



# Draft

# Module 11

# The Audit Committee

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

# Preface to Governance Training Materials

At the time of writing the Governance Training Modules, [the Education Act 2011](#) became law. It confirmed the abolition of the Young Peoples Learning Agency, to be replaced by the Education Funding Agency in April 2012. It also significantly reduced the complexity of colleges' Instrument and Articles of Government giving them greater flexibility to run their own affairs. The details are included in Schedule 12 of the Act which makes a number of amendments to prior legislation. Section 29 b of Schedule 12 states that 'the governing body of the institution may modify or replace its instrument of government and articles of government'. These must however comply with certain requirements set out in Part 2 of Schedule 4, thereby retaining some of the key responsibilities previously enshrined in legislation. Colleges will be considering these changes during 2012 and all governors will need to be aware of the implications for their own organisation. We recommend that governors familiarise themselves with this important piece of legislation when using the Governance Training materials.

At the same time as the Education Act 2011 was passed into law, the Association of Colleges published [The English Colleges' Foundation Code of Governance](#). This voluntary code of practice was developed by the sector following extensive consultation and all colleges are encouraged formally to adopt it. It has the full support of the Minister and is seen by the government as 'an important milestone in making colleges more locally accountable and in freeing them to respond more effectively to local learners, employers and community partners'. It is strongly recommended that governors take full account of the Code when making use of the Governance Training Materials. The government's reform plan for the further education and skills system was set out in [New Challenges, New Chances](#) published on December 1st 2011. This is recommended as a useful guide to current sector policy, a summary of which is available from LSIS: [NCNC Summary](#).

## Acknowledgements

The first edition of these training materials was published by the Further Education Funding Council in 2000 and further updated and amended in 2002 following the establishment of the Learning and Skills Council in 2002. They were commissioned by LSC in 2002 under the Standards Fund and produced by a partnership of national organisations involved in further education.

This third edition of the training materials has been published by [The Learning and Skills Improvement Service](#), as part of the [Leadership Skills for Governance](#) programme.

## Authors

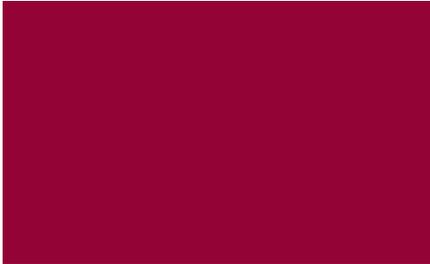
Tina Fahm

We would like to thank the advisory group for their input into developing the modules; and the critical readers for their helpful comments on the draft materials.

Feedback on the modules should be sent to [fegovernance@lsis.org.uk](mailto:fegovernance@lsis.org.uk)

© LSIS 2012

Extracts from this publication may be reproduced for non-commercial education or training purposes on condition that the source is acknowledged and the findings not misrepresented. Otherwise, no part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical photocopying, recording, or otherwise, without the prior permission of the copyright owner.



## Contents

Introduction	04
<b>Section 01</b> Why have an Audit Committee?	06
<b>Section 02</b> What does an Audit Committee do?	08
<b>Section 03</b> Risk assessment and risk management	10
<b>Section 04</b> Membership of the Audit Committee	14
<b>Section 05</b> Appointing, reappointing and dismissing auditors	16
<b>Section 06</b> How the Audit Committee uses internal and external audits	19
<b>Section 07</b> The Audit Committee annual report	22
<b>Section 08</b> Fraud and irregularities	23
<b>Section 09</b> Developing good practice	25
Module review	28

# 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 external 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 build on the information in Module 10 Finance and Resources, Section 10: Audit and financial assurance.

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.

## Aims

**By the end of the 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 organisation'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 and external 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; and
- evaluate the practice and effectiveness of your own organisation's Audit Committee.

## Contents

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

To do	Done		
<input type="checkbox"/>	<input type="checkbox"/>	Section 1	Why have an Audit Committee?
<input type="checkbox"/>	<input type="checkbox"/>	Section 2	What does an Audit Committee do?
<input type="checkbox"/>	<input type="checkbox"/>	Section 3	Risk assessment and risk management
<input type="checkbox"/>	<input type="checkbox"/>	Section 4	Membership of the Audit Committee
<input type="checkbox"/>	<input type="checkbox"/>	Section 5	Appointing, reappointing and dismissing auditors
<input type="checkbox"/>	<input type="checkbox"/>	Section 6	How the Audit Committee uses internal and external audits
<input type="checkbox"/>	<input type="checkbox"/>	Section 7	The Audit Committee report
<input type="checkbox"/>	<input type="checkbox"/>	Section 8	Fraud and irregularities
<input type="checkbox"/>	<input type="checkbox"/>	Section 9	Developing good practice

## **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**

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 with the module, for future reference.

