

# The audit committee



Development materials for governors of further education colleges

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**ACRA** The Association of College Registrars and Administrators is a national organisation which is part of the Association of Colleges and which provides professional support to business managers and clerks. The services for clerks include seminars, conferences and network meetings to share good practice and become familiar with new initiatives.

**fforwm** The Association of Welsh Colleges is a national organisation representing all further education colleges in Wales and providing a range of services to its members

**KPMG** is the leading firm of auditors and advisers to the education sector in the UK. The national advisory practice for governance is based in the Birmingham office.

**LSDA** The Learning and Skills Development Agency is one of the leading research and development organisations operating in the field of post-16 education. Its mission is to be a strategic national resource for the development of policy and practice in post-16 education and training.

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# Module 8 The audit committee

*For suggestions on how to get the most out of these self-study materials, see the booklet on Using the materials.*

## Introduction

This module looks at the role and responsibilities of the audit committee. The governing body is legally required to have an audit committee to provide governors with independent advice on the college's audit arrangements and systems of internal control. This module explains what the committee does, why it is important, and its relationship with the governing body as a whole, and builds on the information in *Module 5 Financial management*, Section 4 'The audit process – governors' responsibilities'.

This module is for all governors, but will be especially useful to governors who are members of the audit committee. Co-opted members of the audit committee who are not governors will also find it useful.

## Summary of changes to the 2002 edition

Module 8 now encompasses Learning and Skills Council (LSC) requirements to produce a risk management plan, and explains the external audit changes required by the new student number audit regime. Be aware that Further Education Funding Council (FEFC) circulars adopted by the LSC when it came into existence are likely to be re-issued or periodically updated, and that it is important to use the latest version of any circular. In particular, the LSC is developing its own Audit Code of Practice for publication in summer 2002. The LSC website ([lsc.gov.uk](http://lsc.gov.uk)) has the latest edition of circulars and draft circulars.

## Aims

By the end of this module you should be able to:

- explain why the governing body has an audit committee and what it does
- outline the terms of reference of your own college's audit committee
- describe the membership of an audit committee
- describe how internal, external and individualised student record (ISR) auditors are appointed
- outline the purpose and content of the reports that are submitted by internal, external and ISR auditors, and reviewed by the audit committee
- outline the purpose and content of an annual audit committee report
- describe an audit committee's responsibilities in investigating fraud and irregularities
- evaluate the practice and effectiveness of your own college's audit committee.

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Mark the sections you want to study and tick them off as you complete them.

To do    Done

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## Working on the self-study activities

These materials have been designed for flexible use. You can work through them with other governors in training and development sessions. You can also work through sections and activities in your own time and at your own pace if you find it difficult to attend organised training sessions. Governors who have used these materials point out how valuable it is to work on at least some of the suggested activities together with another governor or group of governors, as there is such potential to learn from each other's experience. For suggestions on how to organise this kind of support for yourself, see the booklet on *Using the materials*.

## What you will need

To complete activities in this module you will need to get hold of the following documents from the clerk:

- FEFC Circular 98/15 *Audit code of practice*, including the supplements and appendices
- the terms of reference for your audit committee
- your college's most recent internal audit needs assessment, annual internal audit plan, internal audit annual report and external audit management letter
- your audit committee annual report
- your college's written procedures on fraud and irregularities.

Other useful documents may include *Guidance for Audit Committees on the Audit of Individualised Student Record Data and Final Funding Unit Claims at Colleges of Further Education* (September 2001) and Circular 01/04 *Sector Accounting Policies and Return of Audited Financial Statements*. Both of these documents can be found on the LSC website.

Where you need to make notes in response to activity questions, we suggest you do this in a notebook or on separate sheets of loose-leaf paper, and store the information you compile along with the module for future reference.

## Section 1 Why have an audit committee?

The governing body of every college has a statutory responsibility to:

- safeguard public funds
- ensure that the college gets value for money when using public funds
- ensure that public funds are spent according to any restrictions imposed on their use.

To fulfil this responsibility, the governing body must:

- have an audit committee
- appoint internal and external auditors to the college
- ensure that the college has sound internal control systems, and that they are operating effectively.

The audit committee has a number of responsibilities, but its main purpose is to advise the governing body on the adequacy of the operation of the internal control systems in the college. This responsibility covers not only financial controls but **all activities and systems within the college**.

The audit committee has a key role in acting as the governing body's 'independent arm' to ensure that the information provided to the governing body – and the systems that generate it – are robust and accurate. In other words, the audit committee is 'the eyes and the ears' of the governing body. Its members must be capable of independent, authoritative and objective consideration of complex and potentially sensitive issues. The audit committee must provide impartial advice to the governing body.

