

TRANSPORT FOR LONDON

AUDIT COMMITTEE

**SUBJECT:** TRANSPORT TRADING LIMITED AUDIT PLAN – YEAR ENDING  
31 MARCH 2009

**DATE:** 25 NOVEMBER 2008

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**1 PURPOSE**

- 1.1 To present to the Audit Committee KPMG's plan for the audit of the financial statements of Transport Trading Limited and its subsidiaries ("the TTL group") for the year ending 31 March 2009.

**2 BACKGROUND**

- 2.1 The strategy for the audit of Transport for London was presented to the Audit Committee in March this year. This Plan now sets out the audit strategy and approach for the TTL group. The Chief Finance Officer, Director of Internal Audit, and modal Finance Directors have been consulted on the Plan.

**3 RECOMMENDATION**

- 3.1 The Audit Committee is asked to NOTE the Plan and to make any comments as appropriate.

**4 CONTACT**

- 4.1 Contact: June Awty, Engagement Partner, KPMG  
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KPMG LLP

# Transport Trading Limited

Audit strategy – year ending 31 March 2009

Presentation to the Audit Committee on 25 November 2008

AUDIT

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# Introduction

## Scope

- The purpose of this document is to set out our approach to the audit of the financial statements of Transport Trading Limited and its subsidiaries (collectively “TTL”) for the year ending 31 March 2009. The full list of subsidiaries can be seen on slide 5.
- We note that the strategy for the audit of Transport for London (“TfL”), which is the sole shareholder in TTL, is set out in a separate document which has already been presented to the Audit Committee. The audit of the financial statements of TfL is governed by the requirements of the Audit Commission.
- Our audit of TTL serves two purposes:
  - To express an audit opinion on the group reporting packs of TTL and its subsidiaries as part of our audit of the consolidated financial statements of TfL
  - To enable us to express an audit opinion on the statutory financial statements of TTL and each of its subsidiaries
- We note that there has been a significant increase in the scale of the TTL group this year and the number of subsidiary companies which require an audit. This is principally as a result of the acquisition of the two Metronet businesses and Tramtrack Croydon during the current financial year. More detail is provided on this in pages 5 and 6.
- In particular this paper describes:
  - Overview of audit strategy and approach
  - Audit process explained
  - The key audit risks
  - Timeline and principal deliverables
  - The client service team members

## Our responsibilities as auditor

- As auditor to TTL we are required to provide an audit opinion in accordance with the UK Companies Acts on the accounts of all group companies (excluding those which are dormant). Under UK company law, our responsibility is to the shareholders of TTL. In addition we have professional responsibilities to report certain matters, if they come to our attention, to regulatory bodies
- Our audit of TTL is conducted in accordance with Auditing Standards and our formal terms of reference are set out in our existing engagement letter

## Restriction on circulation

- This document is provided on the basis that it is for the information of the TfL Audit Committee and that it will not be quoted or referred to, in whole or in part, without our prior written consent; and that we accept no responsibility to any third party in relation to it

# Overview of audit strategy and approach

## Audit strategy and approach

Our audit strategy is based upon a clear understanding of and focus on the risks facing TTL, which is obtained from a thorough understanding of TTL's strategy, goals and the business environment in which it operates

Our audit approach entails (in overview):

- Documenting our understanding of the key financial processes by which transactions are recorded through to the financial statements, the related controls, including assessing TTL's internal control environment
- Testing that controls which are relied upon, have operated effectively throughout the year; and
- Following our assessment of processes and controls, we determine the focus and extent of substantive testing required to form our audit opinion

## Materiality and reporting of audit differences

Auditing Standards require that we plan our audit to determine with reasonable confidence whether or not the financial statements being reported on are free from material misstatement. We will discuss materiality levels with management and the Audit Committee.

