

Audit Summary Report

Date

# **Protocol for liaison between Internal and External Audit**

**Tonbridge & Malling Borough Council**

**Audit 2009/10**

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## 4 Protocol for liaison between Internal and External Audit

### Introduction

- 1 The Audit Commission has made a commitment to strategic regulation. The principles of strategic regulation have been incorporated into the 2005 Code of Audit Practice. The Code requires external auditors to carry out their audit economically, efficiently and effectively, and in as timely a way as possible. It specifies that as part of their audit approach, auditors should establish effective co-ordination arrangements with internal audit and seek to place maximum reliance on internal audit work wherever possible.
- 2 Although internal and external auditors carry out their work with different objectives in mind, many of the processes are similar and it is sensible and good professional practice that they should work together closely.
- 3 This protocol sets out the responsibilities and joint working arrangements between external and internal audit (IA). External audit will be undertaken by the Audit Commission (AC) and IA by Tonbridge & Malling Borough Council in-house auditors.
- 4 The arrangements take into account:
  - the AC's Code of Audit Practice (CoAP) for external audit;
  - the CIPFA Code of Practice for IA in Local Government (the CIPFA Code);
  - the requirements of the International Standards of Auditing (ISA(UK&I)); and
  - the AC's Managed Audit Guide (2002).
- 5 This protocol will take effect from April 2010 and will be subject to annual review.

### Objectives of the protocol

- 6 The objective of this protocol is to provide a framework which will optimise the benefits of audit to the Council, whilst enabling internal and external audit to deliver their respective responsibilities. It sets out how internal and external audit will work together to achieve this.
- 7 The protocol aims to:
  - clarify the respective roles and responsibilities of external and internal audit;
  - highlight areas for working together and where external audit are likely to place reliance on internal audit; and
  - promote strong liaison arrangements.
- 8 Overall the protocol should develop an effective working relationship, within the bounds of the respective roles of internal and external audit, and optimise the benefit to the Council from available audit resources.

## Roles and Responsibilities

### External audit

- 9 The primary responsibilities of external audit under the CoAP (2005) are:
- to give an opinion on whether the annual statement of accounts presents fairly the financial position of the Council and its expenditure and income for the year, and has been properly prepared in accordance with relevant legislation and applicable accounting standards; and
  - to conclude on whether the Council has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources (using criteria specified by the Audit Commission).

### Internal audit

- 10 Under the Accounts and Audit Regulations 2006, IA is required to undertake its work in compliance with practices contained in the CIPFA code.
- 11 The CIPFA code defines IA as "an assurance function that provides an independent and objective opinion to the organisation on the control environment, by evaluating its effectiveness in achieving the organisation's objectives. It objectively examines, evaluates and reports on the adequacy of the control environment as a contribution to the proper, economic, efficient and effective use of resources."
- 12 Councils are required to prepare an Annual Governance Statement (AGS) which is included in the Council's statement of accounts. The AGS must be supported by assurance that appropriate controls are in place and operating effectively, and IA may provide a significant part of this assurance through its work. Under the CIPFA Code, the Head of IA is required to issue an annual opinion to the Council on the overall adequacy and effectiveness of its internal control environment.

### Working together

- 13 Although internal and external auditors have different roles and responsibilities, there are areas of overlap in the work they are required to undertake. Under the CoAP, external audit is required to place reliance on the work of IA where possible to support its conclusions. Any such reliance is governed by International Auditing Standard (ISAs) (UK and Ireland) 610. This standard requires external audit to review internal audit's work, which usually involves reperforming specific tests as well as a more general review.
- 14 When internal and external auditors work closely together, the following benefits should accrue.

