

GETTING TO GRIPS WITH **AUDIT**

**RESOURCES FOR GOVERNORS OF UK UNIVERSITIES
AND HIGHER EDUCATION COLLEGES**

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FOREWORD

As higher education governance evolves, there are major implications for members of governing bodies: increasing expectations about how they undertake their role; a greater focus on measuring institutional performance with associated implications for information and strategy; coming to terms with an increasingly complex governance environment; and so on. All this means that governors (particularly new ones) need to be well prepared for the challenges they face, so that they can contribute effectively to their boards from the outset.

To support governors in this challenge, this set of materials has been commissioned by the Leadership Foundation for Higher Education and the Committee of University Chairs (CUC)¹ to help governors get to grips with the key resource areas for which they are unambiguously responsible. Produced with financial support from all the UK higher education funding councils (coordinated through Hefce), five different volumes make up the complete set of materials on finance, risk, human resources, estates/infrastructure and - this one - audit.

In an easy to read format, this particular volume is intended to provide the core information that all governors need for a basic understanding of their responsibilities for audit. It is not intended to provide the specialist information that members of audit committees might need, although references to such material are provided. The most obvious source of such specialist guidance is the CUC Handbook for Audit Committee Members in Higher Education².

To support the text there are quotations from governors³, self challenge questions, suggested tasks, and critical incidents called 'governors' dilemmas'. The quotations - some provocative - do not represent any 'agreed' view of the topic concerned, but are rather designed to illustrate different opinions. Similarly, the self challenge questions at the end of each chapter are to enable readers to reflect on key issues for them, and not to be used as a vehicle for governors to place unreasonable demands on their governing body clerk or secretary!

For these reasons, the materials - self evidently - do not represent any agreed view which governing bodies are expected to adopt, but rather are intended to encourage self reflection, debate, and critical thinking. Although we expect that readers will agree with most of what is written, we also hope that some things will be contested.

The materials are intended to be used in different ways: as resources for individual governors (designed to be read as individual chapters rather than in one go); by HEIs for in-house governor development; or as web based material (see www.lfhe.ac.uk/governance). The text does not consider broader issues concerning the overall responsibilities of governors and how their effectiveness might be determined. Readers interested in this should consult an earlier companion volume called 'Getting to Grips with Being a Governor' produced in 2006⁴.

¹ See www.lfhe.ac.uk and www.shef.ac.uk/cuc. The revised CUC Guide for Governors (2009) - available from the CUC website - sets out the definitive responsibilities of governors, and is not duplicated in this material but is cross-referred to where necessary.

² The CUC Handbook for Audit Committee Members in Higher Education available at http://www.hefce.ac.uk/pubs/hefce/2008/08_06 and www.shef.ac.uk/cuc

³ The quotations have been obtained from a wide range of sources, including personal meetings with governors. Where the background of the source governor is known it has been provided at the end of the quotation.

⁴ SCOP, Getting to Grips with Being a Governor, 2006, available electronically at www.guildHE.ac.uk

A note on terminology and diversity

As most governors know, governance in higher education is complicated by the use of different terms for similar functions, so for simplicity some key words have been standardised throughout the five volumes. In all the materials the terms 'governing body' and 'board' are used generically to include: the governing bodies of post-1992 institutions; the councils of pre-1992 universities; and courts in Scotland. Similarly the word 'governor' indicates a member of these different bodies; 'chair' is used for the person convening governing body meetings; 'head of institution' for the vice-chancellor or principal; and 'executive' for members of the senior management team. Finally, the abbreviation 'HEI' is used as the widely accepted shorthand for 'higher education institution'.

UK higher education is very diverse, and this means that some aspects of governance may differ between HEIs. Moreover, governors will have legitimately different views on the issues presented in this material, as will heads of institutions and other senior managers. It follows that if after working through the text important issues are raised for governors about practice in their own HEI (and we hope they will be), then they may need to obtain more detailed information from the clerk or secretary of their board or its chair. However, throughout the need to distinguish between governance and management has been reinforced.

Because higher education is now the responsibility of the devolved administrations within the UK, another aspect of diversity is the need to recognise differences in governance arrangements in HEIs in England, Scotland, Wales and Northern Ireland. This is particularly the case with some financial issues, and variations which exist within the different jurisdictions are pointed out in the text. Where no separate discussion of the different jurisdictions occurs, readers can assume that the content applies to all four higher education systems. The term 'funding councils' is used to indicate the public body which provides primary funding to HEIs in each jurisdiction, although in Northern Ireland this is done directly by the Department for Employment and Learning with no actual funding council intermediary.

Disclaimer

The inevitable disclaimer! Although every care has been taken to try and ensure the accuracy of the content of this material, if in doubt about a specific issue governors should always check with the clerk or secretary of their own board.

Happy reading!

Allan Schofield

Series Editor

Winter 2008

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CONTENTS

OVERVIEW	Ten Key Audit Issues for Governors	4
CHAPTER 1	Why Audit? <i>Is audit just about finance? The structure of audit. Can you leave audit to the audit committee? Where to look for help. What next?</i>	5
CHAPTER 2	The Rules - What are Governors' Responsibilities? <i>The financial memorandum. Audit codes of practice.</i>	9
CHAPTER 3	Understanding the Role of the Audit Committee <i>The working audit committee. Risk. Five guiding principles for audit committees.</i>	12
CHAPTER 4	What Should Governors' expect from an Audit Committee?	16
CHAPTER 5	External Audit <i>The formal tasks of external auditors. How do external auditors work? The annual external auditors' management letter. What value should you place on their opinion?</i>	19
CHAPTER 6	Internal Audit <i>Who are the internal auditors? How internal audit works. How much time or resource should internal audit take? Evaluating internal audit.</i>	24
CHAPTER 7	Value for Money <i>A practical approach. Looking a bit more deeply. The annual VfM report.</i>	29
CHAPTER 8	Other Kinds of Audit <i>Funding council data audits. Institutional review. Academic audit and quality assurance.</i>	32
CHAPTER 9	When Things Go Wrong <i>What to look out for. What to do. Governors' dilemmas.</i>	36
CHAPTER 10	Some Future Developments in Audit	42
ANNEX A:	Some Key References	44
ANNEX B:	Annual Audit Cycle	45
ANNEX C:	Suggested Answers to Governors' Dilemmas	46

OVERVIEW: TEN KEY AUDIT ISSUES FOR GOVERNORS

In the following pages a large number of issues are identified in the area of audit for you to consider as a governor. However, a quick overview of ten key points may be helpful for you to think about:

- 1 Audit shouldn't just be left to the audit committee. Effective audit is an essential source of information and support for all governors, so you need to know how well it's working.

[SEE CHAPTER 1 ►](#)

- 2 The accuracy and robustness of institutional data is very important, and governors must be able to rely on it.

[SEE CHAPTER 4 ►](#)

- 3 Your interest in audit will increase its impact and standing in your HEI - you'll help 'set the tone' which expects a high degree of integrity from staff. Getting better value for money will also benefit from your interest.

[SEE CHAPTER 7 ►](#)

- 4 Chairing the audit committee is a key role - it should be in the hands of an experienced and senior governor, who should operate independently of management.

[SEE CHAPTER 3 ►](#)

- 5 The audit committee's independence is critical - whilst always being constructive it should not be over respectful of management.

[SEE CHAPTER 3 ►](#)

- 6 Governors must receive positive assurance that all is in order. That is why the internal audit service exists and it should be delivering what you need, not what it thinks appropriate.

[SEE CHAPTER 6 ►](#)

- 7 The governing body must take reports from the audit committee seriously and allocate sufficient time to them. Does yours?

[SEE CHAPTER 4 ►](#)

- 8 The external auditors' annual management letter is a key assurance document - but it is not a 'financial health' assessment.

[SEE CHAPTER 5 ►](#)

- 9 Enterprise activities can be a tricky area and should receive regular internal audit attention. Similarly, joint ventures and PFI arrangements deserve careful consideration by auditors.

[SEE CHAPTER 6 ►](#)

- 10 The independence of the internal audit service is critical and may need safeguarding if provided by employed staff.

[SEE CHAPTER 6 ►](#)

1. WHY AUDIT?

- 1.1 Effective audit is an essential source of information and support for governors. Even where confidence in management is high, all governors will at some time ask themselves: can we have confidence in the information that is provided to us, and the processes providing it? Sound audit provides some of that reassurance, and through independent scrutiny assurance can be obtained that standards of control, management and governance are satisfactory. In practice, it is an essential part of enabling you to be satisfied that your HEI is being properly governed, managed and controlled.
- 1.2 In turn, this means that a governing body can provide assurance to its various funders that the data it provides to them is accurate and can be relied upon. Without such confidence the idea of a governing body being accountable and having "unambiguous and collective responsibility for overseeing the institution's activities"⁵ simply can't exist in practice.
- 1.3 Therefore those who undertake audit for the governing body, are - in a sense - its 'eyes and ears'. They investigate issues in levels of detail way beyond what a board could (and should) do, and - as we will see later - it follows that there needs to be a high level of confidence between a governing body and those it asks to undertake an audit role for it.
- 1.4 What does 'assurance' mean? HM Treasury defines it as "*an evaluated opinion, based on evidence gained from review, on the organisation's governance, risk management and internal control framework*".⁶ Assurance therefore draws attention to how risk management, governance and internal control are functioning and, just as important, the aspects that need to improve. Assurance helps a board to judge whether or not it is focusing on the most significant issues in relation to achieving the institution's objectives and whether best use is being made of resources.

Is audit just about finance?

- 1.5 Historically the answer was, generally, yes, but things are changing. The history of audit is certainly based in the scrutiny of financial records and systems, and this still forms an essential part of any institutional audit programme. The appointment of a firm of professional auditors to report on the institution's accounts each year (referred to as the external auditors), and the structure for their reporting is a key part of the assurance process for governors to understand. It is a mandatory requirement of the financial memorandum with the funding council, as well as of your HEI's governing instruments. (For details of the financial memorandum see the separate material on finance in this series. Make sure you have the current version.)

"Oh, I never read that audit stuff, the board papers are too thick as it is. I just leave all that to those who are interested"

LAY GOVERNOR

"The audit committee? That's just to stop the finance director fiddling the books isn't it?"

STAFF GOVERNOR

⁵ See the CUC Governance Code of Practice, in the CUC Guide for Members of Higher Education Governing Bodies in the UK, revised version 2009. Available from www.shef.ac.uk/cuc

⁶ Audit Committee Handbook: HM Treasury, March 2007. Original quotation from Management of Risk - Principles and Concepts: HM Treasury, October 2004

- 1.6 However, audit now encompasses a much wider brief. The whole structure of governance and management of an HEI is subject to scrutiny, to give assurance that the objectives set by the governing body are being realised in practice, with proper regard to economy, efficiency and effectiveness, and value for money (VfM). For this purpose, institutions are required to have an internal audit service. In addition, all HEIs must have active risk management systems in place, and the audit function will usually review how these systems are working, and whether they are providing the level of confidence required by the governing body.
- 1.7 That is not all. In recent years, audit of the academic function has grown into a substantial activity. How this has been done is summarised in Chapter 8, but it has been driven by government interest, concerns about standards, and the need to demonstrate suitable academic performance to the public. The assessment of academic activity may be a different form of audit and more to do with external accountability, but it is no less valuable in giving assurance to governors about the fundamental activities of an HEI.

SUGGESTED TASK

Before reading any further identify the main elements of an audit structure that exists in your HEI. How well do they work in practice?