An omission or misstatement is regarded as material if it would reasonably influence the user of financial statements; this therefore involves an assessment of the qualitative and quantitative nature of omissions and misstatements

Generally, we would not regard differences in opinion in respect of areas of judgement to represent 'misstatements' unless the application of that judgement results in a financial amount falling outside of a range which we consider to be acceptable

Whilst our audit procedures are designed to identify misstatements which are material to our opinion on the financial statements as a whole, we nevertheless report to the Audit Committee misstatements of lesser amounts to the extent these are identified by our audit work

Under UK Auditing Standards (SAS 610) we are obliged to report omissions or misstatements other than those which are 'clearly trifling' to those charged with governance, and to request that adjustments are made to correct such matters

## Working with Internal Audit

We plan to work closely with Internal Audit to ensure that information is shared, that verification work is targeted at areas of greatest risk and that duplication of work is avoided. We generally rely on the work of Internal Audit as part of the overall framework of internal control and keep up to date with the findings of their own work. We have regard to their work, where appropriate, in planning the procedures that we have to perform for our external audit. In order to place such reliance we will need to satisfy ourselves as to the level and quality of Internal Audit's work during the current financial year

We will work closely with the Internal Audit IT auditors regarding the effectiveness of Group IM arrangements and will consider this when defining the scope of our follow up audit work on the SAP system

The Internal Audit work plan includes a number of areas e.g. FSC payment processes and Treasury which we will take into account during our audit and not duplicate.

In addition we will liaise closely with Internal Audit on the split of controls work on the new businesses that have come into the group this year

# Audit process explained

- The audit process is outlined below. It is structured in a way which allows us to focus on the key issues and complete the audit in an efficient manner

## Planning

- Obtain an understanding of your business and environment, including your accounting policies, practices and financial performance
- Understand and evaluate the design and the implementation of the Internal controls framework operating with TTL as relevant to the audit
- Identify the risk of material misstatement of the accounts, including risks of fraud and error
- Develop our audit strategy in response to those risks e.g. timing of work composition of team, materiality and use of specialists
- Develop our detailed audit approach for significant balances, risks and disclosures

## Control Evaluation

- Gain a detailed understanding of your accounting and reporting processes and procedures including related controls
- Evaluate the design and implementation of selected controls to assess the risks of significant misstatement for each of our planned audit areas
- Test the operating effectiveness of those controls during the year to assess whether we can rely on them to provide audit evidence and thus modify the extent of our substantive procedures

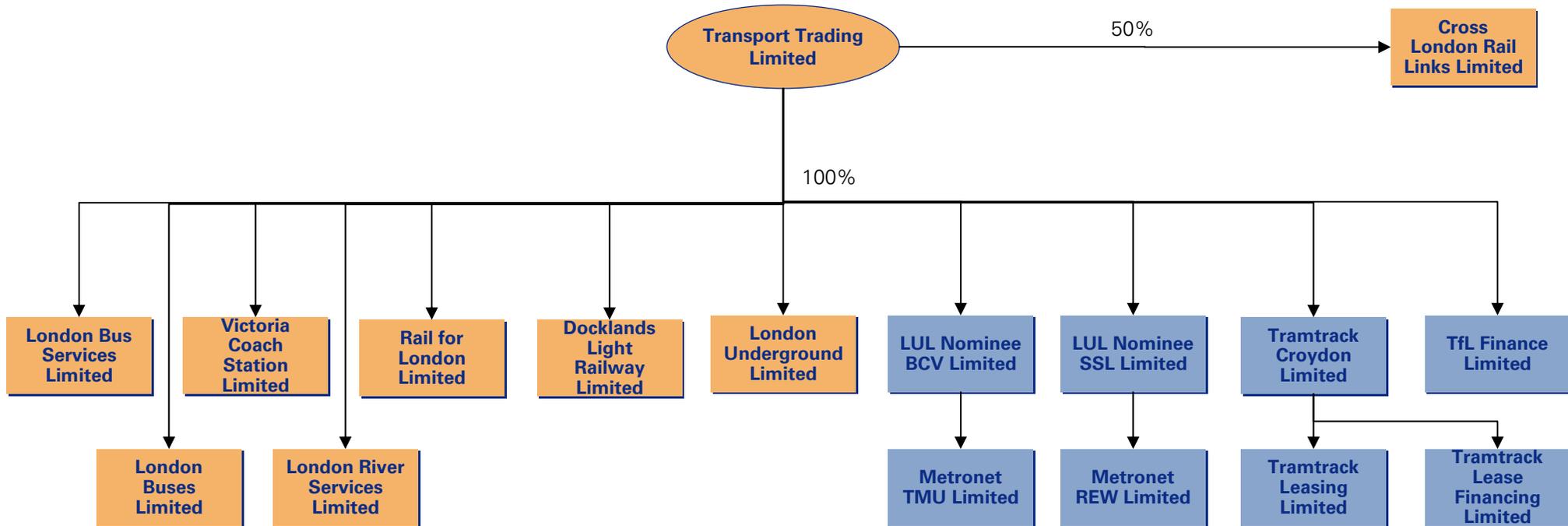
## Substantive Testing

- Perform substantive audit procedures on those audit balances where our Control evaluation work has concluded that such work is necessary to obtain adequate audit evidence
- Substantive procedures include analytical tests, test of detail and specific fraud procedures

