

TRANSPORT FOR LONDON

AUDIT COMMITTEE

SUBJECT: KPMG - INTERNAL AUDIT/EXTERNAL AUDIT PROTOCOL

DATE: 25 NOVEMBER 2008

1 PURPOSE AND DECISION REQUIRED

1.1 The purpose of this paper is to present the internal/external audit protocol to the Committee for approval.

2 BACKGROUND

2.1 The review of the Effectiveness of Internal Audit carried out by KPMG earlier this year recommended that a protocol should be developed setting out how internal and external audit would work together to ensure that external audit made full use of the internal audit work carried out.

2.2 The attached protocol, which largely describes current practice, has been developed in discussion with the Director of Internal Audit.

3 RECOMMENDATION

3.1 The Audit Committee is requested to APPROVE the attached protocol.

4 CONTACT

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**KPMG – Internal
Audit/External
Audit Protocol**
Transport for London

6 November 2008

AUDIT

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1 Introduction

Introduction

Transport for London's ('TfL') Internal Audit function and the KPMG audit team have an established working relationship. A summary of the respective responsibilities of internal and external audit and how liaison is planned to work in practice was set out in a paper to the Audit Committee dated 21 November 2007.

Following a review of TfL Internal Audit earlier this year (report dated 4 June 2008) a recommendation was made that this relationship be further formalised by developing a formal protocol, which should be approved by the Audit Committee and performance monitored on a regular basis. Defining areas of co-operation and assistance will also help to reduce any unnecessary overlap of audit effort.

Background

The Code of Audit Practice issued by the Audit Commission provides that external auditors should establish 'effective co-ordination arrangements with internal audit' and 'seek to place maximum reliance on the work of internal audit whenever possible'. The CIPFA Code of Practice for Internal Audit and International Standards on Auditing provide further guidance.

It is relevant to note that internal audit is an independent assurance function within an organisation, whereas external audit is responsible for giving an independent opinion on the organisation's financial statements and a conclusion on the organisation's arrangements for securing economy, efficiency and effectiveness in its use of resources. The relationship between internal and external audit needs to take account of these differing roles and responsibilities.

The remainder of this document presents:

- The principles and general arrangements that are put in place to ensure that KPMG and TfL Internal Audit are able to implement the managed audit approach and the arrangements that will be followed to ensure that the relationship remains effective (*section two*)
- The specific arrangements that are required to support the managed audit approach for the financial statements (*section three*);
- How KPMG will use the work of TfL Internal Audit in relation to use of resources and electors' enquiries (*section four*);
- The specific arrangements that are required to support the managed audit approach for fraud and corruption (*section five*).

2 General arrangements

Planning and liaison

TfL Internal Audit's financial year runs from 1 April to 31 March. The Director of Internal Audit and KPMG's appointed auditor will meet during the January to March period prior to the financial year in order to facilitate the audit process of both sets of auditors. The aim of this meeting will be to discuss the extent of the work planned by IA in order to identify and eliminate areas of overlap. TfL Internal Audit will provide KPMG with copies of relevant key planning documentation, including the annual workplan.

KPMG will in turn provide TfL Internal Audit with copies of audit work programmes for systems reviews and other audit work.

Specific areas where KPMG plan to rely on Internal Audit work will be detailed in the annual external audit plans.

In addition to the annual planning meeting, KPMG's appointed auditor will meet with the Director of Internal Audit before each Audit Committee meeting. Meetings between the KPMG senior manager and the Senior Internal Audit Manager - Business Processes will be held every two months, as will meetings between KPMG's computer audit specialist and the Senior Internal Audit Manager - Information Management. Standard agenda items are likely to include:

- Update against KPMG and TfL Internal Audit plans.
- Confirmation of reports finalised.
- Significant concerns about financial systems or financial performance.
- Update on audit response to business changes/issues
- Other issues, for example KPMG involvement in system development work or new requirements from the Audit Commission.

Additional liaison meetings will also be held on an ad hoc basis as and when necessary. For example, if reviews are to be performed that are additional to those included in the plan, additional liaison meetings will be held.

TfL Internal Audit will send interim and final reports to KPMG on a regular basis. KPMG will send reports to TfL Internal Audit before distribution to Audit Committee.

