**Audit and Assurance Committee**

**Date:** **13 July 2017**

**Item:** **EY Report to Those Charged with Governance**

---

**This paper will be considered in public**

## 1 Summary

1.1 To report to the Committee on the key issues identified by EY during the course of their audit of the Statement of Accounts for the Transport for London Group for the year ended 31 March 2017.

## 2 Recommendation

2.1 **The Committee is asked to note the report.**

### 3 Background

3.1 EY have, as required by International Auditing Standards, prepared a report for the benefit of those charged with governance. The report outlines the respective responsibilities of the auditor and TfL, and provides an overview of the status of the audit and accounting policy changes. The report also comments on judgemental areas within the accounts. EY's report is attached for the Committee's review.

**List of appendices to this report:**

Appendix 1: EY's Report to Those Charged with Governance

**List of Background Papers:**

None

Contact Officer: Ian Nunn, Chief Finance Officer
Number: 020 3054 8941
Email: IanNunn@tfl.gov.uk

Appendix 1

# Transport for London

## Audit Result Reports
## for the year ended 31 March 2017

Presented to the Audit and Assurance Committee

13 July 2017

Building a better working world

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Tel: + 44 20 7951 2000
Fax: + 44 20 7951 1345
ey.com

The Audit and Assurance Committee
Transport for London
Windsor House
42-50 Victoria Street
London
SW1H 0NL

27 June 2017

Dear Members of the Audit and Assurance Committee

We are pleased to attach our audit results report for consideration at the forthcoming meeting of the Audit and Assurance Committee. This report summarises our audit conclusions in relation to the Transport for London Group financial position and results of operations for the year ended 31 March 2017.

The Transport for London (TfL) Group and Corporation audits form part of our framework contract with Public Sector Audit Appointments Limited. We have undertaken our work in accordance with the requirements of the Local Audit and Accountability Act 2014, the National Audit Office's Code of Audit Practice, auditing standards and other professional requirements.

We are also the auditors of TfL's subsidiaries, Transport Trading Limited Group (TTL) and Crossrail Limited. TfL's subsidiaries are subject to the accounting requirements of the Companies Act 2006. We have undertaken our work in accordance with the requirements of UK auditing standards.

We are keen to ensure that our audit is aligned with the Audit and Assurance Committee's expectations. We welcome the opportunity to discuss this report with you on at the Audit and Assurance Committee on 13 July 2017.

Yours faithfully

Karl Havers
For and on behalf of Ernst & Young LLP

# Table of contents

# 1. Executive summary

Our audit is driven by our assessment of the financial statement risks facing Transport for London as a Group. This is then overlaid by our assessment of risks in TTL and individual companies within the Group and the propensity for these risks to result in an undetected error in the financial statements. This determines the scope and focus of our audit.

We are also required under the National Audit Office's Code of Audit Practice to form a conclusion on whether in all significant respects, Transport for London have proper arrangements in place to secure value for money in their use of resources. This is described as our Value for Money conclusion.

## 1.1 Risked based approach to audit

TfL

### Financial

- Pensions accounting and impact of potential changes
- Financial shared service centre – effectiveness of control environment
- Treasury – controls and valuation of borrowing and investments

### Strategic

- Future funding, impact on credit rating and borrowing limits, including impact of external factor on markets such as Brexit
- Strategic changes impacting cash flow and asset values, e.g. commercial development, alignment with Mayor of London strategic priorities.
- Asset renewal and maintenance, e.g. new train stock and signalling
- Successful cultural change

### Operational

- IT security and controls, e.g. asset registers, general ledger, procurement system and data protection.
- Revenue processes and recognition.
- Fixed asset management, classification and valuation.
- Cyber and information security incident – responding to the threat as fast as it evolves.
- Robustness of procurement and contract management processes.

### Compliance

- Claims resulting from failure, e.g. major events, contract delivery.
- Accuracy of claims and provisions, e.g. Compulsory Purchase Orders.
- Impact of legislative change.
- Fraud risk from management override

The risks highlighted above are consistent with those communicated in our Audit Planning document dated 11 October 2016 with the exception of the requirement for TfL to adopt the measurement requirements of the CIPFA Highways Network Asset (HNA) Code from the 2016/17 financial year. At a meeting on 8 March 2017, the CIPFA/LASAAC Code Board decided not to proceed with the introduction of the Highways Network Asset Code into the financial reporting requirements for local authorities. The Code Board decided that, currently and in particular in the absence of central support for key elements of the valuation, the benefits are outweighed by the costs of implementation for local authorities. The Code Board determined that it will give further consideration to this issue only if provided with clear evidence that benefits outweigh costs for local authorities. Due to the decision taken by CIPFA/LASAAC, this risk is no longer relevant.

# 1.2 Audit results and other key matters

The National Audit Office's Code of Audit Practice (the Code) and International Standards on Auditing (UK and Ireland) require us to report to those charged with governance (the Audit and Assurance Committee) on the work we have carried out to discharge our statutory audit responsibilities together with any governance issues identified.

This report summarises the findings from the 2016/17 audit which is substantially complete. It includes the feedback arising from our audit of your financial statements, based on the work completed to date, and the results of the work we have undertaken to assess your arrangements to secure economy, efficiency and effectiveness in your use of resources.

## Financial statements

- In respect of the 2016/17 TfL (Transport for London) Group financial statements, based on our audit findings to date, we expect to issue an unqualified opinion on the financial statements. We note, however, that the Board approval of the financial statements will be delayed until September 2017. As a result, we are required to continue to consider post balance sheet events up to the date of approval and we will consider whether there are any developments which impact the financial statements up to that date. Such matters might include any changes to future capital projects as the business planning process continues.
- We have set out in Section 4 the key areas of audit focus, which includes the judgements and estimates, such as capital asset valuations and provisions taken in preparing the financial statements.
- During our work we have noted some improvements in some aspects of the control environment. We have included some observations on the control environment resulting from our financial statement audit included on page 15.
- At the date of reporting there is one uncorrected audit misstatement being an over-provision for severance at 31 March 2017 of £5.6 million, which is offset by the impact in the current year of the prior year uncorrected item of £5.9 million, given a total unadjusted difference of £11.5 million. During our testing we identified one significant misstatement relating to an additional liability of £65 million for rolling stock which has been correct by management.
- We reported last year, that significant improvements could be made to narrative reporting, to ensure that the Annual report provides a fair, balanced and understandable overview of the performance in the year. We have seen some improvement in the current year and will continue to feed back our comments to management on areas that could be further enhanced in the next year.

## Value for money

- Our review of TfL's arrangements to secure economy, efficiency and effectiveness in its use of resources is complete. Overall we have found that TfL have made appropriate arrangements to secure economy, efficiency and effectiveness in its use of resources, however our report provides additional observations for TfL to consider, details of which are set out on page 17 of this report.

