

**Financial Scrutiny and Audit
Committee**

11 February 2014

Agenda Item No 10

Working Protocol between Internal and External Audit for 2013/14 and 2014/15

Report by Head of Internal Audit

Summary:

An Audit Joint Working Protocol has been developed between Internal Audit and the Authority's External Auditors – Ernst and Young, which recognises the respective responsibility of each body, relevant audit areas that will be covered, liaison and information sharing arrangements between the two bodies, audit testing and sample size requirements to be observed by the two bodies and generic key financial controls requiring examination each year.

The Protocol has been formulated to avoid any potential duplication of work and determine the assurance that can be placed on the respective work of the two parties, whilst also ensuring that External Audit can place maximum reliance on the work of Internal Audit, wherever possible.

Recommendation: The Committee is requested to approve the Audit Protocol and thereby give its endorsement to the level of interaction, which will be adopted by Internal and External Audit throughout the remaining quarter of 2013/14 and the financial year 2014/15.

1 Introduction / Background

- 1.1 Prior to Ernst and Young being appointed as the Authority's External Auditors, Internal Audit had operated an Audit Joint Working Protocol with the Audit Commission to facilitate close working relationships, ensuring that the services of Internal and External Audit were as integrated as possible, in order to maximise the effectiveness and efficiency of the overall approach to audit operated within the Broads Authority.
- 1.2 Post Ernst and Young being made responsible for the provision of External Audit Services to the Authority, Internal Audit has been actively pursuing formulation of a similar Protocol, aimed at clarifying the individual roles of each body, how they will liaise with each other and where it is feasible to rely on each other's work, ensuring that sample sizes and key control testing are such that the work of Internal Audit can be used by External Audit to inform their work.
- 1.3 There have been two stages involved in extracting the Protocol which is being presented to the Financial Scrutiny and Audit Committee today. Initially, it was recognised that until such time as Ernst and Young had been through the complete cycle of a Financial Statement Audit, it would be difficult for them to

confirm the key controls applying to the Authority's core financial systems. As an interim measure, it was therefore agreed that Internal Audit would adopt External Audit's approved sample sizes for testing of the organisation's key fundamental systems from 2012/13 onwards and, in addition, Ernst and Young would produce a Briefing Paper which explained fully how they intended to place reliance on Internal Audit's work.

- 1.4 The Briefing paper acknowledged that before the work of Internal Audit could be used to inform the work of External Audit, it was essential to undertake an overall assessment of the Internal Audit function, to determine whether our work was likely to be adequate for the purposes of their audit, and how this could complement delivery of their key in-year tasks. This assessment was duly performed without any issues arising.
- 1.5 Moreover, in recent weeks, we have achieved the second stage of the process - compiling a formal Protocol for adoption from the final quarter of 2013/14 onwards, following a collaborative exercise between the Internal Audit Management Team and the External Audit Manager.

2 Overall Position

- 2.1 The new Protocol, attached at Appendix 1, explains the overarching aims of the document, recognises the respective responsibilities of each auditing body, itemises audit areas of primary concern, reviews liaison arrangements including who will be the key audit contacts at the Authority, and comments on provisions for accessing audit files and reports. There are then three separate appendices, which tabulate the working arrangements that will be followed, the nature of audit sample sizes to be extracted and hence used for testing purposes, and a summary of financial key controls identified for in-year evaluation.
- 2.2 In applying the Protocol, good working relationships between Internal and External Audit will be further strengthened, thereby securing a fully integrated and therefore more efficient approach to the provision of audit services to the Authority.

3 Conclusions

- 3.1 This new Protocol seeks to build on the working relationships that have already been developing between Internal and External Audit, further enhancing how the two bodies will interact, and adopting arrangements designed to secure seamless integration of work and avoidance of any unnecessary duplication of effort.