## Completion

- Evaluate, on an overall basis the results of audit procedures performed, particularly, significant findings and issues resulting from the audit; actions taken by management to address them and the basis for the conclusions reached
- Complete a detailed review of the financial statements including final analytics; and read relevant other information, evaluate independent and ethical issues and obtain management representatives

# Group structure



Note: The blue boxes represent new entities in the period

As at 1 October 2008

# New companies

New company	Nature of activities	Work done to date
<p><b>LUL Nominee BCV Limited &amp; LUL Nominee SSL Limited</b></p> <p>In April 2008, the Mayor gave his approval to the schemes which transfer the business, assets and certain liabilities of the Metronet Infracos to two TfL nominee companies</p>	<ul style="list-style-type: none"> <li>Supplier of the PPP contract to London Underground. Management of sub-contractors.</li> </ul>	<ul style="list-style-type: none"> <li>We have performed a controls review of Metronet and report our findings in a separate document. This would have been done in conjunction with internal audit.</li> <li>We have reviewed the opening balance sheet of Metronet. This is required for the 31 March 2009 group accounts.</li> </ul>
<p><b>Metronet REW Limited &amp; Metronet TMU Limited</b></p> <p>These two companies were acquired as part of the Metronet transfer schemes.</p>	<ul style="list-style-type: none"> <li>Overhaul, maintenance, reconditioning and testing of a range of rolling stock components, and signalling and electronic equipment used at track sides and stations on the London Underground network.</li> </ul>	<ul style="list-style-type: none"> <li>We have performed the 31 March 2008 audit of the two companies and are currently in the process of finalising the statutory accounts.</li> </ul>
<p><b>Tramtrack Croydon Limited &amp; Subsidiaries</b></p> <p>In May 2008 TTL purchased Tramtrack Croydon Limited to bring the PFI contract back in-house.</p>	<ul style="list-style-type: none"> <li>The business of the group is the operation of a light rail (tram) system. Tramlink operates services over 28 route kilometres between Croydon and Wimbledon.</li> </ul>	<ul style="list-style-type: none"> <li>During November we will perform the 31 March 2008 audit of the Tramtrack group of companies. As part of this exercise we will review the opening balance sheet for the purpose of the group audit.</li> </ul>
<p><b>Cross London Rail Links Limited</b></p> <p>Whilst not a new company, once royal assent is achieved this will become a wholly owned subsidiary of TTL.</p>	<ul style="list-style-type: none"> <li>Design and construction of the new CrossRail line which will cross through the heart of London.</li> </ul>	<ul style="list-style-type: none"> <li>We have had Initial technical discussions in relation to the capitalisation of costs during the design phase.</li> <li>We have also opened discussions with Internal Audit on how we can assess the controls together.</li> </ul>
<p><b>TfL Finance Limited</b></p> <p>TfL has incorporated a subsidiary of TTL for the purpose of entering into derivative transactions.</p>	<ul style="list-style-type: none"> <li>Entering into derivative transactions</li> </ul>	<ul style="list-style-type: none"> <li>We have had Initial technical discussions in relation to the accounting for interest rate swaps.</li> </ul>

We will also look to understand how new governance arrangement will work for the new businesses e.g. Cross London Rail Links Limited audit committee.