Draft

# 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 or organisation gets value for money when using public funds; and
- 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 or organisation; and
- ensure that the organisation 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 effectiveness of the organisation's whole system of control, including arrangements for risk management control and governance processes. This responsibility covers not only the financial controls but all activities and systems within the organisation. 'Internal controls' are those controls that are built into the organisation's internal operational processes and procedures that prevent fraud taking place, for example through purchasing or payments. The responsibilities must include those specified in the funding body's audit code of practice, which also sets out standard procedures, such as those needed for the appointment of auditors.

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 based on a robust and challenging scrutiny role.

As the accounting officer, it is the principal's responsibility to ensure that the framework of controls approved by the governing body is operating satisfactorily on a day-to-day basis. However, the Audit Committee and the organisation'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 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 organisation 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 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; and
- 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 however 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 organisation. 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.

It is essential that the terms of reference cover areas such as the committee's independence and objectivity, membership, constitution, frequency of meetings, authority of committee, quorum requirements, reporting and duties (the key duties of the Audit Committee are shown in the checklist below).

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, including the following:**

- to advise the governing body on the appointment, reappointment, dismissal and remuneration of both internal and external auditors;
- to ensure co-ordination between the internal and external auditors so that their work is complementary and provides maximum effectiveness of audit services to the organisation;
- to review the annual audit plan prepared by the internal auditors based on the organisation's risk register and make recommendations to the governing body.
- to consider reports from work 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;
- to review the annual management letter from the external auditors following completion of their audit work.
- to agree management responses to recommendations arising from internal and external audit reports and follow-up implementation.
- to monitor the effectiveness of both the internal and the external audit service;
- to consider audit reports from other external bodies and monitor implementation of recommendations; external bodies include the Skills Funding Agency, the Young People's Agency, Local Authorities, Department for Business, Innovation and Skills, Department for Education (DfE), Ofsted, European Social Fund and the National Audit Office (NAO); and
- to produce an annual report for the governing body containing advice on the adequacy and effectiveness of the of the organisation's whole system of control, and governance processes, and arrangement for economy, efficiency and effectiveness.

## Activity

### Review your Audit Committee's terms of reference

Look at the terms of reference for your own Audit Committee. As a quick check, review them against the checklist. Tick off the items in the checklist that are covered in your committee's term 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.

Draft

## Section 3

### Risk assessment and risk management

Turnbull (see below) sees risk management as a responsibility led by the governing body but running through the entire organisation. Governors monitor this responsibility through the Audit Committee or a separate risk management committee. Increasingly, Audit Committees are expected to have a considerable part to play in the assessment and management of risk in a college.

**Colleges face 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; or
- estates - e.g. poor maintenance of buildings and equipment leading to major repairs or health and safety issues.

**Colleges are required 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 organisation;
- 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 organisation; and
- receiving reports from internal auditors on the adequacy of internal controls, e.g. policies, procedures, systems and insurance cover.

**Colleges usually identify four levels of risk:**

1. business-critical risks - no more than 15 to 20 in number and regularly reported to and overseen by the corporation;
2. operational risks - managed by the principal and senior management team;
3. intrinsic risks - covered by checks and balances in the organisation's operational procedures; and
4. project risks - associated with any major project activity.

These are managed through a detailed risk register, maintained by management and based on the corporation's decision on their risk appetite.

## Turnbull on risk management

The **Turnbull guidance** reflects good practice in the areas of risk management and internal control. It emphasises that an organisation's internal control system has a key role to play in the management of those risks that are significant to the fulfilment of its objectives.

Managing risk effectively can make the organisation more flexible and responsive to its external environment, enabling it to meet the ever changing needs of students and service-users more fully. However, care should be taken to avoid merely selecting risks from a generic matrix. The risks need to be specific to the sector and the individual circumstances of the organisation. It is particularly useful to consider risks in relation to the likely obstacles to achieving the critical success factors associated with the achievement of the objectives of the organisation.

### Useful questions to ask include:

1. How is change affecting the risks we face and the risks we have chosen to take?
2. What would we be reluctant to see reported to the press?
3. What problems or near misses have already happened to us or our competitors in recent years?
4. What are the types of fraud and business probity issues to which the organisation could be particularly susceptible?
5. What are the major regulatory and legal risks to which the organisation is exposed?
6. What risks arise from the organisation's processes?