Background Papers: None
Author: Sandra King, Internal Audit Consortium Manager
Date of Report: 27 January 2014
Broads Objectives: None
Appendices: APPENDIX 1 – Audit Joint Working Protocol

Appendix 1

Audit Joint Working Protocol

The Broads Authority

January 2014

Ernst & Young LLP



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1. Introduction – aims

1. This document sets out the basis for effective co-ordinated working arrangements between The Broads Authority's Internal Audit service and EY as the Authority's appointed external auditors.
2. The aims of the protocol are to aid joined-up working and reduce duplication of audit work by:
 - ▶ Clarifying respective responsibilities for work associated with the Code;
 - ▶ Developing further a close and effective working relationship; and
 - ▶ Facilitating the effective co-ordination of our work without impairing the independence and integrity of either party.
3. This document sets out:
 - ▶ Confirmation of the liaison arrangements between Internal Audit and EY ;
 - ▶ The requirements to be followed in order that EY can place the desired level of assurance on the work of internal audit;
 - ▶ Working protocol Arrangements (Appendix A);
 - ▶ Details of sample sizes (Appendix B);
 - ▶ A detailed summary of control tests that EY consider to be key in proving the internal financial control systems (Appendix C);
 - ▶ The approach for relying on Internal Audit work (Appendix D).
4. The protocol takes into account the requirements of the revised Audit Commission's Code of Audit Practice 2010 (The Code).

2. Respective responsibilities

1. The Broads Authority (The Authority) has a responsibility to put in place proper arrangements for the governance and stewardship of its resources.
2. Internal Audit provides an essential element of the Authority's arrangements. In the course of discharging its responsibilities, Internal Audit is required to deliver a service which meets the professional standards laid down in the Public Sector Internal Audit Standards effective from 1 April 2013. And CIPFA's published Statement on the Role of the Head of Internal Audit in Public Service Organisations 2010.
3. Internal Audit's responsibilities require them to evaluate the effectiveness of the control environment in achieving the organisation's objectives. In part fulfilment of their responsibilities, Internal Audit carry out reviews of systems and key controls, including evaluating and testing those controls. This work is directly relevant to our own responsibilities.
4. Under the Audit Commission Act 1998 and the Code of Audit Practice the external auditor appointed by the Audit Commission is responsible for reviewing and reporting on the Authority's:
 - ▶ Financial statements and Annual Governance Statement;
 - ▶ Arrangements for securing economy, efficiency and effectiveness in its use of resources: and,
 - ▶ Grant certification.
5. In issuing the opinion external auditors express a view whether the Authority's financial statements:
 - ▶ Present fairly the financial position of the Authority and its expenditure and income for the year in question; and
 - ▶ Have been prepared properly in accordance with relevant legislation and applicable accounting standards.
6. External Auditors are required to follow the UK and Ireland's version of International Standards on Auditing – ISA (UK&I). These took effect from 2005/06 requiring greater emphasis on gaining an understanding of governance arrangements of the Audited and Inspected Body (AIB). In order to comply with ISA315, EY identifies, evaluates, documents and tests those of the Authority's systems that have a material impact upon its financial statements.
7. EY also consider whether the Annual Governance Statement has been presented in accordance with relevant requirements and report if it does not meet those requirements or if the statement is misleading or inconsistent with our knowledge of the Authority.
8. Internal and external audit have different roles but many shared objectives. Effective co-operation is essential in order to minimise duplication of effort and maximise the benefits of audit. It should enable both parties to devote more time to the key audit issues and ensure that the Authority gets value from its total audit resource. Both are committed to an open and constructive relationship, based on an understanding of each other's roles and approaches to achieving their respective objectives.
9. The Audit Commission emphasises this need for co-operation in a number of its publications:

- ▶ The Code of Audit Practice 2010 states that external auditors should establish effective co-ordination arrangements between internal and external audit and seek to place maximum reliance on the work of internal audit wherever possible;
- ▶ 'It Takes Two' (Published in 1996) is a good practice guide to assessing and improving co-operation between internal and external auditors; and
- ▶ The Managed Audit Good Practice Guide 1995 promotes a more efficient audit by encouraging reliance on the control environment, which includes internal audit.

