

Date: 4 October 2012

Item 8: External and Internal Audit Protocol

This paper will be considered in public

1 Summary

1.1 The purpose of this paper is to present to the Audit and Assurance Committee the External and Internal Audit Protocol, which outlines the working relationship between KPMG and TfL Internal Audit.

2 Recommendation

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

3 Background

3.1 The attached External and Internal Audit Protocol sets out the agreed working relationship between KPMG and TfL Internal Audit and, in particular, the arrangements by which KPMG will place reliance on the work of Internal Audit for the purposes of its annual audit of TfL's financial statements. This replaces a previous version of the Protocol that was established and presented to the TfL Audit Committee in November 2008.

3.2 The working arrangements described in the Protocol were already largely in place and will not require any significant change to the audit approach applied by either internal or external audit.

List of appendices to this report:

Appendix 1 – External and Internal Audit Protocol

List of Background Papers:

None

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External and Internal Audit Protocol

Transport for London

**Finalised: September
2012 and applicable to
all periods thereafter**

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in connection with this
report are:

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	Page
1. Introduction	2
2. General Arrangements	3
3. Audit of the financial statements	5

Purpose and structure of this document

This document outlines and formalises the working relationship between KPMG and the Transport for London Internal Audit Team, including the Crossrail Internal Audit Team (together referred to as 'TfL IA'), who are responsible for the delivery of audit to TfL and all its subsidiaries. Please note that this does not include the Pension Fund audit.

The reason for documenting the relationship is to formalise areas of co-operation and assistance that can help to reduce any unnecessary overlap of audit effort, and therefore maximise the value of the assurance provision. International Auditing Standard 610 recommends that where external auditors seek to use specific work of internal auditors, the agreement of coverage and approach of internal audit should be set out in advance. This document formalises recent discussions on the approach to audit at TfL.

The remainder of this document presents:

- the principles and general arrangements to ensure that KPMG and TfL IA are able to implement this audit approach (*section two*)
- the specific arrangements required to support this approach for the accounts and systems work (*section three*). Details of the required approach to the testing of key control areas have been separately agreed with TfL IA.

Key Contacts

For the purpose of clarity the key contacts between KPMG and TfL IA will operate as follows:

TfL IA	Clive Walker	Director of Internal Audit	☎: +44 (0)20 7126 3022	✉: CliveWalker@tfl.gov.uk
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Scope and responsibilities

The main areas of co-operation between KPMG and TfL IA centre on KPMG's responsibility as external auditors to give an independent assessment of whether the statements of accounts give a true and fair view of the financial position of TfL. This includes an assessment of whether TfL's income and expenditure account and balance sheet for the year in question have been properly prepared in accordance with the appropriate legislation. The work of TfL IA also informs our Value for Money opinion and our work on Fraud.

KPMG and TfL IA each have their own responsibilities and nothing in this protocol shall override either of their individual responsibilities or preclude either of them from taking any actions that may be considered necessary to meet those responsibilities. Whilst TfL IA has agreed to incorporate certain tests within its internal audit work so as to assist in an efficient overall audit service to the Group, it is jointly recognised and agreed that TfL IA does not accept a duty of care to KPMG in respect of this or any of its internal audit work, and it will be for KPMG to assess the results of internal audit testing performed and to determine for itself whether or not to amend its audit procedures as a result.

Planning and liaison

TfL IA follow a risk based audit approach. This entails an annual risk assessment process, the output of which is the Annual Audit Plan which is presented to the TfL Audit and Assurance Committee annually each March forming part of a wider Integrated Assurance Plan. The Crossrail Audit Plan is presented to the Crossrail Audit Committee annually each March. The audit plan is not cyclical in nature and therefore the frequency with which core financial systems and IT reviews are included in the plan is not standardised and hence the exact amount of TfL IA work which can be used by KPMG will vary year on year. This will be determined each year around February through an IA and external audit meeting to discuss the Annual Audit Plan.

In addition to the February meeting, meetings will be held between KPMG and IA as required to discuss specific reviews. KPMG will seek to meet with both TfL and Crossrail IA prior to each respective Audit and Assurance / Audit Committee each year. This will include a meeting before the start of the KPMG interim audit. Agenda items are likely to include:

- Update against TfL IA plans
- Confirmation of reports finalised
- Significant concerns about financial systems and / or financial performance
- Details of audits not in the original plan
- Other issues, for example TfL IA involvement in system development work
- Confirmation of progress against planned testing on specific reviews

Additional liaison meetings will also be held on an ad hoc basis as and when necessary. TfL IA will distribute finalised reports to KPMG, after the agreement of the findings with the audited body. KPMG reports provided to management or those charged with governance will be made available to TfL IA through the TfL Head of Group Finance.

