June 2004/27 (*web version updated December 2005)*

Core funding/operations

Framework for accountability

This report is for information and guidance

This document contains HEFCE's requirements for accountability and audit arrangements in higher education institutions and HEFCE's related bodies. It supersedes the 'HEFCE Audit Code of Practice' issued in May 2002 (HEFCE 2002/26), and is effective from 1 August 2004.

Accountability and Audit: HEFCE Code of Practice

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND

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Accountability and Audit: HEFCE Code of Practice

(December 2005 updates to paragraphs 37, 38, 132 and 141)

Accountability and Audit: HEFCE Code of Practice

To	Heads of HEFCE-funded higher education institutions, connected institutions and related bodies Heads of universities in Northern Ireland
Of interest to those responsible for	Senior management, Finance, Governance
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Enquiries to	Paul Greaves tel 0117 931 7378 e-mail p.greaves@hefce.ac.uk Peter Collingwood tel 0117 931 7090 e-mail p.collingwood@hefce.ac.uk

Executive summary

Purpose

1. This document sets out our requirements for higher education institutions' (HEIs') accountability and audit arrangements and the broad framework in which they should operate.

Key points

2. This Code replaces the 2002 version of the Audit Code of Practice (HEFCE 2002/26) with effect from 1 August 2004. Its contents reflect:

- a clearer recognition of the importance of corporate governance in institutional accountability and audit
- the reduction in audit burden following changes to the operation of the HEFCE audit team (the auditors are now integrated with HEFCE finance and estates advisers in the HEFCE Assurance Service)
- the requirement for a statement of internal control to be included with published financial statements, as recommended by the Combined Code on corporate governance best practice and reporting following the Turnbull Report, and as reflected in HEFCE's Accounts Directions to the sector
- further reference to risk management arrangements
- revised professional standards for internal auditors, for example from the Treasury

- developments intended to increase the overall degree of self-regulation in the sector, to enable further lightening of touch by the HEFCE Assurance Service, relying where possible on existing information and arrangements.

3. Regard has also been paid to the Smith and Higgs reports where they are relevant to the higher education (HE) sector. Sir Robert Smith chaired a working group of the Financial Reporting Council to advise on updating Combined Code guidance about audit committees in UK listed companies. Although the sector backgrounds are different, the way audit committees are expected to operate is very similar. Derek Higgs reported in the Higgs report on the role and effectiveness of non-executive directors.

4. This revised Code is the result of a re-drafting exercise that involved a focus group of sector and stakeholder representatives, the HEFCE Board and Audit Committee, and a national consultation (HEFCE 2003/60). This process endorsed changes to the Code including the key ones that HEFCE should be open in its risk assessment of HEIs and that in the rare circumstances when an HEI is at high risk we will increase our interventions. Other changes made following the consultation include a new annex on value for money (VFM), revised guidance on internal audit in HEIs, and new guidance on risk-based internal auditing in HE to be added to the HEFCE web-site in autumn 2004.

5. The Code describes our minimum audit and reporting requirements and those that we consider to be good practice or worthy of consideration. It is now a mandatory requirement for institutions to submit their internal audit annual reports. Previously this was optional, although the majority of institutions have submitted the reports. We have also strengthened our guidance on dual appointments to require separate audit providers for internal and external services.

6. Model versions of key documents are provided for HEIs to use at their own discretion.

<u>Context</u>

7. This update of the Code comes at a time when we are seeking to improve our accountability and audit requirements so that the regulatory burden on institutions can be minimised while satisfying the need to account to Parliament for the use of public funds. On the one hand stakeholders demand credible and robust assurance about the proper and effective use of public funds distributed by HEFCE. On the other hand, momentum to reduce the accountability burden has increased following the publication in 2002 of the Cabinet Office Better Regulation Task Force report on higher education. Subsequent work by the Better Regulation Review Group to monitor and challenge the regulatory burden in HE continues this momentum. The Code reflects ongoing work to target accountability resources where they are most needed and to make accountability requirements proportionate to risk. We will continue to co-operate with other agencies who have common interests, to minimise the impact of accountability and audit while maintaining its effectiveness.

8. We are developing a consistent approach to our accountability and audit requirements. Where possible, capital funding, funding for the reward and development of

staff and other initiatives are being implemented with criteria that recognise institutions with good records in performance, sustainability and accountability. In the long term, we wish to use audit and monitoring arrangements to identify successful (in performance terms), sustainable (in broad terms) and accountable institutions, and to minimise intervention at these.

9. The approach of the HEFCE Assurance Service recognises that there is a continuum from regulated to self-regulated. Towards the regulated end of the spectrum, accountability and audit involve considerable external intervention by the HEFCE Assurance Service in the form of visits and other work. We are seeking to promote increased self-regulation where HEIs, through their audit and other reports, demonstrate that they are accountable without the need for intervention.

HEFCE Chief Executive

10. HEFCE's Chief Executive is its accounting officer. He is responsible for ensuring the proper and efficient use of public funds by HEFCE, by HEIs and by others who receive HEFCE funds, and also for ensuring that Treasury guidance is observed. The financial memorandum between the Department for Education and Skills (DfES) and HEFCE requires the issue of an Audit Code of Practice. This is that Code.

Introduction

11. This Code states how effective accountability and audit coverage should be achieved. It sets out our minimum requirements for the reporting of risk management, control and governance arrangements, for internal and external audit arrangements, and the broad framework in which they should operate. The Code also provides an overview of the roles and responsibilities of the HEFCE Assurance Service.

12. The Code applies to the relationship between HEFCE and higher education institutions and in principle to their related companies and other bodies which, indirectly, receive HEFCE funding. These include, for instance, subsidiary entities of HEIs, such as subsidiary companies, student unions and charitable funds, and they should pay appropriate regard to the Code. We fund a small number of connected institutions through HEIs, which are also subject, indirectly, to this Code. The colleges of the universities of Oxford and Cambridge are not funded directly by us but are subject to an agreed audit protocol.

13. We also fund and have relationships with a number of related bodies such as the Quality Assurance Agency for Higher Education (QAA), the Joint Information Systems Committee (JISC) and the Leadership Foundation. All references in this Code to HEIs should be taken as also applying, where appropriate, to HEFCE's related bodies unless stated otherwise.

14. There are a number of mandatory requirements which are conditions of funding under the financial memorandum between HEFCE and HEIs. Within this Code the following words are used in these ways:

- 'must' and 'will' denote mandatory requirements
- 'should' denotes our view of good practice
- 'may' indicates ideas worthy of consideration.

15. For ease of reference, the mandatory requirements are set out in Annex A. The Code also includes a number of 'model' documents as annexes to the Code. These are on the web at www.hefce.ac.uk with this document under Publications. The model documents are for guidance only and should be adapted to meet specific HEIs' requirements as appropriate. Additional guidance is available from the HEFCE Assurance Service.

16. Changes may be notified to the sector and added to the web-based version of the Code. Sector stakeholders are consulted about significant changes, particularly where they affect mandatory requirements. We may also supplement the Code with occasional circular letters specifying guidance and requirements. They will be developed in consultation with the representative bodies in HE, and will be incorporated into any subsequent revision of the Code.

17. We will assess compliance with the Code, having regard to guidance on good practice, and the risk management, control and governance arrangements that an HEI has in place. In line with relevant professional guidance, the HEFCE Assurance Service will seek to satisfy itself about the adequacy of an HEI's risk management, control and governance arrangements at least once every five years. This assessment will include professional peer review of the HEI's audit providers against professional standards. The HEFCE Assurance Service will assess HEIs' arrangements itself, or it may rely on any relevant work of others which it considers to be soundly based, or it may commission work.

18. The Code is primarily for use by internal and external auditors, HEIs' senior management, members of the governing body and audit committees. It may also be of interest to other stakeholders. More detailed advice on any aspect of the Code is available from the HEFCE Assurance Service. The Code is not intended to be a manual. HEIs may choose to develop their own manuals to detail their own procedures.

The corporate governance context

19. The corporate governance arrangements of an HEI are the means by which strategy is set and monitored, managers are held to account, risks are managed, stewardship responsibilities are discharged and viability is ensured. A more complete description of corporate governance in an HEI can be found in the guide by the Committee of University Chairmen (CUC) – 'Guide for Members of Governing Bodies of Universities and Colleges in England, Wales and Northern Ireland', HEFCE 01/20 (an updated guide is due in November 2004). The responsibilities of a governing body as to conditions of HEFCE funding can be found in the financial memorandum (HEFCE 2003/54).