10. Key areas of co-operation are summarised in Appendix A.

3. Audit areas

3.1 Opinion

1. In complying with the Internal Audit standards in undertaking systems work, Internal Audit will follow the relevant guidance to:
 - ▶ Use adequate sample sizes to support conclusions and recommendations;
 - ▶ Select samples appropriately, which are representative of the population and the period covered; and
 - ▶ Evidence and document the work in accordance with professional standards.
2. Internal Audit tests of samples will cover the financial year from 1 April to 31 March. Internal Audit undertakes detailed work on financial systems on a cyclical basis and top up their work with tests of the remaining systems. In this way Internal Audit provide sufficient coverage for the annual Governance Statement and ensure that testing covers the whole financial year.
3. EY liaise with Internal Audit each year to identify the scope for external audit to drawing assurance from Internal Audit systems work. To be successful this will involve synchronising work timetables. EY will liaise with Internal Audit each year as to the timing of Internal Audit's work. Appendix B sets out the minimum sample sizes for the testing of key controls.
4. Appendix C details the key controls within the main financial systems identified by EY as part of the 2012/13 audit work. These controls may change in future years.

3.2 Fraud

5. Internal Audit will notify EY promptly of all frauds exceeding £10,000, and any cases of corruption and any fraud cases of particular interest or complexity, and will set out the details on an AF70 for submission to the Audit Commission Counter-Fraud Unit.
6. In the event of a fraud, both EY and Internal Audit will exchange relevant information. Normally, Internal Audit will then oversee the investigation of the case and keep EY informed of progress.

3.3 Value for money

7. EY and Internal Audit will liaise over any forthcoming value for money work. Should Internal Audit undertake value for money work, EY will consider the findings of that work as part of our review of the Authority's Value for Money Conclusion assessment.

3.4 Other work areas

8. The following additional areas of Internal Audit activity may also be relevant to our work:
 - ▶ Ad hoc investigations into suspected fraud or corruption; and
 - ▶ Reviews of systems development and replacement.

4. Liaison arrangements

1. Liaison meetings will be held regularly in line with the Audit Committee cycle.
2. Standard agenda items for liaison meetings are likely to include:
 - ▶ An update of progress against Internal Audit and EY plans;
 - ▶ Issues affecting delivery of plans;
 - ▶ Reports finalised since last meeting;
 - ▶ Key findings and emerging issues from current work;
 - ▶ Details of special investigations and sensitive issues;
 - ▶ Internal Audit involvement in systems development work, etc.; and
 - ▶ General audit news and intelligence from Internal Audit and EY networks (internally and externally).
3. A representative from EY will be available to attend Audit Committee meetings and any other sessions regarding audit matters. As a minimum EY representative will attend the Audit Committee to present the Audit Plan, Audit Results (ISA 260) Report and the Annual Audit Letter.
4. Key contacts for purposes of communications on the common areas of work are shown in Table 1.

Table 1: Key audit contacts

Authority management	Internal audit	EY
Titus Adam, Head of Finance	Emma Hodds Deputy Audit Manager	David Riglar, Manager

5. First contacts for enquiries on specific audit areas are shown in Table 2.

Table 2: Key audit contacts

Work area	Authority key contact
Audit Planning, control and reporting	Titus Adam, Head of Finance
Financial systems	Titus Adam, Head of Finance
Anti-fraud and corruption	Emma Hodds, Deputy Audit Manager
Performance Management	Titus Adam, Head of Finance
IT	Bill Housden, IT and Tolls Manager

5. Review of Internal Audit: Audit documents and reporting

1. EY reviews Internal Audit's work to consider whether it meets the Internal Audit standards and can be relied upon for providing assurance on the Authority's control arrangements. Reviewing relevant files is an essential step in this process. Internal Audit has agreed to provide us with access to their records and will include EY on the distribution list for all draft and final reports. Any records EY receive from Internal Audit will be kept secure at all times.
2. EY will consider all requests for Internal Audit access to EY files. However, EY will have to take account in each case of the statutory restrictions on the disclosure of information by External Auditors. Internal Audit will have sight of reports that go to the Audit Committee. Where appropriate, meetings will be scheduled with Internal Audit to discuss reports before finalising.
3. EY also undertakes detailed reviews of specific pieces of Internal Audit work upon which EY wishes to place reliance. This will encompass a review of the audit file to assess the scope of the work and the adequacy of sample sizes, standards of evidence and documentation, quality assurance and reporting. This may involve re-performing some tests, or testing an additional sample, if deemed appropriate.
4. Arrangements for relying on Internal Audit work are set out in Appendix D.

