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Handbook for Members of Audit Committees in Higher Education Institutions



Committee of University Chairmen

Please note: The advice in this guide was prepared during 2007. It is provided on the basis that all persons making reference to it undertake responsibility for assessing the relevance and accuracy of its content.

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Contents

	Page
Foreword	5
Message from the CUC Chairman	6
Introduction	7
1 Good practice principles for audit committees	11
2 Creating an effective audit committee	15
2.1 Terms of reference	15
2.2 Choosing the right members	17
2.3 Financial expertise	19
2.4 Other skills, experience and personal attributes	20
2.5 Conflicts of interest	20
2.6 The audit committee chair	21
3 Running an effective audit committee	23
3.1 Setting the meeting agendas	23
3.2 Frequency and timing of meetings	23
3.3 Meeting attendees	24
3.4 In camera or private meetings	24
3.5 Identifying issues early	26
3.6 Responding to crises	26
3.7 Resources for the audit committee	27
3.8 Communication and reporting	28
4 Professional development	31
4.1 Induction for new members	31
4.2 Ongoing professional development	32
5 Oversight of financial reporting	35
5.1 Clarity around the audit committee's role	35
5.2 The year-end timetable	35
5.3 Assessing financial statements and related disclosures	36
5.4 Critical accounting policies, judgements and estimates	37
5.5 Unusual and complex transactions	37
5.6 External audit adjustments	37
5.7 Completeness, clarity and transparency	38

5.8	Keeping up to date with financial reporting developments	38
5.9	Being alert to surplus management	38
6	Oversight of governance	41
6.1	Corporate governance within the higher education sector	41
6.2	The role of the audit committee	42
7	Oversight of risk management and control	45
7.1	Responsibility for the system of risk management and internal control	46
7.2	The system of risk management and internal control	46
7.3	Reviewing the effectiveness of risk management and internal control	47
7.4	The 'regular' review process	51
7.5	The annual review exercise	52
7.6	Reporting	54
8	Fraud, misappropriation and whistle-blowing	55
8.1	Responsibilities	55
8.2	Investigations	56
8.3	The role of the audit committee	57
8.4	Whistle-blowing policy	58
9	Oversight of external audit	59
9.1	The role of the audit committee	59
9.2	Selecting, appointing and removing the auditor	60
9.3	Safeguarding the external auditor's independence	61
9.4	Understanding the audit cycle	63
9.5	Communication	64
9.6	Audit reports	66
9.7	Management letter	66
9.8	Relationship with the internal auditor	67
9.9	Monitoring the effectiveness of external audit	67
10	Oversight of internal audit	69
10.1	Internal audit	69
10.2	In-house or outsourced internal audit	70
10.3	Appointment of the internal audit function	70
10.4	Scope and terms of reference	71
10.5	Assessing the annual internal audit work plan	71
10.6	Ensuring that internal auditors have direct access to the audit committee	72
10.7	Communication and reporting arrangements	72

10.8	Monitoring the effectiveness of internal audit	73
10.9	Relationship with the external auditor	74
11	Value for money	75
11.1	The role of the audit committee	75
11.2	What is value for money?	76
11.3	An approach to determining value for money	76
11.4	A holistic approach	77
12	Assessing audit committee effectiveness	79
12.1	What does effective mean?	79
12.2	Assessing effectiveness	80
	Appendices	83
1	Audit committee: model terms of reference	83
2	Model letter of appointment for audit committee members	86
3	A framework (i.e. work plan) for audit committee meetings	88
4	Specimen year end timetable	90
5	Corporate governance questions	91
6	Audit committee annual report: model format	95
7	Example of a whistle-blowing policy	98
8	Example policy on using external auditors for non-audit services	100
9	Example policy on employing former employees of the external auditor	102
10	Model external audit report for an institution's annual financial statements	103
11	Evaluation of the external auditor	105
12	External audit: model terms of reference	108
13	Internal audit: model terms of reference	112
14	Specimen internal audit plan	115
15	Specimen internal audit report	122
16	Evaluation of internal audit	124
17	Assessment of the audit committee	133
18	Glossary of terms, abbreviations and acronyms	141
19	Bibliography	142

Foreword

In today's complex and ever-evolving world, audit committees can contribute tremendously to a 'no surprises' environment. In the higher education sector, as in any other sector, an audit committee which operates effectively should be a key feature in a strong, effective governance culture and bring significant benefits to an institution. Such committees are supported by fundamental building blocks: an appropriate structure and foundation, reasonable and well-defined responsibilities, an understanding of current and emerging issues, and a proactive, risk-based approach to its work.

Carefully designed practices can also help an audit committee to maximise its contribution to an institution. However, it is important that each governing body and audit committee should assess its own circumstances – governance structure, financial situation, maturity and issues – when building its own agenda.

Those seeking to strengthen corporate governance and enhance audit committee oversight often look for (and recommend) 'leading' or 'best' practices, and with good reason: they suggest processes, policies or approaches that work. Yet practices that work best for one organisation may not be ideal for another – especially in a governance environment where culture, risk and governance needs can vary dramatically from institution to institution. However, certain guiding principles underlie the effectiveness of every audit committee. Even as specific oversight practices evolve to address changing risks, regulatory requirements and governance needs, the right principles can help to ensure that practices are applied effectively – that is, by the right people with the right information, processes and perspectives.

Developing practices which are based on robust principles – whether terms of reference, recruiting the right members, or focused agendas and rigorous processes – is fundamental in fulfilling the audit committee's responsibilities. This handbook articulates the principles underlying the audit committee's role. It provides an array of non-prescriptive guidance to help audit committees (and those who support them) to gain a better understanding of the processes and issues that drive effective oversight of risk management, control and governance, and of economy, efficiency and effectiveness.

I hope this handbook will help audit committees throughout the higher education sector to identify and achieve their objectives and add value to governing bodies, their institutions and other stakeholders.



Ninian Watt

Chair of the Audit Committee Development Group

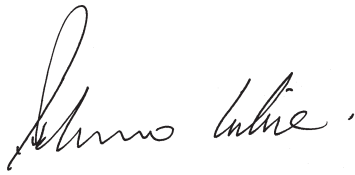
Chair of the Board of Governors, Leeds Metropolitan University

Message from the CUC Chairman

In recent years the Committee of University Chairmen (CUC) has endeavoured to ensure that those who govern UK universities have the most relevant and contemporary guides to assist them in meeting their demanding responsibilities. Those who chair, or serve on audit committees, carry particularly heavy burdens, as they are expected to provide reassurance to fellow governors, the vice-chancellor and to third parties, particularly the relevant Funding Council.

This handbook is a really valuable addition to the guidance available to the sector. It fits well into the array of guidance offered by the CUC in 2008.

I am grateful to those who have worked hard to create the handbook over many months.

A handwritten signature in black ink, appearing to read 'Andrew Cubie', with a large, stylized initial 'A'.

Dr Andrew Cubie CBE, FRSE

Chairman, CUC

Introduction

Governing bodies must ensure that they are fulfilling their responsibility for adequate and effective risk management, control and governance, and for the economy, efficiency and effectiveness (i.e. value for money (VFM)) of their institution's activities. Accordingly, governing bodies of higher education institutions are required by the institution's financial memoranda with the Higher Education Funding Council for England (HEFCE), the Scottish Funding Council and the Higher Education Funding Council for Wales (the funding councils) to appoint an audit committee. Every governing body should consider in detail whether its audit committee arrangements are best suited to its particular circumstances. Audit committee practices should be proportionate to the task, and will vary according to the size, complexity and risk profile of the institution. However, audit committees should not avoid practices simply because they appear onerous – often these are the practices that may be most effective and should receive additional attention if warranted by the circumstances.

The overriding duties of the audit committee should normally include oversight of the:

- effectiveness of the institution's risk management, control and governance arrangements, and the arrangements to promote economy, efficiency and effectiveness
- internal audit arrangements, including advising the governing body on the appointment of the internal audit provider; and oversight of the nature and scope of internal audit and the effectiveness of the internal audit process
- external audit arrangements, including advising the governing body on the appointment of the external auditor; and oversight of the nature and scope of external audit and the effectiveness of the external audit process
- audit aspects of the institution's financial statements, including the external audit opinion, the statement of members' responsibilities, the statement of internal control and any relevant issue raised in the external auditors' management letter.

The audit committee has a key role in the governance framework. It can provide additional, more specialised oversight of risk management, control and governance arrangements. However, it cannot be expected to provide meaningful advice to the governing body unless its members are independent of mind, diligent, knowledgeable, and possess relevant and reliable information. Audit committee members must be in a position to challenge management and draw attention to questionable practices – even in highly successful institutions.

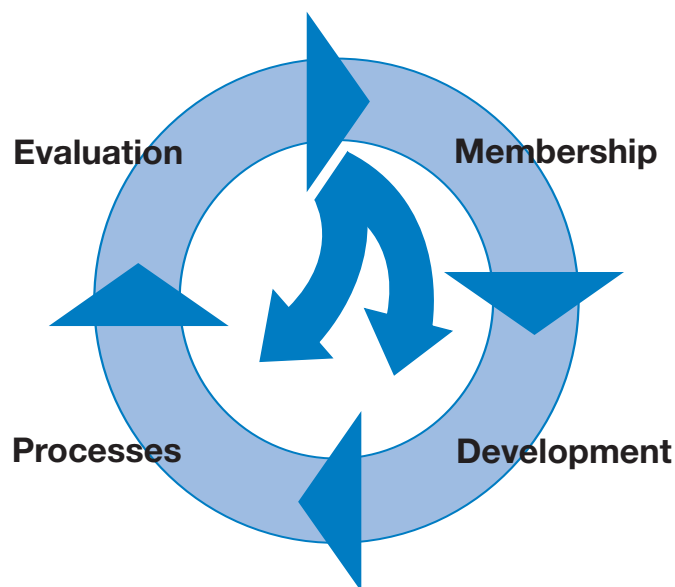
Independence is concerned with the integrity of each audit committee member. So it is not unreasonable to suggest that financial relationships with the institution, its management and auditors – whether personal, business, political or philanthropic – can threaten the independence of audit committee members and therefore their motivation to actively challenge management. Nevertheless, rather than simply meeting some checklist of independence criteria, it is imperative that audit committee members are able in practice, and not just in theory, to express views to the governing body (usually via the audit committee chair) that are, if necessary, different from those of the executive and be confident that, provided this is done in a considered way, they will be taken notice of.

Audit committees fulfil a very important role requiring considerable commitment by their members, whose role must not be perfunctory. To be fully effective, audit committee members must be diligent and prepared to invest the time necessary to understand the institution and the substance of complex arrangements and transactions, and ensure that an effective risk management process is in place and that the financial statements fairly reflect their understanding.

In an age of complexity where financial transactions and accounting standards are becoming increasingly elaborate, it is no longer possible for audit committee members to operate effectively with only a passing knowledge of audit and accounting. They must have expertise, or access to expertise, that goes beyond familiarity with financial statements. They must understand the accounting policies that underpin the preparation of financial statements, why they were chosen and how they are applied, and satisfy themselves that the end result fairly reflects their understanding. However, the skills and experience of audit committee members must also extend beyond the realms of finance. They should also have the skills that enable them to contribute effectively to the oversight of risk management, control and governance, and value for money arrangements. Integrity and probity, the ability to question intelligently and debate constructively, and the ability to challenge rigorously and decide dispassionately are some of the essential characteristics of audit committee members.

Even those members who are vigorously independent, diligent and knowledgeable will prove ineffective unless they have access to, and understanding of, all the relevant information. Audit committees are only as good as the information they receive, and are usually reliant on the executive and internal and external auditors. Audit committees should have confidence in the senior management team, and confidence that management's information systems are sufficient and effective, which brings in the role of internal auditors.

Effective audit committees are supported by fundamental 'building blocks': an appropriate structure; reasonable, well-defined responsibilities and operating processes; an appropriate understanding of current and emerging issues; and a meaningful assessment process. This might be thought of as an 'effectiveness cycle':



First, governing bodies should ensure that the right people are appointed to the committee. Appropriate competences and other attributes should be determined. If necessary, individuals who are not members of the governing body should be co-opted to the audit committee. Professional development is also essential if audit committee members are to stay abreast of current developments in regulation, best practice and the institution's operations.

Carefully designed audit committee processes and practices are also important if the committee is to maximise its contribution to the institution. By comparing its current practice with leading practices, the audit committee can identify and select a 'set' of practices as the most effective and efficient in its particular circumstances. This handbook describes a number of such practices.

Finally, the audit committee should regularly assess its own performance, with the objective of identifying areas in which its practices and processes might be more effective, and skills and/or knowledge gaps in the committee. This may lead to a request for additional training, or require the chair to begin discussions on the possible recruitment of a new member:

Many audit committees are currently operating at a high level. Nevertheless, in an effort to improve their own practices, all audit committees might benefit from comparing their practices against those described in this handbook. Of course, not all practices outlined here will apply equally to all institutions.

Although this handbook focuses on practices that audit committee members can undertake to improve their effectiveness, audit committees also need the support of the governing body, management and auditors. The governing body and management must be fully committed to building and maintaining an effective audit committee, and to working with the committee to ensure that it meets its objectives.

I Good practice principles for audit committees

This handbook contains eight good practice principles for audit committees in the higher education sector. They are summarised below and explained in more detail in the following chapters.

Principle 1: The role of the audit committee

The governing body should establish an audit committee to help it to discharge its responsibility for adequate and effective risk management, control and governance (including ensuring the probity of the financial statements) and for the economy, efficiency and effectiveness of the institution's activities.

The precise role of the audit committee is for the governing body to decide, and will vary according to the institution's needs, the skills and experience of the committee's members, the clarity of the committee's mission, and the tone set at the top of the governance structure. To the extent that the audit committee undertakes tasks on behalf of the governing body, the results should be reported to, and considered by, the governing body. In doing so, the committee should highlight any matters where it considers that actions or improvements are needed, and make recommendations as to the steps to be taken.

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to:

- monitor and review the effectiveness of the institution's risk management, control and governance arrangements
- review the audit aspects of the institution's financial statements, including the audit report, the statement of governors' responsibilities and the statement of internal control
- satisfy itself that suitable arrangements are in place to promote economy, efficiency and effectiveness (value for money)
- consider and advise the governing body on the appointment and terms of engagement of the internal audit function (and the head of internal audit, if applicable), the audit fee, the provision of any non-audit services by the internal auditors, and any questions of their resignation or dismissal
- review the nature and scope of the internal audit process and discuss with the internal auditors any problems and reservations arising from their audit, including their audit reports and any other matters the internal auditors may wish to discuss
- consider and advise the governing body on the appointment and terms of reference of the external auditors, the audit fee, the provision of any non-audit services by the external auditors, and any questions of their resignation or dismissal
- review the nature and scope of the external audit process and discuss with the external auditors any problems and reservations arising from their audit, including the external audit management letter and any other matters the external auditors may wish to discuss

- monitor annually the performance and effectiveness of external and internal auditors, including any matters affecting their independence and objectivity
- oversee the institution's policy on fraud and irregularity, including being notified of any action taken under that policy.

Principle 3: Audit committee membership and meetings

The audit committee should consist of at least three members of the governing body, and should be able to co-opt others with particular expertise or interests who are not members of the governing body. All members of the committee should be independent, objective and non-executive. The audit committee chair should be appointed by the governing body.

