; that is, a change notified in December 1998 should lead to a tender for 1999-2000
- fewer than four months before its year-end, the retender should be for the second year; that is, a change notified to the college in May 1999 should lead to a tender for 2000-01.

Removal or Resignation of Auditors

14 The governing body may by resolution remove the internal audit service or the external auditor, or both, before their terms of office expire. The internal audit service and external auditor may formally resign their position, before their terms of office expire. A period of notice may be agreed for this.

15 The internal audit service and the external auditor have important responsibilities to the governing body of the college. They should have a right to notice of, and attendance at, governing body meetings. This right should extend to being heard at any meeting they attend.

16 Where the college internal audit service or the external 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 college internal audit service or the external auditor may also requisition a special meeting of the governing body to consider the statement. These provisions are analogous to those of the *Companies Act 1985*.

17 The governing body must inform the Council's chief auditor without delay of the removal or resignation of the college internal audit service or the external auditor. In addition, the Council's audit service should be sent a copy of any statement provided to the governing body by the outgoing internal audit service or external auditor.

18 In order to decide whether or not to accept the appointment, the internal audit service provider or external auditor proposing to take up office should obtain the college's permission to communicate with the outgoing auditors. In the same way, outgoing auditors should obtain permission from the college to discuss its affairs freely with the proposed auditors and should disclose fully all information required by the proposed auditors which is relevant to the appointment. These provisions are in accordance with the ethical guidance published by professional accountancy bodies.

Relationship with other Auditors

19 There should be liaison between the college internal audit service and external auditor. Liaison should be, for example, by exchange of plans,

reports and systems documentation. The audit committee may consider attendance by both sets of auditors at the audit committee meeting in advance of the audit year to discuss arrangements for liaison.

20 The internal audit service is part of the whole system of internal control of the college. As with any other internal control, the college external auditor should consider evaluating the work of the internal audit service. Where the college external auditor has assessed the internal audit work upon which it wishes to rely, the external auditor might be able to reduce its own workplans. The college internal audit service and the external auditor should aim to co-ordinate their coverage of particular systems of internal control. This co-ordination should be encouraged by the audit committee.

21 Where the college external auditor assesses the work of the internal audit service, there should be no expectation on the part of the college or its external auditor that certain external audit tasks are to be performed by the college internal audit service. Where this has been found to happen, it involves evaluation and testing, usually annually, of certain financial transactions and student-related processing systems operated by the college. Internal audit service plans should be formulated independently of the duties of the college external auditor and the extent and frequency of coverage of such systems is at the judgement of the head of internal audit. The college internal audit service may take account of external auditor's findings in its own work.

Auditors' Liability

22 For most categories of work undertaken by audit providers, except external audit 'certification work' ('certification work' includes work performed on the final funding unit claim), colleges are not prevented from negotiating with audit firms 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 college, the Council, the DfEE and taxpayers. Value for money will probably mean a substantially lower price, but a firm may offer other benefits such as greater use of more experienced staff.

23 A college will need to assess the likely consequences of any loss suffered by a firm's negligence, the effect of the terms of any restriction

of liability (for example, are there overall financial limits or are certain risks excluded altogether irrespective of the degree of financial loss?); and the level of professional indemnity insurance held by the firm. If a college is satisfied that there are value-for-money benefits in agreeing to a firm's restricting its liability, it may negotiate with the firm on the terms of such restrictions.

24 In cases where the whole of the internal audit function is contracted out to an accountancy firm, the audit partner or equivalent, will be responsible for providing assurance to the governing body on the internal control system. Although colleges are not prevented from negotiating with firms over the terms of any restriction on their liability in the case of internal audit assignments, it seems unlikely that the wider interests of the college, the Council or the DfEE or taxpayers in general would be best served by agreeing to any restrictions in these circumstances. Firms will need to produce very convincing evidence that accepting restrictions on their liability represents value for money in view of the significance to the college of the assurances given on the internal control system and the potential for loss should the firm prove negligent. For internal audit work generally, where assurance is being provided on the internal control system it seems unlikely that the wider interests of the college, the Council or the DfEE or taxpayers will be satisfied if restrictions are accepted.

25 Similar considerations to those described above apply also to 'other work' in general. Colleges are not prevented from negotiating with audit providers which wish to include provisions which restrict its liabilities. Colleges should again be satisfied that there are value-for-money benefits and that the position of the college, the Council and DfEE is safeguarded. In the case of some consultancy assignments, for example, the design and implementation of computer systems, the risk of loss through negligence might be high and firms must put up a very strong case to justify the value-for-money aspects resulting from acceptance of a restriction of liability.