20. The CUC guide is the main source of guidance on governance arrangements in HE and as such it is a framework which informs our assessments of institutional governance. The only mandatory governance obligations we impose are those in the financial memorandum.

21. Our view is that although compliance with CUC guidance is not mandatory, in the spirit of open reporting HEIs should always indicate where their arrangements vary significantly from the guidance, and explain their approach. This 'comply or explain' principle should be applied in all corporate governance reporting.

22. If corporate governance is effective, an organisation can flourish and, in this context, external stakeholders can rely on that organisation. Good governance enables increased self-regulation and reduces the need for external regulation.

23. It follows that if institutions can demonstrate that their corporate governance is effective then we can derive confidence and adjust the level of audit and monitoring accordingly. Opportunities for HEIs to demonstrate the effectiveness of their corporate governance include:

- publishing any reports of reviews of corporate governance. This is consistent with the Smith Report which recommends that boards should undertake formal and rigorous annual evaluations of their own and their committees' performance

- meeting this Code's requirements for audit committee reporting

- publishing as required a statement of internal control that describes an effective system of risk management, control and governance. The statement is a powerful demonstration of corporate governance if it confirms that all key risks have been identified and managed

- publishing with the financial statements a statement of corporate governance

- arranging audit assurance about the effectiveness of risk management, control and governance, including about the statement of internal control

- arranging for, and paying due heed to, the work of effective internal and external auditors.

24. The Code elaborates on the role of auditors and audit committees, and discusses risk management and statements of internal control in more detail below. But the overriding point is that if governing bodies fulfil their responsibilities, including the tasks they are charged with by HEFCE, and demonstrate that they are operating effectively, then this provides considerable assurance.

25. This assurance can form the basis of a more sophisticated accountability relationship as it develops in the future.

The higher education audit framework

26. In accordance with their financial memoranda with us, HEIs must have effective risk management, control and governance arrangements. However, other public bodies also have an interest in these control arrangements, including Parliament, the DfES and, where applicable, the Learning and Skills Council (LSC), the Research Councils, the Department for Employment and Learning (DEL) in Northern Ireland, and the Teacher Training Agency (TTA).

27. Each of these bodies needs to make appropriate arrangements to safeguard its interest. Each has its own auditors, but in practice there are only two groups engaged in regular audit investigation of an institution's systems and records – an institution's internal and external auditors. This is the same level of activity that is common in the private sector. Of the interested parties, DfES, HEFCE, LSC, DEL and TTA seek to avoid duplication by relying on the work of the other auditors whenever possible.

Parliament

28. Parliament's interest is to see that public funds are properly applied and accounted for and used economically, efficiently and effectively by recipients. The Comptroller and Auditor General, head of the National Audit Office (NAO), is the external auditor of HEFCE. He has the right to inspect the accounts of any HEI that receives HEFCE grants, and the right to carry out value for money investigations. The NAO is highly selective in its use of inspection rights: most of its audit work can be undertaken at HEFCE, and value for money investigations normally involve only a sample of institutions at any one time.

Department for Education and Skills

29. Public funds are channelled through the DfES. The DfES Permanent Secretary, as accounting officer, is responsible and accountable to Parliament. The accounting officer must be satisfied that proper arrangements are being made to safeguard public funds. This is achieved through the financial memorandum between DfES and HEFCE which requires HEFCE to have an audit service and appropriate accounting systems. The work of the HEFCE Assurance Service is examined by the DfES audit service, which may observe it at work in HEIs but does not audit HEIs itself.

HEFCE

30. Under the financial memorandum with DfES, HEFCE's Chief Executive is accounting officer for the funds received from DfES and is accountable to Parliament for them. This applies both to money we spend directly on our own operation, and to money spent by the HEIs and other entities that receive HEFCE funds. The HEFCE Assurance Service accordingly provides both the internal audit function within HEFCE, and assurance to the HEFCE Chief Executive on the arrangements within HEIs and other HEFCE-funded entities. This Code is principally concerned with the latter part of the service, namely arrangements in HEIs and other HEFCE-funded entities. However, the internal audit of HEFCE’s arrangements is carried out in accordance with these same standards. In common with the arrangements in HEIs, there is an Audit Committee to assist the HEFCE Board in discharging its accountability and audit responsibilities, in respect of both HEFCE, and HEIs and other entities.

31. The governing body of an HEI is responsible for ensuring the proper use of public funds. Under the financial memorandum with HEFCE the governing body is required to designate a principal officer known as the designated officer. We would expect the designated officer to be the institution’s vice-chancellor, principal or equivalent. He or she should satisfy the governing body in respect of the use of public funds, and may be required to appear before the Public Accounts Committee of the House of Commons, alongside HEFCE’s Chief Executive, on matters relating to the use of HEFCE funds.

32. In the event of any serious weakness, such as a significant and immediate threat to the HEI’s financial position, significant fraud or major accounting breakdown, the designated officer must inform, without delay, the chair of the HEI’s audit committee, the chair of the

HEI's governing body, the HEI's head of internal audit and the HEFCE accounting officer. On receiving any such notification, the accounting officer will discuss what response to make with the HEI's governing body or designated officer, including any action to be taken. If a matter requiring report is discovered by external or internal auditors in the normal course of their work and the designated officer refuses to make a report, then the auditors must report directly to the chair of the HEI's audit committee, the chair of the HEI's governing body and the HEFCE accounting officer. This is to ensure that the HEI has taken appropriate action.

33. In addition, the HEFCE Assurance Service is able to provide advice to HEIs on dealing with fraud and irregularity, particularly when notified at an early stage. The lessons learned will be disseminated throughout the sector by the HEFCE Assurance Service, thereby enabling HEIs to protect their interests. This process should also reduce the need for visits to HEIs by the HEFCE Assurance Service.

34. In this Code, a serious weakness includes one that has resulted in an attempted, suspected or actual significant fraud or irregularity. Significant fraud or irregularity is usually where one or more of the following apply:

- the sums of money involved are, or potentially are, in excess of £20,000

- the particulars of the fraud or irregularity are novel, unusual or complex

- there is likely to be public interest because of the nature of the fraud or irregularity, or the people involved.

35. There may be circumstances that do not fit this definition. In these cases or any others, HEIs can seek advice or clarification from the HEFCE Assurance Service. In view of the public interest, HEIs should normally notify the police of suspected or actual fraud. Where the police are not notified, management should advise the audit committee of the reason. HEIs are also referred to the guidance on fraud we issued in 1999 (published only on the web as HEFCE 99/65).

<u>Learning and Skills Council and the Teacher Training Agency</u>

36. Some HEIs receive funds from the LSC or the TTA, who therefore also have an interest in their management and accountability. To avoid unnecessary duplication, the LSC and TTA will rely on the accountability and audit framework set out in this Code. They will not be directly involved in auditing HEIs, except that they may occasionally request specific audit work to be undertaken in accordance with their own funding conditions. HEFCE and the LSC have a formal protocol on this, and it is reflected in an annual exchange of assurances between the two accounting officers.

General principles for internal and external auditors

Duties

37. These general principles for auditors are intended to supplement, not replace, those issued by the recognised professional bodies (including the Ethical Standards issued by the Auditing Practices Board), and which we expect auditors to follow. The principles set out our requirements for the standards for HEIs' internal and external auditors, and are also the standards to which our own auditors are expected to operate, in recognition of the high level of probity demanded where public funds are involved.

Objectivity

38. Auditors should ensure that the audit committee is appropriately informed on a timely basis of all significant facts and matters that bear upon the auditors' objectivity and independence. In particular, auditors should avoid the following:

a. Official, professional and personal relationships which might cause the auditor to limit the extent or character of the audit.

b. Any responsibility for the executive management of the HEI.

c. Any interest, financial or non-financial, direct or indirect, in the HEI (other than the normal employee or contractor relationship, or the funding of any prize, scholarship or academic appointment).

39. Notwithstanding the need for objectivity, the external and the internal auditors of an HEI should aim to ensure that their work programmes complement each other to optimise the effectiveness of their services.