**Table 1 The benefits of joint working**

Effective working should secure the following benefits

Internal audit	External audit	The Council
Increased credibility and presence with management and members (those charged with governance)	Better understanding of the corporate framework	Clearer, more consistent reporting of audit issues
Greater emphasis on IA's own objectives	The audit is more tailored and relevant to the Council	Reduced incidence of duplication or omission of audit work
Greater awareness of risk from external observer's perspective	Increased awareness of risk factors at the Council	Better focused audit work that provides relevant information
Opportunities for joint working	More efficient audit approach	Maximises the positive impact of audit

15 To achieve such benefits, commitment and delivery from both sides is required. Joint consideration of audit risks and the timely sharing of information will be necessary to achieve optimum results. Audit plans will be constructed on the basis of such commitment being in place.

16 It is also necessary that:

- AC and IA meet appropriate professional standards; and
- officers provide auditors with requested data and explanations promptly with clear supporting documentation.

17 Areas of responsibility and review where the work of external and internal auditors overlap are set out below.

**Risk assessment**

18 Both internal and external auditors produce annual audit plans based on an assessment of audit risks, partly informed by the Council's own risk management process. Sharing and discussion of these risk assessments should enable both parties to devote appropriate time to the key issues facing the Council and ensure that the Council gets maximum value from its total audit resources.

19 AC and IA managers will therefore liaise over their annual risk assessments and preparation of audit plans.

## Financial systems

- 20 The greatest area of overlap in the responsibilities of internal and external audit is in the review of financial systems. Internal audit carry out systems audits as part of their role in providing assurance to the S151 officer on the effectiveness of the system of internal control. External audit consider financial systems for opinion purposes.
- 21 In carrying out an audit of the statement of accounts, external audit is required by the CoAP to comply with current auditing standards i.e. the International Standards on Auditing (ISAs). These include:
- ISA 315, "Understanding the entity and its environment and assessing the risks of material misstatement", which requires us to identify and assess the risks of material misstatement in the statement of accounts; and
  - ISA 330, "The auditor's procedures in response to assessed risk", which requires us to plan and undertake work to establish the impact of assessed risks on our audit opinion.
- 22 ISAs 315 & 300 place a greater focus on identifying, evaluating and testing internal controls that are relevant to the statement of accounts. As a consequence, the AC's audit approach requires external auditors to obtain assurance in relation to those systems which give rise to material figures in the statement of accounts. This assurance is obtained in three stages.

### Stage 1: Identification of material systems

- 23 Each year external audit identify those Council systems which generate material figures in the statement of accounts. For 2009/10 initial external audit planning indicates that these systems are as follows:
- General ledger, including journals;
  - Accounts receivable;
  - Accounts payable;
  - Payroll;
  - Treasury Management
  - Cash and bank;
  - Asset management
  - Council Tax
  - NNDR
  - Leisure income
  - Car park income
  - Housing Benefits.

## **Stage 2: Documentation of systems and key controls**

- 24 External audit is required to document systems which lead to material entries in the accounts. This documentation (flowchart or narrative) will identify:
- how transactions are initiated, recorded, processed and reported; and
  - the controls that prevent and detect material misstatement in these processes.
- 25 For the purposes of ISA (UK&I) 315 external audit is concerned only with those controls which prevent a material mis-statement in the financial statements. There are usually a small number of such controls in each system.
- 26 External audit is required to carry out walkthrough testing annually to ensure that the controls identified are operating as documented. Where necessary external audit systems documentation will be updated for any changes.

## **Stage 3: Testing of key controls to ensure they are effective**

- 27 External audit identify the key controls on which they seek to place assurance for opinion purposes. To obtain assurance for opinion purposes testing of these controls is required on a cyclical basis. Testing of the controls relating to the general ledger is required annually.
- 28 IA also perform compliance testing as part of their responsibility to review the Council's system of internal control.
- 29 External audit will liaise with internal audit each year to identify the key controls where testing is required to provide assurance for opinion purposes. Where possible the testing required for both internal and external audit purposes will be combined, with external audit placing reliance on internal audit work.
- 30 For opinion purposes any external audit testing needs to comply with the requirements of the ISAs and the guidance issued by the Audit Commission centrally. Therefore external audit will only be able to place reliance on internal audit work if it is consistent with this methodology and approach. Details of the current external audit approach to controls testing are at Appendix 2.
- 31 A clear timetable for delivery of the agreed programme of testing is essential if reliance is to be placed on internal audit work. If IA testing is not delivered then additional external audit work will be required.
- 32 Where initial testing indicates that any key controls are not reliable then there will be a need to identify and test any compensating controls, or to design and undertake substantive tests. Substantive testing may incur additional external audit costs for the Council.