Appendix A Working arrangements

Arrangements	Responsibility	Comments
<p>EY and Internal Audit will discuss Internal Audit's annual audit plans for all significant financial systems, one off projects and for anti-fraud and corruption work.</p> <p>Appendix B sets out EY minimum sample sizes for the testing of key controls.</p> <p>Appendix C details the key controls identified by EY from the 2012/13 audit.</p>	Joint	<p>Internal Audit testing in previous years has covered the key controls of the following systems on a cyclical basis and annually to support the Annual Governance statement.</p> <ul style="list-style-type: none"> ▶ General ledger maintenance (including journals) ▶ Purchasing and payables/Creditors ▶ Income receivable/debtors. ▶ Payroll and pensions ▶ Property, Plant and Equipment ▶ Cash; ▶ Tolls
<p>Details of EY expectations for the above work will be supplied by EY. Internal Audit will plan their coverage of the work and ensure their working papers are clearly referenced to indicate how they may be used to support the external audit.</p>	Joint	<p>Internal Audit's first responsibility is to provide a comprehensive Internal Audit service to the Authority. In doing so it is mutually advantageous for Internal and External Audit to closely co-operate over key areas of the audit.</p>
<p>A timetable will be agreed for these systems to ensure that work is available for review at the appropriate time.</p>	Joint	<p>Approximate timings for audit work are agreed at the audit planning meeting usually held in February or March. Details can be updated at each liaison meeting.</p>
<p>Regular meetings will be held to review progress and discuss any matters arising.</p>	Joint	<p>Amongst other things these meetings will provide a forum for feedback and informal discussion of findings, discussions of changes necessary for co-ordination of our work plans, etc.</p>
<p>EY will review aspects of the Internal Audit function on an annual basis.</p>	Joint	<p>The scope of our review of Internal Audit work is set out at Appendix D.</p>
<p>EY will consider all requests for Internal Audit access to EY systems documentation. However, EY will have to take account in each case of the statutory restrictions on the disclosure of information by External Auditors.</p>	Joint	<p>EY and Internal Audit will have sight of reports that go to the Audit Committee. Where appropriate, meetings will be scheduled with Internal Audit to discuss reports before finalising.</p>
<p>Internal Audit should report on the control environment, in line with the Public Sector Internal Audit Standards effective from 1 April 2013.</p>	Internal Audit	<p>Public Sector Internal Audit Standards effective from 1 April 2013 requires the Head of Internal Audit to include in the annual Internal Audit report to the Authority an opinion on the overall adequacy and effectiveness of the authority's internal control environment, providing details of any weaknesses that qualify this opinion and bringing to the attention of the Authority any issues particularly relevant to the preparation of the Annual Governance Statement. Provided it can satisfy itself that Internal Audit operates to the standards set out in the Code, the relevant body is justified in taking assurance from this opinion.</p>
<p>Internal Audit will continue to manage the Authority's involvement in and responses to the NFI programme</p>	Internal audit	<p>EY will consider the work of Internal Audit and the Authority on this project.</p>
<p>Internal Audit and EY will keep each other informed of any frauds discovered or suspected.</p>	Joint	<p>Any frauds discovered are to be reported to both Internal Audit and EY.</p>

Appendix B Controls testing and sample sizes

EY select relevant controls to test that address the ‘what can go wrongs’ (WCGWs) for each relevant financial statement assertion for which EY plans to rely on controls. EY tests controls to evaluate the operating effectiveness of controls over the significant classes of transactions (SCOTs) and significant disclosure processes to prevent or detect and correct material misstatements at the assertion level. Relevant controls are those controls that EY intend to rely on for the purpose of the audit to address the risks of material misstatements at the assertion level. EY will share with Internal Audit details of the controls EY has identified as relevant controls on an annual basis.