Dual appointments

40. Provision of both internal audit and external audit services to an HEI by the same firm or provider **is not permitted** under this Code, as this compromises auditors' objectivity. The only permitted exception is where an external auditor carries out a limited amount of (typically specialist) work in support of the internal audit service, and the extent of this should be monitored by the audit committee.

41. External auditors need to form a view on the quality and coverage of the internal auditors' work, to determine the extent to which they can rely on this to underpin their own work. It is not acceptable for a firm to provide an opinion as external auditor about the same firm's work as internal auditor. Governors and managers need such opinions to be objective and independent. It is also useful to governors and managers to obtain two independent views on risk management, control and governance reflecting the different perspectives of internal and external auditors. Where an HEI currently has such a dual appointment it may be appropriate to complete the remaining period of a contract, but this should be changed as

soon as practicable.

Due professional care

42. In exercising due professional care auditors should:

a. Take reasonable steps to obtain information relevant to the audit. Auditors should take into account information from the HEI and from HEFCE, any changes in legislation, and the results of previous audit work.

b. Keep up-to-date with developments in professional matters.

c. Look out for and take into account any unusual circumstances.

d. Consider audit objectives and plan work to adhere to them while taking into account the HEI's risk management strategy.

e. Document the conclusions arising from the planning process, and detail a budget for staff and time.

f. Discuss the main features of the audit with the HEI.

g. Ensure that audits are staffed with suitably qualified and experienced personnel, and that work is properly controlled and reviewed.

h. Co-ordinate the work of specialist staff.

i. Ensure that conclusions are adequately supported by reliable evidence. This evidence should be sufficient for an experienced auditor with no previous connection with the audit to ascertain what work was done and how the conclusions were reached.

j. Control the costs of audit, including the cost of implementing audit recommendations, weighing costs against likely benefits.

k. Maintain objectivity but also make their expertise available in the form of advice to management.

l. Preserve confidentiality where appropriate.

Audit of HEIs by the HEFCE Assurance Service

HEFCE Assurance Service

43. The HEFCE Assurance Service is made up of internal and institutional auditors and institutional finance and estates advisers (as well as the Secretariat). Up-to-date contact details are available on the HEFCE web-site under Good practice/Audit.

Role and scope

44. The HEFCE Assurance Service is responsible for evaluating the risk management, control and governance arrangements of HEIs and other entities funded by HEFCE, and for giving assurance on those arrangements to HEFCE’s Chief Executive (as accounting officer) and to HEFCE’s Board via its Audit Committee. Our review methods are being developed to maintain and improve the effectiveness of accountability arrangements, while minimising the accountability burden this imposes. For instance, the average frequency of Assurance Service visits to HEIs has been reduced, and visits are of shorter duration, with reduced information requirements. We seek to rely increasingly on HEIs and other entities actively demonstrating that they have sound arrangements in place, to reduce the need for direct work by us.

45. All the activities of HEIs and related bodies are within the remit of the HEFCE Assurance Service. The service works in accordance with the standards for internal audit in the Government Internal Audit Standards issued by the Treasury, and guidance from relevant professional auditing and accountancy bodies. It will consider whether risk management, control and governance arrangements are adequate to manage risk and to secure propriety, efficiency, economy and effectiveness in all areas. It will seek to confirm that management have taken the necessary steps to achieve these objectives.

46. Subject to legislative constraints, the HEFCE Assurance Service has access to all records, information and assets of HEIs and other entities and can require any officer, including members of the governing body, to give any explanation which it considers necessary to fulfil its responsibilities.

47. The service will liaise, whenever appropriate, with the NAO, the HEIs' internal and external auditors (collectively and individually), the DfES, TTA, Scottish Higher Education Funding Council, Higher Education Funding Council for Wales, the DEL and any other appropriate HEFCE officer or relevant organisation. The HEFCE Assurance Service will also liaise with sector bodies as it seeks to promote good governance, management and auditing. Liaison is pursued both for effectiveness and to avoid duplication of effort.

Reporting

48. The Head of Assurance and Audit will report on HEIs’ compliance with the relevant standards to HEFCE’s Audit Committee. The Audit Committee will also consider any assessments of the HEFCE Assurance Service, including any reports that have been

specially commissioned and any by the DfES Head of Internal Audit.

49. The Head of Assurance and Audit will, when appropriate, draw the attention of the HEFCE Chief Executive and Audit Committee to serious weaknesses, significant frauds and any major accounting breakdowns.

50. The Head of Assurance and Audit will submit an annual report to HEFCE's Chief Executive and Audit Committee. This will include the Head of Assurance and Audit's assessment of the adequacy and effectiveness of the risk management, control and governance arrangements within HEIs and other entities funded by HEFCE; report on coverage achieved; and provide audit performance measures.

Ongoing risk assessment

51. HEFCE maintains an ongoing overall risk assessment of HEIs. The HEFCE audit assessment of each HEI, which has for the years from 2000-01 been notified to the designated officer annually in a letter, is an input to this overall risk assessment. The overall HEFCE risk assessment takes into account all information which can inform it, including student recruitment and retention, finances, audit, estates, human resources strategies, incidences of 'whistleblowing' and fraud. The method is being continuously reviewed and developed. We will in future be open with HEIs about the overall risk assessment. We will write an annual letter (as well as at other times if risks change to a significant extent) to inform the HEI of:

- the current overall risk assessment. For the vast majority of HEIs the overall assessment will record that we do not consider they represent a significant risk

- how that assessment compares with the rest of the sector

- what particular risk factors are of current concern

- what actions are needed in response to the risk assessment, if any. Any such actions would be agreed with the HEI and would be designed to support the HEI in dealing with the risks as quickly as possible. Our support strategy for HEIs and related bodies at risk will be available on the HEFCE web-site.

52. Risk assessments will be confidential between HEFCE and individual HEIs. We will not divulge a risk assessment other than to the individual HEI and will not accept liability if HEIs choose to release this information. The only exception to this is that we will need to share our risk assessment with those other public funders that depend on it, including the NAO, NHS, LSC, TTA, DEL and the Office of Science and Technology.

53. We expect HEIs to notify us of significant changes and issues as they arise. This will help us to maintain the currency of the risk assessment. For example, changes of auditors, of key personnel (such as the finance director, or university secretary/registrar) or key

systems changes (such as the implementation of a new finance information system) are potentially significant in our risk assessment.

<u>Annual accountability assessment</u>

54. Every year the HEFCE Assurance Service will assess the extent to which each HEI's audit and related reports, supported by any other relevant information, demonstrate the effectiveness of risk management, control and governance arrangements. This will not normally involve a visit to the HEI. The work will take place after receipt of HEIs' financial statements and other audit returns. The conclusions from the assessments will be taken into account when HEFCE makes its overall risk assessment of each HEI, and will be reflected in the resultant annual letter notifying our risk assessment to the HEI's designated officer. Where HEIs' reports are not provided to us or where they reveal inconsistencies or other concerns, then we will take appropriate action. This may include the HEFCE Assurance Service undertaking audit work or asking for audit work to be done.

55. The specific sources of assurance that influence this assessment include:

- the annual financial statements, including the corporate governance statement and the statement of internal control (HEI reporting requirements now reflect the Combined Code on Financial Reporting)

- the external audit management letter

- the audit committee annual report

- the findings of the most recent HEFCE audit cyclical review and data audit review

- the internal audit annual report. It is now mandatory for HEIs to provide this to us, given its importance in risk assessment and in influencing the amount of audit attention an HEI is to be given

- the annual monitoring statement and the corporate planning statement

- the designated officer's return at Annex K to this Code. This supplements the other material submitted to keep the HEFCE Assurance Service up to date with HEIs' accountability and audit developments in the intervals of up to five years between audit visits. It also provides an opportunity for the designated officer to confirm that the conditions of grant have been satisfied in the period

- other information such as capital grant audit reports or returns made in response to the Transparent Approach to Costing (TRAC) requirements

- any additional material volunteered by HEIs to inform these assessments, including any reports on reviews of corporate governance.

Assessment of HEIs' audit arrangements

56. The HEFCE Assurance Service will establish whether all elements of the risk management, control and governance arrangements on which each HEI intends to rely have been identified by institutional auditors; that audit needs have been assessed adequately and review strategies established; and that audit arrangements are consistent with the Code. This assessment of internal and/or external audit arrangements will seek to confirm that the audit providers are of a suitable standard to undertake the work, based on a review of their work against professional standards. The focus of these assessments may be on an individual HEI, as part of cyclical reviews which are described in the following section, or they may be carried out at providers who serve a number of HEIs.