As the accounting officer, it is the principal's responsibility to ensure that the framework of controls approved by the governing body is operated satisfactorily on a day-to-day basis. However, the audit committee and the college's internal and external auditors contribute to providing assurance to the principal. Although the principal is always the accounting officer, as required by the financial memorandum, in practice the day-to-day operation of the internal controls are the responsibility of the director of finance. The responsibilities of the accounting officer are considered in *Module 5 Financial Management, Section 5 'Approving the budget'*.

Having an audit committee has the following benefits:

- it helps to ensure that the college is getting value for money when spending public funds
- it gives the principal and governing body additional assurance through a process of independent and objective review

- it raises awareness of the need for sound internal control and the implementation of recommendations arising from internal and external audit
- it provides an independent route for either a 'whistleblower' or an auditor to report any significant issues directly to members of the governing body
- it provides a mechanism to deal with fraud or irregularities (although the risk of fraud can never be eliminated, however good the audit committee and stringent the internal controls).

### Activity What is the value of having an audit committee?

Note down what **you** consider to be the two most important benefits of having an audit committee. If you are an audit committee member, draw on your own experience as well as the points covered here. If you are not an audit committee member, you might find it useful to discuss this question with a governor who is.

### Viewpoint

Governors' experience of the work of the audit committee varies widely. There is no right or wrong answer – what you consider to be the most important benefits will be influenced by the circumstances within your own governing body and college. Doing this short activity may help you to clarify what you want to get out of working through the module.

The rest of this module looks in more detail at the role and key responsibilities of the audit committee.

## Section 2 What does an audit committee do?

The audit committee has a number of specific responsibilities that should be included in its terms of reference. Model terms of reference are included in the FEFC Circular 98/15 *Audit code of practice* and summarised in the checklist opposite. The governing body as a whole should **approve and adopt the model terms of reference** for the audit committee contained in the *Audit code of practice*. However, these model terms of reference do not specifically refer to the ISR audit. As this goes to press, an updated code of practice containing revised terms of reference is in preparation. In the interim, the *Guidance for Audit Committees* (referred to in the Introduction to this module) invites audit committees to use some suggested amendments to the audit committee terms of reference to reflect their responsibilities with respect to the ISR audit. Note that this latter guidance is not mandatory in the way that the *Audit Code of Practice* is, but it does reflect the up-to-date position regarding the audit committee's responsibilities. It is essential that the terms of reference do not compromise the audit committee's independence and objectivity. The terms of reference cover areas such as membership, constitution, frequency of meetings, authority of the committee, reporting and duties (the key duties of the audit committee are shown in the checklist opposite).

The audit committee should have the authority to seek any relevant information it requires, and, where appropriate, the authority to engage external professional advice.

The audit committee should meet at least three times a year at times which fit in with key financial and operational dates, including internal and external audit activity.

### ***Checklist: Audit committee responsibilities***

The audit committee has a number of key responsibilities as detailed in FEFC Circular 98/15 *Audit code of practice*, and as suggested in the *Guidance for Audit Committees on the Audit of Individualised Student Record Data and Final Funding Unit Claims at Colleges of Further Education*.

- Advise the governing body on appointment, reappointment, dismissal and remuneration of both internal auditors and external auditors.
- Ensure co-ordination between the internal, ISR and external auditors so that their work complements each other and provides maximum effectiveness of audit services to the college.
- Review the internal audit needs assessment and annual internal audit plan and make recommendations to the governing body.
- Consider reports from internal auditors on individual assignments undertaken on behalf of the college. The audit committee should discuss the recommendations in the report with college management and agree the formal management response. There should be a follow-up to ensure that, where appropriate, recommendations have been acted upon and implemented.
- Similarly, the external auditors should produce an annual management letter following completion of their audit work. This letter should identify key issues discovered during the course of the audit work and make recommendations for improvements. As with internal audit, the audit committee should agree management responses and follow up implementation.
- The ISR auditors will produce a management letter, which will require management responses and follow up. The audit committee should review it in the same way as the external audit management letter.
- Monitor the effectiveness of both the internal and the external audit service. The audit committee also has an important role to play in monitoring the effectiveness of the ISR auditors.
- Consider audit reports from other external bodies and monitor implementation of recommendations; external bodies include the Department for Education and Skills (DfES), European Social Fund, National Audit Office (NAO) and the LSC.
- Produce an annual report for the governing body containing:
  - advice on the adequacy of the college's internal control systems
  - an overview of the main findings of the internal, ISR and external auditors.