## Whole of government accounts

- We have performed our audit to date with Whole of Government (WGA) requirements in mind and we will complete the remainder of our work on the WGA following approval of the financial statements in order to meet the deadline of 30 September 2017.

## Audit certificate

- The audit certificate is issued to demonstrate that the full requirements of the National Audit Office's 2015 Code of Audit Practice have been discharged for the relevant audit year. We expect to issue the audit certificate once the work on Whole of Government Accounts is complete.

# 2. Extent and purpose of our work

## Purpose of our work

Our audit was designed to:

- Express an opinion on the 2016/17 TfL Corporation, Group and TTL Group financial statements and the consistency of other information published with them. This includes full scope statutory opinion audits of TfL and TTL Groups, and Crossrail financial statements and disclosure notes.
- Report on an exception basis on the Annual Governance Statement
- Consider and report any matters that prevent us being satisfied that TfL Corporation had put in place proper arrangements for securing economy, efficiency and effectiveness in the use of resources (the Value for Money conclusion)
- Discharge the powers and duties set out in the Local Audit and Accountability Act 2014 and the Code of Audit Practice, in respect of TfL Corporation.

In addition, this report contains our findings related to the areas of audit emphasis, our views on TfL's accounting policies and judgments and significant deficiencies in internal control.

As a component auditor, we also follow the NAO group instructions and report the results on completion of the WGA work through the Assurance Statement to the NAO and to TfL.

This report is intended solely for the information and use of TfL. It is not intended to be and should not be used by anyone other than this specified party.

## TfL's responsibilities

TfL is responsible for preparing and publishing its Statement of Accounts, accompanied by the Annual Governance Statement (AGS). In the AGS, TfL reports publicly on the extent to which it complies with its own code of governance, including how it has monitored and evaluated the effectiveness of its governance arrangements in the year, and on any planned changes in the coming period.

TfL is also responsible for putting in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

## Updated Materiality

In our audit plan we communicated our preliminary planning materiality as £110.2 million, which was based on the 2015/16 results. We have updated our planning materiality, based on the 2016/17 results.

| 2016/17 results | Group £'million | Percentage used | Planning Materiality £'million |
|---|---|---|---|
| Total gross expenditure – capital and revenue | 10,775 | 1.0% | 108 |

This has not made a significant change to the scope of our work or the procedures we have performed.

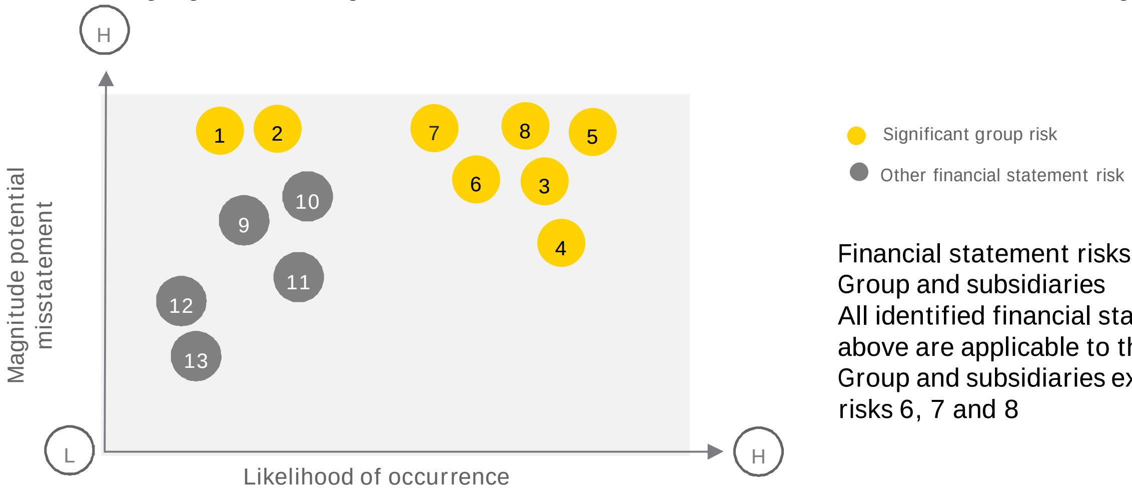
## Change in scope

Based on change in scope communicated by TfL, we no longer perform a full scope audit with a separate statutory opinion on Victoria Coach Station, as following discussions with ABTA, this is no longer required.

# 3. Significant financial statement and VfM risks

Of the financial statement risks identified, we consider some of them to be significant to our Group audit. Auditing standards define significant risks as those with a high likelihood of occurrence and, if they were to occur, could result in a material misstatement of the consolidated financial statements, as set out graphically below. Once identified we are required by Auditing Standards to perform specific procedures over significant risks, including the identification and testing of the effectiveness of key controls designed to address the risks.

Financial statement risk assessment (update)
Below highlights the change in our initial financial statement risk assessment and our findings are set out in Section 4.




Financial statement risks for TTL Group and subsidiaries
All identified financial statement risk above are applicable to the TTL Group and subsidiaries except for risks 6, 7 and 8

| Financial statement risks | Year end update |
|---|---|
| 1. Management override of controls, required by ISA (UK and Ireland) 240 | No change |
| 2. Inappropriate Revenue Recognition , required by ISA (UK and Ireland) 240 | No change |
| 3. Inappropriate capitalisation or potential impairment of capital projects | No change |
| 4. Significant accounting estimates, including complexity of provisions and accruals | No change |
| 5. Complexity of accounting for TfL's property portfolio | No change |
| 6. Judgemental assumptions impacting on TfL's pension deficit | No change |
| 7. Complexity of accounting and disclosures for TfL's borrowing and treasury management | No longer considered a significant risk as no significant new activity in the current year– no material matters arising from our work |
| 8. Implementation of changes in accounting for Highways Network Assets. | No longer relevant following CIPFA code change |
| 9. Consolidation of TTL and subsidiaries | No change – no material matters arising from our work |
| 10. Effectiveness of controls within the FSC and for diversified revenue streams, such as Contactless payment. | No change – no material matters arising from our work |
| 11. Assessment of the Group boundary – Accounting for Joint Ventures and associates | No change – no material matters arising from our work |
| 12. Changes and compliance with IFRS and CIPFA Code of Practice for Local Authority Accounting. | No change |
| 13. Presentation of sensitive disclosures | An expanded remuneration report has been prepared by management |

# 4. Audit risks and execution

## 4.1 Significant Risks

We identified the following significant audit risks during the planning phase of our audit and reported these to you in our Audit Plan. We set out below a summary of the audit procedures performed to gain audit assurance over these risks and our conclusions reached.