Cyclical risk-based audit reviews at institutions

57. The HEFCE Assurance Service carries out periodic review visits (cyclical visits) to HEIs to gain an overview of the adequacy and effectiveness of their risk management, control and governance arrangements. The frequency and nature of these visits are determined by reference to HEFCE's risk assessment of each HEI as discussed above. To minimise duplication, we will rely on the work carried out by the HEI's internal and external auditors where appropriate. As part of our policy of reducing audit burden wherever possible, where assurances provided by HEIs do provide comfort, and where the audit arrangements are considered satisfactory, we have reduced the frequency of cyclical audit visits from three-yearly to, presently, one visit in each five-year period. The reviews are now shorter and are focused on key risks. On average, the majority of HEIs now receive less than one day's HEFCE audit attention in each year.

58. In practice, a cyclical audit will normally require a three-day visit to an HEI by an experienced and qualified auditor working to professional standards. The auditor will be seeking to ensure that the HEI has effective arrangements for the core areas shown in Table 1 below. The areas reviewed will be assessed for effectiveness and good practice. Compliance will be assessed where mandatory requirements apply, and reference will be made to good practice guidance where this exists. The contents of Table 1 are not exhaustive, particularly regarding sources of good practice.

59. In outline, we will usually assess the structure and the operation of each of these core areas. We will consider, for instance, whether arrangements are in place for self-review of governance and how effective these are, seeking to place reliance on the HEI's own processes. For audit arrangements, we will consider internal audit, external audit and the audit committee. Strategic management refers principally to overall management arrangements and strategic planning, and also any significant projects and initiatives. It is the governing body's responsibility to ensure the effective use of resources, or value for money. Within this, management is responsible for operating effective VFM arrangements. There should be a clear reporting line on VFM through auditors, management and the audit committee to the governing body. We will consider the inter-relationship of areas, such as the integration of strategic planning and budgeting.

60. We will not be attempting to provide direct assurance about the whole system of risk management, control and governance arrangements; that is the role of the HEI's internal audit service. However, exceptionally we will undertake direct auditing of areas where a problem is identified and an HEI's auditors have been unable to provide satisfactory assurances. Each HEFCE audit will result in a brief report to the HEI's designated officer and audit committee, which will be followed up as necessary. The precise scope of each visit will vary according to the assessment of risk at that HEI. We may commission risk-based reviews from suitably qualified external providers.

Table 1 Core areas for review of compliance and good practice

Subject	**Compliance source**	**Good practice source**
Governance	Instrument and articles of government or equivalent Financial memorandum Combined Code	CUC guidance
Audit	Combined Code Professional standards HEFCE Code of Practice HEFCE Accounts Directions HE Statement of Recommended Practice (SORP) Government Internal Audit Standards (GIAS) HEFCE Accounts Directions	HEFCE Code of Practice
Financial management	Financial Memorandum	HEFCE guidance on effective financial management in higher education HEFCE guidance on financial strategy in higher education institutions
Strategic management		HEFCE strategic planning guidance
Value for money	Financial Memorandum HEFCE Code of Practice	HEFCE VFM guidance
Risk management	Combined Code	HEFCE risk management guidance Relevant guidance from the British Universities Finance Directors Group (BUFDG)

61. The HEFCE Assurance Service will normally produce a draft report within 15 working days of completing each HEI audit, giving an opinion on the area reviewed and making recommendations where appropriate. We will ask HEIs to respond within one month and will issue a final report within 15 working days of a final draft being agreed. Each report will include an agreed action plan for improvement. Recommendations will be followed up in accordance with the action plan. All final versions of audit reports will be copied to HEFCE's

Chief Executive. A summary of all audit reports is made available to the HEFCE Audit Committee. All HEFCE Audit Committee papers are seen by the DfES and the NAO. The NAO sends a representative to all HEFCE Audit Committee meetings. This assures the DfES and NAO about our audit processes and limits their need for direct work in HEIs.

Work at high-risk institutions

62. From time to time, individual HEIs face financial or other difficulties. Where these difficulties represent a risk to public funds or to the interests of HEFCE and other stakeholders generally, including the staff and students of HEIs, then we will need to become involved. This has been discussed in paragraphs 51 to 53 about our ongoing risk assessment.

63. We have powers to make particular requirements of HEIs facing difficulty, and to make these requirements conditions of grant. It is the responsibility of the governing body to satisfy our conditions of grant. It follows that, at times, it may be necessary for the dialogue between us and the HEI to be at governing body level. We may also need to seek, as a condition of grant, observer status at governing body or audit committee meetings. These and other measures to support HEIs in difficulty and protect public funds will be set out in our support strategy, available on the HEFCE web-site.

Data audits

64. HEIs are required to supply us with data to inform our allocations of funding generally, and in response to specific initiatives. These data may be supplied directly or through the Higher Education Statistics Agency. We have procedures for validating and verifying data received, and may undertake audit work to satisfy ourselves that the information supplied is reliable. As a consequence, the HEFCE Assurance Service undertakes programmes of data audit. The scope and conduct of such audits vary, but normally involve visits to HEIs to evaluate the systems which generate data and to verify data on a sample basis. Our data audit is driven by a risk assessment process and results in an average of less than a half-day's audit attention for each HEI in each year.

Special funding audits

65. We distribute funds in a number of ways and with a range of reporting and monitoring conditions attached. In developing the relevant programmes, these conditions are developed and evaluated by testing the policy proposals against an accountability scorecard. The scorecard seeks to assess whether the reporting and monitoring conditions are reasonable, transparent and appropriate. As such the conditions are meant to be minimal; the HEFCE Assurance Service usually only undertakes or commissions work where conditions of grant are not met, including where audit or other reports are not provided by HEIs.

Value for money

66. There is an underlying duty of care to ensure that public funds are spent on the purposes for which they are intended, and that good value for money is obtained. This duty falls upon HEFCE and on the HEIs that we fund. Further guidance on this subject is available at Annex J.

Special reviews

67. The HEFCE Assurance Service will also consider conducting any special reviews requested by the HEFCE accounting officer. This includes work necessary to fulfil our contractual obligations with the DEL in Northern Ireland.

Audit committees in HEIs

Scope

68. The governing body of an HEI must ensure that it is fulfilling its responsibilities for adequate and effective risk management, control and governance, and for the economy, efficiency and effectiveness (or VFM) of the HEI's activities. Accordingly, HEIs are required by their financial memorandum with HEFCE to appoint an audit committee. The duties of the audit committee will have to be determined in the light of the HEI's needs, but should normally include those described in the model terms of reference at Annex C. Additional information on the role of audit committees is available from the Chartered Institute of Public Finance and Accountancy (CIPFA); the Institute of Chartered Accountants in England and Wales (see the ICAEW Audit and Assurance Faculty guidance ‘The Effective Audit Committee: a Challenging Role’, 2001, and ‘The Power of Three’, May 2003); and in the Smith Report (2003). The updated section on Corporate Governance in the Combined Code following the Smith Report’s recommendations are at Annex D.

69. The audit committee has a key role in the HE accountability framework. It assesses the risk management, control and governance arrangements, and advises the governing body on the effectiveness and outcomes of these. This calls for an independent and challenging approach. The audit committee should be properly constituted, appointed and given sufficient authority and resources by the governing body. It should have the right to obtain all the information it considers necessary and to consult directly with the internal and external auditors. The committee should be advisory and should report directly to the governing body.

Membership

70. The audit committee should consist of at least three members of the governing body, and should be able to co-opt others with particular expertise or interests who are not members of the governing body. The co-option arrangements should be transparent and should operate through the nominations committee of the governing body.

71. A co-opted member of the audit committee should not normally be appointed as its chair, since the chair has to be able to attend, as of right, all meetings of the governing body. Where this is unavoidable, arrangements should be made to ensure the chair has full access to the governing body for reporting purposes. Subject to this, co-opted members should have equivalent status on the audit committee to full governing body members. The committee should have the right, whenever it is satisfied that it is appropriate, to go into confidential session and exclude any, or all, participants and observers.