"I was surprised to find that the audit committee didn't ask many questions of the auditors. Only later did I realise that we all needed training - we hadn't got the necessary knowledge."

NEW AUDIT COMMITTEE MEMBER

The structure of audit

- 1.8 There are a few basic requirements in the structure of audit that need to be briefly set out at the start of this material. First, an essential part of the audit structure is the audit committee. This provides a clear focus to the governance of the assurance process. Your HEI must have an audit committee of independent governors, perhaps with other people coopted because they have relevant experience. The committee's job is to oversee the audit process and tell the governing body what they find.
- 1.9 The role of the audit committee is considered in Chapter 3, but it is more than just a processing centre for the range of assurances available to the board. Its job includes checking whether those assurances are sufficient, as well as testing the evidence on which they are based and the reliability of the conclusions drawn from that evidence.
- 1.10 There are two specific audit appointments - external and internal - which exist to help provide that assurance. Having an HEI's annual accounts (nowadays usually called financial statements) examined by a professional auditor has been a requirement for many years, and giving a professional opinion on the annual financial statements is the role of the external auditor.
- 1.11 The development of internal audit can be seen as a response to the increased complexity of the sector and the large amounts of public money invested in it. Its role is focused on management and control, right from asking whether an HEI's strategies are being realised, to examining the petty cash. Done well, it can be a very useful service to all governors. It may be carried out by a professional firm under contract, a team of staff employed by the HEI, or a consortium arrangement, where several institutions form a joint audit team. The merits of each are discussed later.
- 1.12 The four funding councils have mandatory requirements for audit which are set out in Chapter 2. At this stage, you need to know that:
- Your HEI must have an effective audit committee with an independent governor as its chair, and three or four independent members who do not have executive authority and preferably who are not members of the finance committee or its equivalent.

- Your HEI must have professional external auditors and you must regularly review their appointment.
- Your HEI must have an internal audit service (though what form it takes is optional) and its rights of inquiry must not be restricted. The governing body should regularly review the internal audit arrangements.
- Your HEI must report promptly to the funding council any serious control failures or accounting breakdowns highlighted by the audit process.

Can you leave audit to the audit committee?

- 1.13 This is a very important question. As a new governor, you may wonder whether you need to know much about audit, beyond its existence or otherwise, or take a close interest in the work of the auditors and audit committee. Most governors will not be members of the audit committee and - frankly - may not be very interested in the detail of its work. So what is expected of the other governors? Can audit be left to the audit committee?
- 1.14 The straightforward answer to that final question is 'no'. Governors are responsible for their HEI, and although a systematic audit process can be a great help, fulfilling that duty remains with you and the whole board. All members need to make their own assessment of what assurance can be derived from the work of the auditors and the audit committee.
- 1.15 It's also very unwise to allow the perception to grow that a board is not really interested in audit generally or the work of the audit committee, which needs to know that it has the strong support of the governing body. This can be demonstrated, for example, by allocating sufficient time in board meetings for the audit committee chair to report on significant findings and have them debated. Simply taking the audit committee's report 'as read' - or pressing the audit chair to be brief - has the opposite effect. It is critical that those appearing before the audit committee, or who are subject to its scrutiny, know that the governors will take a close interest in the outcome.
- 1.16 Moreover, there will inevitably come a time when the audit committee will have to probe unsatisfactory situations and seek information which someone would rather not divulge. Weakness at this stage may lead eventually to serious damage to the reputation of the institution and may even threaten its survival. Therefore the governing body has to take the lead in ensuring that audit is taken seriously.
- 1.17 As a governor, you need to know what goes on in the audit process so that you can judge what degree of assurance you personally can draw from what you see. Your interest adds to the audit committee's own perception of its value. That's why it's worth your time reading this material in full, even if you're not a member of the audit committee. The committee's role is to help you discharge your duties, not absolve you from them.

"It's vital to engage the interest of the board in the work of the audit committee. It's about engaging in accountability, with the audit committee as the conscience of the board"

**AUDIT COMMITTEE CHAIR,
OFGEM, QUOTED IN IMPROVING
THE EFFECTIVENESS OF AUDIT
COMMITTEES, HOUSING
CORPORATION 2004**

"I have seen audit committee members selected because the individuals are known to be weak – or were not at the meeting when nominations were agreed!"

EXTERNAL AUDIT PARTNER

Where to look for help

- 1.18 The CUC has published a Handbook for Members of Audit Committees in HEIs⁷. It's a comprehensive guide which is useful for those closely involved, but too detailed for a new governor. However, it has provided much of the background for this volume. The Chartered Institute of Public Finance and Accountancy (Cipfa) has also published a (shorter) Handbook for Audit Committee Members in further and higher education⁸.
- 1.19 Internally there are four key sources of support and advice you can turn to: the chair of the audit committee as a fellow governor and colleague; the finance director; the clerk or secretary to the governing body; and - indirectly - the internal auditors themselves. The first three can be approached directly to answer any questions you have. The internal auditors can be approached through the clerk, and may (for example) be available to run a short seminar or awayday on current issues or aspects of best practice.

What next?

- 1.20 Collecting a few key documents will be useful, and these should probably include: the terms of reference for the audit committee; the most recent financial statements; the most recent annual report of the audit committee; and the external auditors' management letter about those statements. You might also want to look at the National Audit Office website (and in Wales the Wales Audit Office website) for more useful publications⁹.

Self-challenge questions

- Review the last annual report of your HEI's audit committee (perhaps with a governor colleague) and consider how much assurance you can draw from it. From what you know of your HEI, identify areas of activity or risk where there seems to be no element of assurance in the report.
- Review the terms of reference for the audit committee. Do you have assurance from the annual report (or the discussion in the board) that all the terms are being covered?

⁷ CUC Governance Code of Practice, in the CUC Guide for Members of Higher Education Governing Bodies in the UK, revised version 2009.

⁸ See www.cipfa.org.uk

⁹ See particularly www.nao.org.uk/practice_areas/FMAG/Audit_Committees.htm

2. THE RULES - WHAT ARE GOVERNORS' RESPONSIBILITIES?

- 2.1 At the risk of being tedious so early in this material there is a need to write about rules - but they really do form an important foundation for the audit responsibilities of governors. The clerk or secretary to your governing body can provide more information if you wish.
- 2.2 You will find the rules about audit in three places:
- Your HEI's financial memorandum with its funding council, and you should have been given a copy on appointment as a governor - it's a very important document. If you haven't got one then get a copy.
 - The audit code of practice for each of the four funding councils, which sets out both the mandatory requirements and good practice guidance.
 - Your institution's constitutional documents (charter and statutes, articles of governance etc).

The financial memorandum

- 2.3 This contains the main mandatory requirements for audit as set down by the four funding councils. All of them vary in detail, but not in substance. For example, the Welsh funding council's memorandum includes the following - and it's worth noting here that 'shall' and 'will' convey a mandatory requirement:
- "The institution shall appoint an audit committee, and arrange to provide for internal and external audit, in accordance with the Audit Code of Practice and any other directions drawn up by the Council, in consultation with institutions.
 - "The Council's audit service will, from time to time, evaluate the institution's internal control arrangements. The Council's audit service shall be provided with access to all records information and assets and can require any officer to give any explanation which it considers necessary to fulfil its responsibilities. Welsh Office internal auditors may accompany the Council's auditors on their visits to the institution. On such visits the Welsh Office auditors will be concerned with the way in which the Council's auditors are carrying out their tasks and will not themselves audit arrangements within the institution.
 - "The books and records of the institution will be open to inspection by the Council and the Comptroller and Auditor General. The Council may carry out reviews designed to improve economy, efficiency and effectiveness in the management or operation of the institution including value for money studies. The Comptroller and Auditor General may also carry out value for money studies of the institution's use of resources."

In England, Hefce does not audit internal control arrangements nor does it undertake VfM studies.

Audit codes of practice

2.4 As well as much good practice guidance, the audit codes of practice of the funding councils set out the detailed requirements. Some of the key elements are important enough to set out in a little detail (sorry!). Again, they vary in detail, but the intentions are similar. Note the references to the governing body (rather than the institution); it is clear where responsibility lies. The new Hefce audit code which is part of the 2008 financial memorandum¹⁰ gives less detailed specification on how audit arrangements in English HEIs should operate, but some of the provisions of the previous code continue to be relevant to good practice, including:

- The governing body must ensure that the institution meets its responsibilities under the financial memorandum.
- 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.
- Members of the audit committee must not have executive authority. Members should not also be members of a finance committee, unless the institution's governing body has made a clear decision to allow one audit committee member to sit on both - that member must not chair either committee. (The Welsh version sensibly requires that staff or students should not be members either, and the Scottish version suggests that the chair of the finance committee might attend meetings of the audit committee - and vice versa - to improve liaison between the two, rather than be a full member.)
- 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.
- 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 work of the internal audit service must cover the whole of the risk management, control and governance arrangements of the HEI.
- 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.
- The following information must be provided: a signed and approved set of financial statements, a copy of the audit committee's annual report, a copy of the internal auditors' annual report, the completed annual assurance return; and a copy of the external auditor's management letter and any management response.

2.5 We have tried your patience with so much detail for a reason: to demonstrate that this is a highly regulated area, and the whole governing body must have complete confidence that its HEI is complying with all requirements. Failure to do so can have serious consequences. From the end of 2008-09, HEIs in England will be required to provide a statement of assurance on the quality of data supplied to sector funding and statistical bodies.

¹⁰ See www.hefce.ac.uk/pubs/hefce/2008/08_19

2.6 Finally, although your HEI's governance documents are unlikely to demand more than meeting the funding council's audit code, they should be complied with strictly. They usually specify the qualifications required of auditors and the manner of their appointment - something not always set out in the codes.

Self-challenge questions

- Have you read the financial memorandum for your own HEI?
- From the list above in paragraph 2.4, pick three issues which you think your governing body should watch carefully. Are they referred to in the latest annual audit committee report to the board?
- For each one, who do you think is responsible for monitoring compliance with them?

3. UNDERSTANDING THE ROLE OF THE AUDIT COMMITTEE

- 3.1 In this chapter and the next, two closely related issues are examined: first (this chapter) as a governor what you should expect the role and responsibilities of the audit committee to be; and second (the next chapter) how you might assess the effectiveness of the audit committee, and determine if it is doing its job to your satisfaction?
- 3.2 The principal governance mechanism through which the audit process works is the audit committee. This is where the HEI's officers and auditors will interact with governors in a small enough forum for serious review to take place. Material arising from audit reviews in the various parts of the institution will form the basis of the committee's work programme, and the committee's assurance work for the full board. As an ordinary member of the board, making sense of this assurance work is very important.
- 3.3 Chapters 2, 3 and 4 of the CUC Handbook for Members of Audit Committees in HEIs¹¹ give a full account of the audit committee's role and functioning. What follows is short commentary on that Guide, including some suggestions on how to read between the lines and things to watch out for.
- 3.4 As an introduction, the HM Treasury Audit Committee Handbook¹² suggests five principles for audit committees, which are worth noting:
- The audit committee should support the board and chief executive by reviewing the comprehensiveness of assurances in meeting the board's and chief executive's assurance needs, and reviewing the reliability and integrity of these assurances.
 - The audit committee should be independent; each member should have a good understanding of the objectives and priorities of the institution and of his or her role as an audit committee member.
 - The audit committee should corporately possess an appropriate skills mix to allow it to carry out its overall function.
 - The scope of the committee's work should be defined in its terms of reference and encompass all the assurance needs of the board and chief executive. Within this, the committee should have particular engagement with the work of the internal and external auditors and financial reporting issues.
 - The committee should ensure effective communication with the board, the head of internal audit, the external auditor and other stakeholders.