### Activity Review your audit committee's terms of reference

Look at the terms of reference for your own audit committee. How well do you think they match the requirements of the FEFC Circular 98/15 *Audit code of practice*? As a quick check, review them against the checklist on page 5. Tick off the items in the checklist that are covered in your committee's terms of reference. On a separate sheet, make a list of any areas of weakness or gaps in the terms of reference for your audit committee.

### Viewpoint

You may be confident that the terms of reference for your audit committee meet the requirements of the *Audit code of practice*. If you are not sure, or you are unclear about the interpretation or meaning of anything in the circular, make a note to discuss this with the clerk to the governing body. Alternatively, you could ask the college's internal or external auditors for clarification or advice. It may be that your audit committee needs to revisit the circular and make adjustments to match its terms of reference.

## Risk assessment and risk management

Although not a formal requirement (and not included in the checklist on page 5), an audit committee can have a considerable part to play in the assessment and management of risk in a college. Increasingly, colleges are facing a wide range of risks that need to be identified, assessed and managed. These go beyond just financial issues and include areas such as:

- **employment** – e.g. failure to keep abreast of employment legislation requirements, failure to retain key staff
- **academic** – e.g. lower than forecast student numbers, poor teaching quality leading to a deterioration in student achievement
- **estates** – e.g. poor maintenance of buildings and equipment leading to major repairs or health and safety issues.

The LSC now requires all colleges to produce a risk management plan as part of their three-year financial forecast submission. The audit committee can get involved by:

- discussing and recommending to the governing body for approval a risk assessment and management policy for the college
- ensuring appropriate procedures are in place for reviewing the effectiveness of risk assessment and management
- raising awareness of the importance of risk management within the college
- receiving reports from internal auditors on the adequacy of internal controls, e.g. policies, procedures, systems and insurance cover.

### Activity What part does the audit committee play in risk assessment?

Has your audit committee discussed the risk management plan for the college? Are you confident that appropriate procedures are in place for reviewing how well the plan is implemented?

Note down the two or three most significant potential risks for your college. What is the likelihood of their happening and what is the potential financial impact?

What contingency plans does the college have?

### Viewpoint

If you are concerned that your college is not fully prepared for risks, or if you are not sure of the position, you might consider one of the following:

- ask the principal to brief the committee on the current position/plans in hand
- suggest the college holds a seminar or special audit committee meeting on the subject
- arrange that the existing risk management plan is reviewed periodically by the audit committee.

## Section 3 Membership of the audit committee

The audit committee must have at least three members. At least one of the members must be someone with financial and/or audit experience. This person does not have to be a qualified accountant, but they should have some experience in financial or audit-related work. The person with financial and/or audit experience does not have to be a member of the governing body; the audit committee can co-opt a person from outside the governing body specifically to fill this role if necessary. This co-opted member can be the chair of the audit committee, if appropriate reporting arrangements to the governing body are in place.

Other members should have a suitable mix of expertise and experience, including:

- experience of working with auditors in another professional sphere of work
- legal experience
- procurement experience
- experience of risk assessment
- a non-financial background, combined with a readiness to ask for clarification, so that meetings are conducted in a language that all governors can understand – an individual who is prepared to challenge items until a satisfactory response is received in layperson's terms can often be more use than somebody with detailed technical knowledge.

The committee members must be independent of the management of the college. This means that committee members must **not** be drawn from governors who are college staff with management responsibilities (including the principal), members of the finance committee, or the chair of the governing body. The governing body should bear this in mind when agreeing the terms of reference for its audit committee. For example, it would not be appropriate for the audit committee to get involved in any decisions about the management of the college (such as approving capital projects). It is, however, appropriate for the principal and/or finance director to

attend audit committee meetings to provide information and clarification – but they should not participate in the committee’s decision-making.

For the same reason, the clerk to the governing body should not act as clerk to the audit committee if they also have significant financial responsibilities at senior management level within the college.

At the end of each year, in common with all other committees of the governing body, and indeed the full governing body itself, the audit committee should undertake a self-assessment exercise. This should:

- look at whether the committee has appropriate skills and experience to deal with the issues arising
- assess whether it has been able to meet the requirements of its terms of reference
- consider the effectiveness of its meetings.

### Activity What skills and experience do audit committee members need?

- 1 Think about your own audit committee members, and use the checklist below to assess whether the committee membership has the right balance of expertise and ‘common sense’:

- experience of financial management/working with auditors
- legal/procurement/risk assessment experience
- readiness to question jargon and technical terms so that meetings are conducted in a language that all governors can understand.

Are there any significant gaps, weaknesses or imbalances in any of the key areas of expertise or experience? (For example, a committee with a lay governor who ensures that meetings are conducted in plain English may function better than a committee packed with members who have financial expertise but cannot communicate in plain terms with other governors.)