For external audit to use the work of TfL IA effectively and efficiently it is necessary for IA to include within its plans reviews which cover core financial systems.

KPMG will report to the Audit and Assurance Committee in our annual audit plan, which IA reports we will seek to use in our work for the financial year under audit.

Internal audit evaluation

ISA 610 states:

“To determine the adequacy of specific work performed by the internal auditors for the external auditor’s purposes, the external auditor shall evaluate whether:

- a) The work was performed by internal auditors having adequate technical training and proficiency;*
- b) The work was properly supervised, reviewed and documented;*
- c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;*
- d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and*
- e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.”*

As such KPMG will perform an annual review of the TfL IA function, as required by the auditing standards. We will rely on the findings of the three-yearly IA effectiveness review and will update our knowledge through desk based review and with reference to our cumulative audit knowledge and experience.

Review of TfL IA working papers

So that KPMG can use the work of TfL IA, KPMG will undertake a review of TfL IA working papers for each specific review we seek to use. This encompasses the scope of work, sample sizes, audit evidence and review procedures. These work papers should comply with the documentation requirements of ISA 230, *Audit Documentation*, and clearly indicate preparer, reviewer and unique identifier of the item selected for testing.

KPMG will also re-perform TfL IA testing on a sample basis. It will also be agreed how documentation will be shared between teams.

Each year we would expect review of some key financial systems to be included in the Annual Audit Plan. We define key financial systems as including payroll; expenditure; income; treasury management and fixed assets and the associated IT systems which support these processes. We note that TfL IA does not take a cyclical approach to its audit work and therefore it is not possible for IA to specify with certainty which of these will be under review until the Annual Audit Plan is set. The inclusion and testing of these systems and processes on a cyclical basis would provide maximum efficiencies for the audit however we appreciate that the remit of TfL IA is different than that for our external audit.

Interim and roll forward testing phases

As part of our Audit we form an opinion over the operating effectiveness of the entity's control environment throughout the entire financial year in accordance with International Standard on Auditing 330, *The Auditor's Procedures in Response to Assessed Risk* which states:

"when the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period".

It is therefore preferable from an external audit perspective that work takes place in Q3 or Q4 of a financial year as this would guarantee more coverage. Samples from prior financial years would not be relevant for external audit purposes, so any IA samples should be selected from the current financial year. To be assured that the controls operate throughout the financial year top-up work may be required to ensure controls operated up to the end of P13.

TfL IA, should therefore ensure that it performs work over controls for a given period with due consideration to both the timing and phasing of audit procedures in order to meet the requirements of ISA 330. This may include splitting sample size for controls testing set out on page 6 to perform procedures at two points: once inside the financial year and once on or after the 31st March. In this case we will undertake a further review of TfL IA documentation after the financial year-end as part of our usual audit procedures.

Procedures KPMG will still perform

The International Auditing Standards set out the responsibilities of external auditors and procedures which the external auditor is obliged to perform even when also using the work of TfL IA. To summarise, we will still perform the following:

- Assess objectivity and competence of internal audit;
- Review of TfL IA workpapers and re-performance of samples;
- Conduct walkthroughs (potentially through joint attendance with IA);
- Documenting process and updating understanding thereof based upon process flowcharts and documentation prepared by TfL IA;
- Assess whether to increase or reduce substantive work based on results obtained.

Internal and external audit responsibilities

KPMG have a statutory responsibility to express an opinion on whether the accounts present a true and fair view of the financial position of TfL. In addition, part of KPMG's approach is to work to understand the events, transactions and practices that, in our judgement, may have a significant effect on the financial statements, supporting our accounts objective. At our interim audit, this involves using our knowledge of the financial system to identify and test the overall higher-level controls. This provides us with assurance over the figures used to prepare the accounts. This work will draw on that of TfL IA where it is complete and appropriate to do so.

Consideration of fraud risk

As part of our Audit we assess the risk of fraud in accordance with the revised International Standard on Auditing 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* (revised ISA 240). We consider this standard to be a key component in ensuring the quality of audits, which is the cornerstone of our audit practice. Part of this process is to pragmatically and realistically consider fraud risk factors and plan our audit accordingly. We complete this through the incorporation and consideration of fraud risk concerns within our Fraud Audit Program. This provides our team with a step-by-step approach in their consideration of risk of material misstatement due to fraud in each phase of the audit process and addresses relevant documentation requirements. This assessment will include consideration of the risk of fraud at service organisations contracted by the Group, in line with auditor's requirements in ISA 402, *Audit Considerations relating to an Entity*.