"In retrospect the mistake we [the board] made was assuming the audit committee was on top of it all. In fact, they were just looking at whether it was all being done by the book. After all the problems blew up, we realised that nobody had been looking at the bigger picture, about whether the company was actually viable."

**CHAIR OF A FINANCE COMMITTEE
DESCRIBING A UNIVERSITY
COMPANY THAT HAD FAILED**

¹¹ CUC Governance Code of Practice, in the CUC Guide for Members of Higher Education Governing Bodies in the UK, revised version 2009.

¹² HM Treasury, (2007), Audit Committee Handbook

The working audit committee

- 3.5 Clearly, much of the audit committee's effectiveness depends on its chair and members. Chairing this is not a job for a new recruit to the board - one of the most senior or experienced governors is required, to demonstrate the importance of the work, to command respect both within the board and the wider institution, and to ensure a good working knowledge of the HEI itself; the last is perhaps the most important criterion. There is a debate to be had about whether the chair should have a financial or audit qualification; this may be desirable but is - arguably - not essential providing they have substantial experience and other committee members are qualified.
- 3.6 The principal tasks of an audit committee chair are around communication, 'focus and balance', and setting the tone. Ensuring a good balance of coverage of audit issues is important, as is keeping the committee focused on its terms of reference and agenda. It will require good chairing skills, especially if, as is essential, the members do not hesitate to ask questions. The tone of the committee is especially important; it needs to maintain good working relationships with the executive (especially the finance director), it needs to be supportive and understand the challenges they face, but it also needs to be robust and to be clear that good (perhaps best) practice is expected and nothing less will be accepted.
- 3.7 Clearly there are other important tasks that you will expect the chair of the audit committee to do. For example, ensuring that the committee's work is reported accurately to the board after each meeting and in an annual report is a key task, and you might expect a joint meeting with the chief executive and the internal and external auditors at least annually. The committee should explain to the full board how it has gone about its work and its principal findings, including the reports of the internal and external auditors. There is a good argument for the governing body specifying what the report should contain. A copy of the committee's annual report must be sent to the funding council.
- 3.8 Two questions that governors often ask are what should be the roles of the head of institution and finance director at the audit committee, and who should act as clerk or secretary to the committee? The answers to these questions are important, and in some cases can influence the response of the full board to audit committee proposals.
- 3.9 So far as the role of the head of institution is concerned, this may be contentious but it is the audit committee's right to decide who attends its meetings. On balance, it is better for the head of institution to attend by invitation for specific business, not automatically. On the one hand, his or her presence ensures that the head of the institution hears about various reviews carried out by the auditors, how line managers have responded and is put in a good position to know where corrective management action is required. But heads of institution can be dominant individuals, and their presence can sometimes inhibit others from speaking frankly.

"I don't see it as the job of the committee to dig too deeply. If there is a problem I assume the finance director will tell me."

**CHAIR OF AN AUDIT COMMITTEE.
A MAJOR FINANCIAL PROBLEM
OCCURRED A FEW MONTHS
AFTER THIS STATEMENT WAS
MADE!**

- 3.10 So far as the director of finance is concerned, the role is to help steer the audit process through liaison with the internal and external auditors, briefing those parts of the HEI which are due to be audited, taking action on agreed audit recommendations, and keeping the committee informed of good practice developments. The FD, or a member of his or her staff, will contribute a lot of information to the committee's agenda, and there will be regular updates on progress with audit plans and recommendations, value for money and procurement activity and issues affecting the audit or accounting processes. There is also an important role for the FD in interpreting rules and guidance from the funding bodies, as well as from accounting and charity regulators and the tax authorities.
- 3.11 There is, of course, a danger of over reliance on the finance director, if he or she becomes the only channel of communication with the funding council and especially the auditors. There is no substitute for the committee meeting the auditors. Similarly, an opportunity for committee members to meet funding council staff on an audit or other visit will be worth taking.
- 3.12 Providing an effective secretarial service to an audit committee is a professional job, and the roles are very similar to those undertaken by the clerk or secretary to the main board who for this reason often services the audit committee. This also adds to the independence of the committee and ensures consistency with other governing body arrangements. It is not sensible to ask the finance director or one of his or her staff to be secretary. He or she will have more than enough to do without trying to take an accurate minute of committee proceedings - a critical task.
- 3.13 As a governor you will also want to know that in addition to routine business, the audit committee is - on the main board's behalf - ensuring that an appropriate management attitude exists to audit. This is often done by a private meeting between the committee and the auditors, and without any management presence. The CUC Guide for Audit Committees has a useful list of prompts for this meeting, and some of the key ones are worth reproducing here. The important point is preparation - for the committee to seek from the auditors the following information on the board's behalf, and to inform subsequently it of the answers:
- Attitudes: Is there a positive management approach to risk management and internal control systems and procedures? What is the assessment of the auditors of the quality of the institution's financial reporting?
 - Resources: Do the institution's accounting staff and internal audit function have a sufficiently broad range of knowledge and experience to be able to deal with the types of transactions faced by the institution?
 - Relationships: Did the auditors receive full cooperation during the audit and did they get full answers to all questions that were asked? What was the nature of any consultations held with other accountants or auditors?
 - Other issues: what were the two or three issues the auditors spent most time discussing with management?
- 3.14 However, these are not just questions for audit committee members to think about; all governors need to consider them in seeking assurance about the working of the institution and should look for such assurance in reports to the board.

Risk

3.15 There are separate materials in this series on risk, but a brief reference is required here. It is very important for an audit committee to understand where responsibility for risk management lies in an HEI, and in some cases this may still be a grey area. Whilst the governing body has overall responsibility for the way in which risk is managed, it will generally rely on the audit committee to ensure that appropriate risk processes are in place. It is certainly an appropriate area for internal audit review, and the audit committee's annual report must express an opinion on the adequacy and efficiency of the institution's arrangements for risk management.

Five guiding principles for audit committees

3.16 Before leaving this subject, it might be helpful to quote another view on what should guide the work of an audit committee - noting especially the first principle. These are taken from a very useful KPMG publication 'Shaping the audit committee agenda'¹³:

- One size does not fit all; the needs of each HEI are unique.
- It's the job of the board to ensure it has an effective audit committee, with the right mix of skills, especially attitude towards independence, objectivity and effective oversight.
- The board must continually assess whether - and insist that - the 'tone from the top' sets an expectation of integrity and accuracy in financial reporting. The audit committee should make a point of discussing with management the institution's standards and ethics.
- The audit committee's oversight process should facilitate its understanding and monitoring of key roles, responsibilities and risks within the institution - its people, policies and practices.
- The board should expect the audit committee continually to reinforce its direct responsibility for the external auditor.

Self-challenge questions

- In practice, do you think that the audit committee is regarded as a key part of your governing body? If not why not?
- Does the audit committee's work provoke debate in the governing body, either in or outside formal meetings? If not, is this a good or bad sign?
- What are the strengths and weaknesses of the way that audit committee matters are dealt with by your governing body?

¹³ Shaping the UK Audit Committee Agenda; KPMG LLP 2004 - available at www.kpmg.co.uk/pubs/beforepdf.cfm?PubID=1896

4. WHAT SHOULD GOVERNORS' EXPECT FROM AN AUDIT COMMITTEE?

- 4.1 A key issue is what a governor, who is not a member of the audit committee, should expect from the committee. Is its scrutiny effective? Is it robust in its examination of management, risk and control? Does it have enough resources to do a proper job? Is it sufficiently independent?
- 4.2 These are crucial questions, and governors should, generally, not assume that all is well with an audit committee unless there is evidence to demonstrate it. Such evidence, of course, comes from the minutes and papers of the committee, discussions of audit in the full board, and reports of the external and internal auditors. The key question is whether you are getting positive assurance, not just an absence of detected problems. Without such data governors cannot really tell how proactive an audit committee is, and whether it is identifying potential problems early enough. Where things have gone wrong, often nothing was identified by the audit committee until it was too late. The need for early information is crucial for an effective audit committee, and all governors should expect it.
- 4.3 Much of this comes down to style of working - the balance between good working relations between governors and managers on the one hand, and an informed and robust scrutiny process which gets beneath presentational gloss to consider fundamental facts and a serious assessment of performance on the other. Of course, the latter may easily be interpreted as intrusive - impertinent, even - but that is a risk worth taking occasionally. The boundary is not fixed, and it ought to be possible to enquire into sensitive issues on a professional basis, without undermining the basic level of trust between the parties. Transparency on all sides is important here.
- 4.4 The effectiveness of an audit committee is more dependent on the quality and commitment of its members than anything else. The key word is independence: a robust determination to seek whatever information and to meet whoever they wish in order to form a judgment on issues. They must not hold back from enquiring into any dark and dusty corner of the HEI, whatever feathers might be ruffled in the process. Not that it is easy and it can be very uncomfortable - sharp questioning of senior academic staff may be met with hostility - and 'what do you know about higher education?' is not an unknown remark in such circumstances.
- 4.5 For this level of scrutiny to exist you should expect the qualifications and expertise of audit committee members to be targeted to fulfil the role set out in the terms of reference. Many HEIs now use skills sets or similar processes to do this. Whilst the audit committee must have at least one member with recent experience of audit, accountancy or finance, some committees may have several and a few HEIs like all of their audit committee members to have substantial financial experience and may use cooption to achieve this. However, this by itself should not be seen as a guarantee of

SUGGESTED TASK

Look out the last annual report from the audit committee; did it give positive assurance on these issues?

"It was really difficult, because the audit committee chair liked the Finance Director and really didn't want to be seen to criticise him. We [the AC] didn't really start doing our job properly until we got a new chair."

LAY MEMBER OF AUDIT COMMITTEE

effective scrutiny. Some suitably qualified people may not be able to devote the necessary time, others may not wish to incur the potential interpersonal challenge on difficult issues, whilst others (who may enjoy the cachet of involvement with a prestigious institution in the locality) may, in practice, not be as diligent as they once were when they were finance directors or in practice themselves. A few HEIs sadly still nominate some inexperienced or inactive governors who contribute little; this is a dangerous situation.

What to look out for

4.6 In making your own assessment of the effectiveness of the audit processes in your own institution, a key test will be that of 'tone'. This could comprise some of the following three elements:

a) Does the audit committee appear suitably independent?

4.7 The independence of the audit committee is important. It should be able to talk to whoever it wishes without being over respectful of the management hierarchy. However, an annual meeting with the head of institution should be built into the committee's schedule. Serious issues should not be deferred until that meeting. The chair of the finance committee (or equivalent) may be present for the review of the annual financial statements and the external auditors' report on them; he or she might be invited for other relevant business. The two committees have significant common interests and there should be a mechanism for sharing their experiences eg an annual joint meeting. Members of senior management should be invited to attend when audit issues affecting their area of responsibility are being discussed, including internal audit reports. Some issues that might affect independence, and that potentially might cause concern for you as a governor, include:

- Is the committee over reliant on the expertise of one member?
- Who determined the internal audit programme? Did the audit committee challenge any management proposals?
- Is the audit committee secretary independent of the finance director?
- Is the head of institution always present in audit committee meetings?
- Does the committee meet the auditors without management attending?
- Does the committee have delegated authority (and funding to an approved limit) to commission its own expert advice or enquiry?
- Are the committee's non-confidential minutes available to staff?

b) Does the audit committee appear suitably robust?