- 2 Can you suggest how the audit committee could overcome any gaps, weaknesses or imbalances that you have identified?
- 3 Are you confident that all the members of the audit committee and the clerk to the committee are truly independent of college management?

### Viewpoint

- 1 This activity should have helped you think about the membership of your audit committee and whether it has a satisfactory mix of expertise and experience. The audit committee’s self-assessment should also help to identify any gaps, weaknesses or imbalances.
- 2 Solutions for the committee might include:
  - getting training for existing members to develop areas in which there are gaps, weaknesses or imbalances
  - co-opting a new member with appropriate expertise or experience or both.

The clerk to the governing body will be able to give advice on training opportunities and on the process of co-opting governors.

- 3 If you have any doubts about the independence of members of the committee or its clerk, you should raise these informally with the chair of the governing body.

## Section 4 Appointing, reappointing and dismissing auditors

The FEFC financial memorandum (FEFC Circular 99/48) requires that an internal audit service must exist within the college. The work of the internal auditors must comply with the standards set out in FEFC Circular 98/15 *Audit code of practice* and in *HM Treasury: Government Internal Audit Manual*.

Every college is required to offer both internal and external audit services out to tender at least every five years and to follow the guidance contained in FEFC Circular 98/15 *Audit code of practice* when doing this. From the financial year 2000/2001, all colleges have to ensure that external and internal audit services are contracted to separate providers. The actual decision for selection and appointment rests with the governing body but the audit committee plays a key role in advising the governing body on the appointment, reappointment, dismissal and remuneration of both internal and external auditors.

The tender is conducted in the same way as any other tender for goods and services that the college decides to purchase, with one exception: the college must consult the LSC provider assurance service after receiving tender responses but before selection. The LSC provider assurance service checks through the proposals and suggests any areas for the college to clarify or question when interviewing the audit providers who have been shortlisted. The precise tender procedures are determined by the college's own financial regulations.

Circular 01/04 *Sector Accounting Policies and Return of Audited Financial Statements (annex C)* sets out model engagement letters for both internal and external auditors. For external auditors there is unlimited liability. Internal auditors may request restrictions on their liability and the college audit committee should consider this in line with the guidance in the circular.

As with audit committee members, both sets of auditors must be able to demonstrate their independence. For example, it would be inappropriate for one of the audit providers to be an employer of a governor of the college. Most colleges contract out their internal audit services to an external provider but colleges can use their own staff if they want to, provided their independence can be assured.

Although a full selection process is required every five years, the internal and external auditors are appointed for one year at a time. The audit committee is responsible for advising the governing body by monitoring the effectiveness of both internal and external auditors in terms of:

- cost of the service provided
- the extent of preparation and planning
- the skills and experience of the auditors
- the quality of the reports and, in particular, practical recommendations on areas for improvement
- the timing of audit visits, compared with the planned timing
- the promptness of the reporting
- attendance at audit committee meetings (see page 10).

FEFC Circular 98/15 *Audit code of practice* (Supplement A) contains performance indicators (criteria or standards for measuring performance) which colleges can use to measure the effectiveness of their internal and external auditors. Members may also wish to refer to *Guidance for Audit Committees* as this contains matters about which the LSC will seek feedback from colleges on the performance of the ISR auditors.

If as a result of the audit committee's recommendation the governing body decides that it does not wish to reappoint the auditors, it can terminate the appointment, even if the auditors have served less than five years. However, changing auditor frequently can be counter-productive as each set of new auditors has to learn about the college.

Equally, the auditors themselves can resign from their term of office before it expires by giving appropriate notice as set out in the engagement letter. If the auditors are removed or choose to resign, they must provide a statement to the governing body as to whether or not there are any circumstances connected with the removal or resignation that should be brought to the governors' attention. Any change in external or internal audit should be notified to the local LSC.

The college should try to ensure continuity of internal audit provision at all times. Any appointment of new internal auditors should take effect immediately after the termination date of the previous auditors. If the college suddenly finds itself in a position without internal auditors, it should make temporary arrangements until a new internal audit service is appointed.

### Activity When were the auditors last reviewed?

When was the last time your audit committee reviewed the performance of its internal and external auditors? If possible, get hold of a copy of the review and relevant minutes to check the committee's conclusions.

Were the FEFC performance indicators used in the review?

What were the results of the review?

### Viewpoint

Audit committee members should be familiar with the performance indicators provided by the FEFC and use these to monitor the effectiveness of auditors.