| Area of emphasis | Summary of audit performed |
| --- | --- |
| Management override of controls, required by ISA (UK and Ireland) 240<br><br>Management is in a unique position to perpetrate fraud because of their ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. We identify and respond to this fraud risk on every engagement under ISA (UK & Ireland) 240. | For both TfL, TTL groups and subsidiaries, we have:<br>• Tested the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.<br>• Reviewed accounting estimates for evidence of management bias.<br>• Reviewed the business rationale for unusual transactions.<br>• Considered the effectiveness of management's controls designed to address the risk of fraud.<br>• Understood the oversight given by those charged with governance of management's processes over fraud.<br>*There were no material matters arising from our work.* |
| Inappropriate Revenue Recognition, required by ISA (UK and Ireland) 240<br><br>TfL need to have robust controls in place to forecast and accurately recognise and report revenue in its financial statements, including:<br>► £4.3billion fare revenue (2016/17) generated through various sources including cash and contactless payments which is apportioned with the Train Operation Companies "TOC" and recognised over the life od the product;<br>► £328million of congestion charging which is made of a high volume of low transaction amounts;<br>► £142million of commercial revenue which is based on a mixture of minimum guaranteed amount and share based revenue; and<br>► £71million of rental revenue generated from over 2000 contracts. | For Fares Revenue, we have:<br>► Reviewed KPMG's testing of controls over contactless ticketing and Oyster pay as you go, set out in their ISAE3402 report and agreed procedures report, and have placed reliance on their work performed.<br>► Performed control testing over the effectiveness of cash collection and sales made at various outlets.<br>► Tested the Oyster Click Model "OCM" retrospective adjustment which is a result of the change of apportionment methodology from survey approach.<br>► Tested the Fares compensation arrangements with the TOC's resulting from the fares cap introduced in Jan 2015.<br>For the significant revenue streams (i.e. Fare revenue, congestion charging, commercial revenue, rental revenue) we have:<br>► Performed walkthroughs to understand the process which is different for each revenue stream.<br>► Performed a review of the key contract terms;<br>► Set an expectation of revenue based on our understanding of the contract (where applicable).<br>► Performed a review of relevant third party reports.<br>► Performed transaction testing agreeing back to invoice as well as to bank statement.<br>We have also tested the controls over cash collection. |

# 4.1 Significant Risks (continued)

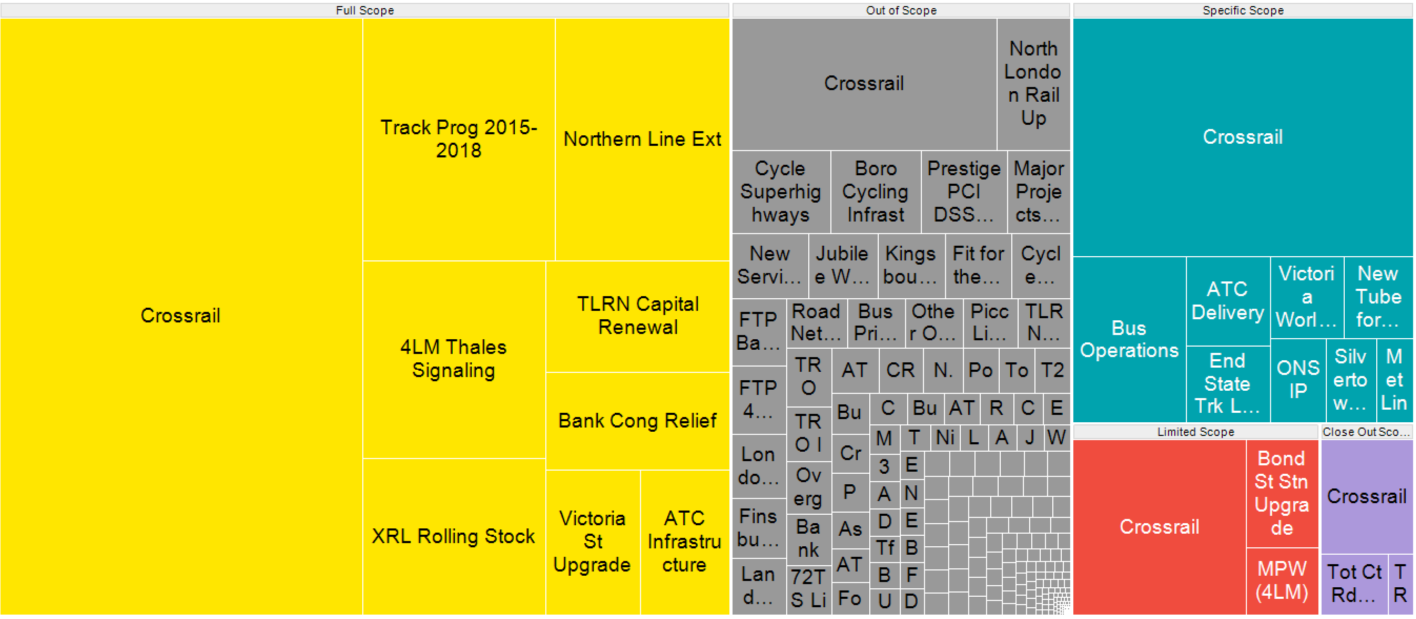
| Area of emphasis | Summary of audit procedures |
| --- | --- |
| Inappropriate Revenue Recognition, required by ISA (UK and Ireland) 240 (continued) | *Our planned procedures in relation to this risk are complete.*<br><br>*We note that in respect of the operation of the new OCM approach to allocating revenue and the fare compensation with the TOCs are the subject of ongoing discussion with the TOCs. The position that has been reflected in the draft financial statements is consistent with the latest information and the calculations provided by management resulting in:*<br><br>Ø *the recognition of additional revenue under OCM*<br>Ø *a cumulative provision for fare compensation*<br><br>*We are satisfied that the positions recorded reflect the latest available information and have been calculated in accordance with the underlying agreements.*<br><br>*There were no other matters arising from our revenue testing.* |
| Inappropriate capitalisation or potential impairment of capital projects<br><br>TfL, TTL and subsidiaries undertake multiple capital projects at any one time which vary in size, complexity and length of time to complete. In 2016-2017 financial year, TfL's capital expenditure was £3.4 billion.<br><br>Judgements and controls needs to be effective to appropriately recognise the revenue costs from these significant projects including:<br><br>• Appropriate split of costs between capital and operating expenditure.<br>• Assessment of the economic useful lives of the asset where costs are capitalised.<br>• Whether to recognise impairments and write-offs for assets to reflect either increased risks of projects being terminated or suspended. | For TfL, TTL groups and subsidiaries we have:<br><br>• Reviewed 20 major projects (including Crossrail) based on quantitative and qualitative thresholds, see further information on the next page.<br>• Understood key controls and governance surrounding capital project accounting and management.<br>• Met with management and project managers during the year and attended management's P12 accruals meetings.<br>• Evaluated management's judgements and assumptions used in determining the future benefits expected from the projects and ensuring they are appropriate and supportable.<br>• Considered pain/gain arrangements and related accounting treatment. Assessed whether or not capitalisation of costs is appropriate.<br>• Considered assets impairment and reviewed written off costs during the year on major projects.<br>• Performed detailed testing on a sample of expenditure incurred and capital accruals to source documentation.<br><br>*During our testing we identified an additional capital accrual of £65m, this related to rolling stock and was specific to this contract. Based on our work, including meeting attendance and knowledge of the underlying contracts, we challenged management on the judgements and estimates made, and are satisfied that the capitalised costs in the year is appropriate after including of the adjusted audit difference.*<br><br>*We have further discussed the risk of impairment on the following page.* |

