

## **Audit and Assurance Committee**

**Date: 8 December 2015**

**Item: External and Internal Audit Protocol**

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### **This paper will be considered in public**

#### **1 Summary**

1.1 The purpose of this paper is to present to the Committee the External and Internal Audit Protocol, which outlines the working relationship between Ernst and Young (EY) 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 EY and TfL Internal Audit, and in particular the arrangements by which EY will make use of the work of Internal Audit for the purposes of its annual audit of TfL's financial statements to ensure the efficient and effective use of audit resource. This replaces the Protocol that was previously in place between KPMG and TfL Internal Audit. There is no significant difference between the KPMG and EY Protocols.

3.2 The Protocol will be kept under review and updated as appropriate. In particular, the Protocol may need to be updated when the National Audit Office publishes its guidance for external auditors on the auditing of organisations' value for money arrangements.

#### **List of appendices to this report:**

Appendix 1: External and Internal Audit Protocol

#### **List of Background Papers:**

External and Internal Audit Protocol – KPMG

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# Transport for London

Appendix 1

## External and Internal Audit Protocol

October 2015 and applicable for all periods thereafter



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**Section 1**

# **Introduction**

# Introduction

## **Purpose and structure of the protocol**

Transport for London (TfL) faces ever-increasing pressure on their resources. As External and Internal Auditors we can assure management and the Audit and Assurance Committee that audit resources are being applied efficiently and represent good value for money by demonstrating our commitment to work together effectively. This protocol sets out the arrangements to support that commitment.

The objectives of this protocol are to:

- ▶ provide a framework for cooperation in planning and conducting our respective audit work;
- ▶ maximise the benefit from available audit resources, through agreed coordination arrangements; and
- ▶ help the Audit and Assurance Committee to fulfil its responsibility for overseeing effective liaison between External and Internal Audit.

To achieve these objectives, we need to work together effectively with clear communication throughout the year. This document reflects our commitment to promote productive joint working between our audit teams.

This document outlines and formalises the working relationship between EY and the TfL 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.

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.

Section 2

# General arrangements

# General arrangements

## Scope and responsibilities

The main areas of co-operation between EY and TfL IA centre on EY'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.

EY 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. It is jointly recognised and agreed that TfL IA does not accept a duty of care to EY in respect of any of its Internal Audit work, and it will be for EY 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 the audit

As External Auditors, EY plan and carry out an opinion audit that meets the requirements of the Code of Audit Practice (the Code) and professional accounting and auditing standards. EY adopts a risk-based approach to planning the audit, and work focuses on the risks relevant to the audit responsibilities under the Code. This entails a continual risk assessment process, the output of which is the EY Audit Plan, presented prior to the financial year ends to the TfL Audit and Assurance Committee annually in October, the Crossrail Audit Committee annually in September and London Transport Museum annually in March.

TfL IA also follow a risk-based audit approach. This entails an annual risk assessment process, the output of which is the IA 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 IA Annual 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 EY may vary year on year. This will be determined each year around February through an IA and External Audit meeting to discuss the IA Annual Audit Plan.

## Liaison arrangements

To ensure the timing, extent and scope of work optimises coverage and avoids duplication of effort, an External and Internal Audit meeting will take place each year around February to discuss the Annual Internal Audit Plan.

In addition, meetings will be held between EY and IA as required to discuss specific reviews. EY will seek to meet with both TfL and Crossrail IA quarterly or at least prior to each respective Audit and Assurance / Audit Committee each year. This will include a meeting at the planning stage and before the start of the EY interim audit. These meetings will specifically seek to update both External and Internal Audit on:

- ▶ Audit plan progress;
- ▶ Finalisation of IA work and resulting reports;
- ▶ Whether any significant financial system and/or value for money concerns have been identified;
- ▶ Details of audits not in the original plan; and
- ▶ Other issues where applicable, including changes to planned reliance on agreed areas of joint working.

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

EY will report to the Audit and Assurance Committee in the annual audit plan, the extent to which External Audit will seek to use the work of Internal Audit for the financial year under audit.

Should EY plan to use the work of TfL IA to support a controls based audit approach, this will be communicated to TfL IA in advance of the audit plan being finalised. Such reliance is governed by the requirements of International Auditing Standard (ISAs) (UK and Ireland) 610.

**Section 3**

# **Roles and responsibilities**

# Roles and responsibilities

The table below outlines the respective roles of External and Internal Audit. The roles and responsibilities are different but complementary. There are therefore benefits to be gained from working together, and from External Audit relying on Internal Audit's work, if appropriate. Any such reliance is governed by International Auditing Standard (ISAs) (UK and Ireland) 610.