## Prioritising the risks

The following 'two by two' matrix is widely used to help prioritise risks. First the gross before risk associated with an event is assessed risk associated with an event is assessed, in other words the probability and impact of an event happening based on the assumption that control processes are very weak or non-existent. Risks are then prioritised according to their impact and likelihood of occurrence. On a number of occasions an A, B, C or D rating will suffice, which can be interpreted as:

- A immediate action
- B consider action and have a contingency plan
- C consider action
- D keep under periodic review

Impact of risk	High Impact Low Likelihood B	High Impact Low Likelihood A
	High Impact Low Likelihood D	High Impact Low Likelihood C

## Likelihood of risk occurring

The impact should be considered not merely in financial terms but more importantly in terms of potential effect on the achievement of the organisation objectives. Naturally not all risks will be identified as significant. Non-significant risks should be reviewed regularly, particularly in the light of changing external events, to check that they remain non-significant.

## Managing the significant risks

Having identified and then prioritised the significant risks in gross terms, it is then helpful to determine for each of them:

- Do the governors wish to accept this risk?
- What is the control strategy to avoid or mitigate the gross risk?
- Who is accountable for managing the risk and maintaining and monitoring the controls?
- What is the residual risk (that is the risk remaining after the application of the control processes)?
- What is the early warning mechanism?

**Control strategies include:**

- accepting the risk;
- transferring the risk (e.g. passing it to another party by changing contractual terms);
- elimination (by adopting an exit strategy);
- control (by building control into the operational process, or additional quality control);
- involving your best people in managing it;
- sharing the risk with another party;
- insuring against some or all of the risk; and
- avoiding the risk in other ways.

Delegation of the responsibility for the totality of risk management should not be allocated to a single individual. Rather it should be spread across those responsible for managing different activities from across the organisation. Risk management is an issue for all employees, not a specialist few within the organisation. Its importance should be communicated to all levels of staff, who should have the necessary knowledge, skills information and authority to fulfil their responsibilities.

At the top, the governing body should set appropriate internal control policies and seek regular assurance that the control system is functioning effectively. It is for the governing body to decide on the organisation's risk appetite.

The governing body should regularly review reports on internal control. These should provide a balanced assessment of the effectiveness of the control system in the areas covered by them and discuss any significant control failings or weaknesses identified, along with their impact and the remedial action being taken. Management's job is to design, operate and monitor a system that reflects the policies of the governing body.

Good risk management has the potential to focus the whole organisation around performance improvement. Turnbull provides the opportunity to improve, not only the management of risk, but the organisation as a whole.

## 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 organisation. What is the likelihood of their happening and what is the potential financial impact?

What contingency plans does the organisation have?

## Viewpoint

If you are concerned that your organisation 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 organisation 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.

Draft

## Section 4

### 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. Subject to the corporation's standing orders, it is entirely feasible to co-opt an independent lay member to the Audit Committee (i.e. someone not on the corporation, but having the appropriate financial, audit and risk management experience to support the work of the Audit Committee). It would not be appropriate for this co-opted member, in view of the reporting lines back to the corporation by the chair, to be appointed chair of the Audit Committee.

**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; and
- 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 organisation. This means 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 terms of reference for its Audit Committee. For example, in most circumstances it would not be appropriate for the Audit Committee to get involved in any decisions about the management of the organisation (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.

Most colleges now engage clerks who do not have another senior role in the organisation. However 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 organisation.

It may be considered, based on the **Nolan Principles**, that the governor appointed chair of the Audit Committee should not be a chair or even a member of any other corporation committee. This would avoid a conflict of interest should the chair of the Audit Committee need to oversee an investigation into a decision made by another corporation committee.

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; and
- consider the effectiveness of its meetings and its members.

## 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’:
  - a. experience of financial management/working with auditors;
  - b. legal/procurement/risk assessment experience; and
  - c. 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 governor without specialist financial experience 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 membership of your Audit Committee and whether it has a satisfactory mix of expertise and experience. The Audit Committee 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; and
  - 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 5

### Appointing, reappointing and dismissing auditors

Guidance from HM Treasury requires that an internal audit service must exist within the organisation.

For external auditors there is unlimited liability. Internal auditors may request restrictions on their liability and the Audit Committee should consider this in line with the guidance 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 organisation. Most colleges contract out their internal audit services to an external provider but organisations can use their own staff if they want to, provided their independence can be assured.

Although a full selection process is required every three to five years (depending on the corporation's standing orders), the internal and external auditors are re-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 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; and
- attendance at Audit Committee meetings

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 organisation.