# 4.1 Significant Risks (continued)

## Capitalised expenditure incurred in the year

As set out in our Audit Plan, we have tested a sample of capital projects. The project sample selection process included stratifying the contracts between full, specific, limited and close out scope based on certain risk factors including target disputes, claims and percentage completion. For all contracts identified as full and specific scope, we have obtained a detailed contract questionnaire and challenged management's assumptions. For full scope contracts this included holding face-to-face contract meetings with the project management team. For all limited and close out scope contracts we have agreed spend in the year to the latest contractor certificates and considered the reasonableness of the forecast costs to complete.

As part of our audit procedures, we have performed detailed contract testing covering 76.5% of the capitalised expenditure incurred during the year. The diagram below shows a box for each active project in the year with the size of the box corresponding to the value of the capitalised spend during in year. The contracts selected for testing during the year are categorised below into their designated scoping.




During our testing we identified that there was no guideline within TfL for the approach to accounting for the pain/gain position on contracts in progress at the year end. We recommended a guideline be developed to management during our interim visit and were pleased to see a guideline has been drafted for future application at the time of our final fieldwork visit.

## In progress Capital Projects

At the balance sheet date, there are a number of significant capital projects at various stages of completion. For example one project is at initial stages and has £68 million capitalised, of which £15 million relates to a train. This particular project is dependent on availability of funding from a number of sources including TfL and the DfT. We have challenged management as to whether this funding is available and included in latest business plans. We will continue to review the position up to the date of approval of the financial statements, given the business planning process will be in progress over that time. We will assess whether there are any significant changes in plans which would indicate this, or any other particular project, was no longer expected to progress further. We will also seek confirmation in the letter of representation that such projects are expected to be funded and that there is no impairment required in the carrying value of in progress assets at 31 March 2017.

# 4.1 Significant Risks (continued)

| Area of emphasis | Summary of audit procedures |
|---|---|
| Significant accounting estimates, including complexity of provisions and accruals<br><br>Certain provisions and accruals (e.g. Compulsory Purchase Orders, litigation, claims and disputes) require complex estimates involving high levels of management judgement and uncertainty.<br><br>TfL, TTL and subsidiaries have complex contract and commercial arrangements. A large proportion of TfL corporations provisions come from its capital investment activities. In particular CPO provisions and contractual disputes are subject to significant estimation and include uncertainty around negotiations. | For TfL, TTL groups and subsidiaries we have:<br>• Tested material provisions and accruals for business purpose and appropriateness of estimation techniques.<br>• Calculated the sensitivity of the provisions to changes in assumptions used for discount rates and inflation to determine if this is material.<br>• Reviewed and critically evaluated management's judgement and estimates applied in the calculation of provisions in the financial statements.<br>*TfL is in the process of implementing a transformation programme. The goal being to reduce inefficiencies, by creating a streamlined and cost effective organisation that is self sufficient. As a result of the transformation program a number of departments are having to reduce head count. Severance provisions totalling £75.4 million have been recognised at 31 March 2017. Whilst the total expected cost of severance is expected to be significantly more than this amount as the programme completes, provisions have been recognised in accordance with accounting standards, where the position is sufficiently clear and communication with the affected individuals has been held . We noted an immaterial amount of £5.6 million which did not meet the conditions for recognition, however this is not material and is reported in our unadjusted differences.*<br><br>*£61.9m compensation and contractual matters and £99.2 million capital investment activities provisions have been recognised at the balance sheet date. These are subject to significant estimation techniques and include uncertainty around negotiations and the fact that the circumstances of the other party will ultimately determine both the timing and level of settlement. We corroborated the provision to latest supporting documentation. We have also reviewed settlements of provisions made for similar matters in the prior year, to assess the accuracy of management's estimations. There were no material matters identified. We are satisfied that the provisions made are within an acceptable range, based on latest available information.*<br><br>*There were no other matters to report.* |

# 4.1 Significant Risks (continued)

| Area of emphasis | Summary of audit procedures |
|---|---|
| **Complexity of accounting for TfL's property portfolio**<br><br>TfL and TTL groups have an extensive property portfolio, with a total book value of assets held at valuation is £884 million as at 31 March 2017. Included within the portfolio are infrastructure assets, office buildings, investment properties.<br><br>The unique and material nature of TfL and TTL groups' property portfolio means that small changes in assumptions when valuing these assets can have a material impact on the financial statements. | For TfL, TTL group and subsidiaries, we have:<br>• Discussed with management and reviewed evidence to gain an understanding of TfL and TTL group property portfolio.<br>• Discussed and reviewed valuation assumptions made by external valuers along with the TfL Property team.<br>• Performed substantive testing and corroborated explanations for property additions, disposals and accounting for lease contracts.<br>• Assessed the classification of TfL and TTL property portfolio, the valuation basis and any material increases or impairments that arise during 2016/17.<br>• Assessed the work of TfL's property valuers. Our EY property valuation team supported our review and testing of the accounting entries and disclosures made in the financial statements.<br>• Reviewed Infrastructure and office buildings, PFI accounting models and appropriateness of accounting and disclosures.<br>• Considered the classification of assets between investment properties, property, plant and equipment and assets held for sale in accordance with IFRS.<br>*Based on the work performed, we have concluded that the property valuations are within an acceptable range.*<br>*We have reviewed the properties classifications and have concluded that they are appropriate disclosed in the financial statements.* |
| **Judgemental assumptions impacting on TfL's pension deficit**<br><br>At the 31 March 2016, TfL's defined pension schemes has a deficit of £3.2 billion. The TfL Group balance sheet includes the deficit on the TfL Pension Fund and TfL's share of the deficit on the Local Government Pension Scheme and liability for unfunded pensions obligations.<br><br>The assumptions used to arrive at the value of the pension deficit are highly judgemental. The setting of these assumptions in accordance with IAS19(R) Employment Benefits will be an area of audit emphasis.<br><br>The current year reflects the inclusion of a Crossrail liability for the first time due to a change in the structure of Crossrail pension obligations. | We have:<br>• Reviewed the actuarial report and fund actuary triennial valuation. Testing the reasonableness of key actuarial assumptions.<br>• Sought to place reliance on information from KPMG in terms of their audit of investment fund/asset values and membership data submitted to the actuary as KPMG are the auditors of the TfL Pension Fund<br>• Used our EY pensions specialist as appropriate to support us with this work and to review the appropriateness of the IAS19 valuation methodology.<br>• Reviewed the disclosure of deficit and assumptions in the financial statements to ensure that it is fair, balanced and understandable<br>*Based on the work performed, we have concluded that the assumptions used in determining the actuarial valuations are within an acceptable range and are neither considered overly prudent or optimistic, we have included our assessment of the assumptions in Appendix B.*<br>*In terms of the audit of pension scheme assets, as noted this is outstanding from KPMG at the time of issuing this report.* |