# Key audit risks (1)

Financial issues	Impact on financial statements	Audit approach
<p><b>Metronet</b></p> <p>On 27 May 2008 certain assets and liabilities of Metronet were transferred into two TTL nominee companies.</p> <p>During the period a significant number of the Metronet finance team have left, which may create a risk of knowledge leaving the business. In addition this also adds additional work load to the TfL finance team.</p>	<ul style="list-style-type: none"> <li>As Metronet has been acquired by TTL the consolidated accounts will need to reflect the acquisition accounting of Metronet. This will lead to goodwill being recognised.</li> </ul>	<ul style="list-style-type: none"> <li>The nominee companies represent a significant increase in the scope of our audit. Therefore we have supplemented our team with additional senior resource.</li> <li>We have discussed the accounting implications with management throughout the period and continue to do so.</li> <li>We have performed a review of the opening balance sheet and the calculation of goodwill to ensure timely identification of any risks.</li> </ul>
<p><b>Accounting for PPP and PFI contracts</b></p> <p>Accounting for the PPP and PFI contracts is a complex area. The accounting is driven from financial models, which calculate the profit and loss account impact.</p> <p>The charge for the year is also impacted by the level of abatements. These are adjustments made to the infrastructure service charge.</p> <p>An additional consideration this year is the ending of the Prestige contract.</p>	<ul style="list-style-type: none"> <li>Incorrect application of the model could lead to incorrect charges in the accounts.</li> <li>Inaccurate collection of abatement data and inaccurate processing could lead to an incorrect charge for the PPP or PFI.</li> <li>The termination of the Prestige contract could lead to additional liabilities.</li> </ul>	<ul style="list-style-type: none"> <li>We will review any changes made to the financial model during the year and discuss those changes made with management.</li> <li>We will review the output from the PPP and PFI models to ensure that the charge for the year is appropriate.</li> <li>We will review the management of the CUPID system which controls PPP abatements. We will discuss major issues arising during the year end their financial impact with management.</li> <li>We will review the documentation related to the termination of the Prestige contract.</li> </ul>

# Key audit risks (2)

Financial issues	Impact on financial statements	Audit approach
<p><b>Accounting for fixed assets under the PPP</b></p> <p>Under the PPP contracts the fixed assets subject to the PPP remain on LUL's balance sheet, because the balance of the risks and rewards is deemed to lie with LUL. As a result LUL is dependent on the Nominee companies and Tube Lines to provide sufficient information on the costs incurred on those fixed assets during the year to enable LUL to maintain its fixed asset register and prepare its accounts appropriately.</p> <p>This risk should have reduced now that Metronet is part of TTL.</p>	<ul style="list-style-type: none"> <li>Inability to account properly for fixed assets and maintain an up-to-date fixed asset register.</li> </ul>	<ul style="list-style-type: none"> <li>We will review this data with management during the interim audit and make any suggestions we deem necessary to improve the quality of the information</li> <li>If necessary, we will discuss with management alternative work which can be undertaken to give us comfort over the fixed asset numbers in the accounts</li> </ul>
<p><b>Accounting for claims and litigation</b></p> <p>TfL is subject to some significant claims in respect of capital works. The most significant are within LUL, including on PFI contracts. Claims have also been received by LUL on the PPP contracts. It might also be anticipated that there will in the future be additional claims arising on the PPP contracts. These claims can be substantial.</p> <p>By their nature the assessment of the amount to provide for a claim in the accounts is a very judgmental matter.</p>	<ul style="list-style-type: none"> <li>The TTL group accounts include provisions for management's best estimate of the likely outcome of these claims</li> </ul>	<ul style="list-style-type: none"> <li>We will discuss the position on outstanding claims with management. We will review any available evidence in making an assessment of the amount to be provided in the accounts</li> </ul>
<p><b>Capital / operating expenditure</b></p> <p>On the majority of projects undertaken within TTL a judgement needs to be made concerning the split of costs between capital and revenue. In many cases projects will involve a mixture of repairs and maintenance (operating expenditure) and replacement (capital expenditure).</p> <p>In addition there is a significant level of capital expenditure in the current period and the control processes need to be robust.</p>	<ul style="list-style-type: none"> <li>Operating expenditure may be misstated.</li> </ul>	<ul style="list-style-type: none"> <li>We will review the allocation of expenditure on a project by project basis and understand the rationale for the allocation. We will ensure that the treatment is in accordance with group policy.</li> <li>We will review the controls for managing capex and monitoring expenditure during our interim audit.</li> </ul>