72. At least one audit committee member should have recent and relevant experience in finance, accounting or auditing. To ensure independence of the audit committee, it is current best practice that all its members should be independent and non-executive. In our view the staff of an organisation are not independent. This is the view expressed in the Higgs Report, which is now incorporated in the July 2003 update of the Combined Code.

73. Audit committee members should not be members of a finance committee or its equivalent. This is because the audit committee needs the independence to challenge the finance committee, so members should not be compromised by having been involved in executive decisions which are then potentially open to audit comment. However, exceptionally, an HEI can apply to us for cross-representation to be permitted so long as the following conditions are met:

- the audit committee has at least three members (not counting co-options)
- the person serving on both committees is not the chair of either
- in HEIs where there is a Treasurer, that individual does not serve on both committees.

74. There should also be a mechanism for all audit committee members including co-opted members to declare any matter in which they have an interest; they may then be excluded from consideration of such items.

75. The chair of the governing body should not be a member of the audit committee.

76. The audit committee should consider whether members, or prospective members, require any training on risk management, control, governance, finance, audit or other related matters. This process could be facilitated via the Leadership Foundation for Higher Education for instance, or visits to departments. Committee members should normally be provided with a copy of the guidance on audit committees issued by CIPFA and the ICAEW. Further advice on any aspect of audit committee membership is available from the HEFCE Assurance Service which, in agreement with the CUC, also arranges training and development events for audit committee members.

Operation

77. The audit committee should be given maximum discretion to determine its proceedings, within the terms of reference set for it by the governing body. The committee should usually meet at least three times in each financial year. The timing and content of the meetings should follow, as far as possible, the planning and reporting cycles of external and internal audit. Relevant managers should be invited to attend audit committee meetings where their area of responsibility is under examination. The internal auditor should normally attend all meetings. The external auditors should normally attend meetings where business relevant to them is to be discussed. Both the internal and external auditors should have the right of access to the chair of the committee, and the right to ask the chair to convene a meeting if necessary.

78. The clerk to the governing body or some other independent person should normally be the clerk to the audit committee. Where the clerk has significant financial or other responsibilities at senior management level within the HEI, the governing body should consider whether the role of clerk to the committee should be transferred to another individual to maintain independence, or whether sufficient safeguards are built into the existing arrangements.

79. The audit committee should agree appropriate performance measures for its internal and external auditors and monitor their performance annually. Experience has shown that performance measures need to be adapted to each institution's requirements to be most effective. Committees should consider any appraisals of their auditors, for example by the HEFCE Assurance Service. In line with the Government Internal Audit Standards (GIAS) requirement for external review of internal auditors every five years, committees may commission independent reviews themselves.

80. The audit committee should consider significant individual audit findings or recommendations, but need not be concerned with more detailed findings, unless the committee considers it valuable to do so. The committee should concentrate on gaining assurance that the HEI's risk management, control and governance arrangements are adequate and effective, for example through the internal auditors' opinions of the areas they have reviewed, through external audit advice and management's responses and other audit-related work. For this purpose, the audit committee should ensure there is an adequate system to monitor the implementation of agreed audit recommendations. The governing body, advised by the audit committee, should ultimately be responsible either for ensuring that management take prompt and effective action on those audit reports which call for it, or for recognising and accepting the risks of management not taking action.

81. The committee will have a role in appraising the effectiveness of the HEI's risk management strategy, in part because the committee's advice will be sought before the governing body can agree the statement of internal control for inclusion in the published financial statements. We issued guidance on the role of the audit committee in risk management in HEFCE Circular Letter 12/2002. The precise role in relation to risk management will vary according to institutional circumstances, including whether the HEI

has established a risk committee of the governing body. The audit committee will need to be satisfied that risk management is embedded in the HEI, and to this end will need to be sure that senior managers signify that they own and manage risks. This can be aided by those managers submitting reports and/or attending appropriate committee discussions.

82. The audit committee, advised by management and its internal audit service, must satisfy itself that satisfactory arrangements are in place to promote economy, efficiency and effectiveness. For this purpose, audit committees should consider institutional VFM strategies, and receive reports on progress against those strategies.

83. The audit committee should form an opinion on the effectiveness of the HEI's risk management, control and governance arrangements, with appropriate reference to the internal and external auditors, for inclusion in its annual report to the governing body.

84. As part of the process of forming its opinion the audit committee should review the draft audited annual financial statements prior to their approval by the Board. We consider it preferable for the audit committee to consider the accounts after the finance committee has done so, to ensure that the audit committee considers and comments on the final version. The audit committee should be concerned with the process of drawing up the accounts. This will include control and accounting issues, including the accounting policies, with particular interest in the following elements:

- the external audit report and opinion
- any relevant issue raised in the external auditor's management letter
- corporate governance statements, including the statement of internal control
- any other audit related matters.

Matters of primary concern to the finance (or equivalent) committee should include accounting principles and their application, financial disclosure and accounts adjustments, as well as financial strategy (see HEFCE guidance 2002/34 'Financial strategy in higher education institutions'), planning and performance.

<u>Reporting</u>

85. The committee must produce an annual report for the governing body and the designated officer. The audit committee annual report must cover the financial year and include any significant issues up to the date of preparation of the report. When the report has been considered it must be sent without delay to the HEFCE Assurance Service. The audit committee annual report should normally be submitted to the governing body before the members' responsibility statement in the annual financial statements is signed. The internal auditor's annual report as well as the audit committee report must be submitted to the HEFCE Assurance Service as they become available, which is usually by the December

following the year end. This informs our institutional risk assessment.

86. The audit committee annual report must include the committee's opinion on the adequacy and effectiveness of the HEI's arrangements for the following:

- risk management, control and governance (the risk management element includes the accuracy of the statement of internal control included with the annual statement of accounts)

- economy, efficiency and effectiveness (value for money).

This opinion should be based on the information presented to the committee.

87. The report should also record the work of the committee, and consider the following:

- the external auditors' management letter

- the internal auditors' annual report

- value for money work

- any HEFCE Assurance Service or other relevant evaluation.

88. The report might also identify any key issues for the HEI arising out of its activity over the year. Further guidance on the content of the audit committee annual report is given in Annex E.

Internal audit arrangements in HEIs

89. Each HEI is required by its financial memorandum with HEFCE to have an internal audit function.

90. Treasury guidance is that a risk-based approach to internal audit should be adopted within the public sector, specifically including the HE sector, and we have taken this approach. The guidance is reflected in the Government Internal Audit Standards, published by the Treasury in October 2001. The introduction of risk management in the sector, following the adoption of the revised Combined Code and associated principles from other sectors, has brought considerable change in the approach to governance, management and internal audit – moving away from a purely systems-based approach to one which primarily reflects inherent and perceived risk.

91. The HEFCE guidance on internal audit practice in HEIs is that we endorse the approach set out in GIAS and that set out in the Code of Ethics and International Standards (March 2004) of the Institute of Internal Auditors (IIA) and that organisation's Position Statement on Risk Based Internal Auditing (August 2003). Both of these documents are

available from the IIA (www.iia.org.uk). Accordingly, we do not include in this Code guidance on the practice of internal audit. We will, however, make available guidance on the application of the risk-based approach to internal audit in HEIs on the HEFCE web-site by autumn 2004.

92. The IIA guidance offers a high level framework for risk-based internal auditing which could be applied in the private as well as the public sector. As stressed in the guidance itself this is not a definitive or prescriptive solution to be applied directly to the specific circumstances of any particular organisation. It is intended to be helpful in designing an approach.

93. HEFCE Assurance Service assessments of internal audit in the sector will be based on a comparison with good practice including reference to the Treasury standards and IIA guidance. Our development work on internal audit will seek to promote the risk-based approach.

94. The current definition of internal auditing according to the IIA is: ‘An independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.’

95. Accordingly, within the HE sector the prime responsibility of the internal audit service is to provide the governing body, the designated officer and the other managers of the HEI with assurance on the adequacy and effectiveness of risk management, control and governance arrangements. Responsibility for these arrangements remains fully with management, who should recognise that internal audit can only provide ‘reasonable assurance’ and cannot provide any guarantee against material errors, loss or fraud. Internal audit also plays a valuable role in helping management to improve risk management, control and governance, so reducing the effects of any significant risks faced by the HEI.

96. Internal audit can also provide independent and objective consultancy advice specifically to help management improve risk management, control and governance, so contributing to the achievement of corporate objectives. Such advisory work contributes to the opinion which internal audit provides on risk management, control and governance.