4.8 Possible issues include:

- Were management responses to audit recommendations challenged?
- Is feedback sought from those who are audited?
- Have accounting policy changes made during an audit been explained?
- Have major estimates made in the course of preparing the annual accounts been explained?

"I don't know why I was made a member of the audit committee - I suppose I was just available. Certainly I don't have any financial background and I really struggled for the first year"

LAY GOVERNOR

"Frankly, I just don't think they [the members] are up to it... Most of the time they just sit there and don't say a word"

INTERNAL AUDITOR ON THE AUDIT COMMITTEE

"We really didn't give any thought to audit and risk when we set it up [a university company], but we soon discovered that the audit committee needed to give it much closer attention."

LAY GOVERNOR

c) How effectively does the governing body consider audit issues?

- 4.9 Finding time for audit in a busy governors' meeting is a challenge. Simply copying much of the audit committee's agenda and papers to the full board will not help focus on key points. Suggestions for finding the right balance between reporting routine audit work and bringing forward important and strategic items for debate include:
- Avoiding reports from the audit committee being too low down the agenda so they are liable to be rushed.
 - Asking the head of institution to comment at the governors' meeting on significant management issues raised in the audit reports.
 - Using exception reporting (ie if the board has approved a schedule of audit reviews it should only be necessary to report when progress is unsatisfactory or serious shortcomings have been discovered).
 - Requiring a self-effectiveness review by the audit committee on an annual or biannual basis; these should be discussed by the committee chair with the chair of the board and a report made¹⁴.
- 4.10 Much of this is cultural. If the culture of the institution is defensive, closed to new ideas and audit is seen as negative and pointless by many managers, the work of the audit committee will be difficult and the extent of assurance you will be able to draw from its work will be limited. You may have an important role in supporting management in changing that culture.
- 4.11 One question you should consider carefully is whether the audit committee has covered all the ground satisfactorily, and one tricky area is enterprise (spin outs, patenting, licensing, consultancy etc). This is where the 'not-for-profit' culture in most parts of an HEI meets the commercialism inevitable in enterprise activities. In many traditional 'academic' activities of an HEI the likelihood of a serious conflict of interest arising is relatively remote. In the latter, however, it is much more likely and the effectiveness of management controls over resources and staff time need assessing.
- 4.12 Another tricky area is student unions. There is a legal duty on HEIs to exercise general supervision of student union financial affairs and quarterly monitoring of their finances is recommended. Whilst intrusion into a union's affairs may be resented, if carried out in a professional manner (by internal audit, for example) it can help the union manage its affairs properly. Student unions are not immune from the financial pressures being anticipated in the sector - indeed, they are affected by changing social habits which can be detrimental to their commercial operations.

Self-challenge questions

- As a governor, do you think that any concern the audit committee might have about financial reporting would reach you? If not why not?
- On reflection, do you have complete confidence in the way your governing body deals with audit? If not, what concerns you?
- Who is the most appropriate person with whom to discuss the issues arising out of any concerns you may have?

¹⁴ Useful templates for such questions can be found in the KPMG publication at footnote 13

5. EXTERNAL AUDIT

- 5.1 The external auditors' role is to give a professional opinion on the quality of the financial statements. This is a key element of assurance for governors - that the institution's financial position is fairly reflected in those statements and they can be used as a firm basis for making judgements about that position.
- 5.2 The auditors will normally comment on several other aspects as well, and this can be most useful information for governors because it is an independent source which reports direct to the audit committee (and in extreme circumstances with the right to address the governing body itself usually written into the institution's constitution).
- 5.3 There is plenty of material in the CUC Guide for Audit Committees on oversight of external audit. This chapter simply clarifies what they are there for and suggests some areas for probing.

SUGGESTED TASK

Before you read this section write down what you think are the main tasks of the external auditors, and what assurance they should give to the board.

The formal tasks of external auditors

- 5.4 The formal position is that the external auditors must report whether, in their opinion:
- The financial statements give 'a true and fair' view of the state of the institution's affairs and of its income and expenditure, recognised gains and losses, and statement of cash flow for the year.
 - Financial statements have been prepared in accordance with the Companies Acts and the Statement of Recommended Practice: Accounting for Further and Higher Education (Sorp).
 - Funds from whatever source administered by the institution for specific purposes have been properly applied to those purposes and, if appropriate, managed in accordance with relevant legislation.
 - Funds provided by the funding council have been applied in accordance with the financial memorandum and any other terms and conditions attached to them.
- 5.5 If you are not familiar with how accountants work, you might want to spend a little time thinking about those time honoured words 'true and fair'. What do they mean? What are the auditors actually saying?
- 5.6 First, it is 'a' view, and not the only view which might be provided. This is a reflection of the fact that many estimates and assumptions will have been made in the preparation of the statements. The most obvious is that an outstanding debt at the financial year end will eventually be paid; if it is not, income will have been overstated. Some of the most important assumptions concern the value of assets and liabilities.
- 5.7 Second, it is 'true', rather than correct. Correct suggests that there is only one acceptable presentation or interpretation. True implies that the statements are consistent with the underlying records and facts.

- 5.8 Third, it is 'fair', rather than correct or accurate. Fairness implies a balance between the various interests in an HEI's financial position. Consider outstanding construction liabilities at the balance sheet date, for example. Final accounts for building projects often take years to settle and can be seriously contentious, but annual accounts will still have to be prepared. As each financial year passes, a judgment has to be made about what may have to be paid at some future point and a suitable entry made in that year's financial statements. An added complication is that the financial statements will be read by the other party if there is a dispute over the amount to be paid! What is fair in these circumstances will be a matter of judgment, but it could not be called correct. The valuation of outstanding or incomplete work is an important area for examination when considering the annual accounts. So is the treatment of disputed items and litigation generally.
- 5.9 As financial statements must be sent to the funding councils by 30 November each year (31 December in Wales) - and time will be needed for the governing body to approve them - an audit committee meeting will be required in early November. A joint meeting with the finance committee may also be appropriate, or a meeting of the audit committee with members of the finance committee invited to attend. Both committees will have an interest in the statements and the quality of the audit work on them, but both may reasonably wish to discuss them from their own standpoint.

How do external auditors work?

- 5.10 Bearing in mind their key tasks, how do they set about their work? Much of what they do is unglamorous checking of records, often on a sampling basis, to test data quality and reliability. Even small HEIs will have complex accounting systems which need to be tested for internal consistency. Asset and liability records need to be checked to see if they actually exist. Much of this will be done by sampling, but crucial figures for cash in the bank or owed to the bank will be checked thoroughly.
- 5.11 Unless values are obvious (cash deposits, for example), estimates will be made by management and these will be assessed by the auditors for reasonableness. Quoted investments and currencies may be straightforward, but other items may be the subject of considerable discussion before the accounts are finalised.
- 5.12 Compliance with the Sorp and accounting standards¹⁵ will be assessed by the external auditors, and the correct application of accounting policies reviewed. These policies are sometimes overlooked by staff when working up the accounts. One particularly important standard is FRS 17, which governs the reporting of pension funds and liabilities in financial statements. The valuation of both assets and liabilities of pension funds is not an exact science, since it involves forecasting such difficult variables as inflation, interest rates and life expectancy rates. But these valuations may have a very significant impact on an HEI's accounts and considerable judgment may be needed to assess just how much weight should be given to them - compared with, for example, the periodic review by an independent actuary. Nor is the basis of valuation to be assumed - it may be the subject of legitimate disagreement between auditors and the institution.

¹⁵ See the separate materials in this series on finance for details about the Sorp.

- 5.13 As a governor, you should expect that careful consideration is given to joint ventures. The assets and liabilities of the venture will need to be valued, its future viability may be an issue and your HEI may have more or less control - these are some of the issues which will need to be assessed because they will have an impact on your accounts. Similarly, arrangements with third parties to provide ongoing services (student accommodation, for example), in which the initial capital requirement is found by the third party (or their bankers) will raise questions when an HEI's accounts are prepared. Such arrangements (often known as PFI or 'off balance sheet') are usually complex and may not be quite what they seem. The HEI may have given undertakings which become real liabilities in some circumstances. Some of the biggest commercial scandals of recent years have centred on such items because the risks have not been properly understood. (For a discussion of PFI see the separate volume in this series on finance.)
- 5.14 The external auditors will also use relevant internal audit reports both to avoid duplication of effort and to ensure that there is a coordinated approach. Whilst the internal auditors' task is different, there is considerable common ground. Above all, the external auditors will take a holistic view of the financial statements and carefully weigh the meaning of the words being used. They take the presentation and description of figures very seriously.
- 5.15 External auditors will work to a structure agreed with finance staff, but which should be reported to the audit committee. Items may include:
- A timetable for the preliminary and substantive audit work and meetings with management to consider technical and other significant issues.
 - A timetable for preparing the management letter and responses to it.
 - Details of personnel who will conduct the audit.
 - Any particularly topical issues to be reviewed.
 - Details of principal audit tests to be carried out.
 - New technical issues affecting the statements eg Sorps and standards.
 - The extent of proposed liaison with the internal auditors.
 - Proposed changes to the audit opinion.

The annual external auditors' management letter

- 5.16 The governing body obviously will be asked to approve the accounts and will receive the associated opinion that the external auditors prepare. Some of the questions to think about when reading their work include:
- Has the timing of any transactions had an effect on the accounts?
 - Are there any significant liabilities or exposures not properly recognised in the accounts, such as pending litigation or PFI arrangements?
 - Are the accounting policies appropriate? Have they changed? Which are most critical to the results?
 - Which significant items involve substantial elements of judgement?
 - Is the statement of internal control appropriate and valid?
 - Are there any unusual or non-recurring transactions?
 - Are there any points of difference between the auditors and the finance team?

- 5.17 The external auditors' management letter is a key document which reports on issues which have given rise to concern during the audit. The letter will eventually be seen by the funding council and will be a key input to the council's annual risk assessment of your HEI. The letter should have been discussed with management before reaching the board (via the audit committee). Reference may be made to perceived accounting or control weaknesses, inappropriate policies or non-compliance with regulatory requirements. On behalf of the governing body, the audit committee should examine such issues in detail, together with management's responses. The full board should discuss the matters raised, and it may want to challenge the management if a lack of appropriate urgency or operational weaknesses have been revealed. The management letter may be accompanied by a 'housekeeping' letter, containing issues of lesser importance, including opportunities for improved efficiency and best practice seen elsewhere.
- 5.18 A management letter which is 'clean' or makes no criticisms may be a good or bad sign. It may indicate either that all is in order or that little serious digging has been done. In considering reports from the audit committee, it is important for the governing body to make an assessment of the quality of the audit team and its performance - especially the partner. What has the partner learned from other audits (particularly in higher education) which has influenced his or her approach in this instance? What technical issues were discussed with management?
- 5.19 It's rare for the external auditors to meet the board of governors. Yet this simple change in practice would demonstrate clearly the board's interest in audit work. The audit partner's appearance at a full board meeting can give the ordinary governor a chance to see and hear 'audit in action', and give some insight into the key issues of service quality and thoroughness, independence and financial stability. Far better that they appear annually, than only when there's a problem.

What value should you place on their opinion?