## Auditors attending audit committee meetings

The auditors have a right to attend any governing body meeting if they have an issue that needs to be raised. As a matter of routine:

- the internal auditors should attend audit committee meetings where reports are being presented, and as an absolute minimum attend the presentation of the annual internal audit report
- the external auditors should attend at least one audit committee meeting per year (usually when they are presenting their management letter).
- the ISR auditors should attend audit committee meetings where reports are being presented.

The audit committee may meet with either (or both) the internal or external auditors without college management present if it wishes to do so. Some governors prefer to hold such a meeting at least once a year.

### **Activity** Whether to meet auditors without management?

Does your audit committee meet with auditors without management present? If so, can you say why it was decided to do this? If not, is this something you would like to suggest to your audit committee?

Think about the pros and cons of meeting the auditors without management being present.

### **Viewpoint**

There are a number of pros and cons you might have thought of which are listed below. There are no right or wrong answers – it is a question of judgement for the audit committee, and depends on circumstances within the college.

#### **Pros**

Some governors find it helpful to discuss specific matters with auditors without management because this:

- is a chance for governors to speak openly and frankly with auditors
- can reinforce the independence of the committee and ensure that it is **seen** to be independent
- provides an opportunity for governors to ask questions of the auditors that they may feel reluctant to ask in an open meeting.

#### **Cons**

Possible drawbacks of meeting without management are:

- management may feel excluded and even defensive
- governors may feel that college managers should hear about problems or issues to be addressed first hand and be given an opportunity to respond
- management will need to be involved eventually since it is their responsibility to act on any problems or undertake specific tasks, so there is a value in involving them at the start.

## Section 5 How the audit committee uses internal and external audits

The audit committee uses internal and external audits to help make judgements and recommendations to the governing body on the adequacy of the college's internal control systems. The committee is also responsible for ensuring co-ordination between the internal and external audits so that their work complements each other and provides maximum effectiveness of audit services to the college. The committee may also wish to use the audit service to help them ensure that the college gets value for money from their resources.

### Internal audit reports

The internal auditors produce the following reports.

- 1 An **audit needs assessment** identifies the college's activities and systems and categorises them according to the likelihood and level of risk associated with the college's internal control systems. Those areas that are identified as high risk are subject to audit review on a more frequent basis than the low risk areas. This assessment is then submitted by the audit committee to the governing body for approval. An **annual internal audit plan** is then derived from the audit needs assessment, setting out the key tasks to be undertaken by the internal auditors in the year ahead. The audit committee considers this plan to make sure that it meets the needs of the college and the governing body. For example, if student data integrity was a particular concern, the audit committee would need to make sure that this aspect had been adequately covered in the internal audit plan. The scope of the audit work in the plan should be sufficient to enable an assessment of the whole system of internal control, i.e. both financial and non-financial controls. The audit committee then submits the plan to the governing body for approval, typically in November each year, but in any event before the commencement of audit work.
- 2 The internal auditors will report to the audit committee on their findings for each of the individual assignments they undertake. The report should contain the following:
  - an outline of the scope of the work
  - an overall assessment of the adequacy of the controls operating
  - any issues identified
  - recommendations for improvement.

The report should be given to the college management ahead of the audit committee meeting, so that management responses can be provided against each of the recommendations. The responses should identify the individual responsible and a date by which the action should be taken. Issues identified by the internal auditors will often be graded according to the significance of the findings, thereby assisting the audit committee to prioritise their actions appropriately. This report should be considered at the next audit committee meeting. The audit committee needs to have in place procedures to follow up agreed action in response to the recommendations made in the report.

- 3 At the end of each financial year, the internal auditors produce an **annual report** to the audit committee covering:
- details of the work undertaken by the auditors during the course of the year and a review of the planned programme of work for the year
  - details of key control issues identified during the course of their work and any significant areas of weakness
  - an overall assessment of the adequacy and effectiveness of the college's internal control systems
  - recommendations for improvement organised in order of priority.

The annual report should be given to college management ahead of the audit committee meeting so that management responses can be provided against each of the recommendations outlining:

- the postholder or individual who will be responsible for implementation
- the date by which action should have been taken.

The audit committee then considers this report and agrees the management responses at its next meeting. The committee can invite internal or external auditors to attend if they wish.

## External audit – financial statements

In their annual audit of the college the external auditors have to:

- report on the truth and fairness of the annual financial statements produced by the college
- confirm that the college has complied with the financial memorandum
- confirm that funds have been used for the purposes for which they were intended by the LSC.

This is similar to what an external audit firm would do for a commercial organisation. As with any commercial organisation, the external auditor may find it necessary to issue a qualified audit opinion if they cannot satisfy themselves on a particular aspect of the college financial statements. The external auditors prepare a management letter addressed to the chair of the audit committee after they have completed their audit work. This letter should highlight any key control weaknesses found during the course of the audit work, and include recommendations for improvement. As with internal audit reports, management should be given an opportunity to respond to the recommendations. The audit committee should then ensure that they set in train a process to implement the recommendations.