TfL IA should ensure that it performs its work while paying due regard to the risk of fraud and corruption across the Group and its service organisations as part of its risk based approach. Where work related to fraud is performed by TfL IA KPMG may use this work to inform its assessment of the control environment.

Value for money

KPMG provides an annual opinion on Value for Money arrangements at TfL. KPMG will review the TfL IA Annual Audit Plan to determine whether any of the reviews could be used to inform this work. Where such reviews are identified KPMG will liaise with the relevant TfL auditor to understand the findings and to determine whether any further information is required.

3 Audit of the financial statements

Sample sizes and selection

When testing the control environment, for external audit purposes, the KPMG audit approach has the following sample size requirements for the testing of controls depending on whether there is deemed to be a lower or higher risk of failure (as defined below):

Where the control is performed:	Sample size (lower risk of failure):	Sample size (higher risk of failure)
Recurring manual control (multiple times per day)	25	40
Daily	15	25
Weekly	5	8
Quarterly	2 (to include period end)	3 (to include period end)
Monthly	2	3
Annual	1	1

Characteristics of controls deemed to have a lower risk of failure	Characteristics of controls deemed to have a higher risk of failure
Control is designed to detect administrative errors over routine transactions, each of which has a low monetary value	Control is designed to detect errors in applying judgments over non-routine transactions, each of which has a high monetary value
The control addresses the accuracy assertion; if the control failed to discover an error, the amount of the error is likely to be only a proportion of the total amount of the transaction being controlled	The control addresses the existence, completeness or ownership assertions; if the control failed to detect or prevent an error, there is a greater likelihood that the amount of the error could be the total transaction amount, or, in the case of the completeness assertion, greater than the transaction
There is a consistent level of routine transactions processed	There is an inconsistent level or significantly increasing volume of transactions in a period
The control is performed by personnel who are experienced in performing this function and have good control consciousness	There is a high level of turnover in personnel performing this control , who generally have little experience and poor control consciousness
Control is a routine, recurring manual control . For example, verifying that an invoice has been approved by an authorized individual before executing payment	The operation of the control is complex and requires significant judgment and occurs quarterly. For example, a control over the review of the determination of the allowance for doubtful accounts
Previous audits have not detected control deviations	There have been a number of control deviations identified through audits in prior years
The control relies on few other controls for its operating effectiveness	The control relies on many other controls for its operating effectiveness. For example, management's review of bank reconciliations relies on the operating effectiveness of the reconciliations

TfL IA, however, may consider it necessary to increase sample sizes to meet their own objectives.

We would expect that TfL IA would consider both the design and operation of processes and controls.

Control deviations

The following steps set out the considerations to be made and the process to be followed where control deviations are identified. This should be applied consistently in all elements of TfL IA testing:

1. Assessment of the nature and impact of the deviation

Per ISA 330, auditors are required to investigate the nature and cause of any deviations identified, including evaluating the possible effect on the evaluation of the control environment of the entity. Considering the consequences of a control deviation is a matter of professional judgment and is influenced by the characteristics of the control and the number of control deviations detected. If deviations are identified then specific inquiries must be made to understand the deviation and its potential consequences.

We would thus expect TfL IA to undertake additional procedures where control deviations are identified in order to ascertain the following (note that documentation of the consideration of each of the points below should be maintained)

- The nature of the deviation. Note that if a deviation is deemed to be systematic or intentional then the control should be deemed ineffective and no further testing will be undertaken;
- How significant the control deviation is from Group policy;
- The financial impact and consequence of the deviation, including any fraud considerations where deviations are deemed to be intentional;
- The effect of the deviation on the assessment of the risk of failure of the control and the evidence to be obtained to support the assessment of operating effectiveness for the rest of the sample;
- Whether deviations have a common feature e.g. type of transaction; location; period of time etc and thus to focus additional procedures on these items;
- Whether there are compensating controls which limit the risk of material misstatement arising from the deviation in another control. These mitigating controls should be fully documented.

2. Anomalous deviations

Where a control deviation is deemed to be an anomaly, TfL IA should obtain a high degree of certainty that the deviation is not representative of the population by performing additional audit procedures to obtain sufficient appropriate audit evidence that the deviation does not affect the remainder of the population, and consider whether to perform additional audit procedures on the population. See step 3.

3. Extending the sample (only for deviations that are not deemed to be systematic or intentional)

If further audit procedures are to be undertaken as a result of the assessment above, the control sample (per page 7) should be extended and an additional sample size at least equal to the original sample size should be tested. If a second control deviation is found the control should be deemed ineffective.



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