<u>Role, scope and terms of reference</u>

97. An HEI must ensure that it has effective risk management, control and governance arrangements. These help to ensure:

a. That the HEI's objectives are achieved as far as possible and that associated risks are managed.

b. That the economic, efficient and effective use of resources is promoted.

c. That there is adherence to management's policies, directives and established procedures, and compliance with any relevant laws or regulations.

d. That the HEI's assets and interests are safeguarded – particularly from losses arising from fraud, irregularity or corruption.

e. That, as far as reasonably practicable, the integrity and reliability of accounting records and other information are maintained.

98. Accordingly, the internal audit service must consider the whole of the HEI’s risk management, control and governance arrangements, including all its operations, resources, staff, services and responsibilities for other bodies. It should cover all activities associated with the institution, including those not funded by HEFCE. For example, it should consider controls that protect the HEI in its dealings with any subsidiary or associated company or student union, or any other activity in which the HEI has an interest.

99. Considering the whole system of risk management, control and governance does not imply that the whole system should be audited. This is the essence of the risk-based approach. If internal auditors are confident about risk management, and if the risk management arrangements effectively mitigate a risk, then that risk should not merit additional audit attention. If, however, internal auditors think for good reason that a risk is insufficiently prioritised or mitigated by management, then that may lead them to form a different view about how effective the risk management system is.

100. Auditors should not question policy objectives, but should consider the effects of and risks arising from policy, how policy objectives have been determined and the means for delivering those objectives.

101. A potential key risk for any HEI is that academic operations will fail in some way and jeopardise the institution’s viability. We would expect the risk management process of all institutions to consider whether there are academic risks and to take appropriate action. Internal auditors will not be qualified to form academic judgements but may need to review academic systems; this is discussed in our web document on risk-based internal auditing in HE to be made available on the HEFCE web-site by autumn 2004.

102. Internal auditors should also assess the adequacy of the arrangements to prevent and detect irregularities, fraud and corruption. However, the primary responsibility for preventing and detecting corruption, fraud and irregularities rests with management, who should institute adequate systems of internal control, including clear objectives, segregation of duties and proper authorisation procedures.

103. The internal audit service should have formal terms of reference, agreed by the governing body on the recommendation of the audit committee. Model terms are provided in Annex G, which should be modified to suit local circumstances. The terms of reference should form part of any contract for the provision of internal audit services by external

providers. This should be made clear when seeking proposals for the provision of internal audit services.

Objectivity and status

104. Objectivity is fundamental to the effectiveness of internal audit. Therefore, while the auditors should consult with senior management on audit plans, these plans should be submitted to, and approved by, the governing body on the recommendation of the audit committee, or directly by the audit committee under delegated authority.

105. Internal auditors may carry out additional work at the request of management, including investigations, provided such work does not compromise the objectivity of the audit service or the achievement of the audit plan. Accordingly, each HEI's audit committee should satisfy itself that the objectivity of the internal audit service has not been affected by the extent and nature of other work carried out. Internal audit services should not have any management responsibilities other than for internal audit.

106. Internal audit should be seen to have sufficient status, respect and support within the HEI. To be effective, the head of internal audit, or equivalent where the service is provided on a contract basis, must have direct access to the HEI's designated officer and to the governing body (normally through the chair of the audit committee), and, if necessary, to the chair of the governing body. Whether provided internally or externally, the day to day line management and overall reporting arrangements for the internal audit service should be such as to preserve its objectivity by avoiding concentration of responsibility and reporting with any one senior person within the HEI. Internal auditors must also have unrestricted access to all records, assets, personnel and premises, and be authorised to obtain whatever information and explanations are considered necessary by the head of the internal audit service.

Reporting

107. The reporting requirements for any internal audit service are discussed in GIAS and in IIA standards. It is a mandatory requirement of this Code that the internal audit service produce an annual report of its activities. The internal audit annual report must relate to the financial year, and include any significant issues up to the date of preparing the report which affect the opinion. This should be addressed to the governing body and the designated officer, and should be considered by the audit committee. The audit committee may forward the report to the governing body with its own report. The report must be submitted to the HEFCE Assurance Service after it has been considered by the HEI's audit committee.

108. The internal audit annual report should include the internal auditor's opinion on the adequacy and effectiveness of the HEI's arrangements for:

- risk management, control and governance, and

- economy, efficiency and effectiveness.

This opinion should be placed into its proper context: that is, the work undertaken has been based on the agreed audit strategy and on the areas reviewed in the year, as well as incorporating knowledge of areas audited in previous years (including from a previous auditor). Internal audit performance measures should be provided, including stating coverage achieved against the original audit plan. It should also draw attention to any significant audit recommendations which the internal audit service considers have not received adequate management attention.

109. An HEI's external auditors should report any inconsistencies between the statement of internal control accompanying the statement of accounts, and their knowledge of the HEI's arrangements. Beyond this minimal assurance which flows from the external audit, HEIs should ensure that processes are in place, including work by internal auditors, external auditors and management, to provide assurance on the soundness of the arrangements underpinning the statement of internal control.

Provision of service

110. There are a variety of ways to acquire an internal audit service and we do not favour one approach above the others. One option is to appoint a head of internal audit and staff as necessary. An 'in-house' team may also be supplemented at a variety of levels by external consultants or contractors, under the direction of the head of internal audit, for instance to meet peaks in workload or to provide specialist skills.

111. Another option is to form a consortium with one or more HEIs, on a geographical or common interest basis. A consortium may be organised in-house, be provided externally or as a mixture of the two. A number of HEIs have set up such consortium arrangements.

112. A third option is to contract directly with an external provider, such as another HEI or an accountancy firm. We require that the same firm should not be appointed as both internal and external auditors because this can lead to a loss of objectivity. In addition, it is important to note that internal and external auditors have different roles and responsibilities. In particular, external audit may need to be satisfied that the internal audit function is operating effectively.

113. Each HEI, advised by its audit committee, should establish which is the most suitable and cost-effective way of obtaining internal audit services. However, at least every seven years, it should consider market testing internal audit services, since this provides a powerful incentive to maintain both quality and cost effectiveness. This external testing should take into account the guidance set out in Annex F.

114. In all cases the audit committee should monitor internal audit effectiveness as discussed in this Code. In addition, where the internal audit service is provided in-house, the audit committee chair should be consulted on the annual performance appraisal of the head

of internal audit. This appraisal process is the responsibility of management.

Standards

115. The head of internal audit should implement measures to annually monitor the effectiveness of the service and compliance with standards. The audit committee should consider and approve these performance measures. In line with GIAS standards, the committee should also consider asking the external auditor, or other suitable professional people, to provide an independent assessment of internal audit's effectiveness at least once every five years. This information should be used to contribute towards the committee's annual assessment of the performance of the internal audit service.

Change of internal audit service

116. Where the internal audit service is externally provided, the HEI should have unrestricted access to the working papers, and this should be made clear in the auditors' terms of engagement. If HEIs change their internal auditors, they should make arrangements for relevant audit documentation to be available to the incoming auditor. This will ease transition and avoid costly repetition of work. Incoming auditors can then seek to rely on the work of the previous auditor in preparing the audit needs assessment, audit plans and annual report. HEIs should also consider making arrangements for the incoming and outgoing auditors to meet. Where internal audit services are provided on a contractual basis, such arrangements should be included in the formal contract or terms of engagement.

117. Where internal audit is provided on a contract basis, the HEI should agree a fixed term of office based on financial years, and consider market testing before the contract expiry date. Provision should be made for outgoing auditors to complete their work and submit an annual report after expiry of the contract term. Attendance by the auditors at the appropriate audit committee should also be considered. If there is a change in auditor, HEIs should ensure that the new contract immediately follows the end of the old contract or other arrangements.

Removal or resignation of auditors

118. Subject to normal staffing arrangements (for 'in-house' auditors) and any contractual arrangements in place, only the governing body (or the audit committee where delegated authority exists) may pass a resolution to remove the internal auditors before the end of their term of office if serious shortcomings are identified.

119. Where internal auditors cease to hold office for any reason, they should provide the governing body with either a statement of any circumstances connected with their removal which they consider should be brought to the governing body's attention, or a statement that there are no such circumstances. The internal auditors may also request an extraordinary general meeting of the governing body to consider the statement. Any such statements should also be sent to the HEFCE Assurance Service by the HEI or, if it fails to do so, by the

outgoing internal auditors.

