

TRANSPORT FOR LONDON

AUDIT COMMITTEE

SUBJECT: EFFECTIVENESS REVIEW OF THE EXTERNAL AUDITORS

DATE: 25 NOVEMBER 2008

1 PURPOSE

1.1 The purpose of this paper is to report to the Audit Committee on external auditor effectiveness.

2 BACKGROUND

2.1 The Terms of Reference of the Audit Committee as set out in Standing Order 1 require the Committee to review the performance of the external auditors. This review covers the performance of the external auditors of all parts of the TfL Group with the exception of London Transport Insurance (Guernsey).

2.2 Guidance on conducting such reviews is available, for example in the Institute of Chartered Accountants in England and Wales publication "Guidance for audit committees – Evaluating your auditors". This guidance is based on the proposals published by the Smith committee on Audit Committees and the provisions of the Combined Code on Corporate Governance. Although this relates to listed companies, the principles are also relevant to entities such as TfL.

2.3 The Smith Guidance identifies four criteria in assessing external auditors:

- qualification
- expertise and resources
- effectiveness
- independence

2.4 KPMG is a "registered auditor" and required to comply with the Audit Regulations which cover such matters as independence and integrity, maintaining competence, compliance with technical standards and monitoring compliance with the Regulations. These requirements ensure that the criterion regarding qualification is addressed.

2.5 Independence of the external auditors is dealt with through separate reports to the Audit Committee on fees for non-audit services, reported twice a year, and on independence and objectivity, reported annually.

2.6 This paper deals with assessing the effectiveness, and also the expertise and resources, of the external auditors.

3. Methodology for assessing external auditor effectiveness

- 3.1 A questionnaire was devised and distributed to key finance staff and senior management to obtain their views on the conduct and effectiveness of the external audit.
- 3.2 Responses were sought under four main headings:
 - audit planning and preparation
 - field work
 - closing meetings and sign-off
 - general
- 3.3 The questionnaire provided respondents with an opportunity to comment on the specific questions and also respond on more general free-form topics.
- 3.4 Fourteen questionnaires were sent out, and eleven were completed and returned. A further two nil responses were received, and all modes and the Finance Shared Services Centre (“FSC”) were covered.
- 3.5 A summary of the questionnaire responses is attached as **Appendix A** to this paper.

4. Results of questionnaire

Planning and preparation

- 4.1 “Prepared by client” (PBC) lists set out the contents of the audit files that are to be prepared by client staff and presented to the auditors at the commencement of the audit. This will include reconciliations, analysis schedules and explanations of variances. PBC lists were agreed and distributed in advance of the audit, although that for Rail for London was late.
- 4.2 Some of the information requested as part of the PBC, particularly payroll analysis, proved difficult to produce. This is believed to be due to confusing wording used in the PBC, and discussions have already taken place with KPMG on centralising and simplifying payroll information requests for next year.

Field work

- 4.3 There were some cases again this year where questions were asked of the FSC that should have been directed to modal finance staff, and vice versa. It is recommended that a briefing is arranged for the audit teams in advance of the audit to remind them of the structure of the group and the respective responsibilities of different areas.
- 4.4 It was noted that the auditors would benefit from reviewing prior year files in advance of the audit. It was also noted that junior staff sometimes appeared to have been inadequately briefed.
- 4.5 It is still widely felt that some of the audit staff are not sufficiently senior to be able to understand the complex issues in the group, particularly the PPP and PFI contracts and that increased involvement of the audit manager on the subsidiary company audits would have been helpful.

- 4.6 At the Group level there were a number of complex issues where there were delays in agreeing the technical accounting treatment. This is probably not surprising given the one-off nature of many aspects of the Metronet transaction, but it was noted that technical resources seemed to be limited. There was also the perception that allocation of grants and prudential borrowing received less audit attention than might be expected.

Closing meetings and sign-off

- 4.7 Agendas were generally provided for meetings, but were often sent out shortly before the meetings were due to take place and were sometimes vague. This provided little opportunity to respond to issues.
- 4.8 The process for finalising subsidiary statutory accounts was significantly improved this year, as a result of process improvements implemented by TfL and KPMG.

5. CONCLUSIONS ON EXTERNAL AUDITOR EFFECTIVENESS

- 5.1 Overall, TfL finance staff are satisfied with KPMG's performance as external auditors. The audit was generally well managed, and audit work carried out efficiently within a tight timetable.
- 5.2 In particular, finance staff at London Underground have commented that the audit for 2008 went much more smoothly than that for 2007.
- 5.3 There is, however, a concern regarding availability of technical resources, and the level of involvement of managers of the limited company audits. TfL Group Finance are currently discussing with KPMG the need for additional senior manager or manager resource for the limited companies, given the expansion in the group this year.

6. RECOMMENDATION

- 6.1 The Audit Committee is asked to NOTE the contents of this report.

7. CONTACT

- 7.1 Contact: Stephen Critchley, Chief Finance Officer
Telephone: 020 7126 4871

TRANSPORT FOR LONDON
EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE
YEAR ENDED 31 MARCH 2008

The Questionnaire

The Terms of Reference of the TfL Audit Committee, as set out in Standing Order 1, require the Committee to review the performance of the external auditors. The purpose of this questionnaire is to assess the effectiveness of KPMG's performance across the Group in respect of the audit of the year ended 31 March 2008.