The following sample sizes are applied to EY controls testing:

Nature of control and frequency of performance	Minimum number of items to test
Manual control, performed daily or many times a day	25
Manual control, performed weekly	5
Manual control, performed monthly	2
Manual control, performed quarterly	2
Manual control, performed annually	1

The sample selected should cover the whole of the financial year to obtain evidence that the control operated throughout the audit period.

The minimum sample size of 25 assumes 250 occurrences. Between 50 to 250 occurrences, the minimum sample is 10% of occurrences. If less than 50 occurrences, the minimum sample size is 5 or 10% if there are less than 5 occurrences.

If errors or uncertainties are identified within the controls testing undertaken an extended sample should be chosen for testing to focus further on the specific area of risk identified.

Appendix C Summary of key financial controls

The following tables set out the key controls that EY identified as part of the 2012/13 audit work. These may therefore change in future years. These are the key controls EY seeks to understand and evaluate on an annual basis to support the external audit work under the Code of Audit Practice. The tables do not detail a complete list of all controls within the financial system and therefore it may be appropriate to supplement these with further controls to meet Internal Audit objectives.

The tables cover the following areas:

- ▶ General ledger maintenance (including journals);
- ▶ Purchasing and payables/creditors;
- ▶ Income receivable/debtors;
- ▶ Payroll and pensions;
- ▶ Property, plant and equipment
- ▶ Cash;
- ▶ Tolls

General ledger maintenance

Key Controls
All manual journals raised are appropriately authorised and input into the system.
Journals are only raised by accounting officers and approved by a senior accounting officer.

Creditors and accounts payable

Key Control
Appropriately authorised orders should be raised for all purchases.
Goods received notes (GRNs) received should be agreed to orders raised.
Invoices received should be matched to orders and GRNs (where applicable) for accuracy and confirmation of receipt of the goods/service.
Invoices should be appropriately authorised.
Invoices input into the system for payment should be checked for accuracy.
BACS payments should be appropriately authorised.
The weekly payment projection report (which shows the amount they are due to pay) equals the amount on the purchase ledger control report.
Creditor control accounts/purchasing system to general ledger system interfaces should be reconciled with all reconciling items should identified, investigated and resolved on a timely basis. An independent review of the reconciliation should be performed on a timely basis
Appropriate segregation of duties and restricted access should be ensured.
New Vendor forms should be appropriately authorised prior to a new vendor being set up on the purchasing system.
Amendments to standing data (e.g. supplier details) should be appropriately authorised and accurately input on to the system.
Tendering procedures should be followed for all purchases above the limit set.

Debtors and accounts receivable

Key Control
Invoice requisitions should be appropriately authorised and raised in a timely manner.
Invoices raised should be checked to invoice requisition to ensure accuracy and completeness of invoices raised.
Receipt of income should be reconciled to the amount banked.
Debtor control accounts/receivables system to general ledger system interfaces should be reconciled and all reconciling items should be identified, investigated and resolved on a timely basis. An independent review of the reconciliation should be performed on a timely basis.
Appropriate segregation of duties and restricted access should be ensured.
Appropriate procedures should be in place for monitoring the recoverability of aged debts.
Bad debts should be written off after appropriate authorisation per the financial regulations.

Payroll

Key Control
Starter forms should be appropriately completed by the HR department and employee (based on the employment contract) prior to input into the payroll system. Input of details into the payroll system should be checked for accuracy.
Leaver forms must be appropriately authorised and accurately input into the payroll system.
Amendments to standing data must be authorised by the employee and appropriate manager and accurately input into the payroll system.
Payroll control accounts/payroll system to general ledger system interfaces should be reconciled and all reconciling items should be identified, investigated and resolved on a timely basis. An independent review of the reconciliation should be performed on a timely basis.
Managers should be asked to verify the completeness and accuracy of employee information on the payroll system on at least a quarterly basis.
The Authority produce a report of all differences in pay greater than 5% from the previous month.
Payroll data file provided by the company providing the payroll service is checked before payroll is processed
Monthly reconciliations of payroll to the ledger include the "payroll control Account" reconciliation.
Appropriate segregation of duties and restricted access should be ensured.