## External audit – student numbers

In a revised approach to monitoring student numbers, which is to be continued by the LSC, the FEFC required colleges to receive a separate student number audit in addition to the financial statements audit. This may or may not be provided by the same firm that audits the financial statements. The FEFC appointed eight audit firms nationally to undertake student number audits, and have allocated one of these audit

firms to each college. Where possible, the FEFC tried to match the appointment of student number auditors to colleges' current external auditors for financial statements.

The colleges use a piece of LSC software to calculate their funding units, known as the Individualised Student Record (ISR). The ISR contains details of all a college's student activity during that year, and can therefore be very complex. This new approach to student number audit is expected to be more thorough and has the following main features:

- the use of computer-assisted audit techniques (CAATs) to interrogate college systems
- a year-round audit
- a more detailed assessment of the overall control environment for student numbers.

The approach places emphasis on assessing a college's risk as the starting point for directing the audit work. The key areas of risk identified are the areas where more of the substantive audit testing will be carried out. Planning should start early in the academic year, thereby allowing any control issues to be identified and addressed before the end of the year, in advance of the main testing. The audit committee should be advised of the outcome of this audit work, and provided with two audit opinions, one based on the July ISR (to be issued by the end of November), and the other based on the December ISR (to be issued by the end of February). The auditors are also required to issue a management letter each year in respect of the ISR audit. The auditors are required to send a copy of the management letter and audit opinions to the LSC, both central and local.

The financial statements auditors do not now need to do any work on the LSC funding line. They will rely on a statement of assurance regarding this funding, which is issued by the LSC following the work of the ISR auditors. The audit committee needs to be aware of this process.

### **Activity** Have auditors' recommendations been implemented?

Get hold of one of the following internal and external audit documents submitted to your audit committee:

- the internal audit needs assessment
- the annual internal audit plan
- the internal audit assignment reports
- the internal audit annual report
- the external audit financial statements management letter
- the external audit student numbers management letter.

Read through the recommendations in the document you have chosen. Were the recommendations in the report accepted by management and fully implemented? Are there any matters still outstanding? Who is responsible for ensuring matters outstanding are brought to the audit committee's attention?

## Viewpoint

Under normal circumstances, all auditors' recommendations should be addressed by management. Where this is not the case, a clear explanation should be given to the audit committee, for example, if the college has been going through a period of major change, or if a particular recommendation has been overtaken by events which make it no longer relevant (e.g. the installation of a new information system). However, the auditors should prioritise recommendations, which should help governors appreciate the relative importance of each issue presented in the report.

Audit committee members cannot be expected to remember all the specific recommendations made by the auditors, so it is important that the clerk to the committee ensures that any matters outstanding are brought forward to the next meeting of the committee.

It may be also helpful to review the impact of the recommendations once they have been implemented for a period of time, e.g. twelve months.

For more information about how the clerk can help support and co-ordinate the work of governing body committees, see *Module 7 The clerk to the corporation, Section 4 'Supporting committees and working groups'*.

## Section 6 The audit committee annual report

At the beginning of this module we identified one of the key roles of the audit committee as advising the governing body on the adequacy and effectiveness of the college's internal control systems. This is done in the audit committee annual report. FEFC Circular 98/15 *Audit code of practice* provides model contents for an annual audit committee report, summarised below.

### ***Contents of the audit committee annual report (suggested by FEFC)***

- details of the membership of the committee during the year with any changes noted
- summary of meetings held
- terms of reference for the committee
- overview of the findings of the internal audit service highlighting any significant control weaknesses found
- summary of the management letter produced by both the external auditors and the ISR auditors again highlighting any significant issues identified
- review of any other work done by the committee
- concluding with an opinion of the audit committee on the adequacy and effectiveness of the college's internal control systems and the extent to which it can be relied upon.

### Activity How thorough is the audit committee's annual report?

- 1 Compare your audit committee's most recent annual report against the features suggested by the FEFC above. Are there any areas which you think are not adequately covered in your audit committee's annual report? If so, what do you think needs to be done or added to improve the report?
- 2 If your audit committee has not produced an annual report, what do you think should be done to ensure that a report is produced in the future?

### Viewpoint

- 1 If you are concerned that there may be inadequacies in the audit committee's annual report then these should be taken on board for the future, perhaps through earlier involvement of the audit committee (or chair of the committee) in preparing the first draft of the report.
- 2 If no report has been produced then it is important to do one – even if it is quite late in the year. The person to discuss this with is the committee chair who has formal responsibility for the annual report.