The questionnaire should be completed by senior management and key finance staff. For each question a score should be used to provide an answer as follows:

- 1. No
- 2. Partially
- 3. Yes
- NA No knowledge or not applicable

Responsibilities of the auditors

The external auditors are required under the Audit Commission Act 1998 to audit the annual accounts of TfL and to report whether, in their opinion, the financial statements present fairly the financial position of the Corporation and the Group in accordance with applicable laws and regulations and the Statement of Recommended Practice on Local Authority Accounting in the United Kingdom 2007. They review whether the Statement of Corporate Governance Assurance reflects compliance with CIPFA's guidance. They read other information published with the financial statements and consider whether it is consistent with the audited financial statements.

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

1. The questions below should be rated on the scale of 1 to 3 or NA, with 1 = no, 2 = partially, 3 = yes, NA = no knowledge or not applicable

SECTION 1 – audit planning and preparation		Rating	Comments
1	Is the audit strategy and work plan agreed in advance of the audit?	3	
2	Does the audit work plan focus on key risk areas, and are these agreed with TfL at the audit planning stage?	3	Group – the view was that the auditors did not focus enough on grant accounting, prudential borrowing allocation etc given the impact this has on reserves levels
3	Do the auditors prepare a timetable for the annual audit which is consistent with TfL’s own timetable?	3	<i>Note: Although not all respondents appear to have seen this timetable</i>
4	Do the auditors plan for the right level of resource at the right times during the course of the engagement, and is that resource delivered?	2.4	Property – auditors do not necessarily have a good knowledge of Property rules and regulations LUL – some junior staff were deployed in discussions with LUL contract managers which are complex, and they do not appear to have correct experience Group – it seemed as though technical advice on certain areas came too late/took too long. This might imply that the auditors did not have adequate technical resource at key stages of the audit

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

5	Do the auditors prepare an appropriate schedule of information requests in advance of the audit and is this schedule relevant and appropriate for the work that is to be performed?	2.7	London Rail – the PBC list for RfL was received quite late and included some superfluous requests. For the 2007/08 audit meetings were arranged for the auditors with the key managers at DLR, to give them a better understanding of the business. After the meetings it became apparent that two other auditors would actually carry out the audit. It would be useful to bring along the auditors who are actually going to be doing the work to avoid duplicated efforts. Property – information requests not always circulated in advance
6	Is all the information requested in advance of the audit visit used during the course of the visit?	2.7	London Rail - Yes, but some of the information is difficult to get hold of e.g. payroll reports
7	Is there a feedback process in place to ensure that TfL is preparing relevant and useful information rather than information which is not used for any particular process?	2.7	
8	Where technical advisers are used, such as actuaries or property experts, is their review time included in the audit timetable?	2	<i>Note: This scoring seems to reflect communication issues, as the timetable did include review time.</i>
9	Is communication prior to the audit appropriate, including dates of audit visits and objectives of work?	2.9	

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

2. The questions below should be rated on the scale of 1 to 3 or NA, with 1 = no, 2 = partially, 3 = yes, NA = no knowledge or not applicable

SECTION 2 – field work		Rating	Comments
1	Is the audit team properly introduced to key TfL staff at the beginning of the field work to ensure that work is channelled through the appropriate member of staff?	2.5	Surface – a lot of queries were coming directly to the mode initially until we asked them to address the FSC Group – some members of TfL staff were not introduced to the audit manager for the TTL Group until the audit closing meeting
2	When TfL working papers and documents are reviewed by audit staff, are they returned promptly and in an orderly manner?	3.0	London Rail - have improved over the years
3	Do audit staff display an appropriate level of technical knowledge and understanding of the business so that they are able to perform the audit work in an efficient and effective way?	2.0	LUL - Too many junior staff without the technical knowledge or experience necessary for LUL's complex contracts. Less staff but at a more senior level would be more appropriate FSC - Business knowledge was limited especially in the TTL area because of the turnover of managers. Junior staff were not properly briefed by the managers. Corporate - There seemed to be an issue with audit staff asking questions which could have been answered by a proper review of prior year files Property – they often do not understand the TfL Group structures and the roles and responsibilities of the various parts, especially the FSC Group – the auditors did not show a good understanding of capital accounting requirements

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

4	Do the audit staff display an appropriate understanding of the risks and controls associated with the business so that they are able to perform their work effectively?	2.4	Group – the auditors did not seem to focus on grant accounting/capital accounting which affects reserve levels Surface – especially for the smaller entities, the materiality of issues raised was questionable Corporate - For certain items they seemed to have too low a level of understanding
5	Do the audit staff clearly understand the objectives of the work that they have been given?	2.7	Property - They are not always aware of the context of a piece of work
6	Is the work performed by the audit staff comprehensive and performed in a timely and efficient manner?	2.5	Group – identification of issues came too late in the day
7	Is there an appropriate number of staff (at the right level of seniority) on site at critical times to ensure that issues are cleared on a timely basis?	2.4	Group - It seemed to take a very long time to get resolution on some issues LUL - Need more visibility of the senior team and use of technical experts LUL - Lack of senior management input on site Surface – on the trading side there were several Leads – due to illness, so the Surface staff had to keep covering the same ground with new people
8	Do the audit team use additional technical resources (tax, treasury, IT, actuaries etc) efficiently – do they sense-check the comments from technical experts before feeding back to TfL so that only relevant points are brought forward?	2.3	<i>Note: relatively low score but no comments were made by respondents</i>