# 4.2 Other audit risks (continued)

| Other area of emphasis | Summary of audit procedures |
|---|---|
| Investment in associate – Earls Court<br>The Group holds a 37% share in Earls Court Partnership Limited (ECP)and accounts for its share of the income statement result and assets and liabilities in the Group financial statements.<br>In the year the Group's share of the value in ECP has reduced by £105 million, representing the significant adjustment in ECP to the carrying value of the land. This has arisen due to issues with planning. | Our approach has been to:<br>► Obtain latest financial information for ECP and test the accounting to supporting documentation.<br>*There were no issues to note with the accounting adopted, however we note that progress on this project needs careful monitoring to ensure further future losses can be mitigated.* |
| Changes and compliance with IFRS and CIPFA Code of Practice for Local Authority Accounting<br>Amendments have been made to the Code of Practice on Local Authority Accounting in the United Kingdom 2016/17 (the code) this year changing the way the financial statements are presented.<br>The new reporting requirements impact the Comprehensive Income and Expenditure Statement (CIES) and the Movement in Reserves Statement (MiRS), and include the introduction of the new 'Expenditure and Funding Analysis' note as a result of the 'Telling the Story' review of the presentation of local authority financial statements.<br>The Code no longer requires statements or notes to be prepared in accordance with SeRCOP. Instead the Code requires that the service analysis is based on the organisational structure under which TfL operates.<br>This change in the code required a new structure for the primary statements, new notes and a full retrospective restatement of impacted primary statements | Our approach has been to:<br>► Review the expenditure and funding analysis, CIES and new notes to ensure disclosures are in line with the code.<br>► Agree the restated comparative figures back to the TfL's segmental analysis and supporting working papers.<br>*The new reporting requirements under the CIPFA code of practice, impacting the CIES and the Movement in Reserves Statement, and the introduction of the Expenditure and Funding Analysis, have been implemented with no issues noted.* |
| Presentation of sensitive disclosures<br>Our audit work on the draft 2016/17 TfL and TTL Group accounts is currently underway. Specific work on those disclosures deemed sensitive include:<br>► Related Party Transactions<br>► Remuneration and termination payments | Our approach has been to:<br>► Test disclosures to underlying records.<br>► Compare of the disclosures made to best practice such as adopted by the FTSE100.<br>*We have completed our procedures and no material issues were identified with validating the information. We have provided comments to management on best practice which have led to additional disclosures compared to prior years.*<br>*We believe that the disclosures go beyond the requirements of public sector organisations, although there are still some areas that could be expanded, to achieve leading practice, as well as additional matters that will become requirements I the future that could be anticipated.* |

# 5. Financial statements audit

## 5.1 Progress of the audit

The following areas of our work programme remain to be completed. We will provide an update of progress at the Audit and Assurance Committee meeting:

- Post balance sheet events up to the date of approval of the financial statements. In particular this will include a review of the latest planning information to consider whether there is any indication of projects that are no longer planned to progress which could result in impairment off assets held in property, plant and equipment at 31 March 2017.
- Receipt of signed letter of representation.

Subject to the satisfactory resolution of the above items, we propose to issue an unqualified audit report on the financial statements.

## 5.2 Misstatements

In the normal course of any audit, we identify misstatements between amounts we believe should be recorded in the financial statements and the disclosures and amounts actually recorded. These differences are classified as 'known' or 'judgemental'. Known differences represent items that can be accurately quantified and relate to a definite set of facts or circumstances. Judgemental differences generally involve estimation and relate to facts or circumstances that are uncertain or open to interpretation.

Our audit to date has identified one significant misstatement which has been adjusted in the draft financial statements. This related to the liability at 31 March 2017 for rolling stock procurement. Our testing identified an additional liability of £65 million which has been adjusted.

At the date of reporting, in addition we highlight the following misstatements to the financial statements which were not corrected by management:

| Uncorrected misstatements | Assets current | Assets non current | Liabilities current | Liabilities non-current | Income/ expenses |
|---|---|---|---|---|---|
| | Debit/ (Credit) | Debit/ (Credit) | Debit/ (Credit) | Debit/ (Credit) | Debit/(Credit) Current period |
| | *£m* | *£m* | *£m* | *£m* | *£m* |
| Judgemental differences: | | | | | |
| ► over-provision for severance | | | 5.6 | | (5.6) |
| Balance sheet totals | - | - | 5.6 | - | |
| Income effect of uncorrected misstatements (before tax) | | | | | (5.6) |
| Less: tax effect at current year marginal rate | | | | | - |
| Cumulative effect of uncorrected misstatements before turnaround effect | | | | | (5.6) |
| Turnaround effect. See note 1 below. | | | | | (5.9) |
| Cumulative effect of uncorrected misstatements, after turnaround effect | | | | | (11.5) |

There are no amounts that we identified that are individually or in aggregate material to the presentation and disclosures of the consolidated financial statements for the year ended 31 March 2017.

Note 1: turnaround effect is the post-tax impact of uncorrected misstatements identified in the prior period, on results of the current period. This was one adjustment relating to the interest free Network Rail loan in Crossrail.

# 5.3 Other matters

As required by ISA (UK&I) 260 and other ISAs specifying communication requirements, we are required to communicate to you significant findings from the audit and other matters that are significant to your oversight of TfL's financial reporting process including the following:

- Qualitative aspects of your accounting practices; estimates and disclosures;
- Matters specifically required by other auditing standards to be communicated to those charged with governance. For example, issues about fraud, compliance with laws and regulations, external confirmations and related party transactions;
- Any significant difficulties encountered during the audit; and
- Other audit matters of governance interest.

## Internal control

It is the responsibility of management to establish and maintain proper implementation of internal control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as auditor is to consider whether management has put adequate arrangements in place to satisfy itself that the systems of internal controls has adequate design and operating effectively.