- 5.20 Whilst the external auditors perform a valuable role in expressing an independent opinion on the annual financial statements, it's very important to realise the limits on their work. In particular, whilst they may make informal comments within the confines of a private board or audit committee meeting, there are things they will not put on the record.
- 5.21 External auditors don't normally express a formal opinion on the financial health of an HEI; the exception is when there is doubt about its continued solvency. Nor do they express a formal opinion on the quality of financial management or governance or creditworthiness. In other words, because your HEI's accounts and financial statements are in shape does not necessarily mean that you are financially well managed.

- 5.22 At its worst, having 'fair and true' accounts doesn't even mean that an HEI is secure. Examples of organisations which have properly certified accounts but are about to fall apart are mercifully rare in higher education - in recent years at least. But examples from the world of commerce are easier to find: look no further than the outcomes of the 'credit crunch'. Before that, the name of Enron was notorious and when it collapsed in 2001 it was revealed that its reported financial condition was sustained substantially by institutionalised, systematic, and creatively planned accounting fraud¹⁶, notwithstanding that the accounts had been produced to professional accounting standards!
- 5.23 The key point here is that external audit is essentially retrospective. If there is sufficient concern about your institution's financial position, you will have to press for an independent review, carried out by a competent consultancy firm. Relying on the auditors to tell you if there is trouble ahead is not sufficient. Several HEIs have been in this position. It may be an uncomfortable period for governors.

Self-challenge questions

- Examine the latest external audit management letter - do you understand what it says - and management's responses?
- Look at the audit certificate in the annual financial statements - do you understand what it is, and the importance of what it says?

¹⁶ <http://en.wikipedia.org/wiki/Enron>

6. INTERNAL AUDIT

- 6.1 Internal audit (however provided) exists primarily to give the governing body and the head of institution assurance about the adequacy of arrangements for risk management, internal control, value for money and associated issues, and governance. Good internal auditors - supported by good audit committee oversight - will go much further and give the governing body valuable insight into the overall quality of management throughout the institution. They are in a sense your 'eyes and ears' as a governor, and it really is up to you to get the best out of them.
- 6.2 A crucial question for all governors is whether an HEI takes internal audit seriously. Does yours? The audit committee's reports should give you some feel for this, and obvious questions are:
- Is internal audit asked to review challenging and potentially difficult issues, and if not why not?
 - Are internal audit recommendations implemented, and does anyone check and report back to the audit committee or the board?
 - Does management make promises which are later ignored?
 - Has internal audit uncovered anything serious recently, and has it challenged management decisions?
 - Is internal audit linked to a wider systematic process of institutional and departmental evaluation which is undertaken by many HEIs?
- 6.3 Unfortunately, there are still some HEIs which regard internal audit as an imposition, the impact of which should be minimised, both in terms of its effect on managers and its cost. This is both dangerous and short sighted. Effective internal audit will both enhance overall institutional effectiveness and control and might be expected to save its own cost - this is not its main purpose, but may be a useful check from time to time.

"I resent paying all this money to the auditors. This year we tried to reduce the amount of time involved but the governors wouldn't have it. I had to ask them where the money was going to come from"

A VICE-CHANCELLOR

Who are the internal auditors?

- 6.4 There are three main options available for the provision of an internal audit service:
- Appointing a professional audit firm. This has the merits of independence from management, the ability to bring best practice seen elsewhere, some assurance of continuity if staff leave, and structured training arrangements. On the other hand, knowledge of the HEI will be less than the alternatives, value for money may not be as good, and the auditors may need more institutional management input.

- Employing internal audit staff. This offers the opposite to a professional firm: closer knowledge of the HEI, potentially better VfM and understanding of local management, but, by the same token, independence may be less assured and there may be a narrower view and a continuity risk. Line management responsibility for internal audit staff under this model may be an issue, and practice varies. Since much audit work has a financial element, a reporting line to the finance director may seem sensible, but such a situation contains an inherent conflict of interest; whilst this may be mitigated if the internal auditor has guaranteed access to the head of institution or another senior officer, backed up by 'whistle blower' protection, it is best avoided. If the HEI has a chief operating officer, reporting through this line may be preferred. However, in any structure, the internal auditor's independence may be threatened by a line manager, and the board through its audit committee is the principal safeguard. Supplementing internal staff with some consultancy on occasions may be a useful hybrid.
- Joining a consortium. This alternative scores well on most of the issues identified previously. There are a few examples around the UK - usually in major conurbations - which have been established for some years and seem to be effective. Joining a consortium operated by other public sector bodies may be another alternative.

6.5 One key point here is that the audit codes of practice do not permit the same firm to provide both internal and external audit services to the same institution.

6.6 Another crucial issue which may determine who the internal auditors are, and the amount of time involved, is the relationship between internal audit and those responsible for undertaking institutional research and review (often located within a planning office). This latter function involves a systematic approach to monitoring and evaluating constantly all aspects of institutional performance, and the processes in place to deliver it. It will usually be the function which generates information on KPIs and the issues arising to the governing body. Such a planning and review function is not well developed in all HEIs, but where it is, the role of internal audit is likely to be more narrowly drawn and to focus on financial, risk, and governance issues. Where such a function is limited or doesn't exist at all, then the internal audit function may expand and involve effectiveness reviews of parts of the institution - often under the guise of seeking better VfM.

How internal audit works

6.7 The key to effective oversight of internal audit - and the effective operation of the audit itself - lies in the preparation and use of an audit plan which is based on the assessment of risk and assurance needs. This plan should set out in some detail how all the institution's key systems and controls will be reviewed by the auditors over a cycle of perhaps three years. It will also specify the resources required. In other words it tells the internal auditors what the governing body wants them to do, and also what the auditors expect to do in adopting professional standards for the HEI concerned. It is, therefore, clear that specifying this work plan should be a matter for the whole board and not just the audit committee.

- 6.8 Whilst using the risk register is often the starting point for an internal audit plan, other considerations need to be borne in mind:
- The strategic plan and the major strategic issues being addressed by the institution.
 - The major spending areas.
 - The perceived major opportunities for improving value for money.
 - Inside knowledge of where performance or standards are variable.

In general, as a governor you might expect all the items highlighted as being at high risk in your HEI's risk register to feature in some way within the work programme for internal audit, unless these are being addressed through a well developed planning and review function (see paragraph 6.7).

- 6.9 Internal audit work will be structured around a series of specific reviews, designed to address all the areas identified in the strategic audit plan, which will usually cover several years. This should be seen and approved by the board, which should also see which topics are to be reviewed in the annual programme before the start of each year. A brief statement of the reasons for each review and the risks associated with the activity will give you some insight into its underlying purpose, and how it fits into the overall structure. Each review will have more detailed terms of reference specifying its purpose and the amount of time expected to be allocated to it. The specific management and operational controls to be tested will also be defined. These terms should be approved by the audit committee.

SUGGESTED TASK

Suggested Task: Make a list of where you think there are major management or control issues in your institution. Then check it against the internal audit strategy and plan. Are there major gaps? (Perhaps keep the list for future reference.)

- 6.10 Once the work is complete, a report should be submitted to the governing body (via the audit committee), setting out the findings and recommendations, along with the management's responses, allocation of responsibility and deadline for implementation. Unless serious issues have arisen, detailed reports to the board should not be necessary. Protocols should be agreed for the content of these reports and especially the timetable for reporting. Each recommendation will be graded on some simple system intended to convey a degree of seriousness. Delays in reporting are a notorious source of annoyance to audit committees so what is expected of both auditors and managers should be made clear.
- 6.11 Once a year, there will also be an annual report from the internal audit service, summarising their work, performance against budget and other targets and key findings. This is an important document because it is the basis of the audit committee's own report to the head of the institution and the governing body on the adequacy and effectiveness of the institution's arrangements for risk management, control and governance. It might be supplemented by inviting the partner to give a presentation to the board.
- 6.12 Appendix 15 of the CUC Guide for Audit Committees suggests an approach whereby three levels of judgments might be used by internal auditors to define any 'priority' or 'risk' associated with their reports:

- High - inadequate systems and controls which if not addressed could expose the institution to significant financial, operational or reputational risk and adversely impact on implementation of its strategic plan.
- Medium - systems and controls which are not fully effective, and failure to improve them could adversely affect operational plans at departmental level.
- Low - good practice dictates that some enhancements to existing systems and controls are desirable.

6.13 Interpreting internal audit reports can be tricky. The most and least serious categories are relatively straightforward. A top rating means that urgent action is essential, and at the other extreme come good housekeeping suggestions which might be considered, but do not amount to significant matters. In between those extremes can be difficult to interpret without a close working knowledge of the HEI. The word 'important' is too ambiguous for this middle group. A more useful description would be 'important enough to be adopted - if not adopted, rejected for a reason which satisfies the audit committee'. Another way would be to ask: what the likely consequences might be if no action was taken.

How much time or resource should internal audit take?

6.14 One of the key issues for governors (and not just the audit committee) is how much resource should be devoted to internal audit? There is not a simple answer, and it is obviously related to the extent of assurance that the governing body requires. However, there are ways of making some checks on what others do. The British Universities Finance Directors' Group¹⁷ conducts an annual survey of spending by HEIs on internal audit. Not all respond, but there is usually sufficient information to give some indication of the range for institutions of all sizes and complexity. Moreover, this sort of data is not usually a closely guarded secret, so your finance director should be able to ask colleagues in comparator HEIs for their level of spend.

Evaluating internal audit

6.15 A periodic assessment of the quality of the internal audit service is good practice - annually is ideal, but every three years as a minimum. Periodically, the way in which the service is provided should be reassessed, or be retendered if on a contract basis. The financial memorandum with the funding council requires that a periodic assessment of performance should take place.

6.16 Although such a review should usually be led by the audit committee, the full board should be given an opportunity at the outset to discuss the requirements, and to give all members the opportunity of reporting on their satisfaction with internal audit arrangements. Of course, after the review has taken place the full governing body should consider the report and agree actions. It follows that without at least some knowledge of audit, all governors will not be able to take part effectively in this debate.

¹⁷ See www.bufdg.ac.uk

6.17 The issue here is whether the internal auditors have been getting 'under the skin' of the institution. A good audit service will show effective leadership and management at the partner or manager level and experience in higher education matters. They will be sufficiently engaged in the institution itself to have insight beneath the surface. Their value to the institution will be enhanced if they are talking and thinking the language of strategy, management quality and performance, as well as risk management and control. As a governor you should be able to see this from their annual report - which might well be enhanced by an appearance and presentation to the full board. An indication of poor audit is when their recommendations are rejected justifiably by management. It would be an unusual institution which contained little that a good auditor could not criticise or improve.

Self-challenge questions

- What evidence can you see that internal audit is operating at a strategic level in your institution?
- Is the annual internal audit programme keeping up to its schedule of activity and reporting?
- Is internal audit coverage giving you positive assurance in all the areas you need as a governor?