Audit committee meetings should coincide with key dates within the financial reporting and audit cycle, to enable the committee to make timely and influential decisions. A quorum should ideally be at least two members.

Principle 4: Skills and experience of audit committee members

The audit committee should include individuals with an appropriate mix of skills and experience to allow it to discharge its duties effectively. At least one member of the audit committee should have recent and relevant experience in finance, accounting or auditing.

Principle 5: Audit committee processes

Audit committee processes and procedures should enable the committee to discharge its duties in an economic, efficient and effective manner. The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time. The committee should have the right to obtain all the information it considers necessary and to consult directly with the internal auditors, external auditors and employees.

The governing body should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the committee reasonably believes it necessary to do so.

Principle 6: Communication and reporting

The audit committee should ensure that it communicates effectively with the governing body, head of finance (or equivalent), internal auditor, external auditor and other stakeholders. The key channel of communication is via the audit committee chair.

The audit committee should produce an annual report for the governing body and the head of institution. This report should include the committee's opinion of the adequacy and effectiveness of the institution's arrangements for risk management, control and governance, and for economy, efficiency and effectiveness (value for money). The report should describe how the audit committee has discharged its duties, and should include any significant issues arising during the financial year and the period up to the date of the report.

Principle 7: Training and development

The institution should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members, and an overview of the institution including, for example, its key risks and critical accounting policies.

Training should also be provided to members of the audit committee on an ongoing and timely basis, and should include an understanding of risk management, control, governance, finance, audit and other related matters. This process could be facilitated via the Leadership Foundation for Higher Education, for instance, through visits to the different faculties, schools and departments, or via other sources.

Principle 8: Assessment of audit committee effectiveness

The audit committee should undertake a regular review of its terms of reference and its own effectiveness, and recommend any necessary changes to the governing body.

2 Creating an effective audit committee

Principle 1: The role of the audit committee

The governing body should establish an audit committee to help it to discharge its responsibility for adequate and effective risk management, control and governance (including ensuring the probity of the financial statements) and for the economy, efficiency and effectiveness of the institution's activities.

The precise role of the audit committee is for the governing body to decide, and will vary in practice according to the institution's needs, the skills and experience of the committee's members, the clarity of the committee's mission, and the tone set at the top of the governance structure. To the extent that the audit committee undertakes tasks on behalf of the governing body, the results should be reported to, and considered by, the governing body. In doing so, the committee should highlight any matters where it considers that actions or improvements are needed, and make recommendations as to the steps to be taken.

Audit committees are established by the governing bodies of institutions to help to discharge their responsibility for adequate and effective risk management, control and governance and for the economy, efficiency and effectiveness of the institution's activities.

How the committee fulfils this mandate varies according to the abilities of its members, the clarity of the committee's mission, and the tone set at the top of the governance structure. However, certain characteristics and practices mark a strong, effective audit committee. Audit committees should review these characteristics, not as elements carved in stone, but as components in a process that can and should be continually improved to enhance the committee's effectiveness.

2.1 Terms of reference

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to:

- monitor and review the effectiveness of the risk management, control and governance arrangements
- review the audit aspects of the institution's financial statements, including the audit report, the statement of governors' responsibilities, and the statement of internal control
- satisfy itself that suitable arrangements are in place to promote economy, efficiency and effectiveness (value for money)

- consider and advise the governing body on the appointment and terms of engagement of the internal audit function (and the head of internal audit, if applicable), the audit fee, the provision of any non-audit services by the internal auditors, and any questions of their resignation or dismissal
- review the nature and scope of the internal audit process and discuss with the internal auditor any problems and reservations arising from their audit, including their audit reports and any other matters the internal auditors may wish to discuss
- consider and advise the governing body on the appointment and terms of reference of the external auditors, the audit fee, the provision of any non-audit services by the external auditors, and any questions of their resignation or dismissal
- review the nature and scope of the external audit process and discuss with the external auditors any problems and reservations arising from their audit, including the management letter and any other matters the external auditors may wish to discuss
- monitor annually the performance and effectiveness of external and internal auditors, including any matters affecting their independence and objectivity
- ensure that all significant losses have been properly investigated and oversee the institution's policy on fraud and irregularity, including being notified of any action taken under that policy.

The audit committee's terms of reference should define the scope of the committee's oversight responsibilities and how these are to be discharged. The role of the audit committee is for the governing body to decide, subject to the specific requirements of any relevant funding council. However, it is essential for the audit committee to be independent, have sufficient authority and resources to form an opinion and report on the institution's risk management, control and governance arrangements, and be able to satisfy itself that the institution has adequate arrangements for ensuring economy, efficiency and effectiveness.

The terms of reference should be tailored to the institution's specific assurance needs, mapped to any regulatory requirements and best practice recommendations. They should clearly outline the committee's duties and responsibilities, including structure, process and membership requirements. Ideally, the terms of reference should describe the background and experience requirements for committee members and set guidelines for the committee's relationship with the governing body, management, internal and external auditors, and others.

In addition, the audit committee's terms of reference should be co-ordinated with the responsibilities of other committees in the institution – finance committee, governance committee, risk management committee, and other committees focused on a particular risk (e.g. investment committee or environment, health and safety committee). These committees may be required to consider the same issue from different perspectives. Care should be taken to define clearly the roles and responsibilities of each committee, when collaboration is required, whether cross-membership is allowed, and whether the audit committee chair or members might attend other committee meetings as an observer (and vice versa).

The terms of reference should be detailed enough to clarify roles and responsibilities' and include items that can be reasonably accomplished. However, audit committees should be mindful of the implications of accepting unrealistic workloads and responsibilities that rightfully reside with the governing body as a whole. The audit committee is not a body that makes binding decisions in its own right: the committee exists exclusively to assist the governing body in discharging its responsibilities.

To ensure that audit committee effectiveness is maintained and improved, the audit committee and the governing body should review and formally approve the committee's terms of reference on an annual basis. A robust annual assessment of the audit committee's responsibilities and its terms of reference should highlight any changes to the institution's circumstances and any new regulations or leading practices that may affect the committee's responsibilities.

Audit committee: model terms of reference can be found at Appendix 1. These model terms of reference are intended to assist audit committees in creating or updating their own terms of reference for their specific circumstances. They should serve as a guide in establishing the audit committee's work plan and meeting agendas.

2.2 Choosing the right members

Principle 3: Audit committee membership and meetings

The audit committee should consist of at least three members of the governing body, and should be able to co-opt others with particular expertise or interests who are not members of the governing body. All members of the committee should be independent, objective and non-executive. The audit committee chair should be appointed by the governing body.

Audit committee meetings should coincide with key dates within the financial reporting and audit cycle, to enable the committee to make timely and influential decisions. A quorum shall be at least two members.

2.2.1 Terms of appointment

All members of the audit committee should have a clear understanding of:

- what is expected of them in their role (including time commitments)
- how their individual performance will be appraised (including a clear understanding of what would be regarded as unsatisfactory performance and the criteria that would indicate the termination of membership)
- the duration of their appointment and how often it may be renewed.

The terms of appointment of an audit committee member should be clearly set out at the time of appointment. A model letter of appointment is set out at Appendix 2. The letter should also specify what other activities the individual may or may not undertake in relation to the institution.

2.2.2 How many members?

The size of the audit committee will vary depending on the needs and culture of the institution and the extent of responsibilities delegated to the committee by the governing

body. Too many members may stifle discussion and debate. Too few may not allow the committee chair to draw on sufficient expertise and perspectives to make informed decisions. Committees of three to five individuals are generally most appropriate.

An audit committee should generally consist of at least three members of the governing body, and should be able to co-opt others with particular expertise or experience who are not members of the governing body. A co-opted member should not normally be appointed as the committee's chair, since the chair has to be able to attend, as of right, all meetings of the governing body. Where this is unavoidable, arrangements should be made to ensure that the chair has full access to the governing body for reporting purposes. Subject to this, co-opted members should have equivalent status on the audit committee to full governing body members. The committee should have the right, whenever it is satisfied that this is appropriate, to go into confidential session and exclude any or all other participants and observers.

As co-opted members are appointed only to the audit committee and not the governing body, they will have to make particular efforts to obtain and maintain an appropriate understanding of the institution. In this respect, appropriate induction training is critical, as is an ongoing programme of activity to ensure that members maintain sufficient appropriate contact with the organisation. Where appropriate, co-opted members should be copied in on the minutes of the governing body and the papers prepared for meetings of the governing body.

Appointments to the audit committee, including co-option arrangements, should be transparent and should be made by the governing body on the recommendation of the nomination committee, in consultation with the chair of the audit committee. Terms of three years, with staggered expiration dates to help to ensure continuity, are common.

2.2.3 Rotation policy

Rotation of audit committee members can provide a practical way to refresh and introduce new perspectives to audit committee processes. Rotation also creates the opportunity for more members of the governing body to gain a greater and first-hand understanding of the important issues dealt with by the audit committee, thus contributing to greater understanding on the governing body. However, given the complex nature of the audit committee's role, rotation needs to be balanced with the desire to have members who possess the necessary skills and experience to discharge their responsibilities effectively.

2.2.4 Independence

The governing body should endeavour to ensure that all audit committee members are independent and objective. Employees of the institution and the chair of the governing body are generally not considered independent, and should therefore not be members of the audit committee.

The governing body should clearly understand any regulatory or funding council definitions of independence, and how a lack of independence occurs and is interpreted in practice. The governing body should also be aware of situations in which commonly held definitions of independence are met, yet perceived conflicts of interest may still arise. When determining the independence of an audit committee member, the governing body might consider whether any material relationships or circumstances are likely or could appear to affect the person's judgement. Such relationships and circumstances may occur if the individual:

- has been an employee of the institution within the last five years

- has, or has had within the last three years, a material business relationship with the institution, either directly or as a partner, shareholder, director, consultant or senior employee of a body which has such a relationship with the institution
- has close family ties with any of the institution's advisers, officers or senior employees
- has significant links with any of the institution's auditors, advisers, officers or senior employees through involvement in other bodies.

Audit committee members should not generally be members of a finance committee or its equivalent. This is because the audit committee needs the independence to be able to challenge the finance committee. Hence members should not be compromised by being involved in executive decisions which are then potentially open to audit comment. Cross-representation might, in exceptional circumstances, be appropriate where the following conditions are met:

- the audit committee has at least three members (not counting co-optees)
- the person serving on both committees is not the chair of either
- in institutions which have a treasurer, that person does not serve on both committees (albeit this individual might attend the meetings of both committees).

Notwithstanding the above, consideration might be given to audit committee members attending finance committee meetings by invitation, as observers and vice versa.

2.3 Financial expertise

Principle 4: Skills and experience of audit committee members

The audit committee should include individuals with an appropriate mix of skills and experience to allow it to discharge its duties effectively. At least one member of the audit committee should have recent and relevant experience in finance, accounting or auditing.

Audit committee members should (at least as a group) possess a wide range of knowledge, skills and personal attributes, including sound judgement, integrity and high ethical standards; strong interpersonal skills; and the ability and willingness to challenge and probe.

At least one audit committee member should have recent and relevant experience in finance, accounting or auditing. What constitutes such experience will, of course, vary from institution to institution, and each governing body should determine its own criteria. In many cases, 'recent and relevant experience' must clearly go beyond basic familiarity with financial statements. Members must be able to understand the rules and, more importantly, the principles underpinning the preparation of the financial statements and auditors' judgements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen and how they are applied, and satisfy themselves that the end result fairly reflects their understanding. As such, past employment experience in a significant financial role or one that included oversight responsibilities for financial reporting, or a qualification in finance or accounting might be appropriate.

While financial literacy is a great asset for an audit committee member, not every member need have recent and relevant experience in finance, accounting or auditing. Indeed, there is great value in having committee members from diverse backgrounds who are not afraid to ask simple questions such as 'Why is that the case?', 'What would one expect to see?' and 'Tell me again because I still don't understand'. These are good questions which, through human nature, are sometimes not asked by more financially literate audit committee members. Nevertheless, the committee as a whole must possess sufficient financial acumen to discharge its responsibilities effectively.

2.4 Other skills, experience and personal attributes

In determining who should sit on the audit committee, the governing body (perhaps via a nominations committee) should not lose sight of the fact that the committee's remit is much broader than financial audit. The audit committee's approach should always be risk-based, and therefore its remit encompasses aspects of governance, risk management and control as well as the economy, efficiency and effectiveness of the institution's activities. It is important that the audit committee does not rely solely on the institution's executive officers to provide it with advice on such matters. Equally, it may be beneficial for members to have experience in areas pertinent to the institution and the specific circumstances in which it operates. For example, including academics from other institutions on the audit committee may help the committee to draw its conclusions as to whether certain governance, risk or control processes will be easily embedded within the fabric of the institution.

When determining the composition of the audit committee, it is also important to balance experience in a number of different areas with a wide range of knowledge, skills and personal attributes such as:

- sound business judgement
- integrity and probity
- the ability to question intelligently and debate constructively
- the ability to challenge rigorously and decide dispassionately
- being trusted and respected by other governing body and committee members.

In some circumstances, it may be more appropriate to co-opt individuals with specific skill sets onto the audit committee rather than trying to draw expertise from members of the governing body. Alternatively, the audit committee should be empowered to procure specialist advice at the expense of the institution on an ad-hoc basis to support it in relation to particular pieces of committee business.

2.5 Conflicts of interest

A mechanism is needed for all audit committee members, including co-opted members, to declare any matter in which they have an interest. Normally, the process for recording declarations of conflicts of interests in the audit committee should mirror that used by the governing body. Each member of the committee should take personal responsibility for declaring proactively at the outset of each meeting any potential conflict of interest relating to business arising on the committee's agenda or from changes in the member's personal circumstances. The chair of the audit committee should then determine an appropriate course of action with the member. For example, the member might simply be asked to leave while a particular item of business is taken, or in more extreme cases the member could be

asked to step down from the committee. If it is the chair who has a conflict of interest, the governing body should ask another member of the committee to lead in determining the appropriate course of action. A key factor in determining the course of action is the likely duration of the conflict of interest: a conflict likely to endure for a long time is more likely to indicate that the member should step down from the committee.

2.6 The audit committee chair

The essential characteristics of a strong committee chair are often personal attributes. Chairs should be recognised for their leadership and vision, and be perceived by other committee members and management as able to set and manage the audit committee's agenda. The chair should be acknowledged as having the personal courage to raise and deal with tough issues and support other members to do the same.

Formal meetings of the audit committee are at the heart of its work. They are not, however, its only point of contact with the institution. The audit committee chair and, to a lesser extent, the other members need to keep in touch with the governing body chair, vice chancellor (VC) or principal, head of finance (or equivalent), external audit partner and internal auditor, and senior members of those audit teams. In many institutions, the audit committee chair meets regularly with each of these individuals as part of the process of developing the meeting agenda and preparing for each meeting. A successful audit committee chair not only understands the importance of the committee's relationships with these individuals, but also has the interpersonal skills to build and maintain effective working relationships.

The audit committee member with the most recent and relevant experience in finance, accounting or auditing is often the right choice for audit committee chair. However, this need not be the case. The chair's role is not to do all the work; rather, the chair should engage the other members in the work of the committee and ensure that their contributions are maximised and effective.