2 General arrangements (continued)

Internal Audit effectiveness

KPMG is required by international auditing standards to review the effectiveness of TfL Internal Audit. This is also a requirement of the annual Use of Resources assessment.

So that reliance can be placed on TfL Internal Audit work, and to adhere to International Auditing Standards, KPMG will undertake a detailed review of working papers relating to those reviews where they plan to place reliance. This encompasses the scope of work, sample sizes, audit evidence and review procedures.

The review of files is arranged at a mutually convenient time. As required by auditing standards, KPMG will also re-perform TfL Internal Audit testing of areas where reliance is placed for external audit purposes on a sample basis.

In addition, a detailed review of TfL Internal Audit is carried out once every three years by a KPMG team that is independent of the external audit team.

Monitoring compliance and updating the protocol

On an annual basis, KPMG and TfL Internal Audit will jointly assess their compliance with the protocol and identify areas for improvement to be actioned in the audit plans for the following year. The protocol will be periodically reviewed and updated if necessary, and submitted to the Audit Committee for re-approval.

3 Audit of the Financial Statements

Internal and external audit responsibilities

One of the roles of internal audit is to ensure that a risk based approach is adopted for the audit of TfL's systems of internal financial control. External auditors are required under the *Code of Audit Practice* to:

"... consider whether the audited body has put in place adequate arrangements to satisfy itself that its system of internal financial control is both adequate and effective in practice."

KPMG will

- take account of TfL's strategic risk assessment, risk control framework and monitoring activity in assessing the risk of material misstatement of the financial statements;
- where TfL Internal Audit work is performed on the financial systems from which the financial statements are prepared, we will review that work, discuss the findings with TfL Internal Audit and take a view on the level of additional work, if any, we need to undertake in order to support our audit opinion;
- follow up points and recommendations raised by TfL Internal Audit in reports on the financial systems in discussions with management during our interim or final audit;
- meet with the Head of Risk Management twice a year and review the work performed on the controls self assurance exercise during our final audit; and
- review and discuss the Statement of Corporate Governance Assurance and the Director of Internal Audit's Opinion with the Director of Internal Audit before these are finalised.

Members of the TfL Internal Audit team will attend audit closing meetings held between KPMG and the accounts teams of the major subsidiaries/modes and KPMG will circulate a draft of our audit highlights memorandum to TfL Internal Audit for review and comment before it is presented to the Audit Committee.

4 Use of resources and electors' enquiries

Use of resources

KPMG's use of resources work focuses on five key themes (financial reporting, financial management, financial standing, internal control and value for money). This work also contributes to the audit conclusion on whether TfL has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

KPMG are required to review the TfL Internal Audit workplan as part of this review and the arrangements described in section 2 will satisfy this requirement.

KPMG also take account of TfL Internal Audit findings and conclusions in assessing the performance of TfL under each of the themes, particularly financial management, internal control and value for money.

The Use of Resources work will be undergoing some change from 2008/09 due to the introduction of Comprehensive Area Assessments ("CAA"). This will require liaison between TfL internal audit, KPMG and the Audit Commission. The Audit Commission's CAA lead will organise these discussions.

Electors' enquiries

Throughout the year, KPMG receives a number of questions or objections from local government electors. In instances where the query or issue raised is relevant to our role and responsibilities as external auditors, we will review any work which TfL Internal Audit has carried out in that area, as well as any responses by TfL management to queries sent directly to TfL. Queries often relate to major projects in the elector's locality, so TfL Internal Audit coverage of project delivery and contract management is often directly relevant.

5 Fraud and corruption

Internal and external audit responsibilities

External auditors are required under the *Code of Audit Practice* to:

"... consider whether the audited body has put in place adequate arrangements to maintain proper standards of financial conduct and prevent or detect fraud and corruption."

The role of internal audit is to ensure that it performs its work while paying due regard to the risk of fraud and corruption as part of its risk based approach.

Co-ordinating those responsibilities

KPMG will meet with the Senior Audit and Investigations Manager at the start of the interim and final audits. Standard agenda items are likely to include:

- Update on fraud prevention work;
- Update on ongoing fraud investigations and on those investigations closed since the last meeting; and
- Sharing of National Fraud Initiative information.