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 their removal or resignation that should be brought to the governors' attention.

The organisation 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 organisation 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.

What were the results of the review?

### 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 all Audit Committee meetings where their reports are being presented, including the presentation of their annual internal audit report; and
- the external auditors should attend at least one Audit Committee meeting per year (usually when they are presenting their management letter). In addition, they may attend the Audit Committee to present their external audit annual plan.

The Audit Committee should 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

### Meeting auditors without the presence of 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 organisation.

### *Pros*

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

- It is a chance for governors to speak openly and frankly with auditors.
- It can reinforce the independence of the committee and ensure that it is seen to be independent.

- It provides an opportunity for governors to ask questions of the auditors that they may feel reluctant to ask in an open meeting with college management and staff present

### **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.

Draft

## Section 6

# 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 organisation'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 and to help them ensure that the organisation gets value for money from its resources.

### Different types of behaviour

The internal auditors produce the following reports.

1. An **audit needs assessment** identifies the organisation's activities and systems and categorises them according to the likelihood and level of risk associated with its 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 organisation 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; and
  - 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 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 organisation's internal control systems; and
  - 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 post-holder or individual who will be responsible for implementation; and
- 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 organisation, the external auditors have to:

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

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 organisation's 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.

## 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; and
- the external audit financial statements management letter.

Read through the recommendations in the document you have chosen. Were the recommendations in the report accepted by the 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' recommendation 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 organisation 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 5 The Process of Effective Governance*, Section 4: Committees and Working Groups.

## Funding auditor

Where their funding body has major cause for concern about an organisation's performance and controls, it may appoint a third auditor, in addition to the organisation's own external and internal auditors, to audit the student numbers upon which funding is based. The reports from the funding auditor will be reviewed by the Audit Committee in their role overseeing the whole system of control, but the funding auditor is directly answerable to the funding body.

## Section 7

### 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 organisation's internal control systems. This is done in the Audit Committee annual report, the main headings of which are summarised below.

#### Contents of the Audit Committee annual report

- 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;
- assessment of the effectiveness of risk management arrangements;
- summary of the management letter produced by the external auditors highlighting any significant issues identified;
- review of any other work done by the committee; and
- an annual report for the governing body containing advice on the adequacy and effectiveness of the of the organisation's whole system of control, including arrangements for risk management control and governance processes, and arrangements for economy, efficiency and effectiveness.

#### Activity

##### How thorough is the Audit Committee's annual report?

1. Compare your Audit Committee's most recent annual report against the features suggested 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 8

### Fraud and irregularities

The responsibility for protecting the organisation 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 organisation'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 organisation'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 organisation, or to request any information it feels is appropriate in order 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 organisation'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 organisation's written procedures on fraud and irregularity are followed and appropriate action is taken.

It is normally up to the chair of the Audit Committee, following discussion with the corporation chair, 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.

This action by the Audit Committee would normally follow any appropriate management action, led by the principal according to the appropriate policy, such as:

- 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); or
- 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.

The topic of Fraud and Irregularities is sometimes a standing item on the Audit Committee agenda, as is the hospitality register (or gift book). The Irregularities and Fraud Register should be signed off by the Audit Committee chair at each meeting and all college policies associated with fraud and internal controls, e.g. fraud policy, whistle-blowing, should be reviewed at appropriate timescales by the Audit Committee for approval by the corporation.

## 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. 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 breach of regulations. This should be clearly stated in the engagement letter from the external auditor. This means that the organisation 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 organisation, what is the current 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 organisation's written procedures on fraud and irregularities. The procedure should be the same for everyone in the organisation, 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 9

### 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 to regularly 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) or '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 The Audit Committee</b>	<b>College response Y, N or D</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 its 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 organisation?	

Internal and external auditors	College response Y, N or D
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 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 the internal audit work is carried out according to the standards set out in the HM Treasury: Government Internal Audit Manual?	
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 organisation'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?	
Section 7 Fraud and irregularities	College response Y, N or D
Does the organisation 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.

# Draft

## 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 organisation'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 and external 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; and
- evaluate the practice and effectiveness of your own organisation's Audit Committee.

If you are not sure that you have achieved a particular goal, look back at the contents list in the introduction of 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.

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 organisation 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 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 organisation.

Draft

# Draft

Friars House, Manor House Drive  
Coventry CV1 2TE  
t 024 7662 7900  
e [enquiries@lisis.org.uk](mailto:enquiries@lisis.org.uk)  
[www.lisis.org.uk](http://www.lisis.org.uk)