120. The governing body must inform HEFCE's Head of Assurance and Audit without delay of the removal or resignation of the internal auditors.

Restriction of auditors’ liability

121. Where the internal audit service is provided through a contractual arrangement with an external provider, the provider may ask the HEI to agree to a restriction in the auditors’ liability arising from any default by the auditors. Normally such liability should be without limit. However, HEIs may negotiate a restriction in liability so long as the decision is made on an informed basis. The governing body, through the audit committee, should be specifically notified of any such request for a liability restriction. Further information on liability restrictions is provided in paragraph 7i of Annex F.

Fraud and corruption

122. Each HEI’s management is responsible for the prevention, detection and investigation of irregularities, including fraud and corruption. To discharge this responsibility, management should ensure that an adequate system of internal control is operated. It is not a primary function of internal audit to detect fraud. However, the work of the internal audit service, in reviewing the adequacy and effectiveness of the internal control system, should help management to prevent and detect fraud. The internal audit service should ensure that it has the right to review, appraise and report on the extent to which assets and interests are safeguarded from fraud. When internal auditors suspect fraud, or are carrying out a fraud investigation, it is important to safeguard evidence. They should assess the extent of complicity to minimise the risk of information being provided to those involved, and the risk of misleading information being obtained from them.

123. Internal auditors should report serious weaknesses, significant fraud or irregularity, or major accounting breakdowns to the designated officer without delay. (Paragraph 34 gives guidance on what is significant.) The designated officer must then inform the chair of the audit committee, the chair of the governing body and the HEFCE accounting officer of such matters without delay. If he or she refuses to do so, then the internal auditor must report to them directly.

124. The HEI should ensure that the internal auditor is informed, as soon as possible, of all attempted, suspected or actual fraud or irregularity. The internal auditor should consider any implications in relation to the internal control system, and make recommendations to management, as appropriate, to strengthen the systems and controls.

Relationship with other auditors

125. There should be regular liaison between internal auditors, the HEI's external auditors and the HEFCE Assurance Service to optimise the service provided to the HEI. External auditors should be given access to the internal audit service's working papers and plans so

that their work programmes can be adjusted accordingly, and so that the extent of their reliance on the work of the internal audit service can be determined.

126. Copies of the internal audit service's reports should be available to the external auditors. The internal audit service should also receive copies of the external auditors' plans and management letters, and any other relevant reports produced for the HEI by other agencies. The HEFCE Assurance Service must be allowed access to any work of the internal auditor, including the annual report, or correspondence between the internal and external auditors.

External audit arrangements in HEIs

Role of external auditors

127. The primary role of external auditors is to report on the financial statements of HEIs, and to carry out whatever examination of the statements and underlying records and control systems is necessary to reach their opinion on the statements. Their report should also state whether, in all material respects, recurrent and specific grants from HEFCE (and other bodies and restricted funds where appropriate) have been properly applied for the purposes provided, and in accordance with the institution's financial memorandum with HEFCE, in other words that the conditions of grant have been met.

128. We accept that we are not the direct client of the external auditor and that the auditor does not have a duty of care to us. However, we expect that external audit engagements in the sector will recognise the requirements of this Code.

Qualification of external auditors

129. The qualifications required for external auditors of higher education corporations are set out in paragraph 59(b) of Schedule 8 of the Further and Higher Education Act 1992. For other institutions, the requirements are the same as under the Companies Act 1985. Auditors should be registered with one of the appropriate professional bodies.

Selection criteria and procedures

130. The governing body is responsible for appointing external auditors, although it will usually delegate the detail of the process to the audit committee. Before receiving proposals, the HEI should determine selection criteria, procedures, and the frequency of external testing, taking into account the guidance given at Annex F. Particular attention should be given to such issues as:

- quality of service, including experience

- audit fees, including a clear commitment on future fee increases.

Letter of engagement

131. The duties of HEIs and external auditors should be clearly presented in the agreed terms of reference. The external auditors' letter of engagement should not depart in any material way from the guidance set out in the model at Annex H. Where significant differences from the model are under consideration, a copy of the proposed letter should be sent to HEFCE's Head of Assurance and Audit without delay.

Additional services

132. HEIs may ask external auditors to provide services beyond the scope of the audit of the financial statements, including special investigation work, taxation compliance and advice, consultancy, and VFM reviews. Generally, it is a matter for HEIs and auditors to agree precise requirements, although the audit committee must be informed of all significant facts and matters that bear upon the auditors' objectivity and independence, related to the provision of non-audit services, including the safeguards put in place. Any additional work must not impair the independence of the audit function and so should normally be the responsibility of different staff within the firm of auditors.

133. The audit committee has a key role to play where the auditors supply a substantial amount of non-audit services. The committee must keep the nature and extent of such services under review, seeking to balance independence and objectivity with the HEI's needs. (See also paragraph 147 in connection with audit liability.) We require that the same firm must not be appointed as both internal and external auditors because this can lead to a loss of objectivity and independence. It is important to note that internal and external auditors have different roles and responsibilities. In particular, external audit may need to be satisfied that the internal audit function is operating effectively.

134. In order to help judge the relationship between the HEI and its external auditors, the HEI must disclose separately, by way of a note to its financial statements, the fees paid to its external auditors for other services. Each HEI's audit committee must review the level of fees incurred, and the future planned work, and satisfy itself that the extent and nature of other work does not affect the objectivity of the external audit.

Management letter

135. External audit should report to the institution by way of a management letter which highlights any significant accounting and control issues arising from the audit. The HEI's management should provide written responses to any recommendations made or issues raised. The Code is not prescriptive about the format or title of a management letter, but it should enable the HEFCE Assurance Service to see what observations have been made about the internal control system and how management has responded. The letter influences our risk assessment of each HEI.

136. External audit should also indicate in the letter:

- that they have reviewed the work of the internal auditors, and

- whether, or to what extent, they are content to rely on the work of the internal auditors in support of external audit work.

These statements will be based on work which should already be carried out for the purpose of external audit. They provide information which is useful to the audit committee and to us in determining institutional risk assessments.

137. It is not sufficient to report in the management letter in general and in brief that some unspecified matters were raised and responses received. The letter, with management responses, should be made available (in draft if necessary) to the HEI's audit committee in time to inform the committee's annual report, and in any event no later than two months after issuing an opinion on the financial statements. HEIs must send a copy of the final management letter (incorporating management responses) to the HEFCE Assurance Service by 28 February in the following year, by which time it should have been seen by the audit committee and/or governing body. External auditors should attend audit committee and/or finance committee meetings at which the audited financial statements are discussed, and attend governing body and other meetings when appropriate.

Audit report

138. The external auditors shall report whether in all material respects:

a. The financial statements give a true and fair view of the state of the HEI's affairs, and of its income and expenditure, recognised gains and losses, and statement of cashflow for the year. They should take into account relevant statutory and other mandatory disclosure and accounting requirements, and HEFCE requirements. The financial statements comply where appropriate with the Statement of Recommended Practice (SORP) on Accounting in Further & Higher Education, and the Companies Act 1985 (where the HEI is incorporated under the Companies Act), and/or other legislative or regulatory requirements. In addition, we issue an annual Accounts Direction which includes the requirement that the statement of internal control must incorporate statements on corporate governance, internal control and risk management.

b. Funds from whatever source administered by the institution for specific purposes have been properly applied to those purposes and, if relevant, managed in accordance with relevant legislation.

c. Funds provided by HEFCE have been applied in accordance with the financial memorandum and any other terms and conditions attached to them. In particular, auditors should have regard to the specific requirements of the financial memorandum, such as compliance with the short-term and long-term borrowing conditions, and the offering of security over Exchequer-funded assets.

139. External auditors have a duty to consider the statement of internal control with the annual financial statements and to comment if the statement is inconsistent with their knowledge of the HEI. It is for each HEI to decide whether they wish their external auditors to do more than this required minimum. Each HEI needs to ensure that processes are in place, including work by internal auditors, external auditors and management, to provide assurance on the effectiveness of the arrangements underpinning the statement of internal control. External auditors may report privately to the governing body (through the audit committee) on the results of their work on this, or may make reference to this in the financial statements, either in their audit opinion report or through a separate report. The July 2003 update of the Accounts Direction (HEFCE Circular Letter 16/2003) provides advice to external auditors on how to respond when there are doubts about the accuracy of the HEI's statement of internal control.