How to Assess Limitation of Liability in Practice

26 In most cases, limitation of liability will result in a cap on liability that will either be based on the level of fees charged for the service or on a fixed monetary sum. This may also be modified by proportional liability whereby, within a defined cap,

the firm accepts liability only to the extent that it bears responsibility for the issue that has caused loss. These policies will often mean that arrangements for limiting liability vary from assignment to assignment depending upon perceptions of risk. It would not be appropriate for firms to submit tenders on two different bases, that is, both with and without limitation of liability, since this wrongly suggests that the service provider is offering insurance to the college at a premium. In assessing tenders for work which contain suggested limitations of liability, colleges must first consider the criteria established above:

- a. there must be very convincing evidence of value-for-money, that is, a substantially lower price, or other benefits;
- b. the reduced level of assurance offered.

27 This process will be complex where colleges are considering several tenders which contain varying costs, levels of service and limitations of liability. Audit providers will consider limitation of liability as part of determining the balance of risk and reward in tendering for work. Colleges should press audit providers as to the rationale behind any proposed limitation. It is helpful for colleges to understand the factors that audit providers will take into account in considering whether to limit liability. Guidance produced by the ICAEW indicates that these factors fall into three categories:

- a. those related to the individual college:
 - i. the size, nature and complexity of a college's operations when considering both the level of risk and size of any potential loss
 - ii. the majority of college operations are not inherently risky, but providers will be aware that particular colleges may have specific risks perhaps associated with contracts (building work or collaborative provision, for example)
 - iii. previous history of frauds or other losses
 - iv. previous history of claims against auditors;
- b. those related to the service to be provided:
 - i. the greater extent of any restrictions that are placed on the operation of the service (in terms of internal audit this may mean restricted access to certain activities or people or a restriction on the number of

- days), the greater the prospect that the provider will seek a lower limit
- ii. the less management's involvement (including governors) with the service, the less responsibility they are perceived to be taking, the greater prospect that the provider will seek a lower limit
 - iii. where internal audit has a low profile or a poor reputation, the less the prospect of identifying problems which could lead to the provider to seek a lower limit;
- c. those related to the provider:
- i. the better the firm's understanding of the service to be provided (for example, knowledge of further education or the public sector more generally, or the greater the experience of internal audit and so on) the greater the likelihood that a higher limit would not be needed
 - ii. the better the firm's quality control procedures (for example, calibre of personnel, training or briefing of staff, review procedures, internal quality control reviews, or results of external reviews such as the Council), the greater the likelihood that a higher limit would not be needed
 - iii. the greater the resources of the firm, the greater the possibility that a higher limit could be offered.

28 In practice it will be difficult for colleges to assess the practical impact of a limitation of liability. The governing body must specifically consider and approve any request for a liability restriction. This consideration should have regard to this guidance and include receipt of evidence that the level of professional indemnity insurance held by the auditor is sufficient to cover the limited sum. To assist colleges, the Council provides in table 1 the limits below which colleges should not accept limitation of liability for individual assignments or contracts, without prior reference to the Council's chief auditor.

Table 1. Lowest limitation of liability

<i>College turnover</i>	<i>Lowest limitation of liability for each contract</i>
less than £10 million	£5 million
£10 million to £20 million	£7.5 million
greater than £20 million	£10 million

SELECTION OF THE COLLEGE INTERNAL AUDIT SERVICE AND EXTERNAL AUDITOR

1 In advance of receiving proposals, the audit committee should consider the selection criteria it intends to adopt. The college audit committee might find the checklist in table 1 on page 11 useful. This is presented in three parts:

- assessment criteria that should be applied to both the internal audit service and the external auditor (part 1)
- assessment criteria relating to the external auditor (part 2)
- assessment criteria relating to the internal audit service (part 3).

Changes in Audit Needs

2 Colleges should be prepared to accept a change to the audit need from that quoted in the proposal. At the same time, colleges will understandably be reluctant to allow tenderers for an internal audit service unlimited licence to revise their bids after appointment. Various devices might be employed to limit the potential for this by increasing the accuracy of the fee in the proposal:

- colleges may offer information on their whole system of internal control, that while not commercially sensitive, will inform bids
- those tendering might be allowed limited access to the college to gather information for their proposal
- the proposed fees might be expressed as a maximum to be charged with information on the daily rates and number of days supplied, to allow for sensitivity analysis.