3 Running an effective audit committee

Principle 5: Audit committee processes

Audit committee processes and procedures should enable the committee to discharge its duties in an economic, efficient and effective manner. The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time. The committee should have the right to obtain all the information it considers necessary and to consult directly with the internal auditors, external auditors and employees.

The governing body should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the committee reasonably believes it necessary to do so.

3.1 Setting the meeting agendas

A detailed work plan helps to keep the committee focused. It is good practice for the audit committee agenda to be set with input from those officers with whom the committee has significant contact, in particular the head of finance (or equivalent) and the internal and external auditors. In some institutions the clerk and the secretary to the committee also play a significant role in setting the audit committee agenda. The chair of the audit committee, however, should maintain accountability for the agenda and not delegate it to management.

Meeting agendas ultimately drive the work that the committee does. For this reason, agendas should be carefully linked to the audit committee's terms of reference, and map across to significant related requirements and persuasive recommendations such as those provided by funding councils and others (e.g. the audit codes of practice of the funding councils and the Committee of University Chairmen (CUC) Guide for Members of Higher Education Governing Bodies in the UK (2004)).

A detailed work plan helps audit committee members to stay focused on their role. However, the nature of audit committee responsibilities and the ever-changing environment in which higher education institutions operate may make it difficult to determine a fixed agenda of topics for each meeting. The committee should assess what is currently important and develop its agenda accordingly, where necessary restricting agenda items to those that require consideration or a decision by the committee. A framework for what could be covered in each meeting for an audit committee that meets four times a year can be found at Appendix 3.

The secretary to the audit committee should ensure that the committee receives the meeting agenda and supporting materials in a timely manner, to enable committee members to give full and proper consideration to the issues. This would usually be at least one week prior to the meeting.

3.2 Frequency and timing of meetings

The audit committee should meet as often as its role and responsibilities require. In practice, most audit committees within the higher education sector meet around four times a year.

Timing meetings to coincide with key dates within the financial reporting and audit cycle enables the audit committee to make timely and influential decisions. Equally, having sufficient time available at each meeting is critical. The committee must be able to cover all agenda items, hold as full a discussion as may be required, and enable all parties to ask questions or provide input. There should be sufficient time for audit committee members only to have a private session at each meeting (if necessary).

An appropriate interval should be allowed between audit committee meetings and other related meetings (such as those of the governing body or finance committee) to allow any work arising from the audit committee meeting to be carried out and reported on as appropriate.

3.3 Meeting attendees

No one other than the audit committee members should be entitled to attend any meeting of the audit committee. The audit committee itself should decide who ought to attend any particular meeting (or part of a meeting). However, it may choose to invite specific governors, officers or members of other committees because of their specific knowledge and perspective on the issues being discussed.

Many audit committees invite, when appropriate, the head of the institution, head of finance (or equivalent), head of operations, the person co-ordinating risk management, and representatives from internal and external audit to attend committee meetings. The vice chancellor often has valuable insights to share about the challenges facing the institution, but the chair of the audit committee should ensure that the head of institution's presence does not inhibit open discussion at the meeting. Other individuals who may attend audit committee meetings at a number of institutions include the secretary/clerk. However, when inviting attendees, the audit committee chair should be mindful of the primary purpose of the meeting and not allow it to become so large as to inhibit discussions among the audit committee members.

In practice, the chair and other members of the finance committee rarely attend audit committee meetings. Likewise, the chair and other members of the audit committee rarely attend finance committee meetings. In certain circumstances there may be some merit in a representative of each committee observing meetings of the other committee – especially those at which draft annual audited financial statements are reviewed prior to approval by the governing body – because of the complementary nature of the work of both committees. However, independence considerations generally preclude members of the audit committee from being formal members of the finance committee.

Notwithstanding the audit committee's right to decide who ought to be entitled to attend any particular meeting, the internal and external auditors should have unrestricted right of access to the audit committee and/or its chair and the right to ask the chair to convene a meeting if necessary.

3.4 In camera or private meetings

A number of audit committees hold meetings (or parts thereof) with only the formal committee members present (i.e. no officers attending). Holding such meetings in camera gives the members a good opportunity to discuss any issues or concerns among themselves, and positions them to better understand and challenge management and the auditor at the audit committee meeting.

It is also good practice to hold separate in camera or private meetings with the internal and external auditors. Frequently, such sessions are held at the end of the scheduled audit committee meeting. The executives are asked to leave, and the committee then invites comments from, and asks questions of, the representatives from internal and external audit.

A private session where management is not present arguably reinforces the independence of the audit committee and allows it to ask questions on matters that might not have been specifically addressed as part of the audit. It allows auditors to provide candid, often confidential, comments to the audit committee on such matters. However, the audit committee chair should manage such private sessions carefully as they introduce a lack of transparency, in that executives do not hear about any problems or issues first hand and may not be given an opportunity to respond. This in turn may cause them to feel excluded and even defensive. Introducing such sessions as part of the regular process might alleviate some of these tensions.

Typically, there should be few such items to discuss in camera. Nevertheless, it is useful to have a process in place should issues arise. All key matters related to risk management, financial reporting and internal control should usually be reviewed in a candid, robust manner with the executives, audit committee and auditor during the audit committee meeting. The audit committee can use the private session as a follow-up if members are not satisfied with the answers given at the committee meeting, or if they thought the discussions were too guarded or uneasy. However, it is preferable to air such matters fully at the audit committee meeting, so they do not need to be readdressed in the private session.

The following is a list of illustrative questions that the audit committee might choose to ask the auditor during the private session. It is not exhaustive, but is intended to stimulate thought as to the type of issues that could be raised. Typically, each private session might address a few matters that may vary from meeting to meeting, in addition to any matters of current concern.

Attitudes

- Do senior managers successfully set an appropriate ethical tone?
- Is there a positive management approach to risk management and internal control systems and procedures?
- Do managers respond positively to audit recommendations and their timely implementation?
- What do you believe are the reasons management did not adjust for the uncorrected audit differences?
- Does management have plans to correct these audit differences in the future?
- Was management fully supportive of the corrected audit differences?
- What is your assessment of the quality of the institution's financial reporting?
- How does this institution's attitude towards financial reporting compare with other institutions?

Resources

- Do the institution's accounting staff and internal audit function have the appropriate number of people?

- Do these people have a sufficiently broad range of knowledge and experience to be able to deal with the types of transactions faced by the institution?
- Are these people competent for their position? Do you have any concerns?
- Has management adequately responded to your prior management recommendations?
- Are there other areas where internal audit should focus its activities?

Relationships

- Did you receive full co-operation during the audit and did you get full answers to all questions that were asked?
- Was any information withheld from you?
- Was management forthcoming in discussions with you?
- Do you enjoy effective relationships with management at all levels?
- What was the nature of any consultations held with other accountants or auditors?

Other issues

- Did you receive everything you requested on a timely basis?
- Did you have adequate time to carry out all your audit procedures?
- Is the audit fee set at an appropriate level?
- On what area was the most amount of audit time spent?
- What were the two or three issues you spent the most amount of time discussing with management?

3.5 Identifying issues early

Questions of substance should not be raised for the first time at the year-end audit committee meeting. Serious problems may result if there are unexpected answers. If the year-end audit committee meeting is to be conducted effectively, the chair should be communicating with the head of finance (or equivalent) as well as the internal and external auditors during the weeks before the meeting. The chair should also bring matters of potential concern to the attention of audit committee members ahead of time. The relationship with both internal and external audit should be such that any serious concerns are brought to the audit committee's attention promptly, but in a non-adversarial way.

An effective annual plan for meeting agendas can help the audit committee to identify issues and discuss them as early as possible during the year.

3.6 Responding to crises

Institutions may, from time to time, get into difficulty. These may be associated with fraud, 'black holes' in the budget, industrial action by staff, failure to meet a key piece of legislation (e.g. health and safety) or many other reasons. On such occasions, the governing body acting through executive management is responsible for recovery. Nevertheless, the audit committee is ideally placed to advise, provide appropriate oversight and deal with outside agencies.

The audit committee should consider the key processes and policies required to determine when to undertake an internal investigation, and ensure that any investigation is sufficient in scope and objective and is thorough.

Who would participate in the investigation? What disclosures would be required or advisable? Who would lead the investigation? How would an independent legal counsel or outside expert be selected? To what extent should the investigation be documented? These and other essential aspects of an internal investigation should form part of a robust action plan, which can be invaluable in guiding the investigation to a timely, credible and conclusive result – particularly when faced with time pressures.

Independent investigations may be required when, for example:

- an institution is unable to meet its requirements under its financial memorandum
- an institution is required to restate its accounts either by prior adjustments or by revision
- fraudulent activity or other misconduct is alleged
- a regulatory inquiry has been launched.

When the governing body (on the advice of the audit committee) determines that an independent investigation is required, the following factors can be essential to establishing the credibility of the investigation:

- conducting the investigation in an objective and timely manner
- employing outside experts – such as legal counsel and forensic accounting professionals – who are truly independent and appropriately qualified (such experts can help to define the scope of the investigation and ensure the immediate preservation of electronic and other evidence)
- considering external auditor involvement, including what communications and updates may be appropriate (the external auditor may conduct its own parallel or ‘shadow’ investigation)
- managing the flow of information among the appropriate parties at the appropriate points in the investigation, while ensuring that the information is not shared with individuals who may be implicated (thereby tainting the investigation)
- making timely and accurate disclosures to regulators, funding councils and others, as appropriate or required
- documenting key processes, findings and remedial actions taken (as recommended by legal counsel)
- investigating the matter until the audit committee is fully satisfied that all relevant issues have been addressed.

Audit committees should also be regularly apprised of the legal and regulatory issues that arise during an investigation, including financial reporting deadlines and necessary disclosures.

Approaching accounting investigations in a proactive manner can offer important advantages. An internal corporate investigation can allow the institution to ‘take control’ of a potentially negative situation and effectively manage the flow of information and the pace and direction of the investigation. A well-managed internal investigation may also result in a shorter and less disruptive external inquiry.

3.7 Resources for the audit committee

The audit committee should be provided with sufficient resources to undertake its duties and make effective use of its time.

Internal audit is likely to be the single most significant resource used by the audit committee in helping the governing body to discharge its responsibilities. The relationship between the audit committee and the internal audit function is discussed in Chapter 10.

The audit committee should have a secretary – normally the clerk to the governing body or some other independent person. In determining the secretary to the committee, the governing body should consider whether the proposed secretary has significant financial or other senior management responsibilities that might impair, or be seen to impair, the independence of the individual.

The secretary should support the committee in all audit committee matters, including supporting the chair in planning the committee's work and drawing up meeting agendas, maintaining minutes, drafting material about the committee's activities for the annual report, co-ordinating the timely collection of supporting papers and distributing them, and other support as needed. As noted earlier, the chair must maintain the committee's independence while securing the necessary input and support from management. The institution via the governing body should also make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the committee reasonably believes it necessary to do so.

3.8 Communication and reporting

Principle 6: Communication and reporting

The audit committee should ensure that it communicates effectively with the governing body, head of finance (or equivalent), internal auditor, external auditor and other stakeholders. The key channel of communication is via the audit committee chair.

The audit committee should produce an annual report for the governing body and the head of institution. This report should include the committee's opinion of the adequacy and effectiveness of the institution's arrangements for risk management, control and governance and for economy, efficiency and effectiveness (value for money). The report should describe how the audit committee has discharged its duties, and should include any significant issues arising during the financial year and the period up to the date of the report.

The audit committee needs to have open, timely communications with the governing body if it is to assist the governing body effectively in discharging its responsibility for adequate and effective risk management, control and governance and for the economy, efficiency and effectiveness of the institution's activities.

The minutes of each audit committee meeting should be prepared on a timely basis and copied to the chair of the governing body. The minutes should be prepared in such a manner as to clearly:

summarise the work undertaken by the audit committee, explaining if necessary the importance of the work and any conclusions drawn or actions taken

advise the chair of the governing body on any matters relevant to the governing body, including any matter on which the audit committee believes the governing body should be taking action.

Audit committee minutes are normally copied to the head of internal audit and the external audit partner. Further communications with external and internal audit are covered in chapters 9 and 10.

The audit committee should also produce an annual report for the governing body and the head of institution, timed to support preparation of the statement of internal control for inclusion in the published financial statements. The audit committee's annual report must include the committee's opinion of the adequacy and effectiveness of the institution's arrangements for risk management, control and governance and for securing value for money. Further information about the annual report is included in chapter 7.

4 Professional development

Principle 7: Training and development

The institution should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members, and an overview of the institution including, for example, its key risks and critical accounting policies.

Training should also be provided to members of the audit committee on an ongoing and timely basis, and should include an understanding of risk management, control, governance, finance, audit and other related matters. This process could be facilitated via the Leadership Foundation for Higher Education, for instance, through visits to the different faculties, schools and departments, or via other sources.

All audit committee members will have professional development needs. New members, particularly those without prior audit committee experience, will need some form of induction to help them to understand the institution and their role within it. Existing audit committee members will also have ongoing development needs, such as understanding new regulation, accounting or auditing standards, or the implications of changes in the institution's strategy or risk profile.

4.1 Induction for new members

It is common practice to provide a formal induction programme for new audit committee members. This helps to ensure that they understand their responsibilities, current issues and the intricacies of the particular institution. The programme may include meetings with senior management, briefings by the institution's auditors and site visits; the objective is to give new members an insight into the institution and, among other things, its key governance and risk and control issues. Given the complex nature of the audit committee's role, additional time may be spent with new audit committee members to ensure that they are aware of their particular responsibilities and the expectations of the governing body.

The induction programme might include:

- briefings on the audit committee's responsibilities, including its oversight and reporting duties
- briefings on how the committee fits into the institution's governance structure, including its relationship with the governing body, finance committee and other key committees; the management team, including the head of finance or equivalent; and the internal and external auditors
- briefings about the institution and its operations and financial reporting processes, including its key mechanisms for ensuring effective governance, risk management and control
- briefings on the role and responsibilities of internal and external audit

- briefings on the fundamental concepts of financial reporting, including the critical accounting policies selected by the institution and current audit and financial reporting issues, including significant accounting policies and estimates, unusual transactions, outstanding contingencies and litigation
- site visits to understand better the institution's operations and its key officers
- an introduction to the internal and external auditors.

Written materials should support any oral presentations, so that new audit committee members have appropriate reference materials and tools as a result of the induction programme. It would be reasonable to provide new audit committee members with:

- the institution's instrument and articles of governance (or equivalent)
- the financial memorandum
- the relevant Code of Audit Practice, CUC guidance and other relevant material from funding councils
- the committee's terms of reference, recent committee minutes, annual work plan and any presentations to the board
- relevant policies, including the institution's code of conduct and whistle-blowing policy
- a summary of the institution's risk register
- the internal audit terms of reference, work plan and recent reports to the audit committee
- the external auditor's work plan, the most recent year-end report to the audit committee and the most recent management letter
- the most recent financial and governance statements
- the latest annual report prepared by the audit committee for the governing body and the head of institution
- the latest funding council audit report or other relevant evaluation
- any management and/or audit reports on the effectiveness of governance, risk management and control
- any management and/or audit reports on the economy, efficiency and effectiveness of the institution's activities
- any recent press releases.

Newly appointed board members may feel overwhelmed if they are given all the necessary information on their first day. It is important that the audit committee chair, or appointed person, plans a new member's induction so that the programme is staggered over an appropriate time frame. After a suitable period of time has elapsed, new members should be given an opportunity to review the induction programme to ensure that it has met their needs.