Internal Audit	External Audit
<p>Internal Audit is defined by the Public Sector Internal Audit Standards as</p> <p><i>“an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”</i></p> <p>Internal Audit must have documented terms of reference that accord with the requirements of the Public Sector Internal Audit Standards.</p> <p>The key output from Internal Audit is the annual opinion on TfL’s control environment which is reported to the Audit and Assurance Committee.</p> <p>Internal Audit’s strategy and audit plan is agreed between Internal Audit and management and is approved by the Audit and Assurance Committee.</p>	<p>EY have a statutory responsibility to express an opinion on whether the accounts present a true and fair view of the financial position of TfL. EY conduct their work in accordance with International Standards on Auditing (ISAs) (UK and Ireland) and the Code of Audit Practice.</p> <p>External Audit, where appointed by Public Sector Audit Appointments are characterised by three distinctive features:</p> <ul style="list-style-type: none"><li>▶ External Auditors are appointed independently.</li><li>▶ The scope of auditors' work covers the audit of financial statements, and value for money in the use of resources.</li><li>▶ Auditors may report aspects of their work widely to the public and other key stakeholders</li></ul>

Section 4

# Audit of the financial statements

# Audit of the financial statements

## Controls based audit approach

Where a controls based audit approach is planned, the requirements of ISA 610 apply. ISA 610 states:

“The External Auditor shall perform sufficient audit procedures on the body of work of the Internal Audit function as a whole that the External Auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

- (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;
- (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
- (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.”

External Audit cannot direct the work of Internal Audit and External Audit recognises that remit of TfL IA is different to that for External Audit.

## Where EY plans to use the work of Internal Audit

If EY plans to use the work of Internal Audit to support the controls based audit approach, EY will perform an annual review of the TfL IA function, as required by the auditing standards. This will include taking into account the findings of a) the internal and external assessments as required by the Public Sector Internal Audit Standards, and b) our cumulative audit knowledge and experience.

So that EY can use the work of TfL IA, EY 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.

EY will also re-perform TfL IA testing on a sample basis.

For External Audit to use the work of TfL IA effectively and efficiently it may be necessary for IA to include within its annual plans reviews which cover core financial systems. Preferably these reviews should take place in Q3 or Q4 of a financial year to ensure adequate coverage.

## Substantive audit approach

Where a substantive audit approach is planned (as this may be a more efficient audit approach) it is unlikely reliance will be placed on the work of Internal Audit. External Audit will continue to review the output from Internal Audit to inform the External Audit risk assessment and associated audit strategy.

In addition, in coming to a view on the TfL Annual Governance Statement and the annual assessment of Internal Control, External Audit will refer to the findings from Internal Audit reports and the opinion issued by the Director of Internal Audit.

## Procedures EY will still perform

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 Internal Audit.

To summarise, EY will still perform the following regardless of whether a controls or substantive audit approach is followed:

- ▶ Assess objectivity and competence of Internal Audit;
- ▶ Review of finalised TfL IA reports;
- ▶ Document significant classes of transactions and update understanding thereof based upon flowcharts and systems documentation prepared by TfL IA;
- ▶ Undertake walkthroughs of each significant class of transaction (i.e. tracing a single transaction through the system from beginning to end); and
- ▶ Assess whether to increase or reduce substantive work based on results obtained.

# Audit of the financial statements (cont.)

## 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 ).

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 Considerations form, which is updated annually.

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.

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, EY may use this work to inform its assessment of the control environment.

In addition, as part of the pre-statements audit, EY will request representations as to:

- ▶ How those charged with governance hold management to account;
- ▶ Internal Audit's procedures to detect fraud and their views on the risk of fraud at the entity and group level; and
- ▶ Management's processes for managing fraud, governance and compliance with laws and regulations and obtaining assurance over the going concern concept.

## Value for Money

Under section 20(1) of the Local Audit and Accountability Act 2014, External Audit are required to satisfy ourselves that TfL has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources.

We complete this work on a risk based approach, referring to guidance notes issued by the National Audit Office (NAO). The NAO are currently updating and consulting on the guidance notes for 2015/16 audits and the scope of this work may therefore be broader than in previous years, requiring us to consider more Internal Audit work accordingly when forming a view on the adequacy of TfL's overall value for money arrangements.

We will update this protocol once the final guidance notes have been released.

EY will continue to review the TfL IA Annual Audit Plan to determine whether any of the reviews could be used to inform this value for money work. Where such reviews are identified, EY will liaise with the relevant TfL auditor to understand the findings and to determine whether any further information is required.

Section 5

# Sample sizes

# Sample sizes

When testing the control environment, for External Audit purposes , the EY audit approach has the following sample size requirements:

Frequency of control	Minimum sample size to be tested
Annual control	1
Quarterly control	2
Monthly control	2
Weekly control	5
Daily control	25 (or 60, if the control in question only covers one audit assertion)
Recurring control (multiple times per day)	25 (or 60, if the control in question only covers one audit assertion)

TfL IA, however, may consider it necessary to increase sample sizes to meet their own objectives. TfL IA should also consider both the design and operation of processes and controls.

**Section 6**

# **Key contacts**

# Key contacts

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

Organisation	Name	Title	Telephone	Email
TfL IA	Clive Walker	Director of Internal Audit	+44 (0)20 3054 1879	<a href="mailto:CliveWalker@tfl.gov.uk">CliveWalker@tfl.gov.uk</a>
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