We have tested the controls of TfL only to the extent necessary for us to get a reasonable assurance over the controls. Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate significant deficiencies in internal control. We have not identified any significant deficiencies in the design or operation of an internal control that might result in a material misstatement in TfL's financial statements of which the management is aware.

We have highlighted a number of recommendations for internal control to management. The most significant of which remains our view that the number of 'firefighter' user access to core IT systems remains high and indeed is higher than the prior year, whilst management has implemented a review control to monitor what changes such users are making, this creates additional work and perhaps a more effective approach would be to reduce the number of users with such access rights.

Our other observations included improving controls surrounding inventory and improvements in the capital projects process to support the drive for efficiencies. We have set out further detail in Appendix A.

## Data analytics

During our testing we performed various analyses of data relating to procurement to pay, payroll and journal entry posting. We have shared our detailed findings with management and we can share further information with the Audit Committee if that would be helpful.

Our analysis highlighted a number of areas where efficiencies could be generated such as in the procurement to pay process, for example:

- There were high volumes of invoices from the same supplier for small amounts which could be consolidated by the supplier and reduce processing administration by TfL.
- There were also examples of the same supplier being used by a number of different areas of the business, however there was no coordination to ensure that the best price was obtained given the volume of business placed with the suppliers.

# 5.3 Other matters (continued)

## Annual Governance Statement

We have yet to receive the Annual Governance Statement. Once we receive a copy of the AGS we will review it to ensure:

- it complies with the requirements of CIPFA/SOLACE Delivering Good Governance in Local Government Framework; and
- it is consistent with other information that we are aware of from our audit of the financial statements.

## Request for written representations

We will request a management representation letter to gain management's confirmation in relation to a number of matters. At the date of this report there are no additional specific representations required other than the standard representations.

## Whole of government accounts

Alongside our work on the financial statements, we also review and report to the National Audit Office on your Whole of Government Accounts return. The extent of our review and the nature of our report are specified by the National Audit Office.

We aim to conclude our work in this area by the WGA deadline of the 30 September 2017 and will report any matters that arise to the Audit and Assurance Committee.

# 6. Arrangements to secure economy, efficiency and effectiveness

The Code of Audit Practice (2015) sets out our responsibility to satisfy ourselves that Transport for London has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources. Proper arrangements are defined by statutory guidance issued by the National Audit Office.

## Overall conclusion

We considered your arrangements to:

- Take informed decisions;
- Deploy resources in a sustainable manner; and
- Work with partners and other third parties.

We identified one significant risk in relation to these arrangements in our audit plan dated 11 October 2016:

- Sustainable resource deployment

The work  we have undertaken in response to these risks are summarised in the table below.

Our review of your arrangements to secure economy, efficiency and effectiveness in your use of resources is complete. We did not identify any significant weaknesses in TfL's arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people. We therefore anticipate issuing an unqualified value for money conclusion.

We identified the following VFM risks during our audit. Here, we set out how we have gained audit assurance over those issues. We are only required to determine whether there are any risks that we consider significant, which the Code of Audit Practice which defines as: "*A matter is significant if, in the auditor's professional view, it is reasonable to conclude that the matter would be of interest to the audited body or the wider public*".

| VFM risk identified | Key Findings |
|---|---|
| Sustainable resource deployment – Significant risk | |
| 1. TfL has significant financial risks in its Business Plan to 2020/21 and we note that a revised Business Plan will be published in December covering the period to 2021/22. TfL's external funding sources are reducing and are subject to change and uncertainty in future years. In addition, significant cumulative cost reductions are planned for over the course of the next five years to 2020/21. | Through its year end capital and revenue outturn, annual budget setting, use of reserves and its medium term financial planning, TfL continues to plan well to secure sustainable resource deployment.<br>Passenger numbers on both London Underground and Buses have been lower than forecast, resulting in lower fare revenue for the year. This has been mitigated through lower operating costs, which result from lower card payment fees and payments to bus operators which are partly based on passenger numbers.<br>The 2017/18 budgeting process is soundly based. Arrangements underpinning the 2017/18 budget are considered good, with TfL leveraging the work being performed elsewhere as part of the cost reduction programme.<br>The forecast operating surplus for 2017/18 included in the budget is £26m lower than in business plan published in December.  This reflects updated economic forecast and decrease in fares income, driven by bus passenger numbers, which forecast an increase of 1.4% in the business plan, but now anticipating a decrease of 2.3%, resulting in lower operating revenue. The fall in passenger numbers reflects issues with road speed reliability as a result of current congestion on bus routes, which is an ongoing challenge.<br>Operating expenditure forecast to be lower than in the business plan by £75m, which offsets part of the decrease in operating income. The lower costs are partly due to lower passenger numbers, and the corresponding decrease in variable costs, and as a result of TfL's cost reduction programme. |

| VFM risk identified | Key Findings |
| --- | --- |
| | Along with many other public organisations, TfL is facing significant financial challenges over the next five years. TfL's external funding sources are reducing and are subject to change and uncertainty in future years. In addition, significant cumulative cost reductions of approximately £4 billion are planned for over the course of the next five years to 2021/22.<br>Meeting these challenges also requires the successful implementation of the commercialisation plan, including developing land for housing, set to generate £850m over the business plan period, and establishing a commercial trading arm to sell TfL's expertise to other cities and transport operators across the UK and the rest of the world. |
| TfL's operations and ongoing Investment Programmes are subject to a number of risks, particularly the exposure to economic risks associated with revenue reductions, and financial markets disruption impacting on TfL's ability to borrow. | Some of the future opportunities and challenges facing TfL include:<br>► government funding and grant reductions, reducing by 49% compared to 2016/17, reducing to nil in 2018/19;<br>► planning for future assumptions on fare inflation, growth and charges;<br>► volatility in business rate income forecasts that the GLA itself is subject to, and the impact this may have on future levels of business rates income due from GLA; and<br>► Impact on capital projects of changes in policy and funding.<br>These are particularly challenging aspects to budget for, adding a significant degree of uncertainty to TFL's funding position in the medium term.<br>Bridging the substantial funding deficit of the future is also heavily dependent on the effective execution of the commercialisation programme and the cost reduction programme. |

## Other observations – Decision making

Overall we have considered your arrangements to:

- Take informed decisions;
- Deploy resources in a sustainable manner; and
- Work with partners and other third parties.

As noted above our risk focus for 2016/2017 was on how TfL deploys resources in a sustainable manner. However, we also considered the arrangements in place for TfL to take informed decisions and work with partners and other third parties as part of our overall VFM work.