4.2 Ongoing professional development

The environment in which higher education institutions operate is constantly changing, whether through new regulations and funding council requirements, new partnerships entered into by the institution, the impact of new technology or simply changes in financial

reporting and auditing standards. It is essential that audit committee members have sufficient training to enable them to keep abreast of such developments. The committee chair, in consultation with the governing body, should monitor the needs and opportunities for ongoing professional development.

All members should seek periodic continuing professional education both inside and outside the audit committee. The secretary to the audit committee might be tasked with ensuring that appropriate training opportunities are made available to audit committee members, whether in-house briefings or externally organised seminars. The most common means of updating the audit committee is through briefings by internal and external audit, the audit committee chair, the secretary, the clerk, the vice chancellor and the head of finance. In addition, many members attend external courses and conferences and ensure that they are familiar with relevant circulars issued by the funding councils and CUC.

Co-opted members have to make particular efforts to obtain and maintain an appropriate understanding of the institution. Induction training and an ongoing programme of activity to ensure that co-opted members maintain sufficient appropriate contact with the institution are both critical. Where appropriate, co-opted members should be copied in on the minutes of the governing body and the papers prepared for the meetings of the governing body.

5 Oversight of financial reporting

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to: ...

- review the audit aspects of the institution's financial statements, including the audit report, the statement of governors' responsibilities and the statement of internal control...

The audit committee is responsible for reviewing, on behalf of the governing body, the audit aspects of the institution's financial statements. Audit committees need to be clear about this role and ensure that it is consistent with the role of the finance (or equivalent) committee.

5.1 Clarity around the audit committee's role

Audit committees generally focus on the audit and control aspects of the financial statements, paying particular attention to:

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

Matters of primary concern to the finance (or equivalent) committee generally include accounting principles and their application, management's critical accounting judgements and estimates, and necessary disclosures, as well as financial strategy.

Clarity around the audit committee's role in relation to the financial statements and how it differs from the role of the finance committee is more important than the precise delineation between the two roles. In practice, different institutions adopt different practices. This is particularly apparent in relation to 'critical accounting policies', 'compliance with accounting standards' and 'disclosure', where either the audit committee or the finance committee might take the prime responsibility. Even where the audit committee does not exercise prime oversight responsibility over an area such as 'critical accounting policies', it is still likely to be actively engaged in understanding the key issues and whether the financial statements reflect that understanding.

Notwithstanding the independence considerations that preclude audit committee/finance committee cross-membership, each committee has a clear interest in the debate and discussions undertaken by the other. There should be good lines of communication between the two committees, and consideration given to audit committee chairs attending meetings of the finance committee as observers, and vice versa.

5.2 The year-end timetable

If the audit committee is to make an effective contribution, it should review the final draft version of the audited annual financial statements (i.e. after consideration by the finance

committee) prior to their approval by the governing body. An appropriate interval should be left between the audit committee meeting at which the committee recommends approval of the financial statements and the governing body meeting at which the financial statements are approved. This allows any work arising from the audit committee meeting to be carried out and reported as appropriate.

An example year-end timetable is given at Appendix 4.

Any delays in preparing and auditing the financial statements should be followed up by the audit committee, as they might indicate underlying problems within the finance function or external audit process.

To perform their role effectively, audit committee members need to understand the context for financial reporting, and in particular:

- management's responsibilities and their representations to the committee
- management's remuneration plan, especially any incentive arrangements
- the external auditor's responsibilities under generally accepted auditing standards
- the nature of critical accounting policies, judgements and estimates
- unusual transactions.

Audit committees should be confident that they are being made aware of any relevant accounting policy or disclosure issues or changes, and that this information is communicated to them early enough to enable appropriate action to be taken. A two-way dialogue between the audit committee and the head of finance/finance committee should be considered. Many audit committees also look to the external auditor for support, using the auditor's insights to help to identify potential issues early and assist the committee to oversee the quality and reliability of the institution's financial information.

5.3 Assessing financial statements and related disclosures

Management – not the audit committee or the external auditor – is responsible for preparing complete, accurate financial statements and disclosures in accordance with generally accepted accounting principles and other applicable rules and regulations. The audit committee needs to understand and assess these financial statements and related information. The audit committee's relationship with management, the finance committee and the external auditor should allow, where necessary, a full, frank and timely discussion among the parties, covering all material issues.

At the core of the audit committee's discussions with management and the external auditor should be its assessment of the appropriateness of the institution's accounting policies, underlying judgements and estimates, and the transparency of the financial disclosures in reflecting financial performance. The discussion should consider the numerous qualitative factors that can affect financial statements.

5.4 Critical accounting policies, judgements and estimates

The audit committee needs to understand and assess the quality, not just the acceptability, of critical accounting policies, judgements and estimates by asking such questions as:

- How appropriate is management's selection of accounting principles and critical accounting policies?
 - Have they changed in the current period? Why have they changed?
 - How might the changes affect current and future financial statements?
- What are management's judgements and critical accounting estimates?
 - What are the key assumptions behind those estimates?
 - How sensitive are current and future financial statements to changes in those assumptions?
 - What is the relative degree of aggressiveness or conservatism in the resulting estimates?
 - Is there potential management bias in developing the estimates?
- What are the alternative accounting treatments?
 - What are other institutions doing in similar circumstances, based on publicly available information?
- Is the external auditor satisfied that the accounting policies, judgements and estimates made by management, and approved by the finance committee, reflect an appropriate application of generally accepted accounting practice?

5.5 Unusual and complex transactions

The audit committee should assess the treatment of any unusual or complex transactions, and should consider asking the above questions in terms of the accounting policies, judgements and estimates relating to such transactions, as well as transaction-related questions such as:

- What is the business rationale?
- Is the transaction disclosed in the financial statements?
- What is the effect on the comparability of financial condition and performance among past and future periods?
- What are the factors affecting the accounting for any unusual transaction?
- How appropriate and clear is the disclosure regarding any commitments, contingencies and uncertainties associated with the unusual transaction?

5.6 External audit adjustments

The audit committee should review the external auditor's recommended audit adjustments and disclosure changes, focusing on both the adjustments and changes made by management and those that management has not made.

To establish a framework for these reviews, the audit committee should:

- tell the external auditor and management what audit differences the committee wants to hear about – material audit differences or a broader definition
- convey its expectations that the external auditor will promptly identify, discuss with management and the audit committee, and recommend audit adjustments and disclosure changes
- understand the reason behind any mis-statements
- encourage management to adjust for all audit differences.

5.7 Completeness, clarity and transparency

Overall, the audit committee needs to assess the completeness, clarity and transparency of the financial statements and related disclosures, by asking such questions as:

- Do the financial disclosures consistently reflect the institution's financial performance?
- How clear and complete are the financial statement note disclosures?
- What are other institutions doing, based on publicly available information?

Management and the external auditor can greatly assist the audit committee in understanding and assessing these matters by providing the committee with clearly written communications, augmented with face-to-face discussions.

5.8 Keeping up to date with financial reporting developments

The audit committee should consider the impact on the financial statements of any changes to accounting standards or generally accepted accounting practices. Audit committees should satisfy themselves that:

- management has sufficient resources devoting appropriate attention to understanding recent developments in financial reporting
- the application of new requirements is appropriate in light of the nature of the institution's operations and significant transactions.

To keep their knowledge up to date, audit committees should consider asking management and/or the external auditor to describe and explain recent developments in financial reporting. What is required is more than a general update. Audit committee members must clearly understand if and how the developments or changes will affect the institution. Ideally, the audit committee should be briefed before any changes come into effect.

Audit committee members must also stay abreast of changes in areas such as funding regulations and other regulatory matters, corporate law and risk management, and business trends. These development needs can be met by attending external courses and conferences, roundtables or discussion forums; through self-study and reading; or by web-based learning.

5.9 Being alert to surplus management

The audit committee must remain alert to inappropriate surplus management. Inappropriate practices might include questionable revenue recognition; inappropriate deferral of expenses; misuse of the materiality concept; and misconstrued recognition, reversal or use of provisions and allowances without events or circumstances to justify such actions.

Accounting standards do not produce financial statements that are 'right' in the sense that there is only one possible answer; application of the standards can sometimes produce a range of possible answers. For example, valuations and estimates – which inevitably require judgement – are needed for many elements of the financial statements, particularly for transactions that span the year-end or several years (such as retirement benefits and major capital projects). The audit committee should enquire about the basis used by management when making significant judgements.

Estimates in accounting are required because of the uncertainty inherent in many transactions. No matter how carefully estimates are made, revisions to some of them may prove necessary from time to time. Revisions should be based on new developments, subsequent experience or new information. The audit committee should enquire into changes in estimates to ascertain the degree to which management bias (if any) is evident.

6 Oversight of governance

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to:

- monitor and review the effectiveness of the risk management, control and governance arrangements...

In accordance with their financial memoranda, higher education institutions must have effective risk management, control and governance arrangements. Other public bodies also have an interest in these control arrangements, including Parliament and, where applicable, the Learning and Skills Council (LSC), the Research Councils, the Department for Employment and Learning in Northern Ireland (DEL) and the Training and Development Agency for Schools (TDA).

Governing bodies are responsible for ensuring that proper governance arrangements are in place. However, audit committees have a key role in that they should assess the institution's governance arrangements and advise the governing body on their effectiveness.

6.1 Corporate governance within the higher education sector

Corporate governance as applied to a higher education institution is the system by which the institution is directed and controlled in the interests of its stakeholders. The issue of oversight of governance is twofold: it concerns both the effectiveness and the accountability of governing bodies.

The effectiveness of governing bodies, and therefore the quality of leadership and direction they provide, is measured by performance and ultimately by enhanced value for the institution's stakeholders. Governing bodies are entrusted with funds, both public and private, and as such are accountable for the stewardship of those funds and have a responsibility to discharge their duties with due regard to the proper conduct of public business (i.e. the Nolan Principles). This includes ensuring and demonstrating integrity and objectivity in the transaction of their business, and wherever possible following a policy of openness and transparency in the dissemination of their decisions.

The Nolan Principles: The seven principles of public life

The 'seven principles of public life' defined by the Nolan Committee provide the framework within which public bodies should conduct their affairs.

Selflessness: Holders of public office should act solely in terms of the public interest. They should not do so in order to gain financial or other benefits for themselves, their family or their friends.

Integrity: Holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might seek to influence them in the performance of their official duties.

Objectivity: In carrying out public business, including making public appointments, awarding contracts or recommending individuals for rewards and benefits, holders of public office should make choices on merit.

Accountability: Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.

Openness: Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.

Honesty: Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.

Leadership: Holders of public office should promote and support these principles by leadership and example.

Source: *First Report of the Committee on Standards in Public Life, May 1995*

Against this background, the sector has devised a framework of rules, regulations and voluntary codes of practice. These seek to minimise the risks of over-prescription, while at the same time providing a robust governance framework tailored to the specific needs of the higher education sector and individual institutions.

The Committee of University Chairmen publications *Guide for Members of Higher Education Governing Bodies in the UK* (2004) and *Monitoring of Institutional Performance and the Use of Key Performance Indicators* (2006) are perhaps the main sources of guidance on governance arrangements within the higher education sector. This guidance is aimed at governors of higher education institutions in the UK and other interested parties. It sets out good practice across the sector and proposes a voluntary code of practice and general principles to which, it is hoped, all institutions will be able to subscribe.

Though the CUC guidance is voluntary, institutions are encouraged to state that they have had regard to the code, and to provide an explanation in the corporate governance statement of their annual audited financial statements where their practices are not consistent with particular provisions of the code.

6.2 The role of the audit committee

The governing body is ultimately responsible for corporate governance within an institution. However, the audit committee plays a key role in assessing the institution's governance arrangements and advising the governing body on the effectiveness of those arrangements. The role is one of oversight and to a large extent the committee will be advised by the work of internal audit, the external auditor's management report, and its informal discussions with both internal and external audit.

The audit committee should understand the institution's legal status and the constitutional arrangements governing its operation. It should also understand the processes by which the governing body satisfies itself that the Nolan Principles have been adhered to and that conflicts of interest are identified, disclosed and managed.

When assessing the effectiveness of the institution's corporate governance arrangements, in addition to reviewing reports from management and internal and external audit, audit committees may wish to consider the questions set out at Appendix 5 and request any assurances they might deem appropriate.

7 Oversight of risk management and control

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to:

- monitor and review the effectiveness of the risk management, control and governance arrangements...

Governing bodies are responsible for ensuring that proper arrangements are in place for adequate and effective risk management and control. Audit committees have a key role in that they should assess the risk management and control and governance arrangements within the institution and advise the governing body on the effectiveness of such arrangements. Audit committees also receive, and advise the governing body of, any risk assessments carried out by the funding councils or other external agencies.

It is important that risk management and control are not seen as a burden on the institution, but rather the means by which opportunities are maximised and potential losses associated with unwanted events reduced.

Risks manifest themselves in a range of ways and the effect of risks crystallising may have a positive as well as a negative outcome for the institution. It is vital that those responsible for the stewardship and management of an institution be aware of the best methods for identifying and subsequently managing such risks.

Internal controls are one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptably risky activities. Institutions can accept risk, but need to do so objectively and transparently and within the governing body's policy regarding risk appetite.

The risks facing institutions are continually changing and the system of internal control should be responsive to such changes. Effective risk management and internal control are therefore reliant on a regular evaluation of the nature and extent of risks.

Successful risk management is the process that achieves the most efficient combination of controls necessary to provide reasonable assurance that the institution's objectives can be achieved reliably.

7.1 Responsibility for the system of risk management and internal control

The governing body is ultimately responsible for the system of risk management and internal control. Although governing bodies normally delegate to management the task of establishing, operating and monitoring the system, they cannot delegate their responsibility for it.

The governing body should ensure that management sets appropriate policies for risk management and internal control, and regularly assure itself that appropriate processes are

functioning effectively to monitor the risks the institution is exposed to, and that the internal control system is effective in reducing those risks to an acceptable level. It is essential that the right tone is set at the top of the institution – the governing body should send out a clear message that control responsibilities must be taken seriously.

In determining its policies with regard to risk management and internal control, and thereby assessing what constitutes a sound system, the governing body should consider the:

- nature and extent of the risks facing the institution
- extent and categories of risk it regards as acceptable for the institution to bear
- likelihood of risks materialising
- institution's ability to reduce the incidence and impact of materialised risk
- cost of control relative to the benefit obtained in managing the related risks.

Ultimate responsibility for the risk management and internal control system rests with the governing body, but all staff have some accountability towards implementing the governing body's policies on risk and control. Management is responsible for implementing the policies adopted by the governing body. In fulfilling these responsibilities, management should identify and evaluate the risks faced by the institution, and design, operate and monitor an appropriate system of internal control.