## Grants work

- 33 The certification of grant claims falls outside the CoAP. However, in some circumstances external audit of claims may require testing of the underlying systems on which the claims are based. Where this is the case external audit will seek to co-ordinate testing and place reliance on work performed by IA.

## Computer audit

- 34 Computer audit should form an integral part of IA's work. The Audit Commission may assist by providing specialist computer auditors to undertake projects which will be determined in consultation with IA.
- 35 Under their audit approach external audit are required to undertake an annual IT risk assessment. The outcomes from this assessment will be shared to ensure that known risks are considered by IA when planning and undertaking work in this area.

## Data Quality

- 36 To support the use of resources assessment external audit are required to perform annual work on data quality, including a detailed review of arrangements and spot check testing for a small number of performance indicators. In completing this work external audit will consider any relevant internal audit work.

## Fraud and corruption

- 37 Details of any fraud over £10,000 or corrupt acts which are identified by internal audit will be notified to external audit using AC form (AF70). The information will then be forwarded to the Audit Commission centrally for inclusion in national statistics.

## Co-operation and co-ordination

- 38 Effective co-operation between external and internal auditors means more than avoiding duplication. An effective framework of co-operation and co-ordination ensures liaison, co-operation on work programmes and the sharing of information. Reflecting this, the protocol covers:
- liaison meetings; and
  - arrangements for sharing documents and information.
- 39 The principles of co-operation and co-ordination are set out below.

## Liaison meetings

- 40 Liaison meetings will be held at least quarterly to update issues identified in relation to the audit, review progress and exchange information. Liaison during the annual planning process is essential.

## **Arrangements for sharing documentation and information**

- 41 External audit will be provided with access to IA's audit reports, documentation and working papers by arrangement at a mutually convenient time and place. Such documentation will not be removed from IA offices without the consent of the Chief Internal Auditor.
- 42 IA will be included on the distribution list for external audit final reports. External audit will receive internal audit reports as agreed through ongoing liaison and where internal audit consider items should be brought to external audit's attention. External audit will not require copies of all internal audit final reports.

## **Review of internal audit work**

- 43 Where external audit seeks to place reliance on internal audit work it is required to understand
  - under ISA 315: how the audited body monitors internal controls and
  - under ISA 610: the organisational status, role and competence of internal audit.
- 44 External audit is required to make this assessment each year but where appropriate will take into account the findings from previous year work.
- 45 External audit is also required to review and evaluate specific pieces of internal audit work on which it seeks to place reliance. This review will assess e.g. the scope of the work, standards of evidence and documentation. Under Audit Commission guidance this assessment may also involve some element of reperformance. External audit will provide feedback to the Chief Internal Auditor on the outcome of these reviews.

# Appendix 1 – Key contact details

## Internal Audit

**Table 2 Key Internal Audit Contacts**

Key contacts for Internal Audit are as follows

Position	Name	Contact details
Chief Internal Auditor	David Buckley	01732 876086
Internal Audit Manager	Karla Etuate	01732 876085

## The Audit Commission

**Table 3 Key Audit Commission contacts**

Key contacts for Audit Commission are as follows

Position	Name	Contact details
District Auditor	Andy Mack	<a href="mailto:a-mack@audit-commission.gov.uk">a-mack@audit-commission.gov.uk</a> 07765 898682
Audit Manager	Trevor Greenlee	<a href="mailto:t-greenlee@audit-commission.gov.uk">t-greenlee@audit-commission.gov.uk</a> 07909 534624
Team Leader	Hannah Lill	<a href="mailto:h-lill@audit-commission.gov.uk">h-lill@audit-commission.gov.uk</a> 07896 684762

## Appendix 2 – Testing of controls

"Material" systems for external audit opinion purposes are those which give rise to material amounts in the financial statements. Each year external audit identify and document these systems, testing their understanding through a walkthrough of transactions.