## Section 7 Fraud and irregularities

The responsibility for protecting the college against fraud or other irregularities ultimately lies with the governing body. The financial memorandum that all colleges have with the LSC states that the governing body should ensure that the college's financial, planning and other management controls, including controls against fraud and theft, are appropriate and sufficient to safeguard public funds.

One of the key duties of the audit committee is to advise the governing body on the adequacy of the college's internal control systems, including controls against fraud and theft. As a further aspect to ensuring independence, the audit committee must have powers to commission an investigation into any particular activity of the college, or to request any information it feels is appropriate to discharge its responsibilities effectively.

All colleges must have a written policy on the procedures to be followed if evidence of potential fraud or irregularity is discovered, including guidance on the process to be followed if the issue is particularly urgent. The policy can normally be found within the college's financial regulations.

If the audit committee suspects that fraud or irregularity has occurred, this should be reported to the full governing body at the earliest opportunity. If the issue is particularly urgent this may be before the next meeting of the governing body. The chair of the audit committee should ensure that the college's written procedures on fraud and irregularity are followed and appropriate action is taken. If the suspected fraud or irregularity is significant, the chief executive of the LSC should be notified immediately.

It is normally up to the chair of the audit committee to set up an investigation into any allegation of fraud or irregularity, and to come back to the governing body with

advice as to what action, if any, should be taken. The action would normally be in two parts:

- action against the individual or group of individuals who were responsible for the fraud or irregularity (this could mean disciplinary action, including dismissal, or even referring the matter to the police)
- action to improve processes and procedures to minimise the risk of a recurrence of the incident.

The audit committee can use external professional advisers to help it conduct an investigation if appropriate.

## Internal and external audit responsibility

The internal and external auditors should also have written procedures on the action to be taken if they suspect or discover fraud or irregularity. If an internal or external auditor identifies any serious control weaknesses, fraud or material accounting errors, it should be reported immediately to the principal, the chair of the governing body, and the chair of the audit committee. It should also be reported to the chief executive and the LSC Assistant Director of Finance – PFA. The governors may wish to hold a special meeting to discuss the matter.

Remember though that the external auditors are not required to search specifically for fraud or other irregularities such as corruption or a breach of regulations. This should be clearly stated in the engagement letter from the external auditor. This means that the college cannot rely upon external auditors to detect fraud and other irregularities, although they can be expected to plan and conduct their audit work so that they have a reasonable expectation of detecting material misstatements in the accounts resulting from irregularities.

### Activity What is the procedure for reporting possible fraud or irregularity?

In your college, what is the correct procedure if you uncover a potential fraud or irregularity? Is the procedure the same for:

- students
- teaching staff
- other staff
- governors?

### Viewpoint

The clerk to the governing body should be able to let you have a copy of your college's written procedures on fraud and irregularities. The procedure should be the same for everyone in the college, whatever their role or status. Given the key role of the audit committee, it is vital that all members of the committee are clear what the procedure is.

## Section 8 Developing good practice

Now you have almost completed this module, you should be in a position to review the effectiveness of your own audit committee. Given the key role of the audit committee in supporting the work of the governing body, it is a valuable exercise for the committee regularly to review what it does and seek to develop best practice. Completing the checklist below on an annual basis would be a useful means of self-assessment for the committee.

### Activity How effective is the audit committee?

Use the checklist below and answer 'yes' (Y), 'no' (N) or 'further development needed' (D) to each question. If you are unsure about a particular question you should refer to the relevant section in this module. If you are unsure about your own audit committee's position it may be helpful to discuss the matter with either the clerk to the governing body or the director of finance. It may be useful for your audit committee as a whole to consider its response to these questions at one of its meetings.

<b>Good practice checklist</b>	<i>college response</i> Y, N or D
<b>Sections 1, 2, 3, and 6 The audit committee</b>	
Does the audit committee have written terms of reference which are approved by the governing body?	
Do the written terms of reference allow the audit committee to maintain their independence from the management of the college?	
Are the members of the audit committee separate from the management of the college to ensure their independence?	
Is there at least one member of the audit committee who has an appropriate finance and/or audit background?	
Does the audit committee meet at least once per term?	
Is the timing of audit committee meetings arranged so that key decisions and areas of advice can be fed into full governing body meetings?	
Does the audit committee carry out a self-assessment exercise on its own performance on an annual basis?	
Does the audit committee produce an annual report for the governing body advising them on the adequacy of the internal control systems operating at the college?	