7.2 The system of risk management and internal control

An effective risk and control system encompasses the policies, processes, tasks, behaviours and other aspects of an institution that, taken together, facilitate its effective and efficient operation, help to ensure the quality of internal and external reporting, and help to ensure compliance with applicable laws and regulations. An institution's system of internal control commonly comprises the following:

- **Control environment.** The control environment provides discipline and structure. Factors include the integrity, ethical values and competence of the institution's people; management's operating style; the way authority and responsibility are assigned; and the attention and direction provided by the governing body.
- **Identification and evaluation of risks and related controls.** Risk assessment is concerned with identifying and evaluating those risks that threaten the achievement of the institution's objectives.
- **Control activities.** Control activities are the policies and procedures which help to ensure that necessary actions are taken to address those risks that threaten the achievement of the institution's objectives.
- **Information and communication processes.** Information must be identified, captured and communicated in a timely manner and in a form that enables people to carry out their responsibilities.
- **Processes for monitoring the effectiveness of the internal control system.** The performance of the system of internal control should be assessed through ongoing monitoring activities, separate evaluations such as internal audit, or a combination of the two.

7.3 Reviewing the effectiveness of risk management and internal control

7.3.1 Responsibility for reviewing the effectiveness of risk management and internal control

The governing body is ultimately responsible for the system of risk management and internal control and for reviewing its effectiveness. Management is accountable to the governing body for developing, operating and monitoring the system of risk and control and for providing day-to-day assurance to the governing body that it has done so.

Aspects of the review work are usually delegated to the audit committee, which may seek assurances from appropriate committees such as a risk committee or health and safety committee. These committees may be sub-committees of the governing body. Alternatively, they may include representatives from throughout the institution (e.g. a risk committee may include representatives from management and other assurance functions).

The audit committee, however, has a key role in assessing the institution's risk management, control and governance arrangements, and advising the governing body on the effectiveness and outcomes of these arrangements. Furthermore, the audit committee must form an opinion on the effectiveness of the institution's risk management, control and governance arrangements, with appropriate reference to the internal and external auditors, for inclusion in its annual report to the governing body. As a result, the audit committee provides a single focal point for the wider review of internal control and the proposed statement for inclusion in the annual report prior to approval by the governing body.

To assess properly the adequacy of the institution's risk management and control arrangements, the audit committee needs to establish:

- how key business risks are identified, evaluated and managed
- the rigour and comprehensiveness of the review process.

The audit committee's role is, however, a non-executive one. In enquiring into these matters it is not seeking to take on an executive function that properly belongs to management. Instead, it is aiming to satisfy itself that management has properly fulfilled its responsibilities.

7.3.2 The process for reviewing effectiveness

An institution's system of risk management and internal control has as its principal aim the management of risks that threaten the achievement of the institution's objectives. Therefore, in order to have effective risk management and control processes, an institution needs to:

- identify its objectives
- identify and assess the risks that threaten the achievement of those objectives
- design internal controls and strategies to manage/mitigate those risks
- operate the internal controls and strategies in accordance with their design specification
- monitor the controls and strategies to ensure that they are operating correctly.

The governing body, acting on the advice of the audit committee, should review the effectiveness of the system of risk management and internal control, and report that it has done so in the statement of internal control included in the published financial statements.

7.3.3 Identifying objectives

The governing body should identify all the strategic business objectives that are key to the institution's success. By making these explicit, the likelihood of overlooking significant risks which threaten the survival of the institution or could lead to a significant impact on its performance or reputation will be reduced.

Linking the identification of key business risks to the institution's strategic objectives may already be part of the normal calendar of work supporting the strategic planning and budgeting process. It is important to ensure that this process is sufficiently balanced in its appraisal of the financial and non-financial risks.

7.3.4 Risk identification

The audit committee should review the process by which the institution's significant risks are identified and ensure that the governing body is aware of the significant risks facing the business.

Significant risks facing institutions might be:

- failure to attract and retain high-quality students
- maintaining excellence in research and teaching – Research Assessment Exercise 2008
- unpredictable government funding policy
- reduced grant income
- capital spend – e.g. estate not fit for purpose and does not support financial and academic objectives, estate development costs out of control
- systems – management information inadequate and failing to identify potential problems
- escalating salary bill and long-term staff costs
- joint ventures
- succession planning
- failure to communicate vision to stakeholders
- reputation.

7.3.5 Risk assessment

When assessing risk, management should consider the underlying gross risks, which are the risks faced by the institution before any form of control, not merely the risks which are currently exposed after existing controls. This enables evaluation of potentially critical controls and any significant under/over control.

For each identified risk, a value judgement must be made as to the impact – both financial and reputational – its crystallisation would have on the institution and the likelihood of the risk occurring. It is particularly important to consider the reputational impact as well as the financial or operational impact, since the consequence of a risk crystallising may go beyond the initial financial/operational impact. The effect on an institution's reputation may over the medium term have a far greater cost than the perceived initial impact.

The process for assessing risks should:

- be clear and transparent
- assess both the probability of the risk occurring and its likely impact
- apply causation analysis to identify the root cause of risk
- acknowledge that risks can have single or multiple causes and single or multiple impacts. These interdependencies can be critical in identifying the real impact of risks, and hence the cost-benefit analysis applied to their mitigation.

For those risks that are controllable, the institution must decide whether to accept them or whether to mitigate the risk through control procedures. For those risks that cannot be controlled, the governing body must decide whether to accept them or whether to withdraw from or reduce the level of activity concerned.

The audit committee may want to ask:

- Does the institution have clear objectives and have they been communicated so as to provide effective direction to staff on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
- Are significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis?
- Do management and others within the institution have a clear understanding of what risks are or are not acceptable to the governing body?

7.3.6 Identification of appropriate controls

Internal controls should be used to maintain the risks facing the institution within the defined risk tolerance levels set by the governing body, bearing cost-benefit considerations in mind.

The audit committee may not know the fine detail of how all risks which could lead to a material loss are controlled, but should satisfy itself that proper control policies, procedures and activities have been established and are operating as intended. Controls may be both preventative and detective.

The audit committee may want to ask:

- Does management have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks? Has the governing body been consulted?
- Do the institution's culture, code of conduct, human resource policies and performance reward systems support its objectives and the risk management and internal control system?
- Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the institution?

- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the institution appropriately co-ordinated?
- Does the institution communicate to its staff what is expected of them and the scope of their freedom to act? This may apply to areas such as health, safety and environmental protection; security of tangible and intangible assets; expenditure; accounting; and financial and other reporting.
- Do staff have the knowledge, skills and tools to support achievement of the institution's objectives and to manage effectively risks to their achievement?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

7.3.7 Monitoring of controls

Procedures for monitoring the appropriateness and effectiveness of the identified controls should be embedded within the normal operations of the institution. Although monitoring procedures are part of the overall system of control, such procedures are largely independent of the elements they are checking.

Examples of monitoring procedures include:

- *Management self-assessment reviewed and tested by internal audit.* Such self-assessment needs to be carefully managed. Management already has an implicit responsibility for the design and operation of the system of internal controls, and self-certification is a means of formalising this responsibility.

Self-certification may not be sufficient on its own, as the right amount of independent challenge may not be built into the process. The results should be independently reviewed (for example, by internal audit) on behalf of the governing body or audit committee. This independent review should challenge the:

- completeness of the institutional objectives covered
 - process for identifying and assessing the associated risks
 - design and operation of the key mitigating controls
 - process for reporting any excess of residual risk beyond defined risk tolerance levels
 - process for reporting any significant over/under control.
- *Internal audit visits on a cyclical basis.* Although internal audit should maintain independence from management, it can perform more than just a monitoring role. In many institutions internal auditors also act as facilitators and internal advisers to management on effective means of controlling operational risk. Internal audit arrangements naturally vary, but have the potential to play a central role within the monitoring process.
 - *Special reviews by external auditors or specialists on a cyclical basis.* Responsibility for reviewing and concluding on the effectiveness of internal control rests with the

governing body. However, the external auditors are likely to have useful knowledge and access to specialist consultants with expertise in specific aspects of risk management and control evaluation. Such procedures are outside the scope of the statutory audit, but could be provided as part of a separate engagement. Before any such review takes place, care must be taken to ensure that there are no circumstances which could potentially impair the independence and objectivity of the external audit.

While effective monitoring throughout the institution is an essential component of a sound system of internal control, the governing body cannot rely solely on embedded monitoring processes to discharge its responsibilities. The governing body, with the assistance of the audit committee, should regularly receive and review reports on internal control and be informed about how the reviews giving rise to the reports have been undertaken.

In addition, the governing body – again supported by the audit committee – should undertake an annual assessment exercise for the purposes of making its statement in the annual report. This is to ensure that it has considered all significant aspects of internal control for the accounting period and the period up to the date of approval of the annual report and accounts.

The governing body should define the process to be adopted for its review of the effectiveness of internal control, and ensure that it is provided with appropriately documented support for its statement on internal controls in the annual report and accounts. Much of this support will come from the audit committee, which in turn will base its opinion on the work of the internal and external auditors. The governing body also needs to consider the scope and frequency of the reports it receives during the year, together with the process for its annual assessment.

The audit committee may want to ask:

- Do management and the governing body receive timely, relevant, reliable reports on progress against the institution's objectives and the related risks that provide them with the information needed for decision-making and review purposes?
- Are information needs and related information systems reassessed as objectives and related risks change, or reporting deficiencies are identified?
- Are periodic reporting procedures effective in communicating a balanced, understandable account of the institution's position and prospects?
- Are there established channels of communication (e.g. whistle-blowing) for individuals to report suspected breaches of laws or regulations or other improprieties?

7.4 The 'regular' review process

The reports from management and/or others qualified to prepare them in accordance with agreed procedures should provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in the areas covered. Any significant control failings or weaknesses identified should be discussed in the reports, including the impact they have had, could have had, or may have on the institution and the actions being taken to rectify them.

It is essential to have a frank, open dialogue between management and the audit committee and governing body on matters of risk and control.

When reviewing reports during the year, the audit committee/governing body should:

- Consider the significant risks and assess how they have been identified, evaluated and managed. The governing body must satisfy itself that all the significant risks threatening the achievement of business objectives have been identified, assessed and controlled within its defined risk tolerances.
- Assess the effectiveness of the related system of internal control in managing the significant risks, having particular regard to any significant failings or weaknesses that have been reported.
- Consider whether appropriate action is being taken on a timely basis to remedy any significant failings or weaknesses. It is not sufficient for the governing body to satisfy itself that weaknesses are being identified. It must also consider the remedial actions taken and whether such steps are appropriate.
- Consider whether the findings indicate a need for more extensive monitoring of the internal control system. Where a weakness identified in one area of the institution may be duplicated in other areas, it may be appropriate for the governing body to commission a more comprehensive review. Alternatively, the governing body may consider that the degree of risk involved or the potential for control breakdown warrants further investigation.

7.5 The annual review exercise

The annual assessment should consider the issues dealt with in the reports reviewed during the year, together with additional information necessary to ensure that the governing body has taken account of all significant aspects of internal control for the institution's accounting period and the period up to the date of approval of the annual report and accounts.

The annual assessment should consider:

- Changes since the last review in the nature and extent of the significant risks and the institution's ability to respond effectively to changes in its operations and external environment. The governing body should review the institution's activities and operational structure to identify changes that might alter the risk profile. The ability to respond effectively to changed circumstances is vital.
- The scope and quality of management's ongoing monitoring of risks, the system of internal control and, where applicable, the work of the internal audit function and other assurance providers. The governing body should consider whether management's approach to ongoing monitoring of the internal control system covers the key risks to the institution in what it believes to be an appropriate cycle and with a level of diligence it deems satisfactory. The internal audit function may provide significant additional comfort, as long as it has sufficient resources and authority to be effective.
- The extent and frequency of communications with the governing body, enabling it to build up a cumulative assessment of the state of control in the institution and the effectiveness with which risk is identified and managed. The governing body should consider whether it receives the output from the monitoring process regularly enough to be able to form a timely opinion of the ongoing effectiveness of the process. If the

governing body does not receive, review and act upon the results of the monitoring on a timely basis, strategic decision-making may be impaired.

- The incidence of significant control failings or weaknesses identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have a material impact on the institution's performance or reputation. The governing body will want to reflect on the incidence of control weaknesses occurring during the period and the effect those weaknesses have had, could have or still may have on the institution's results.
- The effectiveness of the reporting process. The efficiency of the year-end reporting process from all areas of the organisation will provide an indication of the level of management control throughout the organisation.

Should the governing body become aware at any time of a significant failing or weakness in internal control, it should determine how this failing or weakness arose and reassess the effectiveness of management's ongoing processes for designing, operating and monitoring the system of internal control.

The audit committee may want to ask:

- Are there ongoing processes embedded within the institution's operations, and addressed by senior management, that monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews.)
- Do these processes monitor the institution's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, business and external environment?
- Are there effective follow-up procedures to ensure that appropriate modification or action occurs in response to changes in risk and control assessments?
- Is there appropriate communication to the governing body (and committees) on the effectiveness of the ongoing monitoring processes for risk and control matters? This should include reporting any significant failings or weaknesses on a timely basis.
- Are there specific arrangements for management to monitor and report to the governing body on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the institution's reputation or financial position.

7.6 Reporting

Principle 6: Communication and reporting

...The audit committee should produce an annual report for the governing body and the head of institution. This report should include the committee's opinion of the adequacy and effectiveness of the institution's arrangements for risk management, control and governance, and for economy, efficiency and effectiveness (value for money). The report should describe how the audit committee has discharged its duties, and should include any significant issues arising during the financial year and the period up to the date of the report.

The audit committee must produce an annual report for the governing body and the head of institution. This annual report must cover the financial year and include any significant issues up to the date of preparation of the report. The audit committee annual report should normally be submitted to the governing body before the members' responsibility statement in the annual financial statements is signed.

The audit committee annual report must include the committee's opinion of the adequacy and effectiveness of the institution's arrangements for risk management, control and governance as well as its arrangements for securing value for money (i.e. economy, efficiency and effectiveness, see chapter 11). The risk management element includes the accuracy of the statement of internal control included with the annual statement of accounts.

The audit committee's opinion should be based on the information presented to it, including internal audit's work on the adequacy and effectiveness of the institution's system of risk management, internal control and governance. The audit committee should also consider any reports on the operation of risk management and control received from senior management, the external auditor's management letter; any specific value for money work, and any assessments performed by funding councils or other relevant evaluations.

Further guidance on the content of the audit committee annual report can be found at Appendix 6.

8 Fraud, misappropriation and whistle-blowing

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to:

- oversee the institution's policy on fraud and irregularity, including being notified of any action taken under that policy.

The governing body plays an important role in the oversight and implementation of controls to mitigate the risk of fraud and misappropriation – not only in monetary terms but also intellectual property rights, inappropriate use of an institution's assets by employees, staff identity and qualifications and other matters. The governing body's duty is not only to ensure that an institution has systems and controls in place to address the risk of wrongdoing, but also to make sure that such controls are effective.

As a practical matter, governing bodies typically delegate principal oversight of the risk of fraud and irregularity to the audit committee, which is tasked among other things with:

- reviewing and discussing issues raised during the institution's assessment of the risk of fraud and irregularity
- reviewing and discussing with the internal and external auditors findings on the quality of the institution's anti-fraud systems and controls
- establishing procedures for the receipt and treatment of questions or concerns regarding possible improprieties in accounting, auditing and other matters.

8.1 Responsibilities

Direct responsibility for anti-fraud efforts should reside with a member of the senior management team, such as the chief financial officer or another officer with specific compliance duties. This person should be responsible for co-ordinating the institution's approach to the prevention of fraud and misconduct, detection and response. When fraud and irregularity issues arise, this individual can draw together the right resources to deal with the problem and make necessary operational changes. The compliance officer may also co-ordinate the institution's risk assessment efforts in this area by:

- establishing policies and standards of acceptable practice
- overseeing the design and implementation of anti-fraud programmes and controls
- reporting to the governing body and/or audit committee on the results of the institution's fraud risk management activities.