7. VALUE FOR MONEY

- 7.1 At one level, getting best value from the resources available to an HEI should be an obvious management objective. Who would do otherwise? Yet governments of all parties have thought it necessary to seek improvements. But perhaps this is not surprising as most academics will be much more concerned about the quality, impact and reputation of their work than how much it costs or the value for money it provides. Therefore the governing body (along with its other financial responsibilities) has to ensure that its institution is achieving optimal value for money (VfM).
- 7.2 VfM is usually defined in three ways:
- Economy - achieving best value taking price and quality into account.
 - Efficiency - maximum output for minimum use of resources.
 - Effectiveness - the optimum realisation of objectives.
- 7.3 Whilst the first of these is a reasonably straightforward concept (given identical goods or services, pay as little as possible for them), the second and third may not be and balancing acts may be required. Research is a classic example, and maximising the volume of published papers in third rate journals is not the way towards international recognition of an HEI as research driven. Likewise, a policy of publishing only in first rate journals regardless of the resource consumed may have the same effect, because either the research is not of sufficient quality to be published, or the magnitude of the resources required means that little is produced.
- 7.4 The reality is that getting better VfM needs regular pressure and it's the governing body's job (through the audit committee) to see that management takes the task seriously. VfM can be investigated through various routes - internal audit investigations, interviews with management, use of benchmarks etc - but should stop short of governors doing the job themselves. Here, as in many other aspects of governance, the job is to ensure that robust arrangements are in place, that they are functioning well, and that the results are measured and actions taken.

A practical approach

- 7.5 Almost certainly, the next few years will see increased financial pressures on most HEIs, and the need for VfM will be even greater. Accordingly, it might be a good time for a governing body to consider the effectiveness of its attempts to date to achieve better value. A review and updating of the institution's VfM strategy might be beneficial, and relevant questions for governors to ask might include¹⁸:
- Have we set out our approach to VfM and the underlying rationale?
 - Has the strategy been endorsed by governors and senior management?
 - Does the strategy set out individual responsibilities?
 - Are there effective management arrangements for implementing strategy?
 - Are there sufficient resources to implement the strategy?
 - Has the strategy been effectively deployed throughout the institution?
 - Are the results of our VfM activity reported to governors and senior management?

"The University is not a business and that word should not be used in official documents"

A UNIVERSITY SENATE MINUTE

¹⁸ Some of this chapter is taken from Value for Money Strategy, Hefce 1998. The publication contains much useful background material for a review of VfM activity. See www.hefce.ac.uk/finance/assurance/vfmstrat.htm

- 7.6 The task of actually improving VfM is a management responsibility, but the governing body (through the audit committee) should be informed of the planned programme of work and any resulting objectives and targets. Work might include:
- Promoting a culture of continuous improvement throughout an HEI.
 - Considering any VfM reports from the funding councils, the National Audit Office, the Wales Audit Office, and any other relevant source, and taking appropriate action on their recommendations.
 - Monitoring the implementation of any studies undertaken.
 - Ensuring that market testing of all externally contracted services is properly conducted by line management at the agreed frequency, and considering other market testing opportunities.
 - Encouraging the adoption of good VfM practice in all areas throughout the institution, and reviewing any reasons for not doing so.
 - Reviewing existing performance indicators on key elements of the institution's activities to contribute to its assessment of economy, efficiency and effectiveness.

Looking a bit more deeply

- 7.7 Some areas are obvious candidates for VfM investigation - purchasing, catering, transport, estate maintenance, information technology, insurance and so on. They are all worth putting into a regular cycle of reviews, but they are mainly outside the academic heartland. Other areas may feel like a difficult challenge for a VfM review, but may yield considerable improvement, given the right approach. These include:
- Efficient organisational structure (governing body, management, administrative, academic).
 - The active management of staff costs (especially part time costs and vacancy management).
 - The existence and implementation of a procurement strategy.
 - Participation in sector wide benchmarking activities.
 - Space management techniques.
 - The use of an information strategy to integrate all the information needs of the administrative and academic community.
 - The adoption of good corporate staff management practices, including recruitment, induction, appraisal and staff development.
 - Sharing support services with a neighbouring institution.
- 7.8 The key to a successful review in the above areas may be the use of specialist staff or consultants. Many institutions belong to one of the higher education management services groups, which specialise in providing advice to HEIs. There are also several specialist consulting firms.

The annual VfM report

- 7.9 Securing an annual report from management on VfM can be a key discipline and all governors should expect to receive one. This is the governing body's chance (through the audit committee) to raise the challenge of getting better VfM by insisting on a report of work done and achievements made during the year and debating it with the head of institution. This report, backed up with evidence, could be the most valuable source for the board's view of VfM and the seriousness with which it is pursued.

- 7.10 Getting better VfM is a continuous process, so the constant search for improvement is a key aspect to look for in any review. It is also a cultural issue at heart and stems, like many other aspects of institutional success, from the top. Does the head of institution drive it? Does it have a narrow focus just on housekeeping issues? Does the finance director challenge costs, operating methods and procurement arrangements, for example? In looking at the annual report, it might be pertinent to ask if any sacred cows have been disturbed this year and what protests resulted - if any.
- 7.11 There is still a widespread belief outside higher education that better value could be secured from the public resources devoted to the sector. This has resulted in government led inquiries in the past, and it remains a major issue. If government believes it is not being taken seriously, not only is further regulation likely, but the sector's regular bids for enhanced funding may meet with the response that 'it is time to put your own house in order'. One vice-chancellor described his appearance before the Public Accounts Committee for a discussion of this issue as the most uncomfortable interview of his life!

Self-challenge questions

- Have the savings proposed in last year's VfM plan been achieved? As a governor how would you know?
- Is there any evidence of benchmarking of costs?
- Has VfM work gone beyond administrative areas?
- Are 'shared services' on the institutional agenda?

SUGGESTED TASK

Think about what evidence of better VfM you have seen as a governor during the last 12 months. Have you got positive assurance that your HEI takes this seriously?

8. OTHER KINDS OF AUDIT

8.1 This material has so far considered the kind of audit that would be familiar to many governors, particularly those with a private sector background. However, there are at least three other activities in HEIs that involve other aspects of audit in some way, and these are briefly reviewed in this chapter. They are:

- The requirement of some funding councils for data audits, and the role of the governing body in validating the accuracy of data (in some HEIs in England Hefce ask for the process of completing Trac¹⁹ returns to be audited).
- Institutional reviews and audits conducted by funding councils, and the implications for the governing body.
- Academic audit and quality assurance, and the implications for the governing body.

Each of these is briefly considered in turn, but not all apply across the UK and the text notes differences where these occur.

Funding council data audits

8.2 All the four UK higher education funding councils have necessarily complex funding models by which they fund teaching. These take account of factors such as the mode of study (full time, part time, etc), the level of study (undergraduate, postgraduate, etc), the subject of study (different subjects cost different amounts to teach), and so on. It is therefore important that the data returned by HEIs is accurate. For financial returns, the financial statements and the work of the external auditors assure this (although not for the statistical returns), but there is no equivalent for student data which, of course, represents institutional income.

8.3 The complexity associated with student data has grown considerably in recent years, and is likely to grow further. In the past, the position was relatively straightforward: most students were full time, took one (or at the most two) subjects for a whole year, and drop out rates during the year were low. As a result student registration within HEIs was not too complex, and the returns to the funding councils (through Hesa - the Higher Education Statistics Agency) were likely to contain relatively few errors.

8.4 However, the student data world has changed and registrations are now much more complex. This means that relatively predictable data based on the full time single subject student has gone for many HEIs, and the current one may be much more difficult to track. For example, a medium sized HEI may have literally tens of thousands of data entries in its student record, and a failure to record them accurately (using the Hesa and funding body conventions) could potentially make a significant difference to the eventual income that an HEI receives.

¹⁹ For details of Trac see Chapter 4 of the volume on finance in this series

- 8.5 For this reason all the funding bodies are now moving towards asking governing bodies (through audit committees) formally to validate the main institutional student data returns, just as they have previously done in relation to the annual accounts. Already, some governing bodies do this, and undertake annual compliance checks to ensure that all is well, and that the advice they are receiving from senior officers is accurate. Internal audit may have a role to play in this area.
- 8.6 However, most governing bodies do not do such data checks, and the prospect of their having to introduce them is worrying some governors, who see a potentially increased cost of compliance at a time when national policy is to try and reduce the accountability burden on HEIs.
- 8.7 Whatever the cause of the problem, it is important that the governing body ensures all data (whether financial or otherwise) sent by HEIs to the funding bodies is robust and complies with the conditions of funding. Failure to do so, will inevitably raise issues about the expertise of management and the robustness of governance.

"How are we supposed to know whether the [student] data we send to HESA is accurate or not... The cost of checking it could be huge"

LAY GOVERNOR AND AUDIT COMMITTEE MEMBER

Institutional review

- 8.8 In England and Northern Ireland the funding councils have a process called 'institutional review' whereby HEIs are visited in order to assess audit and other arrangements. In a sense, this is an audit of the institution's own audit arrangements, and is undertaken on a cycle with a visit at least every five years for those HEIs presenting the least risk. Institutional reviews also take place in the Wales and Scotland, although their form differs.
- 8.9 These visits are important, and the clerk or secretary to the governing body will prepare for them in detail. The reviewers will want to meet members of the audit committee, and perhaps other governors in relation to any specific issues that may arise. In England, the broad areas that the institutional review will address are²⁰: governance; audit; risk management; financial management; strategic management; and related areas.
- 8.10 A critical judgement from such a review would be a very serious outcome for a governing body, and would suggest that significant failures were occurring in the way the board was undertaking its duties. However, this has happened, and governors should not be complacent about the review process. This is particularly the case where (for some reason) boards may have decided not to undertake robust effectiveness reviews of their own.

²⁰ See www.hefce.ac.uk/finance/assurance/InstRev/

Academic audit and quality assurance

- 8.11 Historically, in many HEIs the governing body had relatively little role in relation to the main academic areas of teaching and research, despite those in post-1992 HEIs in England having a formal responsibility for 'determining educational character'. As higher education becomes more market driven the position is changing, and boards are becoming much more involved in issues such as the student experience, internationalisation, employability, and so on - not to mention their overall responsibility for approving and measuring strategy with academic issues at its heart. Indeed, a common observation from many new external governors is to express surprise that most governing bodies tend to have little responsibility for the core products of the institution in teaching and research.
- 8.12 One specific question that this raises for the governing body is what role should it have in relation to the audit of academic activity and ensuring the quality of the academic provision? Conventionally (although this is also changing in some HEIs) the answer has been none, and it has been an academic board or senate issue (depending on local structures). The question for all governors is: is this approach still appropriate, and if not in what ways might it be changed? In Scotland, this question is now being posed in a practical sense as from 2009 the governing bodies of all Scottish HEIs will be required by the Scottish Funding Council to agree a 'baseline' document setting out how their institution is enhancing the quality of learning and teaching.
- 8.13 In practical terms, the issue facing the governing body is to what extent does it receive and discuss the substantial amount of existing data on academic quality? The exact information given to governors will vary between HEIs and different UK jurisdictions, but is likely to include:
- Results of the institutional reviews (or equivalent) of all HEIs undertaken by the QAA (Quality Assurance Agency)²¹.
 - In England, results of collaborative provision audit and IQER (Institutional Quality Enhancement Review of higher education in further education colleges).
 - Professional body course accreditation reviews.
 - For some HEIs cross-sector further education provision reviews by Ofsted.
 - The results of the National Student Survey (NSS).
 - Internal course review information, for example, end of year course evaluations, etc.
 - For research, obvious information includes the results of the Research Assessment Exercise (RAE), but also any internal data generated on research productivity and quality.

"I have never been on a board before, which has never seriously discussed the main products we are delivering, or the needs of its customers. And worse, nobody else seems to find this unusual!"