	<i>college response Y, N or D</i>
<b>Sections 4 and 5 Internal and external auditors</b>	
Do all auditors have direct reporting access to the audit committee?	
Do all auditors attend at least one audit committee meeting annually?	
Does the audit committee monitor the effectiveness of the service provided by internal audit, external audit and the ISR audit?	
Does the audit committee review and recommend to the governing body for approval the internal audit needs assessment and the internal audit annual plan?	
Is the audit committee satisfied that internal audit work is carried out according to the standards set out in the <i>HM Treasury: Government Internal Audit Manual</i> ?	
Are appointment procedures for internal and external audit properly followed including consultation with the LSC?	
Do the internal and external auditors adequately resource the work with individuals who have relevant skills and experience?	
Are internal audit reports produced promptly after individual assignments, allowing enough time for management responses before the next audit committee meeting?	
Are internal audit reports clearly laid out, providing an overall assessment on the controls of the area reviewed, with practical recommendations where weaknesses have been identified?	
Do internal auditors plan their work so that they can follow up implementation of recommendations from previous reports after an appropriate period of time?	
Do the internal auditors produce an annual report for the audit committee that includes an overall assessment of the adequacy and effectiveness of operation of the college's internal control systems?	
Are the management letters from the external auditors for both financial statements and student numbers clearly laid out, identifying significant issues arising out of their audit work, with practical recommendations for improvements?	
<b>Section 7 Fraud and irregularities</b>	
Does the college have written procedures on the action to take if a case of suspected or known fraud or irregularity is reported?	
Is the audit committee satisfied that the external auditors have planned and conducted their audit work so that they have a reasonable expectation of detecting material misstatements in the accounts resulting from irregularities, including fraud or corruption, or breach of regulations?	

## Viewpoint

For questions that you answered 'yes' – that aspect of college audit is probably satisfactory but all aspects should be kept under review as situations, members, and pressures may change.

For questions that you answered 'no' – raise this with the clerk in the first instance, who may wish to discuss the matter with the auditors, if appropriate. Consider placing this on the agenda of the next meeting.

For questions where you think further development is needed – you might consider proposing this as an agenda item at the next meeting. Where the issue suggests that audit committee members may need further training or development, you could discuss this with the clerk in the first instance.

## Module review

This module has looked at the role and responsibilities of the audit committee. If you have worked through the module you should now be confident that you can:

- explain why the governing body has an audit committee and what it does
- outline the terms of reference of your own college's audit committee
- describe the membership of an audit committee
- describe how internal and external auditors are appointed
- outline the purpose and content of the reports that are submitted by internal, external and individualised student record (ISR) auditors and reviewed by the audit committee
- outline the purpose and content of an annual audit committee report
- describe an audit committee's responsibilities in investigating fraud and irregularities
- evaluate the practice and effectiveness of your own college's audit committee.

If you are not sure that you have achieved a particular goal, look back at the contents list in the Introduction to the module. You may find it useful to reread the relevant section.

## Summary of key learning points

All colleges must have an audit committee that can advise the governing body on the internal control systems operating at the college, to assist the governors in adequately discharging their duty to safeguard public funds.

The audit committee's specific responsibilities should be included in its terms of reference. The responsibilities included in the terms of reference should not in any way compromise the independence of the audit committee.

Members of the audit committee should have a suitable mix of expertise and experience, including at least one member with relevant financial and/or audit experience.

Members of the audit committee must be able to demonstrate that they are independent of the management of the college.

The audit committee advises the governing body on the appointment, reappointment, dismissal and remuneration of internal and external auditors, and monitors the effectiveness of the audit services provided.

The audit committee reviews the reports and recommendations made by the internal and external auditors and agrees the formal management response with the governing body.

The audit committee produces an annual report for the governing body containing an overview of the main findings of the internal and external auditors, and advising the governors on the adequacy of the college's internal control systems, including controls against fraud and irregularities.

It is normally up to the chair of the audit committee to set up an investigation into an allegation of fraud or irregularity in the college and to advise the governing body on what action should be taken, if any.

## Where next?

You have now completed work on *Module 8 The audit committee*. If there are areas in which you need more guidance or information, they may be covered in other modules. Turn to 'Check your current knowledge and skills' in *Using the materials*. This self-assessment questionnaire will help you to decide which modules or sections of modules may help to fill these gaps. Tick the useful sections for further study.

If you cannot find the information you need within these materials, turn to the 'Action planner' in *Using the Materials*. Note down what further information, support or guidance you would like. The 'Action planner' gives advice on who may be able to help, and how.

## Putting it into action

We hope that working through this module has raised useful questions, increased your awareness of issues and given you ideas for practical action that you would like to follow up. The 'Action planner' in *Using the Materials* contains a section where you can note down any questions or action points that you want to follow up within your own college.

# The audit committee



commissioned by



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