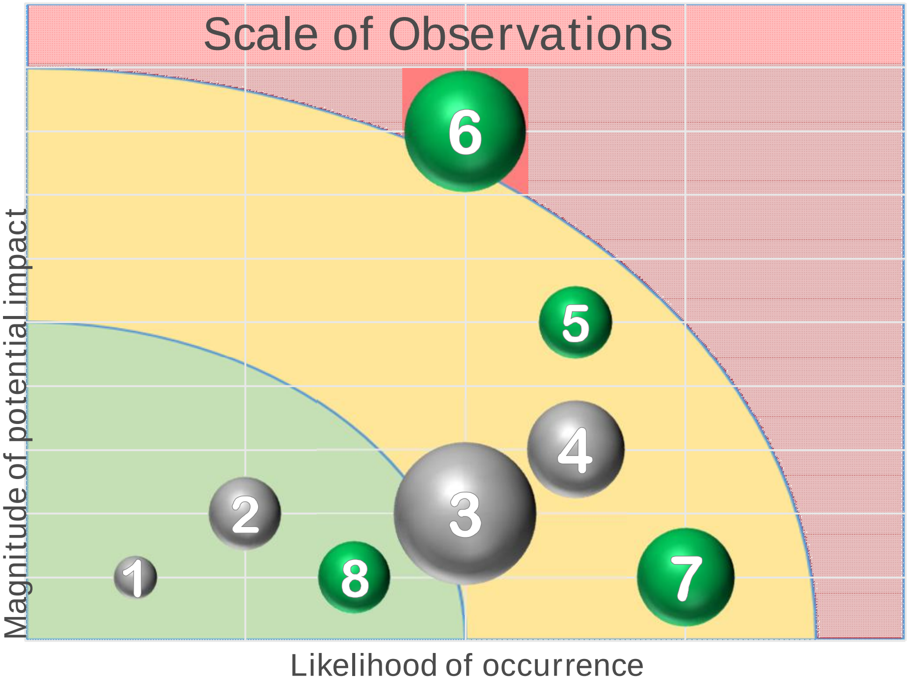
Our observations show that there are increasing demands on the internal management reporting requirements for more reliable and transparent information to drive better decision making and improve performance. Current reports can be long documents, which can be difficult to follow and key points are lost in the detail.

The organisational changes currently underway provide TfL with the opportunity to redesign its reporting arrangements, streamlining reports to make them more focused on the issues that matter for each stakeholder. This will help to reduce the amount of time spent on preparing and considering reports, enabling faster decision making and improving confidence that issues are appropriately addressed.

# Appendix A – Internal control observations

As noted in section 15, we shared with management observations arising during our audit testing. When we discussed these with management, we included our view on the ease of which the recommendations could be implemented.

In the graph below, the position of the bubble indicates the likelihood of potential consequences, should the risk not be addressed, against the magnitude of the potential impact. The sized of the bubble indicates the ease of which the risk can be fully mitigated. The colour of the bubble indicates the status of managements response to the identified risk.

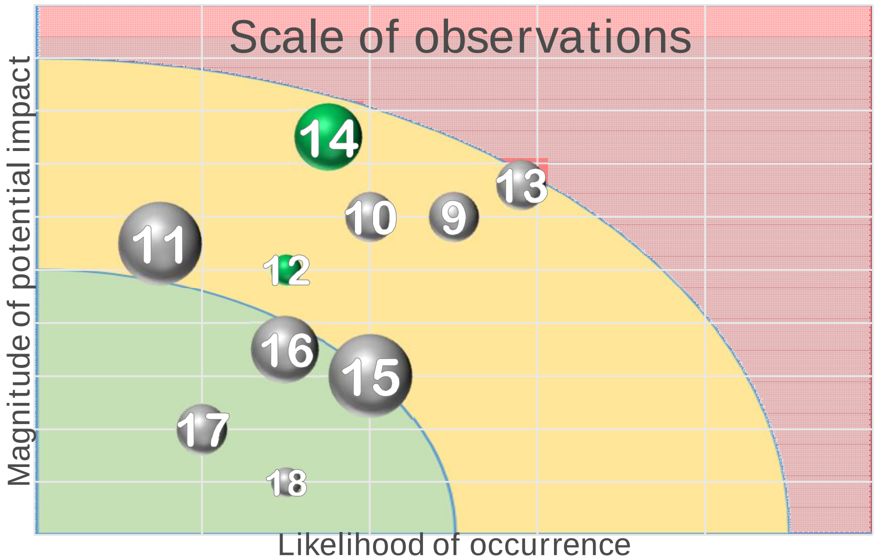



| Obs. # | Area of review | Recommendation |
|---|---|---|
| 1 | Revenue – LU Fares Cash Collection | Retention of reconciliation of G4S reports |
| 2 | Revenue – Rental Rev Reconciliation | Implementation of a monthly or quarterly reconciliation of rental revenue information |
| 3 | Capital Projects – P2P | Reduce volume of invoices from the same supplier |
| 4 | Capital projects – WBS creation on SAP | Implement a standardised WBS form |
| 5 | Capital Projects – Pain/Gain policy | Develop a guideline on accounting for pain/gain elements of contracts |
| 6 | Inventory – Security | Reinforce consistent application of site security |
| 7 | Inventory – Stock booking | Implement a more formalised policy to book out stock |
| 8 | Inventory – Location record | Improve location tracking of stock |

# Appendix A – Internal control observations (continued)

Our observations on improvement to the IT control environment are summarised below.

In the graph below, the position of the bubble indicates the likelihood of potential consequences, should the risk not be addressed, against the magnitude of the potential impact. The sized of the bubble indicates the ease of which the risk can be fully mitigated. The colour of the bubble indicates the status of managements response to the identified risk.




| Obs. # | Area of review | |
|---|---|---|
| 9 | Manage Access - Segregation of duties (depreciation) | Timely review of access arrangements when an individual's role or responsibility changes |
| 10 | Manage Access - Deletion of user accounts post employment termination | Timely removal of leavers access to systems |
| 11 | Manage Access - User able to perform unauthorised transactions | Adopt formal policies for user access creation for all types of system access |
| 12 | Manage Access - Firefighter IDs | Review and control firefighter IDs |
| 13 | Manage Change - Develop and migrate changes | Impose segregation of duties between developing and migrating changes |
| 14 | Manage Access - User SAP access without approval | Document approval of highly privileged access rights |
| 15 | Manage Access - Review of user access | Implement periodic reviews of access rights |
| 16 | Manage Access - Formal process of creating/amending users | Standardise user access processes including for graduates/apprentices, bulk starters/movers |
| 17 | Manage Access - Unauthorised changes | Reduce end user access to create and amend job schedules |
| 18 | Manage Access - Password Settings | Enforce stricter password settings |

# Appendix B – Summary of pension assumptions

We have summarised below the assessment of pension assumptions used for the TfL Pension Fund, the overall basis for the purposes of IAS19 disclosures at the balance sheet date is acceptable.