# Key audit risks (3)

Financial issues	Impact on financial statements	Audit approach
<p><b>Croydon Tramlink</b></p> <p>During the period Croydon Tramlink has been brought back in-house.</p> <p>A number of accounting judgements would have been made historically, for which people may not have the retained knowledge due to members of the finance team leaving.</p>	<ul style="list-style-type: none"> <li>Incorrect accounting treatments could be retained.</li> </ul>	<ul style="list-style-type: none"> <li>We will review the assessment of risks and rewards within the contract and other judgemental aspects of accounting as part of our interim audit.</li> </ul>
<p><b>Cross Rail</b></p> <p>On the assumption that Cross Rail becomes part of the group. The point at which costs are capitalised should be considered, as currently all costs are being expensed.</p> <p>The related issue which will arise will be compensation claims on compulsory purchase schemes.</p>	<ul style="list-style-type: none"> <li>Operating expenditure may be misstated.</li> <li>Claims for compensation may be misstated.</li> </ul>	<ul style="list-style-type: none"> <li>We will review the allocation of expenditure and understand the rationale for the allocation. We will ensure that the treatment is in accordance with group policy.</li> <li>We will review the process for managing land compensation claims. We will review samples of claims to ensure they are appropriately provided.</li> </ul>
<p><b>Property valuations</b></p> <p>The group have a significant property portfolio and this represents a significant part of the balance sheet.</p> <p>A number of properties received full external valuations, however a proportion of the portfolios is indexed by IPD each year.</p>	<ul style="list-style-type: none"> <li>Incorrect property valuations could be included within the group accounts.</li> </ul>	<ul style="list-style-type: none"> <li>We will involve KPMG property specialists in the review of the property valuations.</li> <li>In addition we will review the indexed properties for indications that more formal valuations are required.</li> </ul>
<p><b>IT Risks</b></p> <p>The group have a number of complex IT systems in place which impact on the preparation of the year end financial figures.</p> <p>In addition concerns have been noted over user access, where employees have access to elements of the system they should not.</p>	<ul style="list-style-type: none"> <li>Errors could be incorporated into the financial information through accident or malice.</li> </ul>	<ul style="list-style-type: none"> <li>Our IT auditors will perform an IT General Controls Review of SAP, Cupid, Elipse and Oricle.</li> <li>We have regular meetings with internal audit to discuss the progress of Project Versa (user access project).</li> </ul>

# Key audit risks (4)

Financial issues	Impact on financial statements	Audit approach
<p><b>Hedging</b></p> <p>TfL acquired new powers under the TfL Act, 2008, to manage its risks using derivative investments.</p> <p>TfL has about £7bn of borrowing commitments up to 2018. TfL are seeking to fix its interest rate risk using pre-hedging, typically forward starting interest rate swaps.</p>	<ul style="list-style-type: none"><li>● At a TfLFL level the entity would account for the options as “off balance sheet”. However in the TfL group accounts the fair value of the swaps would need to be recognised.</li><li>● The movement in fair value will then either go to the profit and loss account or reserves depending on whether hedge accounting has been adopted.</li></ul>	<ul style="list-style-type: none"><li>● We have started discussions with management over this very complex area.</li><li>● We will review the documentation of all swaps which are taken out in the period and review the hedging documentation where appropriate.</li></ul>

# Timeline and deliverables

## Timeline and deliverables

The key phases of our workload, and associated deliverables, for the audit of TTL for the year ending 31 March 2009 are detailed below:

Activity	Timing	Addressees	Deliverables
Interim audit	October- November 2008	Audit Committee TfL Management	A report, by exception, of the significant control findings arising from our audit
Year-end audit	April - June 2009	Audit Committee TfL Management	Summary of the key: audit, accounting, control, and tax findings arising from our audit A summary of unadjusted audit differences for consideration and confirmation of immateriality by the Audit Committee in respect the statutory entities shown on page 5.

Due to the level of new businesses in the period there is an increased risk to the timetable and therefore it is important that the new businesses report on time.

# Client service team

## Your KPMG team

We aim to ensure that our team blends experience of TTL with industry knowledge and specialist input.

We regularly review the succession plans for those involved in key roles.

Key team members:

- *Andrew Marshall* – TTL audit engagement partner  
Andrew will be responsible for the delivery of the audits of TTL and its subsidiaries and signing the audit opinions on those accounts.
- *Chris Dicks* - Audit senior manager of TTL Group  
Chris will be responsible for the day to day direction of the TTL Group audit in support of Andrew.
- *June Awty* – TfL audit engagement partner  
June will be responsible for leading our communication with the TfL Audit Committee and Senior Executives. She will also be responsible for overall client service.

In conducting the audit of TTL we work in conjunction with the KPMG audit team undertaking the audit of TfL. Where possible we undertake procedures jointly in order to maximise the efficiency of the audit, e.g. in looking at controls at the FSC.