Table 1. Selection criteria for internal audit service and external auditor

<i>Criteria</i>	<i>Assessment</i>
Part 1 Internal audit service and external auditor	
Knowledge of Sector	
1 Does the provider demonstrate knowledge of: <ul style="list-style-type: none"> • audit of public sector enterprises • education audit, especially of further education • legislation and Council requirements for further education • the Council's requirements for audit • auditing subsidiary companies of charitable bodies • the college, its operations, complexity, activities special to the college, its mission statement, strategic plan and major relationships with other bodies? 	
2 Either: <ul style="list-style-type: none"> • is this knowledge supported by direct experience of the work, or • if little or no experience, how has the provider demonstrated an investment in training and technical development to enable it to do the job? 	
Staffing	
3 Do the provider's proposals specify the senior personnel assigned to the audit?	
4 Have the curricula vitae of the external audit partner or head of internal audit and of the manager and specialist personnel been provided?	
5 How do these support the provider's claims of relevant knowledge and experience?	
6 Is the external audit partner or head of internal audit to be involved at the annual planning stage and in the final clearance process of each report?	
7 Does the external audit partner or head of internal audit intend to visit the college for important meetings and to be available to discuss wider issues as they arise during the year?	
8 What continuity of personnel is offered, for example, the minimum period of service at each grade with special emphasis on the external audit partner or head of internal audit and manager?	
9 Does the mix of staffing approximate to: <ul style="list-style-type: none"> • external audit partner or head of internal audit 2% – 5% • manager 8% – 20% • other qualified personnel 30% – 60% • unqualified personnel 30% – 60% 	
10 Does the provider acknowledge the need to provide specialist skills, including computer audit, as part of the routine work?	

<i>Criteria</i>	<i>Assessment</i>
Audit Fees	
11 Is the calculation of fees in line with normal practice, that is, based on actual time spent by individual personnel, multiplied by differential rates per grade of personnel (partner, manager and so on)?	
12 Is a fixed total fee for the audit quoted?	
13 Does this fee include VAT?	
14 What are the expected pre-audit costs (paragraph 2, appendix to supplement D)?	
15 For how long is the initial fee quoted expected to be binding?	
16 What is the basis for future charges? (Assurance should be obtained that fees will not rise sharply after an initial low quote.)	
17 Where future increases are based upon an inflator, is this the retail price index (RPI)? (Colleges are advised against agreeing to increases based on the audit provider's internal inflation rates as these are likely to be significantly higher than inflation increases experienced by colleges.)	
18 Does the work covered by the fixed fee include: <ul style="list-style-type: none"> for the college external auditor, work on the audit of statistical returns required by the Council for the college internal audit service and external auditors, audit of collaborative provision and college subsidiary companies? 	
19 How are expenses treated?	
20 Can the provider serve other locations of the college at reasonable expense if geographically removed?	
21 Does the fee include attendance at audit committee and governing body meetings?	
Additional Services	
(paragraph 9, supplement D)	
22 Is the provider able to offer the college any additional services it may require such as: <ul style="list-style-type: none"> assistance with accounts work PAYE, VAT and other taxation advice management consultancy assistance with systems development? 	
23 Has the provider given firm quotes for fees for additional services?	
24 Is there a discount for fees for additional services to allow for the providers' familiarity with the college?	
25 How does the provider propose to maintain the independence of staffing for the college internal audit service and external auditor from those providing other services? (As far as possible this should be totally separate.)	
Other Relevant Factors	
26 Are there any conflicts of interest and close relationships between the auditors and the college governors and staff?	
27 What are the auditors' requirements of the college in terms of facilities (a room with a telephone and lockable cabinets is usual) and college personnel time?	

<i>Criteria</i>	<i>Assessment</i>
Relationships	
28 Is the provider proposing to limit its liability? (code, paragraph 58)	
29 What practical steps in co-operation with their counterparts (meetings, sharing of plans and systems documentation, copying of reports) does the college internal audit service or external auditor intend to take in order to maximise audit effort and minimise duplication? (paragraphs 19 to 21, supplement D)	
30 Is the team proposing to the college those who will actually do the work? (The college should insist that this is so.)	
31 Does the selection panel, after meeting the proposed audit personnel, consider that it can work with them and have confidence in them?	

Part 2 External auditor

<i>Criteria</i>	<i>Assessment</i>
External Audit Proposal	
1 Where the college internal audit service is tendering for appointment as the external auditor, will staffing be separate, ideally at all levels but as a minimum at manager and below? (supplement B, paragraph 7)	
2 Is the external auditor qualified to do the work? (code, paragraph 52)	
3 Does the external auditor assume as a matter of course in the fee that its work will be reduced by reliance on the work of the internal audit service? (If this is assumed, the fact should be stated.)	
4 How do the proposed deadlines for accounts production and timing of audit work suit the college's needs?	

Part 3 Internal audit service

<i>Criteria</i>	<i>Assessment</i>
Internal Audit Service Proposal	
1 Where the college external auditor is tendering for appointment as the internal audit service, will staffing be separate ideally at all levels but as a minimum at manager and below? (supplement B, paragraph 7)	
2 Does the internal audit service intend to work to <i>Government Internal Audit Manual</i> standards and good practice and to report its work using the opinions at appendix 5 and appendix 6, supplement B.	
3 Is at least 75 per cent of the proposed plan to be systems-based audit? (supplement B, paragraph 36)	
4 Is routine, annual substantive testing excluded from the audit need? (supplement B, paragraph 36)	
5 How is the preparation of the audit needs assessment to be charged for – as part of the first year’s fee or separately and extra? (Typically a few days is required for its preparation (appendix to supplement D, paragraph 2).)	