Other people such as department heads should also participate in responsibilities under the institution's anti-fraud strategy, overseeing areas of daily operations in which risks arise.

Department heads can serve as subject-matter experts to assist the compliance officer in their particular areas of expertise or responsibility.

The internal audit function is a key participant in anti-fraud activities, supporting management's approach to preventing, detecting and responding to fraud and irregularity. Typically, internal audit is tasked with:

- planning and conducting evaluation of the design and operating effectiveness of anti-fraud controls
- assisting in the institution's fraud risk assessment and helping to draw conclusions as to appropriate mitigation strategies
- reporting to the audit committee on internal control assessments, audits, investigations and related activities.

It should be noted that the external auditors have a duty to report in writing to the head of institution any serious weaknesses, fraud, irregularities or accounting breakdowns they come across in the normal course of their duties. If the head of institution refuses to make a report, the auditors should write to the governing body and the accounting officer of the funding councils without delay.

8.2 Investigations

When information relating to actual or potential fraud and irregularity is uncovered, management should be prepared to conduct a comprehensive and objective internal investigation. The purpose of such an investigation is to gather facts leading to a credible assessment of the suspected violation, so that management can decide on a sound course of action.

By conducting an effective internal investigation, management can address a potentially troublesome situation and have an opportunity to avert a potentially intrusive external investigation. A well-designed investigative process will typically include the following attributes, among others:

- 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 little or no ties to the institution's management team, who can perform an unbiased, independent and qualified investigation
- vetting by the institution's external auditor so that the latter can rely on the proposed scope of work in the audit of the institution's financial statements
- a full co-operation 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 co-operation and transparency.

Based on a number of factors, including the nature of the potential illegal act, parties involved and materiality, an institution may decide to use one or more of the above steps. Management should consult with the appropriate oversight functions and internal protocols to determine the steps that best address the allegation.

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.

8.3 The role of the audit committee

How can the audit committee ensure that appropriate procedures are in place to minimise the risk of losses arising from fraud? Unpalatable though it may be, the audit committee has to address the risk of fraud head-on. Identification of the risk of losses arising from fraud, through diagnostic studies of the risk of fraud and misconduct within the institution, should be considered an important first step. The audit committee should question whether management has considered those risks likely to have greatest financial, reputational or regulatory impact on the institution. This should include identifying fraud risks and a rigorous assessment of any relevant internal controls and their ability to prevent and/or detect fraud.

The audit committee should determine whether a consistent approach is taken across the institution, whether those risks assessed as high are dealt with appropriately, and whether management is engaged in the process.

It is important that staff at all levels receive some training in fraud awareness relevant to their role. A common theme arising from the investigation of many frauds is that countless people in the affected organisation knew or suspected that irregularities were occurring, but were not given the skills to identify the signs of fraud or provided with an opportunity to communicate their concerns. The audit committee should enquire as to whether the institution has an effective awareness programme which is updated as appropriate and provided in a relevant format to different levels of management and staff (including new joiners).

The audit committee is not involved in day-to-day management, and therefore not closely involved with the detail of matters related to fraud and improper activities. However, it can usefully focus attention on the need for proper policies and procedures to help in preventing fraud. In some institutions the governing body may delegate this role to an 'ethics committee'.

The audit committee should question whether appropriate policies have been issued and whether they are user-friendly and adopted throughout the institution. Policies which might be considered include a fraud response plan and a whistle-blowing policy (see below). The committee should consider not just whether these policies are appropriate, but whether they are effective and how management has confirmed this. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action – i.e. an oversight role.

The committee should ensure that management is providing clear direction to the institution on fraud, and requesting and receiving relevant information on suspected fraud and risks.

The following are, among other factors, sometimes seen as symptomatic of a potential for fraud to occur:

- overly dominant senior executives with unfettered powers
- frequent changes in finance or other key personnel, auditors or other professional advisers
- implausible explanations as to surpluses, or projections that are too good to be true

- individuals who have expensive lifestyles or habits that are potentially at variance with the remuneration they receive from the institution
- over-complicated corporate structures involving havens of secrecy.

8.4 Whistle-blowing policy

When reviewing whistle-blowing procedures, the audit committee should consider the following:

- Are whistle-blowing procedures documented and communicated throughout the institution?
- Does the policy make clear that it is both safe and acceptable for staff and students to raise concerns about wrongdoing?
- Were whistle-blowing procedures arrived at through a consultative process? Do staff buy in to the process?
- Are concerns raised by staff and students responded to with a reasonable time frame?
- Are procedures in place to ensure that all reasonable steps are taken to prevent the victimisation of genuine whistle-blowers?
- Are there procedures to ensure that all reasonable steps are taken to keep the identity of whistle-blowers confidential?
- Has a senior person been identified to whom confidential concerns can be disclosed? Does this person have the authority and determination to act if concerns are not raised with, or properly dealt with, by department heads?
- Are success stories publicised?
- Do department heads understand how to act if a concern is raised? Do they understand that staff and students have the right to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle-blowing procedure?

An example of a whistle-blowing policy is set out at Appendix 7.

9 Oversight of external audit

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to: ...

- consider and advise the governing body on the appointment and terms of reference of the external auditors, the audit fee, the provision of any non-audit services by the external auditors, and any questions of their resignation or dismissal
- review the nature and scope of the external audit process and discuss with the external auditors any problems and reservations arising from their audit, including the management letter and any other matters the external auditors may wish to discuss
- monitor annually the performance and effectiveness of external and internal auditors, including any matters affecting their independence and objectivity..

The primary role of external auditors within the higher education sector is to report on the financial statements of the institution, carrying out whatever examination of the statements and underlying records and control systems is necessary to form their opinion of the statements. Their report should also confirm that, in all material respects, funds provided by the funding council have been properly applied to the relevant purposes and in accordance with the requirements of the financial memorandum.

Institutions may ask external auditors to provide services beyond the scope of audit of the financial statements, including special investigation work, taxation compliance and advice, consultancy and value for money reviews. Generally, it is a matter for the institution and the auditors to agree precise requirements, although the audit committee must be informed of all significant facts and matters that bear on the auditors' objectivity and independence. Any additional work must not impair the independence of the audit function, so it should normally be the responsibility of different staff within the firm of auditors. An example policy for non-audit services is set out at Appendix 8.

9.1 The role of the audit committee

The audit committee assists the governing body by providing independent oversight over external audit. Specifically, the audit committee should:

- consider and advise the governing body on the appointment and terms of reference of the external auditors, the audit fee, the provision of any non-audit services by the external auditors, and any questions of their resignation or dismissal
- review the nature and scope of the external audit process and discuss with the external auditors any problems and reservations arising from their audit, including the management letter and any other matters the external auditors may wish to discuss
- monitor the performance and effectiveness of external and internal auditors each year, including any matters affecting their independence and objectivity.

The committee also needs to ensure that it exercises appropriate oversight over the audit of subsidiaries as well as the institution itself. Where the same firm audits both subsidiary entities and the institution, the audit committee should review the nature, scope and results of the external audit process with the 'group' auditor. Similar considerations apply where subsidiary entities are audited by different auditors. Here, the audit committee needs to satisfy itself that the group auditor is factoring into the audit plan significant subsidiary audit risks, and that appropriate audit evidence is sought.

9.2 Selecting, appointing and removing the auditor

The duties of the audit committee have to be determined in light of an institution's needs, but normally include making recommendations to the governing body on the appointment, reappointment and removal of the external auditor. The audit committee's recommendation to the board should be based on its assessment of the qualifications, expertise, resources and independence of the auditor and the effectiveness of the audit process.

The qualifications required for external auditors of higher education 'corporations' are set out in paragraph 59(b) of Schedule 8 of the Further and Higher Education Act 1992. For other institutions, the requirements are the same as under the Companies Act 2006. The same auditor must not provide both internal and external audit services, as this can lead to loss of objectivity.

The audit committee should approve the terms of engagement set out in the auditor's engagement letter and recommend the compensation to be paid to the auditor in respect of their services. In doing so, the committee should satisfy itself that the level of fees for the audit is appropriate and that an effective audit can be conducted for such a fee. The respective funding councils provide details of their expectations regarding the content of engagement letters. Any significant departures from these expectations should be agreed with the relevant funding council before agreeing the letter.

9.2.1 Reappointment of external auditors

Institutions should reappoint external auditors on an annual basis. Each year the audit committee should assess the auditors' work to ensure that it is of a sufficiently high standard and represents value for money. The committee should then make a recommendation to the governing body regarding reappointment of the auditors. Performance measures could be used as part of the assessment. Provided the auditors' performance is satisfactory, it is not necessary to repeat the full selection process each year. However, it is good practice to undertake a competitive tendering process at least every seven years. Such tendering exercises are often overseen by a panel drawn from members of the audit committee and governing body, supported by an officer of the institution. Following a recommendation by the panel, the audit committee proposes that the governing body approve the appointment. Before making the recommendation, consideration is normally given to a range of factors, including:

- understanding of the institution's risks and needs
- proposed fee and value for money considerations
- perceived value added
- experience of sector and existing client list
- staff experience and number of planned partner/senior staff hours.

One partner in the audit firm – the engagement partner – is normally responsible for the institution’s audit. The appropriateness of that partner continuing as the engagement partner should be considered by the firm and audit committee at regular intervals, but in any case this person should not hold the position for more than five continuous years. Anyone who has acted as an engagement partner should not hold any position of responsibility in relation to the audit until another five years have elapsed. Any other audit partner who has significant involvement in the audit engagement (key audit partner) should not hold such a position for longer than seven continuous years, nor return to such a position until a further two years have elapsed.

9.2.2 Removal or resignation of auditors

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

External auditors who have resigned or been removed from office for whatever reason should be entitled to attend, and make representations to, the governing body general meeting at which their term of office would have expired, or at which it is proposed to fill the vacancy caused by their resignation or removal. They are generally entitled to receive notices of, or other communications relating to, that meeting and to be heard on any part of the business which concerns them as former auditors of the institution.

Where auditors cease to hold office for any reason, they should provide the governing body with a statement of any circumstances connected with their removal which they consider should be brought to the governing body’s attention, or a statement that there are no such circumstances. The audit committee should investigate the issues giving rise to such resignation and consider whether any action is required. If necessary, the audit committee chair should ensure that each member of the governing body has a copy of the auditors’ statement.

The funding council should be notified promptly of any change of external auditors.

9.3 Safeguarding the external auditor’s independence

The external auditor should remain independent and objective. At least annually, the audit committee should consider the external auditor’s independence and carry out procedures to help to ensure the auditor’s independence and objectivity, taking into consideration relevant UK professional and regulatory requirements. For its part, the audit firm should have properly monitored internal policies and procedures in place to establish that the firm and its individual members are independent from the institution.

In considering matters that may impair the auditor’s independence, the auditor and the audit committee should both examine whether conflicts exist, covering such areas as:

- the auditor holding a financial interest, either directly or indirectly, in any of the institution’s associated bodies
- the personal and business relationships of the auditor’s immediate family, close relatives and partners with the institution
- the nature of the relationship between the audit partner and the institution’s officers, in particular the head of institution and the head of finance (or equivalent)
- the economic dependence of the auditor through its relationship with the institution

- the nature and extent of services provided by the auditor in addition to the audit engagement.

Each year the audit committee should obtain from the audit firm information about its policies and processes for maintaining independence and monitoring compliance with relevant requirements, including those regarding the rotation of audit partners. The audit committee should understand the firm's plans for audit partner rotation on its engagement.

9.3.1 Employment of former employees of the external auditor

The audit committee should agree on a policy for the employment of former employees of the external auditor. Particular attention should be paid to individuals who were part of the audit team before moving directly to the institution. The committee should monitor the application of the policy, including the number of former employees of the external auditor currently employed in senior positions in the institution, and consider whether (in light of their employment) there has been any impairment, or appearance of impairment, of the auditor's judgement or independence.

An example policy on employing former employees of the external auditor can be found at Appendix 9.

9.3.2 Pre-approving non-audit services

To help to ensure that non-audit services provided by the auditor do not impair, or appear to impair, the auditor's independence or objectivity, the audit committee should develop a policy on the provision and pre-approval of all non-audit services. In determining this policy, the committee should consider the skills and experience of the audit firm, potential threats to the auditor's independence and objectivity, and any controls put in place by the institution and the auditor to mitigate such threats. In principle, the committee should not agree to the auditor providing a service if the result is that:

- The audit firm or a member of the engagement team has a financial or other interest that might cause them to be reluctant to take action that would be adverse to the interests of the firm or a member of the engagement team (self-interest threat).
- The results of the non-audit service performed by the audit firm may be included in the institution's financial statements, and thus not subject to proper audit review (self-review threat).
- The auditor undertakes work that involves making judgements and taking decisions which are the responsibility of management (management threat).
- The audit firm undertakes work that involves acting as advocate for the institution and supporting a position taken by management in an adversarial context (advocacy threat).
- The auditor is predisposed, for example because of a close personal or family relationship, to accept or not sufficiently question the institution's point of view (familiarity threat).
- The auditor's conduct may be influenced by fear or threats (intimidation threat).

The audit engagement partner should inform the audit committee of all significant facts and matters bearing on the auditors' objectivity and independence, including those related to the provision of non-audit services, and any safeguards in place.

The pre-approved policy devised by the audit committee should formally specify the types of non-audit work from which the external auditor should be excluded, and the types of work for which the external auditor can be engaged. It may be appropriate for the policy to allow pre-approval for certain types of work, detailed as to the particular service, perhaps subject to a fee limit determined by the audit committee. The pre-approval policy may also require that some or all non-audit services be approved by the audit committee, or by one or more of its members, on a case-by-case basis. The subsequent provision of any service by the auditor should be presented for review at the next meeting of the audit committee. The extent of any non-audit work should be disclosed in the institution's financial statements.

An example policy on the appointment and remuneration of external auditors for audit and non-audit work can be found at Appendix 9.

9.4 Understanding the audit cycle

The audit committee needs to understand the scope of the audit and how it is to be approached. An effective way to achieve this is to hold a meeting with the auditor prior to the auditor's finalising the audit plan. The discussions may uncover areas where the committee assumes that work is done but is not, and other areas where audit effort is directed but of which the committee may be unaware. Discussion should also focus on what the auditor considers to be the significant balances and the transactions posing the most risk.

The committee should determine that an appropriate audit plan is in place. It should carefully consider and discuss whether the business risks identified by the auditor are the only business risks or whether, because of the committee's own knowledge of the institution's risk environment, other risks should also be taken into account. This focus should apply at both the strategic level (those risks that are fundamental to achieving the institution's strategy) and the more detailed operational level (those risks that affect day-to-day operations, the recognition of revenue and costs, the custody and value of assets, and the completeness of recognition of liabilities).

In general terms, the audit committee should understand those areas where the auditor intends to perform detailed substantive testing and those where the auditor intends to rely on internal controls. The committee should also understand the auditor's materiality for both planning and reporting purposes.

The committee should also be concerned, for example, that subsidiaries and associated operations receive adequate coverage – particularly those that are geographically or culturally remote. In addition, it should know whether other audit firms are involved in auditing specific operations that might impact on the institution's overall risk profile.