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

9	Does the audit team maintain an “issues list” of outstanding information/explanations or contentious issues and is this circulated as necessary to ensure that all issues are resolved as appropriate?	2.9	
10	Are key accounting and audit judgements that arose during the course of the audit discussed with senior management before being raised at the audit committee?	3.0	Group – yes the issues were raised with management and were not a surprise at the Audit Committee
11	Do audit staff display an ability to judge context and significance as well as an independence of mind in discussions of subjective and contentious issues?	2.5	LUL - Difficulties on complex contract issues Corporate - Tendency to concentrate too much on immaterial issues
12	Do the auditors use internal audit’s work when appropriate?	2.8	<i>Note: Although many did not score this question and some commented that they were not sure</i>
13	Do the auditors demonstrate that they have reviewed and understood appropriate internal audit work?	3.0	<i>Note: Many did not score this question</i>
14	Was the level of communication throughout the audit process satisfactory? In particular, were key members of the audit team in regular contact throughout the field work and did they respond to attempts to contact them in a timely manner?	2.7	LUL - Lack of KPMG audit senior management contact Group – TfL staff not always kept abreast of issues throughout the fieldwork – issues all seemed to arise at the end – although this may be because the issues were only discovered by KPMG at the end of the audit

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

3. The questions below should be rated on the scale of 1 to 3 or NA, with 1 = no, 2 = partially, 3 = yes, NA = no knowledge or not applicable

SECTION 3 – closing meetings and sign-off		Rating	Comments
1	Do audit staff prepare and circulate an appropriate agenda prior to each meeting in order to focus on material issues?	2.8	Property - Not always Group - Agenda very vague and issued late which didn't give TfL staff chance to prepare relevant information before the meeting
2	Are appropriate issues i.e. contentious issues and areas of subjectivity and judgement raised at the closing meetings with senior finance staff?	3.0	
3	Are auditors' reports to the Audit Committee sent to TfL to review in advance of the deadline for submission to the Audit Committee so that amendments can be processed as necessary?	2.4	Group and Internal Audit - Not always
4	On the finalisation of subsidiary statutory accounts, was the audit work and clearance process efficient and timely?	2.9	Group – clearance of subsidiary accounts was fine

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

4. The questions below should be rated on the scale of 1 to 3 or NA, with 1 = no, 2 = partially, 3 = yes, NA = no knowledge or not applicable

SECTION 4 – general		Rating	Comments
1	Do you have any concerns regarding the objectivity and independence of the partners and senior managers on the audit?	1.0	Group - No issues
2	Are you aware of any succession plans in place to ensure continuity of expertise on the audit, and if so are you satisfied that audit quality will be maintained?	1.0	General - No awareness of any succession plans
3	Do you consider that members of the audit team have the appropriate technical qualifications necessary for their role?	2.8	Group - TTL audit partner good but there was a big gap to the manager. Some of the TfL audit team seemed out of their depth. They did not focus on key risks and were not able to quickly resolve issues. Property – they do not necessarily have specialist Property knowledge
4	Do you consider that audit staff acted in a professional manner throughout the audit?	3.0	Property - Without fail

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

5. The questions below are free form and allow for more general observations

SECTION 5 – other comments		Comments
1	What did KPMG do well?	<p>LUL – Planning and clarity of work plans London Rail - Completed the field work on time Surface - The managers on both the Trading and the Corporation kept in touch and flagged any potential issues FSC - Having familiarised themselves with SAP the junior staff were able to perform some tests independently</p>
2	What could they have done better?	<p>FSC - Communicated more amongst themselves. Same question was asked by more than one auditor in the team. Reference to prior year audit file for familiarisation of opening balance transactions. Surface - Look at the materiality of some of the issues they raised on the trading side. London Rail - Have more knowledge of the business LUL - KPMG senior manager input as issues emerge. More involvement and visibility of Senior Team on complex issues Property - Get to understand TfL group structures and modal roles and responsibilities, especially the FSC London Rail - PBC list to be more relevant and to be distributed earlier. This was the first audit for RfL so KPMG will have a better knowledge for next year. Also, the audit teams of the different companies should liaise more closely (e.g. liaison with LUL team re East London Line extension project) Group - Better focus on risks, been prompter and more confident with technical advice, identified issues earlier, had a stronger team on the ground for TfL audit (technically)</p>

EXTERNAL AUDITOR ASSESSMENT QUESTIONNAIRE

3	Overall, are you satisfied with KPMG's performance as external auditors?	Only one negative response
---	--	----------------------------