140. A model external audit report for an HEI's annual financial statements is given at Annex I.

Reappointment of external auditors

141. HEIs should reappoint external auditors formally each year. The audit committee should assess the auditors' work each year to ensure that it is of a sufficiently high standard and represents value for money. The committee should then make a recommendation to the governing body regarding the reappointment of the auditors. Performance measures could be used as part of the assessment. Provided that the auditors' performance is satisfactory, it will not be necessary to repeat the full selection process each year. However, full market testing should be undertaken at least every seven years. One partner in the firm (the engagement partner) is normally responsible for the institution's audit. The appropriateness of them continuing as the engagement partner should be considered by the audit firm and audit committee at least every five years, but in any case he or she should not hold this position for more than seven continuous years. Anyone who has acted as an engagement partner should not hold any position of responsibility in relation to the audit until another five years has elapsed. Any other audit partner who has a significant involvement in the audit engagement (key audit partner), should not hold such a position for longer than seven continuous years, nor return to such a position until a further two years have elapsed. See also Annex F paragraphs 1 to 3.

Removal or resignation of auditors

142. The governing body may pass a resolution to remove the auditors before the end of their term of office if serious shortcomings are identified.

143. External auditors who have resigned or been removed from office for whatever reason should be entitled to attend, and make representations to, the general meeting of the governing body at which their term of office would have expired, or at which it is proposed to fill the vacancy caused by the resignation or removal. They are entitled to receive notices of,

or other communications relating to, that meeting, and to be heard on any part of the business which concerns them as former auditors of the HEI.

144. Where auditors cease to hold office for any reason, they should provide the governing body with either a statement of any circumstances connected with their removal which they consider should be brought to the governing body's attention, or a statement that there are no such circumstances. The auditors may also request an extraordinary general meeting of the governing body to consider the statement. These provisions are analogous to those in the Companies Acts. Any such statements should also be sent to the HEFCE Assurance Service without delay, by the HEI or, if it fails to do so, by the outgoing auditors.

145. The governing body must inform HEFCE's Head of Assurance and Audit without delay of the removal or resignation of the external (or internal) auditors.

146. In deciding whether or not to accept the appointment, anyone proposing to take up the office of external auditor should obtain the HEI's permission to communicate with the outgoing auditors. Outgoing auditors should also obtain permission from the HEI to discuss its affairs freely with the proposed auditors, and should disclose all information required by the proposed auditors that is relevant to the appointment. These provisions are analogous to those in the Guide to Professional Ethics of the ICAEW.

Restriction of auditors' liability

147. HEIs must not agree to any restriction in external auditors' liability in respect of the external audit of their annual financial statements, except where an audit provider is a limited liability partnership under the Limited Liability Partnerships Act 2000, which may affect the liability limit. This principle matches that of Section 310 of the Companies Act 1985, which prohibits any capping of the auditors' liability in respect of audit opinions given under the Act.

148. For other types of work performed by the external auditors, the provider may ask the HEI to agree to a restriction in the auditors' liability arising from any default by the auditors. Normally, such liability should be without limit. However, HEIs may negotiate a restriction in liability so long as the decision is made on an informed basis. The governing body, through the audit committee, should be notified of any liability restriction agreed. Further information on liability restriction is provided in paragraph 7i of Annex F to this Code.

HEFCE access to external auditors

149. The HEFCE Assurance Service may wish to meet with HEIs' external auditors, particularly in connection with a visit to the HEI. The HEI should not limit access in any way. Formal discussion should normally be arranged through the HEI's designated officer or representative. The HEFCE Assurance Service will exchange letters where necessary with both parties to deal with confidentiality and the terms under which access is given.

150. We need to be confident that we and the HEIs we fund can rely on the work of the sector's external auditors. The HEFCE accounting officer, for example, needs to be confident

that summary assurances provided to him on the basis of external audit opinions in financial statements are reliable. Accordingly it is necessary to assess the standards of the work of the audit firms active in the sector against professional standards.

Annex A

Mandatory requirements

The following are mandatory requirements of this Code of Practice and we will assess compliance with these.

1. The governing body of each HEI must take reasonable steps to ensure that there are sound arrangements for risk management, control and governance, and for economy, efficiency and effectiveness (value for money), within the HEI.

2. Each HEI must have an effective audit committee, which produces an annual report for the governing body and the designated officer. The audit committee annual report must relate to the financial year and include any significant issues up to the date of preparing the report which affect the opinion. The audit committee annual report must include the audit committee's opinion on the adequacy and effectiveness of the HEI's risk management, control and governance arrangements; and arrangements for promoting economy, efficiency and effectiveness. Further detail on the opinion is given at paragraph 86 of this Code and at Annexes C and E.

3. Members of the audit committee must not have executive authority or be members of a finance committee, unless the institution can satisfy us that there are good grounds for this and that the conditions in paragraph 73 of the Code have been met.

4. The audit committee of each HEI, advised where appropriate by its internal audit service, must satisfy itself that satisfactory arrangements are in place to promote economy, efficiency and effectiveness.

5. Each HEI must have an effective internal audit function, which reports regularly to the audit committee and at least annually to the governing body and the designated officer. The internal audit annual report must relate to the financial year, and include any significant issues up to the date of preparing the report which affect the opinion.

6. The work of the internal audit service must cover the whole of the risk management, control and governance arrangements of the HEI.

7. The head of the internal audit service must have direct access to the HEI's designated officer, the chair of the audit committee and, if necessary, the chair of the governing body. Internal, as well as external auditors, must also have unrestricted access to information including all records, assets, personnel and premises, and be authorised to obtain whatever information and explanations the head of the internal audit service or the external auditor considers necessary.

8. Internal audit and external audit services must not be provided by the same firm or provider.

9. Fees paid to external auditors for other services must be disclosed separately in a note in the financial statements.

10. Subject to legislative constraints, the HEFCE Assurance Service must have unrestricted access to information, including all records, assets, personnel and premises, and can require anyone to give any explanation which it considers necessary to fulfil its responsibilities. This includes access to any work of the internal auditors and the external auditors, or correspondence between internal and external auditors. For access to external audit work, the HEFCE Assurance Service will exchange letters where necessary with both parties to deal with confidentiality and the terms under which access is given.

11. The governing body must not accept any restriction of liability in respect of the external audit of the HEI's financial statements, except where an audit provider is a limited liability partnership under the Limited Liability Partnerships Act 2000, which may affect the liability limit.

12. The following information must be provided:

a. The governing body must send: (i) a copy of the audit committee's annual report; (ii) a copy of the internal auditors' annual report; and (iii) the completed annual audit return (Annex K of the Code) to HEFCE's Head of Assurance and Audit. These should be supplied when available, which would usually be by the December following the year end.

b. The governing body must send to HEFCE's Head of Assurance and Audit, by 28 February in the following year at the latest, a copy of the external auditor's management letter and any management response.

c. The HEI's designated officer must report any serious weakness, such as a significant and immediate threat to the HEI's financial position, significant fraud or major accounting breakdown without delay to the chair of the HEI's audit committee, the chair of the HEI's governing body, the HEI's head of internal audit and the HEFCE accounting officer. If the designated officer refuses to make an appropriate report, then the internal and/or external auditors must report to them directly.

d. The governing body must inform HEFCE's Head of Assurance and Audit without delay of the removal or resignation of the external or internal auditors.

Annex B

List of abbreviations

CIPFA	Chartered Institute of Public Finance and Accountancy
Combined Code	'The Combined Code on Corporate Governance', July 2003, Financial Reporting Council
CUC	Committee of University Chairmen
DEL	Department for Employment and Learning in Northern Ireland
DfES	Department for Education and Skills
GIAS	Government Internal Audit Standards
HE	Higher education
HEFCE	Higher Education Funding Council for England
HEI	Higher education institution
ICAEW	Institute of Chartered Accountants in England and Wales
IIA	Institute of Internal Auditors
LSC	Learning and Skills Council
NAO	National Audit Office
SORP	Statement of recommended practice
The Code	Accountability and Audit: HEFCE Code of Practice
TTA	Teacher Training Agency
VFM	Value for money