At the pre-audit planning meeting, the audit committee may determine that the external auditor should perform additional work to satisfy the needs of the institution, such as increased internal control testing.

9.4.1 *Reviewing representations by management or the board*

The auditor receives many representations during an audit, either unsolicited or in response to specific enquiries. The audit committee should review any written representations by management or the governing body. Representation letters cover matters such as:

- confirmation that all accounting records have been made available, all transactions properly recorded in the accounting records, and all other records and related information made available

- management's plans or intentions that may affect the carrying value of assets and liabilities
- knowledge of events occurring subsequent to the balance sheet date that would require adjustment to the financial statements
- presentation and disclosure of the fair value measurement of material assets, liabilities and components of equity
- knowledge of fraud, or suspected fraud, affecting the institution
- confirmation that the effects of uncorrected financial statement misstatements are immaterial
- confirmation that all information provided regarding related parties is complete.

The audit committee should give particular consideration to matters relating to non-routine or unusual issues. It should consider whether the information provided is complete and appropriate based on its own knowledge.

Where the institution is incorporated under the Companies Acts, the 'directors' (members of the governing body) are required to report publicly that they have taken steps to make themselves aware of relevant audit information and have disclosed all relevant information to the external auditor.

9.4.2 Reviewing the audit findings

Moving to the end of the audit cycle, the audit committee should review the audit findings, including any changes in audit approach or any modification to the auditor's report. The issues to be discussed will depend on institutional and audit circumstances. Nevertheless, the committee should:

- discuss with the external auditor any major issues that arose during the course of the audit and were subsequently resolved, and those issues that have been left unresolved
- review any problems detected in internal control
- review key accounting and audit judgements
- review levels of errors identified during the audit, obtaining explanations from management and, where necessary, the external auditor about why certain errors might remain uncorrected.

It may seem strange to review issues which have subsequently been resolved and uncorrected misstatements that are not material to the truth and fairness of the financial statements. However, such issues can suggest weaknesses in the design or operation of internal control, or be indicative of management's approach to the preparation and presentation of financial information.

9.5 Communication

Principle 6: Communication and reporting

The audit committee should ensure that it communicates effectively with the governing body, head of finance (or equivalent), internal auditor, external auditor and other stakeholders...

The external auditor and audit committee should have a strong, candid relationship – anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The committee should establish that the auditor is directly accountable to the audit committee and, through it, to the governing body. The committee should make sure that its actions and communications with the auditor are consistent with this accountability. The audit committee should also be sure to communicate its expectations to the auditor, and that both parties understand and agree to those expectations.

It is good practice for the external auditor to attend all audit committee meetings and any finance committee meetings at which the audited financial statements are discussed, and to attend governing body and other meetings when appropriate.

The chair of the audit committee should communicate with the audit partner prior to each audit committee meeting. This allows the chair and the audit partner to review agenda items, and should reduce any surprises arising at the committee meeting. Of course, if particularly controversial or difficult items are identified, the chair should also discuss these with management and consider the need to give advance warning to the other members of the audit committee (see also section 3.4 on in camera meetings).

Sufficient time should be allowed to enable the audit committee to complete its review and engage in an appropriate dialogue with the external auditor, including one or more discussions in camera. The governing body, management and the auditor should agree on an appropriate timetable.

Major issues should not be raised for the first time at the meeting at which the audit committee intends to recommend approval of the financial statements. While this notion may appear common sense, it is not always followed in practice and can create significant pressure on the committee. If the final audit committee meeting is to be conducted effectively, audit findings should be reviewed on an ongoing and timely basis, for example after any interim audit work. Issues can then be identified at an early stage and surprises reduced. The audit committee chair should talk with the external auditor in advance of each meeting so that the chair can direct the attention of the committee members to matters of substance on the agenda. The relationship with the external auditor should be such that if there are serious concerns the auditor will bring them to the audit committee's attention promptly.

The external auditor is required to bring to the attention of those charged with governance – usually the audit committee – any unadjusted misstatements in the financial statements, other than those that are 'clearly trifling'. Auditors are also required to discuss, in an open and frank manner, the quality and acceptability of the institution's reporting, including for example:

- the appropriateness of the accounting policies to the particular circumstances of the institution
- the timing of transactions and the period in which they are recorded
- the appropriateness of accounting estimates and judgements made
- the potential impact of any uncertainties, including significant risks and exposures, such as pending litigation
- material uncertainties that may cast doubt on the institution's ability to continue as a going concern

- the extent to which the financial statements are affected by unusual transactions, including non-recurring surpluses
- inconsistencies between the financial statements and any other information in the document containing the financial statements
- the overall balance and clarity of the financial statements.

9.6 Audit reports

The auditors must report clearly 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:
- The financial statements have been properly prepared in accordance with the Companies Act 1985 (where appropriate) 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.

The auditor's report must be either unqualified or qualified, and must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report. Qualifications are exceptional and should be brought to the attention of the audit committee as soon as they are anticipated. Institutions should take any necessary actions to avoid a qualified audit report.

External auditors also have a duty to consider the statement of internal control with the annual financial statements, and to comment if it is inconsistent with their knowledge of the institution. External auditors may report on the statement privately to the governing body (through the audit committee), or may make reference to it in the financial statements, either in their audit opinion report or through a separate report.

A model external audit report for an institution's annual financial statements can be found at Appendix 10.

9.7 Management letter

External auditors only consider governance and internal control processes to the extent necessary for them to form their opinion of the financial statements. However, where the auditors identify significant deficiencies or material weaknesses in accounting or internal control systems during their audit, they should report these findings by way of a letter to management. Management should then provide written responses to any recommendations made or issues raised.

As part of the ongoing monitoring process, the audit committee should review the management letter. It should also review and monitor management's responses to the auditors' findings and recommendations, to ensure that appropriate action is taken in a timely manner.

The management letter should also indicate:

- that the external auditor has reviewed the work of the internal auditors
- whether, or to what extent, the external auditor is content to rely on the work of the internal auditors in support of external audit work.

The letter, with management responses, should be made available to the audit committee (in draft if necessary) in time to inform the committee's annual report. If submitted in draft, a final version should be submitted to the audit committee as soon as possible thereafter, and not later than two months after issuing an opinion on the financial statements.

It is not uncommon for the body of the external auditor's management letter to resemble the format set out in the specimen internal audit report at Appendix 15.

9.8 Relationship with the internal auditor

The audit committee should ensure that internal and external audit complement one another and that, where appropriate, they co-ordinate their audit effort and avoid duplication.

External auditors should be given access to the internal audit service's working papers and plans so that their work programmes can be adjusted accordingly and the extent of their reliance on the work of the internal audit service determined.

Copies of the internal audit service's reports should be available to the external auditors.

The internal audit service should also receive copies of the external auditors' plans and management letters, and any other relevant reports.

9.9 Monitoring the effectiveness of external audit

The audit committee should monitor annually the performance and effectiveness of external audit, including any matters affecting its independence and objectivity. The committee's evaluation should consider the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to the institution's size, complexity and risk and control profile.

The audit committee should draw its conclusions based on its own experience and contact with external audit as well as the views of others. Many audit committees seek the views of a wide range of individuals such as the head of finance (or equivalent), internal auditor, vice chancellor and clerk.

When agreeing appropriate performance measures for external audit, the committee should recognise that such measures need adapting to each institution's requirements to be most effective. The following are some of the more common measures used to monitor the performance of external audit:

- clear audit plan with emphasis on key issues (i.e. understanding the organisation)
- achievement of audit timetable and timeliness of engagements
- staff calibre and continuity
- management letter and quality of recommendations
- openness in discussion with committee

- views of those audited
- days spent compared to budget
- maintenance of fees (year on year and actual v budget).

A checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of the external auditor can be found at Appendix 11.

10 Oversight of internal audit

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to: ...

- consider and advise the governing body on the appointment and terms of engagement of the internal audit function (and the head of internal audit, if applicable), the audit fee, the provision of any non-audit services by the internal auditors, and any questions of their resignation or dismissal
- review the nature and scope of the internal audit process and discuss with the internal auditors any problems and reservations arising from their audit, including their audit reports and any other matters the internal auditors may wish to discuss...
- monitor annually the performance and effectiveness of external and internal auditors, including any matters affecting their independence and objectivity..

Internal audit is likely to be the single most significant resource used by the audit committee in helping the governing body to discharge its responsibilities. This is because internal audit, in accordance with the professional standards of the Institute of Internal Auditors and Government Internal Audit Standards, has a responsibility to provide an annual audit opinion on the adequacy and effectiveness of the institution's arrangements for risk management, control and governance, and for economy, efficiency and effectiveness.

The audit committee assists the governing body by providing independent oversight over internal audit. Specifically, the committee should:

- assist the governing body in the appointment, or termination of appointment, of the institution's head of internal audit or externally provided internal audit function
- ensure that the internal auditors have direct access to the chair of the audit committee and the governing body, and are directly accountable to the audit committee for their performance
- review and assess the annual internal audit work plan
- receive periodic reports on the results of the internal auditors' work
- review and monitor management's responsiveness to the internal auditors' findings and recommendations
- monitor internal audit's performance annually against agreed performance measures.

10.1 Internal audit

The prime responsibility of internal audit within the higher education sector is to provide the governing body (usually via the audit committee), head of institution and other senior managers with assurance regarding the adequacy and effectiveness of arrangements for risk management, control and governance. Responsibility for these arrangements remains

ultimately with the governing body. However, the governing body and management should recognise that internal audit can only provide 'reasonable assurance' – it cannot provide any guarantee against material errors, loss or fraud.

Internal audit can also provide independent and objective advice specifically to help management to improve risk management, control and governance, so contributing to the achievement of corporate objectives and reducing the effects of any significant risks faced by the institution.

10.2 In-house or outsourced internal audit

The governing body, advised by its audit committee, should establish the most suitable and cost-effective way of obtaining internal audit services. The decision as to the most appropriate way to source internal audit is usually driven by the availability of appropriate skills and the breadth and depth of experience to cover the institution's operations adequately. The cost implications of each approach may differ.

Many institutions outsource their internal audit requirements to an audit firm or form a consortium to provide internal audit services to a range of institutions on the basis of geography or common interest. A consortium may be organised in-house, be provided externally, or comprise a mixture of the two.

An in-house team may be supplemented at a variety of levels by external consultants or contractors under the direction of the head of internal audit to meet peaks in workload or provide specialist skills.

Where an in-house internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the chief internal auditor, and help to determine the required qualifications, reporting obligations and compensation. The audit committee should also help to ensure access to all necessary contacts, both at board level and within the organisation.

The same auditor must not provide both internal and external audit services as this can lead to a loss of objectivity and independence.

10.3 Appointment of the internal audit function

Making recommendations to the governing body on the appointment, reappointment and removal of the internal auditor (or head of internal audit, if applicable) is an important audit committee responsibility. The committee's recommendation to the governing body should be based on its assessment of the qualifications, expertise, resources and independence of the internal auditor and the effectiveness of the audit process (see below).

Where internal audit is provided by an external provider on a contract basis, the institution should agree a fixed term of office and consider market testing before the contract expiry date. Most institutions which derive their internal audit service from external providers put internal audit out to competitive tender every five years.

There is also a growing practice of testing the quality and effectiveness of in-house or consortium internal audit by requiring it to participate in a competitive tender every five years. This process often reveals issues that are not otherwise apparent.

Provision should be made for outgoing auditors to complete their work and submit their final annual report. Attendance by the auditors at the appropriate audit committee meeting

should also be considered. If there is a change in auditor, institutions should ensure that the new contract immediately follows the end of the old contract or other arrangements.

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

Changes to internal audit arrangements should be notified promptly to the funding council.

10.4 Scope and terms of reference

Applying a risk-based approach, internal audit should consider the whole of the institution's arrangements for risk management, control and governance and for economy, efficiency and effectiveness. This should include all its operations, resources, staff, services and responsibilities for other bodies. Internal audit should cover all activities associated with the institution including, for example, controls that protect the institution in its dealings with any subsidiary, associated company or student union, or any other activity or venture in which the institution has an interest.

Considering all the arrangements for risk management, control and governance does not, however, imply that the whole system should be audited. Internal auditors should adopt a risk-based approach when planning their audit work. If they are confident about risk management, and if the risk management arrangements effectively mitigate a risk, then that risk should not merit additional audit attention. If, however, internal auditors consider a risk to be insufficiently prioritised or mitigated by management, this may lead them to form a different view as to the effectiveness of the risk management system.

Internal auditors should also assess the adequacy of arrangements to prevent and detect irregularities, fraud and corruption. However, the primary responsibility for prevention and detection rests with management, who should institute adequate systems of internal control, including clear objectives, segregation of duties, proper authorisation procedures and effective diagnostics. These and any whistle-blowing process should be reviewed by internal audit.

The internal audit service should have formal terms of reference defining its objectives, responsibilities, authority and reporting lines. The terms of reference should be agreed by the governing body on the recommendation of the audit committee. Model terms, which should be tailored to suit specific circumstances, are provided at Appendix 13.

10.5 Assessing the annual internal audit work plan

The internal auditor should prepare an audit plan based on the institution's assurance needs. This plan should address how all the institution's key systems and processes will be audited during the audit cycle, together with the resources to be applied – normally expressed in 'man days'. Areas of greater risk should be addressed at the beginning of the audit cycle and may be revisited later in the cycle.

As an audit plan is unlikely to cover all areas of risk within a single year, the plan for any given year should place its work in the context of work done in the preceding year and projected for the succeeding year. The audit committee and management may take a different view of timing and priorities, which should be resolved through discussion.

A specimen internal audit plan is included at Appendix 14.

The audit committee should review the audit plan and satisfy itself that appropriate audit coverage will be devoted to all the institution's assurance needs. If internal audit is not covering a particular area, then other means of assurance should be in place. When the audit committee is satisfied with the audit plan, it should recommend the plan to the governing body for approval, if its terms of reference so require. Once the plan has been approved, the audit committee should monitor the auditor's progress against it during the year.

Internal auditors may carry out additional work at the request of management (including investigations), provided such work does not compromise the objectivity of the audit service or achievement of the audit plan. The audit committee should satisfy itself that the objectivity of internal audit has not been affected by the extent and nature of other work carried out.

10.6 Ensuring that internal auditors have direct access to the audit committee

A significant challenge for internal audit lies in understanding its responsibility to both the governing body (via the audit committee) and the head of institution. The internal auditor is employed by management and yet reviews management's conduct. In addition, the internal auditor reports to the audit committee and yet is not line-managed on a day-to-day basis by the audit committee (although the committee has a significant role in appointing the internal auditor).

It is very important for internal audit to retain a degree of independence from management so that it may carry out its function impartially. It is therefore key that while the head of internal audit may report directly to the head of institution (maybe via the head of finance, clerk or designated senior manager), he or she also has a clear line of responsibility to the audit committee. The committee should have processes in place to facilitate confidential exchanges with the internal auditor; with regular meetings scheduled between the audit committee and the head of internal audit. Many audit committee chairs maintain informal contact with the internal auditor between meetings.

The audit committee should also do its utmost to ensure that internal audit has:

- sufficient status, respect and support within the institution
- unrestricted access to all records, assets, personnel and premises
- authorisation to obtain whatever information and explanations are considered necessary by the head of internal audit
- adequate human and other resources to perform its work effectively.