LAY GOVERNOR

²¹ See www.qaa.ac.uk

8.14 Clearly, the time to discuss this information at full governing body meetings is limited, and therefore the board will need to take a decision about whether responsibility needs to be given to a subcommittee to take discussions forward. There appear to be four main possibilities:

- To take no action and leave this entirely to the senate or academic board (receiving reports from them as required).
- To give responsibility to a joint committee of the governing body and senate or academic board.
- To give responsibility to a governing body committee concerned with strategy (at least one HEI now has an educational strategy committee as a subcommittee of its governing body).
- To give responsibility to the audit committee - although this may not be the best solution given the committee's likely existing workload.

8.15 The last option is particularly relevant to audit, and some HEIs already provide all the information in 8.13 to their audit committees. The idea of a generic audit committee with responsibility for coordinating all audit activities is attractive to some HEIs and not to others. Certainly, it is not a traditional approach, but if a new HEI were being established without the need to adopt a governance structure of the past, then it is quite possible that such an audit committee would have a considerable attraction. It could also lead to some interesting innovations in assessing academic quality, for example the adoption of a risk based approach. Of course, the changes required to introduce such a generic audit committee would be considerable. Many finance directors would be uncomfortable with a broader remit, and the professional audit firms would have no expertise (and probably little interest) in these new areas.

8.16 There are advantages and drawbacks associated with all four approaches, but what is important is that as a governor you should be confident that this increasingly important issue of what the board should know about academic quality is being dealt with in an appropriate way.

Self-challenge questions

- What is, and what is not, the role of your governing body in determining whether the quality of teaching and learning and/or the quality of research is acceptable, and how does it relate to that of the senate or academic board?
- Is there agreement within your HEI about the responsibilities of all the key bodies and the executive team for matters concerning the quality of academic activities and the student experience?
- Are there effective systems in place for reporting to the governing body on key issues concerning academic quality and the student experience?
- What are the potential dangers of governing body involvement in this area?

9. WHEN THINGS GO WRONG

9.1 There have been remarkably few instances of governance or financial failure in UK HEIs, but those that have occurred serve to emphasise the key role of audit and an effective audit committee. It is hard to believe, but the external auditors for one HEI in the mid-1980s refused to cooperate with another audit firm sent by the government to conduct an independent appraisal of the college's financial situation, once its problems became a source of public concern. Although times have changed and that problem could not reoccur, other potential problems remain. Those of a more general financial nature are dealt with in the separate materials in this series on finance, but in this chapter some issues specific to audit are considered.

SUGGESTED TASK

Read Chapter 13 on 'Working with the Management' in the separate materials on finance in this series. Then consider: where do you think the main focus of audit effort should be?

What to look out for

- 9.2 There are four main categories of problems that may occur when things go wrong with audit, and each is briefly considered in turn:
- Governance processes associated with audit are not robust and coherent enough.
 - The external and/or internal auditors are not performing effectively.
 - Management does not place a high enough priority on audit, and the issues that audit is designed to enhance (eg VfM).
 - The finance director is resistant to the internal audit function.
- 9.3 The potential consequences of such failures can be very significant, and range from inefficiency in operation (and perhaps poor VfM) right through to fraud and criminal activity. The latter - though very rare - do occur in higher education, indeed at the time of writing the courts are considering a case involving allegations against the managing director of a university subsidiary company in a large HEI.

Governance processes associated with audit are not robust

- 9.4 To put it frankly, any failures in this area in your own HEI are down to you and your fellow governors. Typical problems (all of which are capable of being tackled) include:
- Unsuitable audit committee membership or chairing.
 - Too close a relationship between the governing body chair and chief executive.
 - Aggressive accounting policies, for example, excessive capitalisation (ie deferral) of building refurbishment and minor capital costs, which would be better written-off immediately; over optimistic valuations of investments; failure to provide for probable liabilities; etc.
 - The audit committee not meeting privately with the auditors.
 - Inadequate assessment of acquisitions and mergers.
 - Failure to understand fully the full implications of joint ventures or PFI arrangements.
 - Poor reporting from the audit committee to the governing body.
 - Lack of time given to audit issues by the governing body.
 - A lack of constructive challenge by governors (including audit committee members).

The external and/or internal auditors are not performing effectively

9.5 Your HEI will be but one of a large number of clients for most of the main audit firms, and it is inevitable that some clients receive a better service than others. Typical problems include:

- Poor performance by auditors.
- Unexpected or inadequately explained change of audit staff.
- Too much work being undertaken by junior audit staff.
- Internal auditors not being sufficiently knowledgeable about some of the issues specific to your HEI that they need to review.
- Tardy reporting.
- Too close a relationship with the director of finance.

9.6 All these issues can be addressed relatively easily, but only if the governing body and its audit committee have the interest and the will to do so. In many cases depending upon the director of finance to tell the board that there are problems may be very optimistic: why should a finance director want to cause more work for him or herself by increasing the amount of challenge from the auditors? This is not to say that the FD will deliberately mislead the board (that would be a wholly different - and more serious - issue), but only that most are already fairly confident that their financial and audit processes are adequate for their needs - which may not be the same as those of the governing body.

Management does not place a high enough priority on audit

9.7 This is a more challenging problem for a board to address. Most frequently it stems not from an executive being difficult or obstructive, but just from being 'too close' to all the key management and operational issues in an HEI. In such circumstances it is understandable that managers feel that they are 'doing all that can be done', or that they are 'on top' of all the main issues facing the institution. In a sense managers in such a position may be almost 'too close' to day to day issues to see the bigger picture, or to sympathise with the broader strategic concerns of the governing body.

9.8 Typical problems might include:

- Management letters from the auditors showing increasing numbers of control issues or disagreements on remedial action.
- Tardiness in responding to audit recommendations.
- Over dominant chair or head of institution.
- Autocratic management.
- Poor relationship between board and senior management.
- Reporting to board only through chief executive.
- Open disputes between senior managers.
- A focus on the past.
- Resignations of senior managers, especially at short notice.
- Concerns by the clerk or secretary to the board about his or her inability to fulfil the role effectively due to pressure from the executive.

The finance director is resistant to the internal audit function

- 9.9 This is probably the least common problem. Again it will rarely be an FD wanting to hide things (although this does occur), but of someone feeling that he or she is fully 'on top' of issues, and that no audit is necessary. Some governors may be sympathetic to this view and want the FD to get on and manage his or her empire, but there are obvious dangers.
- 9.10 Typical problems might include:
- Information not being made available in time for auditors or the governing body.
 - Resistance to involving the governing body or audit committee in some financial areas within their areas of responsibility.
 - Drawing the distinction between governance and management more narrowly around governance than is good practice.
 - Deteriorating staff morale in the finance department.
 - Failure to comply with statutory obligations or banking covenants.
 - Unexpected losses or cash crises.
 - Major projects out of control, especially new buildings.

What to do

- 9.11 In short, act proactively both as an individual governor and at board level! The chances are that if you are not a member of the audit committee you may not have been alerted to potential problems, but your very independence might alert you that something is wrong. If so, think about the possible problem in the following stages.
- 9.12 First, reflect carefully on what you think the problem is. If it's just that you don't agree with a management or governing body decision to invest in one thing rather than another, then probably decide not to take any further action. You may not agree with a policy, but that doesn't make it wrong, and providing the governing body took the decision properly just conclude that a majority disagreed with you.
- 9.13 Second, if your concern is to do with implementation of policy or reporting, then have an informal word with other - trusted - governors and see if they have concerns or agree with your view. If you are in a minority of one beware - you may be right, but the chances are that you are missing something that others can see!
- 9.14 Third, if other governors share your concerns, have an informal word either with the governing body chair or with the clerk/secretary. At this point you should obtain a good explanation for your concerns, or failing that an agreed approach to pursuing them further on behalf of the board as a whole. Of course, if the chair is unwilling to take up the matter then the problems become more murky! However, for most queries, this approach should provide a mechanism for questions to be asked, and if not answered satisfactorily, to be put on the agenda of the audit committee or governing body.

- 9.15 Such an approach is likely to provide a way of addressing almost all of the concerns that individual governors are likely to have during their period of office. However, just occasionally, a very serious issue may arise, when an allegation is made against a member of senior management - perhaps fraud or the like. Such cases are rare, and most governors will - fortunately - never experience one in their periods of office. However, you do need to be prepared for it.
- 9.16 The CUC Handbook for audit committees provides useful guidance, which - in summary - recommends that when information relating to actual or potential fraud and irregularity is uncovered, management should be prepared to conduct a comprehensive and objective internal investigation. Every HEI should have a fraud policy in place.
- 9.17 A well designed investigative process will typically include:
- Oversight by the institution's audit committee, or a special committee of the governing body, either of which must comprise independent governors who are able to ward off undue pressure or interference from management.
 - Direction by outside counsel selected by the audit committee, with few or no ties to the institution's management team, who can perform an unbiased, independent and qualified investigation.
 - Vetting by the external auditor so that the latter can rely on the proposed scope of work in the audit of an HEI's financial statements.
 - A full cooperation requirement, allowing no employee or member of management to obscure the facts that gave rise to the investigation.
 - Reporting protocols, providing the external auditors and, where appropriate, funding councils with information relevant to the investigation's findings in a spirit of cooperation and transparency.
 - Informing the relevant funding council without delay if the amount involved exceeds the threshold stated in the financial memorandum.
- 9.18 There should also be a policy as to when to involve external agencies, including the police. Institutions should be aware that they would often lose control over the issue (including the management of public relations) when the police are involved.
- 9.19 There is no doubt that fraud and other criminal activity can be a very unpleasant experience for all involved. Governors should anticipate that investigations will be lengthy, disruptive and reputationally damaging. The key point is to take action promptly and effectively.
- 9.20 Below there are governors' dilemmas that you might like to answer about things that might - or might not - be wrong in relation to audit. It is suggested that you make a note about what action you would take in each case, and compare your answers with the notes provided in Annex 3.

GOVERNORS' DILEMMAS

A GOVERNOR'S DILEMMA 1:

You have recently joined the governing body of a university. At the autumn board meeting, when the annual accounts are presented for approval, you hear that the finance director is about to retire and a lunch will follow the meeting to mark the event.

The draft annual financial statements are tabled at the meeting, along with the external auditor's opinion. The audit manager is in attendance and says that the management letter will be written later, when the partner returns from sick leave. She says that the firm values highly the long standing relationship with the university. The chair acknowledges that the auditors have always been staunch supporters of the university. The chair of the audit committee is absent and the chair of the finance committee does not speak.

The financial statements reveal a less than healthy position. There is a deficit on the income and expenditure account and a bank overdraft, and you notice quite a lot of material under the section on contingent liabilities, including the suggestion of litigation. The retiring finance director says he is happy to be leaving with the HEI looking so healthy, judged by its reserves. The vice-chancellor thanks the finance director warmly.

The agenda item to approve the accounts has taken all of five minutes, and you feel uncomfortable about the way it was handled. It is now 1.15pm and the chair is clearly ready for lunch! What do you do?

A GOVERNOR'S DILEMMA 2:

Times are hard in the HEI of which you are a governor and a number of unpleasant savings measures have been suggested by the finance director. Among them is a proposal to terminate the internal audit service provided by a professional firm on the grounds of expense. Instead, it is suggested that one of the senior finance staff should carry out the function. What might be your reaction to this suggestion and why?

A GOVERNOR'S DILEMMA 3:

You know from business contacts that several academic staff in the Department of Hypothetical Studies are engaged in private consultancy to a considerable extent and are living well in consequence. A recent internal audit review of consultancy activity has revealed little of concern. As someone who has recently become a governor of an HEI, you find this strange. How might you start to raise any concerns you have?