Property, plant and equipment

Key Control
All capital additions should be appropriately authorised in accordance with procedures.
All capital disposals should be appropriately authorised in accordance with procedures.
The fixed asset register is reconciled to the general ledger on a regular basis. The reconciliation should be signed and dated by the preparer as evidence of completion. An independent review of the reconciliation should be performed and evidenced by the reviewer (signature and date).
Restricted access to the fixed asset register should be ensured.
Capital expenditure should be monitored and controlled against budget. The budget set should be realistic and based upon appropriate assumptions.

Cash

Key Control
The amount of income received on the cash receipting system should be checked to the amount of income recorded as banked from bank statements / reports.
A monthly exception / verification report is produced from the cash receipting system which highlights any differences / errors.
The amount of cash received in the cash system is automatically posted to the ledger; exception reports / suspense highlight any errors or omissions. The general ledger suspense account should be reviewed on a monthly basis, and any long outstanding items cleared.
Bank reconciliations for all bank accounts should be performed on a monthly basis and all reconciling items fully identified, investigated and resolved as necessary. The reconciliation should be signed and dated by the preparer as evidence of completion. An independent review of the reconciliation should be performed and evidenced by the reviewer (signature and date).
Appropriate segregation of duties and restricted access should be ensured.

Tolls

Key Control
Once toll payment has been received a plaque is sent out this being recorded on the TMS system. The plaque being a sequentially numbered sticker which is attached to the vessel to prove payment of toll. Navigation rangers inspect vessels on the waterway to ensure they have a valid plaque.
Tolls staff input the batches into the TMS system. TMS will not allow a batch to be input unless it balances with payments received. Therefore, differences are investigated which usually relate to payments including non-toll related income.
Batch header totals are reconciled to totals from the TMS system for hire tolls, private tolls, overpayments and other payments (such as the sale of tide tables) on the bottom half of the batch header.
Applicant is given a sequentially numbered toll plaque which must be stuck onto vessel. Navigation rangers inspect vessels for presence of plaques.
Total of batch sheet is reconciled to the information on TMS split into the various toll types and payments received through the receipt book for that period is also reconciled on the batch sheet.
Reconciliation of GL, TMS (tolls management system) and balancing figure of the debit (the cash and cheques banked for the batch) agrees to what was actually banked.

Appendix D Approach to reliance on Internal Audit

In accordance with International Standards on Auditing (ISA) 610, when EY plan to rely on the work completed by Internal Audit, EY:

- ▶ Undertakes an overall assessment of the Internal Audit function to determine if Internal Audit's work is likely to be adequate for the purposes of EY's audit. EY evaluate:
 - ▶ The objectivity of the Internal Audit function
 - ▶ The technical competence of the Internal Auditors
 - ▶ Whether the work of the Internal Auditor is carried out with due professional care
 - ▶ Whether there is effective communication between Internal and External audit.
- ▶ Determines the effect of Internal Audit's work on EY's procedures. When determining whether, and to what extent, EY uses the work of Internal Audit, EY will consider both the risks associated with the areas being tested and our judgments as to the competence and objectivity of those who have or will perform the work. If EY plan to use the work of Internal Audit, EY will agree in advance with Internal Audit:
 - ▶ The work that EY plan to use and the timing of such work
 - ▶ Testing thresholds
 - ▶ Method of sample selection
 - ▶ Documentation of the work including retention of working papers
 - ▶ Review and reporting procedures.
- ▶ Evaluate the individual piece of work completed by Internal Audit that EY plans to use and conclude whether it is adequate for EY's purposes. EY will evaluate whether:
 - ▶ The work was performed by Internal Auditors having adequate technical training and proficiency
 - ▶ The work was properly supervised, reviewed and documented
 - ▶ Adequate audit evidence has been obtained to enable reasonable conclusions to be drawn
 - ▶ Conclusions reached and reported are appropriate
 - ▶ Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

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