10.7 Communication and reporting arrangements

Principle 6: Communication and reporting

The audit committee should ensure that it communicates effectively with the governing body, head of finance (or equivalent), internal auditor, external auditor and other stakeholders...

While the internal auditors report to the head of institution (or designate) on a day-to-day basis, the audit committee has an oversight responsibility. As such, the committee needs to

determine appropriate communication channels and reporting arrangements with internal audit. Some audit committees want to see every audit report, some a summary of every report, and others a periodic summary. Progress reports, comparing audit activity against the audit plan, are also useful.

An illustrative internal audit report is set out at Appendix 15.

It is important that the audit committee considers significant individual audit findings or recommendations, though it need not be concerned with more detailed findings unless the committee considers it valuable to do so. It is good practice for internal auditors to prioritise their findings against agreed standards. This indicates the importance of each audit recommendation and the urgency of any required action.

The audit committee should concentrate on gaining assurance that the institution's risk management, control and governance arrangements are adequate and effective. For this purpose, the committee should ensure that there is an adequate system to monitor the implementation of agreed audit recommendations. An implementation plan detailing the recommendation, the required action, priority, person responsible and timescale is a good method of fulfilling this objective.

Internal audit should have a systematic process of follow-up to obtain appropriate assurance that management has taken timely and effective action. It should promptly advise the audit committee of its findings and further action required.

The governing body, advised by the audit committee, should ultimately be responsible for either ensuring that management takes prompt and effective action on those audit reports which call for it, or recognising and accepting the risks of management's not taking action.

10.7.1 Annual reporting

The internal audit service should provide the governing body and head of institution with an annual report of its activities. This report should relate to the financial year, and should include any significant issues up to the date of the report. Such reports are generally reviewed by the audit committee.

The annual report of internal audit should include the internal auditor's opinion of the adequacy and effectiveness of the institution's arrangements for:

- risk management, control and governance
- economy, efficiency and effectiveness.

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

10.8 Monitoring the effectiveness of internal audit

The audit committee should monitor annually the performance and effectiveness of internal audit, including any matters affecting the service's independence and objectivity. In addition, the Government Internal Audit Standards require an external review of internal auditors every five years.

Each year, the head of internal audit should implement performance measures, considered and approved by the audit committee, to monitor the effectiveness of the service and compliance with standards. However, self-assessment by the head of internal audit should not be the sole means of assessing the effectiveness of internal audit. The audit committee should draw its own conclusions, based on its own experience and contact with internal audit as well as the views of others. Many audit committees seek the views of a wide range of individuals such as the head of finance (or equivalent), external auditor, vice chancellor, clerk and a variety of those audited.

When agreeing appropriate performance measures for internal audit, the audit committee should recognise that such measures need to be adapted to each institution's requirements to be most effective. The following are some of the more common measures used to monitor the performance of internal audit:

- performance against agreed programme, scope and time
- staffing continuity, skills mix, quality and seniority of team
- timeliness of engagements and reports
- clarity and accuracy of reports, and effectiveness of follow-up of previous recommendations
- audit committee attendance
- maintenance of fee level
- focus on risk and key issues
- openness in discussion with the audit committee
- daily rate charged compared to budget.

Funding councils require institutions to maintain effective internal audit arrangements, and audit committees need to satisfy themselves that effective arrangements exist.

A checklist framework for an audit committee to carry out a formal review of the effectiveness and efficiency of the internal audit function can be found at Appendix 16.

10.9 Relationship with the external auditor

The audit committee should ensure that internal and external audit complement one another. Where appropriate, the auditors should co-ordinate their audit effort and avoid duplication.

External auditors should be given access to the internal audit service's working papers and plans, so that their work programmes can be adjusted accordingly and the extent of their reliance on the work of the internal audit service can be determined.

Copies of the internal audit service's reports should be available to the external auditors. The internal audit service should also receive copies of the external auditors' plans and management letters, and any other relevant reports.

II Value for money

Principle 2: Terms of reference

The role and responsibilities of the audit committee should be set out in written terms of reference, and should include to: ...

- satisfy itself that suitable arrangements are in place to promote economy, efficiency and effectiveness...

Higher education institutions have a formal obligation through their financial memoranda with the funding councils to deliver value for money (VFM) from public funds. Governing bodies are charged with overseeing the arrangements by which institutions secure VFM, and typically rely on the audit committee to provide the evidence to enable their duty to be discharged. As a result, audit committees, advised by management and the internal auditor, must satisfy themselves that suitable arrangements are in place to promote VFM within the institution. For this purpose, audit committees should consider institutional VFM strategies and receive reports on progress against those strategies. In addition, the annual report of the audit committee must include its opinion on the institution's arrangements for economy, efficiency and effectiveness, i.e. value for money.

II.1 The role of the audit committee

The key distinction between the governing body's responsibility and that of the audit committee is that the governing body needs to be satisfied that VFM has actually been achieved, whereas the audit committee is only responsible for gaining assurance on the arrangements in place for securing VFM. As a result, the reports reviewed by the audit committee should focus on the arrangements more than the outcome of individual VFM-related activities.

In fulfilling its responsibility, the audit committee needs to be aware of:

- the aims and objectives for pursuing VFM within the institution
- the way in which the institution plans to achieve VFM during the year
- the processes undertaken and, if appropriate, the principal benefits that the institution has received/should receive as a result.

Management's role is to support the governing body and audit committee in fulfilling their respective responsibilities. Management is therefore responsible for establishing and operating processes and mechanisms which ensure that the institution achieves VFM from all its activities. The key method for achieving this is by setting a cultural standard in the institution that focuses on continual improvement. This is a responsibility that should evolve as the institution develops and changes, to ensure that processes, mechanisms and management styles adapt to the changing environment such that they continue to deliver an optimal level of VFM for the institution.

11.2 What is value for money?

Value for money is commonly understood to be a combination of:

- **economy** – the ability to achieve an outcome while minimising the consumption of resources
- **efficiency** – the ability to do something well or achieve an objective without wasted energy or effort
- **effectiveness** – the ability to achieve the best/desired result.

However, a difficulty of these three aspects of VFM is that they are not all measurable. 'Economy' is perhaps the easiest element to understand and quantify as it typically represents the cost, the number of hours of resources, or a quantity of materials. It is no surprise that reports on procurement activities often represent a significant proportion of the evidence collated by audit committees. 'Efficiency' also has a degree of tangibility as it is typically associated with the length of time taken – something that with the appropriate records can be quantified, albeit with some management judgement. The most difficult processes for audit committees to assess are those concerning 'effectiveness'. This can be difficult for many reasons, including subjectivity, a lack of clear objectives and a need for reliable benchmarks.

11.3 An approach to determining value for money

Value for money does not necessarily mean the cheapest. This is most evident in tendering capital projects, where the cost is considered in relation to the likely quality of the prospective contractors and their ability to actually deliver the results that the institution requires.

Nevertheless, the evidence in support of the audit committee's annual opinion on VFM typically comprises one-off reports on specific operations within the institution. These might include:

- establishing a VFM policy
- creating a VFM working/steering group
- tendering and quotation requirements within the financial regulations
- a programme of tendering for key services (e.g. energy suppliers, banking, photocopiers)
- establishing framework agreements for professional services (e.g. estates)
- VFM reviews (e.g. catering, security, procurement)
- the effective use of resources (e.g. lecture and laboratory facilities, IT, library, student accommodation)
- internal audit's feedback on the efficiency, effectiveness and economy of the systems and processes they have reviewed
- benchmarking exercises undertaken with peer institutions, or cross-sector benchmarking.

Although these one-off exercises provide a useful contribution, they may well fail to provide assurance on the whole framework of VFM across the institution. Value for money reviews,

for example, provide a level of critique and challenge for the area being reviewed and may well identify scope for improvement. However, in the context of the current environment, with the explicit need for institutions to become more financially sustainable while remaining attractive to potential students, researchers and businesses, the question is whether these reviews address the areas necessary to support and assist the institution in meeting its key challenges.

At the same time, the following routine management activities within institutions impact on VFM albeit they are not specifically thought of as VFM exercises and, as such, are not brought to the attention of the audit committee:

- strategic planning process
- financial strategy and the budget setting/cost reduction process
- National Student Survey
- risk management
- course costing and portfolio reviews
- business process reviews and systems development
- performance appraisals and career development
- programme quality processes
- funding council initiatives (e.g. rewarding and developing staff)
- discrete reviews (e.g. retention, student experience).

Each of these activities represents a performance improvement exercise – whether in terms of efficiency, effectiveness or cost. Each has an objective and a desired outcome, and will result in some recommendation that the institution should action. However, such activities are rarely reported to the audit committee in the context of the VFM agenda, as any value for money achieved by such routine management processes may only be a by-product of the exercise and might not have been planned at the outset. Yet general financial and operational performance measures are often intrinsically linked to VFM. Hence the institutional framework for monitoring and managing performance can also further the level of VFM information at the audit committee's disposal.

11.4 A holistic approach

Taking a holistic approach allows management to integrate its VFM activities into regular management processes. In this way, VFM activities are aligned with the strategic aims of the institution and focus on the whole spectrum of institutional activities, both academic and non-academic.

Such an approach incorporates the pursuit of VFM/enhanced performance into existing practices, with the ultimate aim of its becoming embedded (along the same lines as risk management) in the institution's management culture. Taking a holistic approach requires the institution to:

- clearly articulate its aims and objectives for its value for money and performance improvement activities in a VFM strategy
- use a structured method for appraising improvement priorities, to ensure that the institution focuses its efforts on improving areas of greatest strategic importance without duplicating work already planned or ongoing in other parts of the institution

- develop an annual performance improvement plan to provide a tangible basis from which progress in performance improvement can be understood and monitored by the audit committee and management
- use the most appropriate resources to undertake further investigations, reviews or research
- report findings from work undertaken through the performance improvement plan to management and the audit committee, using action plans as a basis from which agreed activities can be implemented
- review and appraise the approach to VFM annually, revising the process as required to ensure that it evolves to meet the needs of the institution. A key element of such review is to appraise how embedded VFM is becoming in the institution's management approach.

A further explanation of the holistic approach to value for money will be found in the HEFCE Audit Code to take effect from 1 August 2008.

12 Assessing audit committee effectiveness

Principle 8: Assessment of audit committee effectiveness

The audit committee should undertake a regular review of its terms of reference and its own effectiveness, and recommend any necessary changes to the governing body.

The audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans and forums of discussion and communication. Regular assessment may identify areas in which the committee and its processes might be more effective, or may highlight skills and/or knowledge gaps in the committee. This may lead to a request for additional training or require the chair to begin discussions on the possible recruitment of a new member with the nomination committee. The audit committee needs to ensure that it has the requisite knowledge to discharge its responsibilities at all times. For this to be achieved, the audit committee chair, working with the nomination committee, should annually review the status of succession to the audit committee and aim to ensure that there is continuous access to suitable candidates.

12.1 What does effective mean?

An effective audit committee is one that successfully supports the governing body to fulfil its responsibility for adequate and effective risk management, control and governance and for the economy, efficiency and effectiveness of the institution's activities. This goes beyond simply meeting the criteria set out in the audit committee's own terms of reference. An effective committee will:

- comprise a capable chair and members who are independent, diligent and knowledgeable
- have timely access to all the appropriate information
- be efficient in the discharge of its business
- operate in an environment where committee members and others within the organisation have a common understanding of the committee's role
- strike an appropriate balance between robust oversight and strong relationships with the institution's officers and auditors
- focus on the key issues and a risk-based approach to its work
- be alert for and responsive to emerging issues
- have a positive impact within the institution
- be credible within the institution (and to funding councils and other external stakeholders)
- take action to sustain best practice in risk management, control and governance within the institution.

12.2 Assessing effectiveness

The precise method by which the governing body and audit committee assess the audit committee's effectiveness should be for the governing body and committee to decide. No single process will be appropriate for all institutions. Nevertheless, the following guidelines are recommended.

Independence: To be credible, the assessment process must be independent – and be seen to be independent – of executive influence or authority. The audit committee chair should control the assessment process and criteria, albeit taking into consideration the views of the chair of the governing body, vice chancellor and other officers as appropriate.

Clearly established goals: Clear goals for the assessment should be established. If the assessment of the audit committee is to be more than a box-ticking exercise, it must be designed to encourage audit committee members to perform the inherently difficult task of candidly and constructively critiquing each other's performance as individuals as well as their collective performance as a committee.

Tailoring evaluations to the institution and the board: Each evaluation process should be tailored to meet the needs of the institution. The audit committee chair should establish a process and performance criteria that suit the individuals and the culture of the institution.

Ensuring candour, confidentiality and trust: The audit committee chair should encourage candour, openness, fairness and discretion in the assessment process while ensuring strict confidentiality with respect to each participant's input and feedback. Implementing a constructive assessment process depends on the committee's ability to develop a culture of frankness and mutual trust.

Regular review of the assessment process: Any assessment process will be shaped by many forces, including the institution's circumstances and performance, committee tenure and relationships between individual committee members. Consequently, the committee should periodically review its assessment practices and criteria to ensure their continued efficiency and appropriateness.

Feedback: To ensure credibility, it is important that those involved in the evaluation process receive feedback.

As noted above, the audit committee should regularly assess its own effectiveness and the adequacy of its terms of reference, work plans and forums of discussion and communication. This should be done by:

- ascertaining whether the board of governors is satisfied with the committee's performance
- comparing the committee's activities to any relevant guidelines or recommendations
- comparing the committee's activities to leading practices in different sectors
- comparing the committee's activities to any previously established 'success' criteria
- comparing the committee's activities to any previously identified shortcomings

- comparing the committee's activities to the terms of reference, the committee's aspirations and any objectives set by the board of governors.

The committee should also request feedback on its performance from both management and the internal and external auditors.

Questionnaires are one mechanism that audit committees can use in assessing their effectiveness. However, consultation and feedback might be improved by face-to-face discussions where appropriate. Informal meetings with the auditors or in camera sessions during regular audit committee meetings can be employed for this purpose.

A suggested framework for an audit committee's review of its own effectiveness and the adequacy of its terms of reference and work plans can be found at Appendix 17. The results of the evaluation and any action plans arising should be reported to the governing body after discussion with the chair of the governing body. Any necessary changes should be recommended to the governing body.

The audit committee chair should also assess the performance of individual committee members as well as the performance of the committee as a whole. The performance evaluation of individual members should consider several aspects, including:

- expertise
- enquiring attitude and independence
- ability to take a tough, constructive stand at meetings when necessary
- understanding of the institution
- willingness to devote the time needed to prepare for and participate in committee meetings and deliberations
- approach to conflict and whether the person helps the committee to manage conflict constructively and productively.

The evaluation of the audit committee chair should be done by the chair of the governing body, based on similar criteria. The results should be reported to the governing body.

Evaluations which are well performed demonstrate the committee's intention and commitment to achieve its responsibilities in an effective, diligent manner. They should focus on:

- What is the committee for and what does success look like?
- Do others within the institution understand what the audit committee is supposed to do?
- Outcomes rather than activities – not what the committee did, but how it did it.
- Is time spent on the right areas?
- What impact has the committee had? Has it added value to the governance process?

After completing the evaluation, the chairs of the governing body and the audit committee should discuss the outcomes so that appropriate action can be taken. The audit committee chair should discuss with individual members the outcomes of the evaluation and any required actions.