| Financial assumptions | | Prudent | Central | Optimistic |
|---|---|---|---|---|
| Discount rate | | | 2.65% | |
| Price inflation (RPI) | | | 3.35% | |
| Price inflation (CPI) | | | 2.35% | |
| Salary increases (above RPI infl) (1) | | | +0.00% | |
| Pens incs in payt (above infl) (1) | LPI 5% | | -0.10% | |
| | RPI | | +0.00% | |
| | CPI 3% | | -0.30% | |
| Pens incs deferment (above RPI infl) (1) | | | +0.00% | |
| **Demographic** | | **Prudent** | **Central** | **Optimistic** |
| Mortality in retirement | Base table | | S2NA (various scaling factors) | |
| | Projections to 2015 | | CMI 2014 1.60% LT | |
| | Projections from 2015 | | CMI 2015 1.25% LT | |
| Retirement age | | | NRA | |
| Commutation | | | 90% of max | |

(1) The assumptions for salary & pension increases (both in deferment and payment) have been stated relative to inflation rather than as absolute figures.

We have summarised below the assessment of pension assumptions used for the Crossrail Shared Cost Section of the Railways Pension Scheme ("the Scheme"), the overall basis for the purposes of IAS19 disclosures at the balance sheet date is acceptable.

| Financial assumptions | | Prudent | Central | Optimistic |
|---|---|---|---|---|
| Discount rate | | | 2.65% | |
| Price inflation (RPI) | | | 3.40% | |
| Price inflation (CPI) | | | 2.40% | |
| Salary increases (above RPI infl) (1) | | | +0.00% | |
| Pens incs in payt (above infl) (1) | CPI | | +0.00% | |
| | CPI 3% | | -0.30% | |
| Pens incs deferment (above CPI infl) (1) | | | +0.00% | |
| **Demographic** | | **Prudent** | **Central** | **Optimistic** |
| Mortality in retirement | | | S1NxA<br>93%/118% m/f<br>CMI2012 until 2010<br>CMI2015 from 2011<br>1.25% LT | |
| Retirement age | | | 60 & 58.5 | |
| Commutation | | | 5% of pension | |

(1) The assumptions for salary & pension increases (both in deferment and payment) have been stated relative to inflation rather than as absolute figures.

# Appendix B – Required communications with the Audit and Assurance Committee

There are certain communications that we must provide to the Audit Committees of UK clients. We have detailed these here together with a reference of where and when they were covered:

| Planned/actual timing of communication to the Audit Committee | |
|---|---|
| | |
| Planning and audit approach<br><br>Communication of the planned scope and timing of the audit including any limitations. | Discussed within our Audit Planning Report |
| Significant findings from the audit<br><br>► Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures<br>► Significant difficulties, if any, encountered during the audit<br>► Significant matters, if any, arising from the audit that were discussed with management<br>► Written representations that we are seeking<br>► Expected modifications to the audit report<br>► Other matters if any, significant to the oversight of the financial reporting process<br>► Unless covered by other communications on planning matters or significant findings, this information shall include views on:<br>► Business risks relevant to financial reporting objectives, the application of materiality and the implications of our judgments in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified.<br>► The significant accounting policies (both individually and in aggregate);<br>► Management's valuations of the entity's material assets and liabilities and the related disclosures provided by management;<br>► Internal control*, specifically on:<br>  ► The effectiveness of the entity's system of internal control over financial reporting; and<br>  ► Other risks arising from the entity's business model and the effectiveness of related internal controls,<br>► Any other matters identified in the course of the audit that we believe will be relevant to the board or the audit committee in the context of fulfilling their responsibilities referred to above. | Discussed within this report |

# Appendix B – Required communications with the Audit and Assurance Committee (continued)

| Planned/actual timing of communication to the Audit Committee | |
|---|---|
| | |
| Misstatements<br>► Uncorrected misstatements and their effect on our audit opinion<br>► The effect of uncorrected misstatements related to prior periods<br>► A request that any uncorrected misstatement be corrected<br>► In writing, corrected misstatements that are significant | Discussed within this report |
| Fraud<br>► Enquiries of the audit committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity<br>► Any fraud that we have identified or information we have obtained that indicates that a fraud may exist<br>► A discussion of any other matters related to fraud | No issues to report |
| Related parties<br>Significant matters arising during the audit in connection with the entity’s related parties including, when applicable:<br>► Non-disclosure by management<br>► Inappropriate authorisation and approval of transactions<br>► Disagreement over disclosures<br>► Non-compliance with laws and regulations<br>► Difficulty in identifying the party that ultimately controls the entity | Discussed within this report - no issues to report |
| External confirmations<br>► Management’s refusal for us to request confirmations<br>► Inability to obtain relevant and reliable audit evidence from other procedures | No issues to report |
| Consideration of laws and regulations<br>► Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off<br>► Enquiry of the audit committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the audit committee may be aware of | No issues to report |

# Appendix B – Required communications with the Audit and Assurance Committee (continued)

| | Planned/actual timing of communication to the Audit Committee |
|---|---|
| | |
| Independence<br>Communication of all significant facts and matters that bear on EY's objectivity and independence<br>Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as:<br>► The principal threats<br>► Safeguards adopted and their effectiveness<br>► An overall assessment of threats and safeguards<br>► Information about the general policies and process within the firm to maintain objectivity and independence<br>For listed companies, communication of minimum requirements as detailed in the ethical standards:<br>► Relationships between EY, the company and senior management<br>► Services provided by EY that may reasonably bear on the auditors' objectivity and independence<br>► Related safeguards<br>► Fees charged by EY analysed into appropriate categories such as statutory audit fees, tax advisory fees, other non-audit service fees<br>► A statement of compliance with the ethical standards<br>► The audit committee should also be provided an opportunity to discuss matters affecting auditor independence | Discussed within our separate letter tabled for the meeting on 13 July 2017 |
| Going concern<br>Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including:<br>► Whether the events or conditions constitute a material uncertainty<br>► Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements<br>► The adequacy of related disclosures in the financial statements | Discussed within this report – see Section 6 |
| Significant deficiencies in internal controls identified during the audit | No material deficiencies – control observations are included in this report |

# Appendix B – Required communications with the Audit and Assurance Committee (continued)

| Planned/actual timing of communication to the Audit Committee | |
|---|---|
| | |
| Group audits<br>► An overview of the type of work to be performed on the financial information of the components<br>► An overview of the nature of the group audit team's planned involvement in the work to be performed by the component auditors on the financial information of significant components<br>► Instances where the group audit team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work<br>► Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted<br>► Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements | Discussed within our Audit Planning Report - there are no further matters to report. |

EY | Assurance | Tax | Transactions | Advisory

Ernst & Young LLP



ED None

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

ey.com