Where external audit identify key controls within these systems which prevent or detect the risk of material misstatement it may seek to place reliance on the operation of these controls. In this case audit testing is required to ensure that the controls are operating effectively

Testing is carried out on a cyclical basis, with the key controls in each system tested every three years. Where possible external audit will seek to place reliance on internal audit work in this area.

In order to take assurance for external audit opinion purposes controls testing needs to be performed in accordance with the requirements of the ISAs and the audit approach specified centrally by the Audit Commission. The key requirements of this approach are summarised below. If the testing performed by internal audit is not consistent with these requirements then it will not be possible to place reliance on it for external audit opinion purposes.

### Controls to be tested

External audit evaluate the design of material systems and identify key controls using ETC (Evaluation and Testing of Controls) forms. After completion of walkthrough testing it will provide copies of these forms to internal audit for all systems where testing of controls is required by the external audit cyclical plan.

### Scope of control testing

Testing of controls should allow the external auditor to form a view on whether the control was

- applied as designed;
- consistently applied throughout the year under review; and
- performed by the correct person/people (if appropriate).

Auditors are also expected to ensure that the effective operation of the control is properly tested. So for example, Audit Commission guidance is that;

- when testing a control account reconciliation, auditors are expected to ensure that the amounts reconcile properly, that there are no unexplained balancing figures, and that any non-reconciling amounts have been investigated and corrected in a timely manner. It is not sufficient to simply check that the reconciliation had been signed off as having been undertaken.
- where the control involves authorisation, it is not sufficient to check for a signature. Auditors are expected to review the underlying controls, ie clarify what checks the authoriser performs to enable them to authorise the transaction.

**Sample size**

The sample size will depend on the frequency of the control activity. Samples should be selected to provide coverage over the whole of the period under review e.g. for "more than weekly" controls it would not be appropriate for the entire sample of 20 to be taken from a single month. For quarterly and monthly controls the sample should include the final period ie year-end.

Where internal audit work is performed prior to year end, and therefore covers only part of the financial year, sample sizes should be adjusted pro rata.

Top up testing will be required to cover the remainder of the financial year. Internal and external audit will agree locally on how this work is to be completed. Some testing will be most appropriately performed by external audit' as part of year end work.

The required samples sizes are as follows:

**Table 4      Sample sizes**

<b>Frequency of controls</b>	<b>Sample size</b>
Quarterly	2 (including period end)
Monthly	2
Weekly	5
More than weekly	20
Fully automated controls	For a low risk environment, walkthrough testing by external audit should provide sufficient assurance.

**Investigating errors in control testing**

If an error is identified there is a need to conclude whether the error is isolated, systematic or random.

**Isolated error** - This is an error that arises from a clearly identifiable one off circumstance. An explanation is needed as to why the error can be regarded as isolated.

**Systematic error** - This is an error which given a similar set of circumstances could occur again. If there is a systematic error then it may be appropriate to test a second sample of items which have the characteristics of the error found, for example if it is considered that the error relates to a particular individual.

**Random error** - The default position should be that an error is random unless proven otherwise. If it is decided the error is random then for external audit opinion purposes there is a need to either test an additional sample across the whole population or obtain the required assurance by other means (for example by testing an alternative control ,or substantive testing). It is recommended that if internal audit identify random errors from control testing they discuss their findings with external audit before performing further work

### **Recording of work**

The approach to recording any internal audit work on controls testing will be agreed each year between internal and external audit before any internal audit testing commences.