A GOVERNOR'S DILEMMA 4:

You notice that the external auditors' management letter makes a specific point of recording the governors' opinion that the institution is a 'going concern' ie it will survive at least the next twelve months. There has been no debate about this matter and you wonder quite what prompted the comment. What should you do if anything?

A GOVERNOR'S DILEMMA 5:

You notice in the annual financial statements that a substantial severance payment has been made during the preceding year, which has been declared in accordance with the accounts direction. However, no reference was made to it during the discussion about the statements to the governing body. From your experience, the amount looks very generous indeed. What might you do if anything?

10. SOME FUTURE DEVELOPMENTS IN AUDIT

- 10.1 Finally, just a few thoughts on some future general developments in audit that you might look out for as a governor. We are not concerned here with technical changes to undertaking audit (which will generally only involve the auditors and audit committee) but issues which will reach board level.
- 10.2 The basic work of audit will continue to be focused on the essentials of management, control and governance, but it will evolve, especially as IT systems become even more fundamental to the daily operations of institutions. The IT capacity of an audit team should be one of the key criteria in assessing their fitness to undertake an audit appointment. The days of 'tick and bash' may be gone, but the fundamental requirement to check that the records fairly reflect reality remains. Without understanding how an institution's computer systems work, it is impossible to form an opinion on that point.
- 10.3 This volume has made several references to auditors 'raising their game' by shifting some of their work away from routine checking towards consideration of strategy implementation and management quality. Risk based auditing is another aspect of this gradual movement towards a holistic and broad view of audit, which starts with the strategic plan and works down. Of course, attention must still be paid to what goes on at the point of delivery to students and other customers, but there needs to be a sensible balance between the two.
- 10.4 Under government pressure to lighten the regulatory burden, the English funding council has made some moves towards reducing the accountability burden on its HEIs. Audit visits to institutions are planned (in normal circumstances) to be shorter and less frequent. The development of reliable and sophisticated KPIs may permit more to be done away from the institution. However, some will see this trend as undesirable - most auditors would argue that there is no substitute for on site work. This enables an experienced auditor to get a feel for the quality of institutional management, attitudes towards compliance, risk taking and similar issues. Tensions are likely to remain here.
- 10.5 Wider institutional audit has grown (albeit slowly) to the point where it now forms a structured review system in some institutions. Integrating this activity with internal audit seems an obvious development, but not without its challenges in finding the right mix of staff, especially at senior level.
- 10.6 Recent events in the banking and finance world seem likely to bring fresh demands for improvements in corporate governance. This will eventually impact on HEIs and lead to added emphasis on the strength of internal controls and risk management. The annual statement on internal control in the accounts will come under the auditor's spotlight more and more.

- 10.7 Those current events will also lead to calls for closer examination by auditors of any financial transaction or arrangement which is less than straightforward eg PFI and off balance sheet structures. Auditors will spend more time making sure they understand (and the institution understands) the precise nature of the risks and potential liabilities such arrangements entail, and that they are properly recognised and quantified in the accounts.
- 10.8 Added focus will be given to statistical returns, since they often form the basis of funding. Reference has been made earlier to the need for accuracy in student statistics, which have been the subject of concern in several institutions. There are others (staff, research activity, enterprise, pensions) which may also be the subject of closer scrutiny. Extending audit work to these is a sensible precaution to consider. It is surprising to find that the finance return (to Hesa) is not usually audited. Doing it at the same time as the annual accounts would not increase costs significantly (it is mainly restating the same figures) and would be a worthwhile safeguard.
- 10.9 The higher level internal audit work referred to above is not always a strength of the major accounting firms, whose expertise lies more in the external audit field. There are specialist internal audit firms and there may be a growth in this activity. This is worth consideration when the time comes to examine internal audit arrangements.
- 10.10 Similarly, there are a few internal audit consortiums in existence in higher education and the government's promotion of shared services in public services might be the prompt for others to come into existence. This arrangement offers a good combination of independence, specialism and sustainability of service which should be worth considering.

ANNEX A: SOME KEY REFERENCES

There are several useful sources of further information on audit that can be consulted:

- a) Your funding council's audit code is essential reading. They can be found at:
- | | |
|-------------------------|--|
| England | - www.hefce.ac.uk/pubs/hefce/2006/06_24/ |
| Scotland | - www.sfc.ac.uk/information/information_gmap/financial_memorandum_jan_06 . |
| Wales | - http://194.81.48.132/FinanceAssurance_Docs/Financial_Memorandum.pdf |
| Northern Ireland | - available from the Department of Employment and Learning. |
- b) The CUC *Guide for Members of Higher Education Governing Bodies* in the UK has a short section on governors' responsibilities in relation to audit. Available from www.shef.ac.uk/cuc

The references which follow were produced mainly for audit committee members, but some sections will be worth reading by all governors:

- c) *Handbook for Members of Audit Committees in Higher Education Institutions, CUC, 2008*. A comprehensive guide for audit committee members, but particular chapters worth reading by all governors include Chapter 2, Creating an Effective Audit Committee and Chapter 12, Assessing Audit Committee Effectiveness. Available from www.shef.ac.uk/cuc, but your governing body clerk should also be able to provide a copy.
- d) *Handbook for Audit Committee Members in Further and Higher Education, 2nd Edition, Cipfa 2005*. A more concise guide covering much the same ground as the CUC publication. Available from Cipfa, or through your governing body clerk. From www.cipfa.org.uk.
- e) *Shaping the UK Audit Committee Agenda; KPMG LLP 2004* - available at <http://www.kpmg.co.uk/pubs/beforepdf.cfm?PubID=1896>. Though intended for the commercial sector, contains plenty of thought provoking material for audit committees and governors generally.
- f) The National Audit Office website contains a useful list of audit publications, including self-assessment checklists. It also has links to other useful sites. See: http://www.nao.org.uk/practice_areas/FMAG/Audit_Committees.htm

ANNEX B: ANNUAL AUDIT CYCLE

It may help to have a checklist of what an outline annual audit cycle looks like. Here is a typical cycle for the higher education financial year, which runs from August to July:

TYPICAL AUDIT ANNUAL CYCLE FOR AUDIT COMMITTEES IN HEIS

MEETING	CATEGORY	REPORT
Autumn	Recommend to board	<p>Audit committee annual report.</p> <p>Executive team report on effectiveness of internal controls.</p> <p>Letter of representation to external auditors.</p> <p>Meeting with external auditors to review their work on the financial statements.</p> <p>External auditors' management letter, including management responses.</p>
	Discussion	<p>Internal controls assurance and corporate governance statements for inclusion in annual financial statements.</p> <p>Audit committee in camera meeting with external auditors (on other occasions if appropriate).</p> <p>Annual review of both audit appointments and arrangements.</p> <p>Accounting policies used in annual financial statements.</p>
Spring	Recommend to board	<p>Annual internal audit operational plan.</p> <p>Internal audit three year strategic plan.</p>
	Information	<p>Survey of audit fees.</p> <p>Annual risk assessment by funding council.</p> <p>Annual report of regulatory compliance.</p>
Summer	Discussion and information	<p>External audit plan.</p> <p>Audit committee meeting with chief executive.</p> <p>Annual review of risk register.</p> <p>Annual training event for members.</p> <p>Review of the committee's effectiveness.</p>
Each audit committee meeting	Discussion and information	<p>Internal audit reports.</p> <p>Internal audit progress report.</p> <p>Follow up report on outstanding audit recommendations.</p> <p>Review register of members' interests.</p> <p>Review fraud register.</p> <p>Review litigation register.</p> <p>Meeting with member of executive.</p>

ANNEX C: SUGGESTED ANSWERS TO GOVERNORS' DILEMMAS

A) GOVERNORS' DILEMMAS

Dilemma 1 (page 40)

This is probably not the best time to challenge an unsatisfactory state of affairs. However, lunch provides a useful informal opportunity to test how long it's been going on like this and whether anyone else is unhappy about it. Depending on what you find and how you want to approach making an improvement, these are among the points that need attention:

- The annual financial statements should not be put on the table at the meeting - they should be available to all governors at least seven days beforehand.
- The external auditors' management letter should also be available seven days beforehand, along with management's responses and the audit committee's comments.
- If the audit partner is ill, another partner should attend; complete dependence on one person is unacceptable.
- It is not the job of external auditors to be 'staunch supporters' of the HEI; their independence is critical.
- The audit committee should have a deputy chair - or another member should have been elected to speak on this occasion.
- The chair of the finance committee should be pressed to speak by the chair of governors.
- The underlying financial position needs review - probably independently.
- Bank overdrafts are subject to recall on short notice - what are the terms?
- Governors should receive regular reports on litigation.
- You shouldn't spend reserves in this way!
- The agenda item at the governors' meeting which approves the accounts should be allocated a significant amount of time, so that a proper discussion can take place; if there is only one board meeting in the autumn term, half an hour would be ideal. One institution offers those interested an hour long briefing in greater depth before the governors' main meeting starts.

Dilemma 2 (page 40)

You shouldn't be comfortable with the proposal, because it breaches the fundamental requirement of independence. The reporting line for staff carrying out internal audit work is an issue - the finance director may be the obvious choice for work which will often have a strong financial element. But he or she will have a built in conflict of interest. Although economy will be one factor in determining the annual plan of internal audit reviews it is only one factor, and such costs are an inevitable element in sound basic management.

Dilemma 3 (page 41)

As a new governor lots of things may strike you as odd, so you will probably need to tread carefully out the outset and avoid making too many assumptions! In this case you will find that employment contracts in higher education (particularly for academic staff) tend to be very different from those elsewhere. Institutional practice concerning consultancy varies widely, and staff will often be permitted to undertake some consultancy work and keep the proceeds, provided they have institutional approval to do so. Transparency of the arrangements is perhaps the key issue here. A visit or telephone call to the HR director would be a good first step if you wanted more information.

Dilemma 4 (page 41)

You might speak to the audit committee chair or the finance director to test whether you have misinterpreted a comment. Can the latter provide you with some sector statistics, which show where your institution stands on a comparative basis? Perhaps check the previous year's management letter to see if it has actually changed, or are the auditors just covering themselves? Perhaps you might seek out a governor with a financial qualification and ask his or her view on the issue. This might be the first hint of a bigger problem ahead, so keep it in your mind as other information appears during the coming months eg the management accounts. It is good practice to tell through each item in the management letter.

Dilemma 5 (page 41)

There has been public concern about the size of some severance payments, so this is an important matter which you should pursue. A first check would be with the clerk to the governing body, to see if the institution has a policy. The funding councils have issued guidance which requires, among other things, that the external auditors review severance payments against the guidance and report the facts to governors in their management letter. In extreme cases, the auditors should report the facts to the funding council. Depending on what you discover, the matter needs to be discussed with the chair of the governing body.

²² See for example Hefce guidance at www.hefce.ac.uk/pubs/circlets/2003/cl15_03.htm and Hefcw guidance at www.hefcw.ac.uk/Finance_and_Assurance/risk_assurance.htm

ABOUT THE AUTHOR:

Michael Pearson

Spent most of his career on the finance staff at Loughborough University, becoming bursar and finance director from 1990 to 2007 where he was responsible for the financial direction and business management of the University, including estates, student residences, sports facilities and commercial operations.

In 1984, he was awarded a Commonwealth Universities Fellowship to travel overseas, and later seconded to the National Committee of Inquiry into University Efficiency (the Jarratt Committee). He was chairman of the British Universities Finance Directors' Group from 1999-2002. He currently chairs the boards of a housing association and a group of independent schools.



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