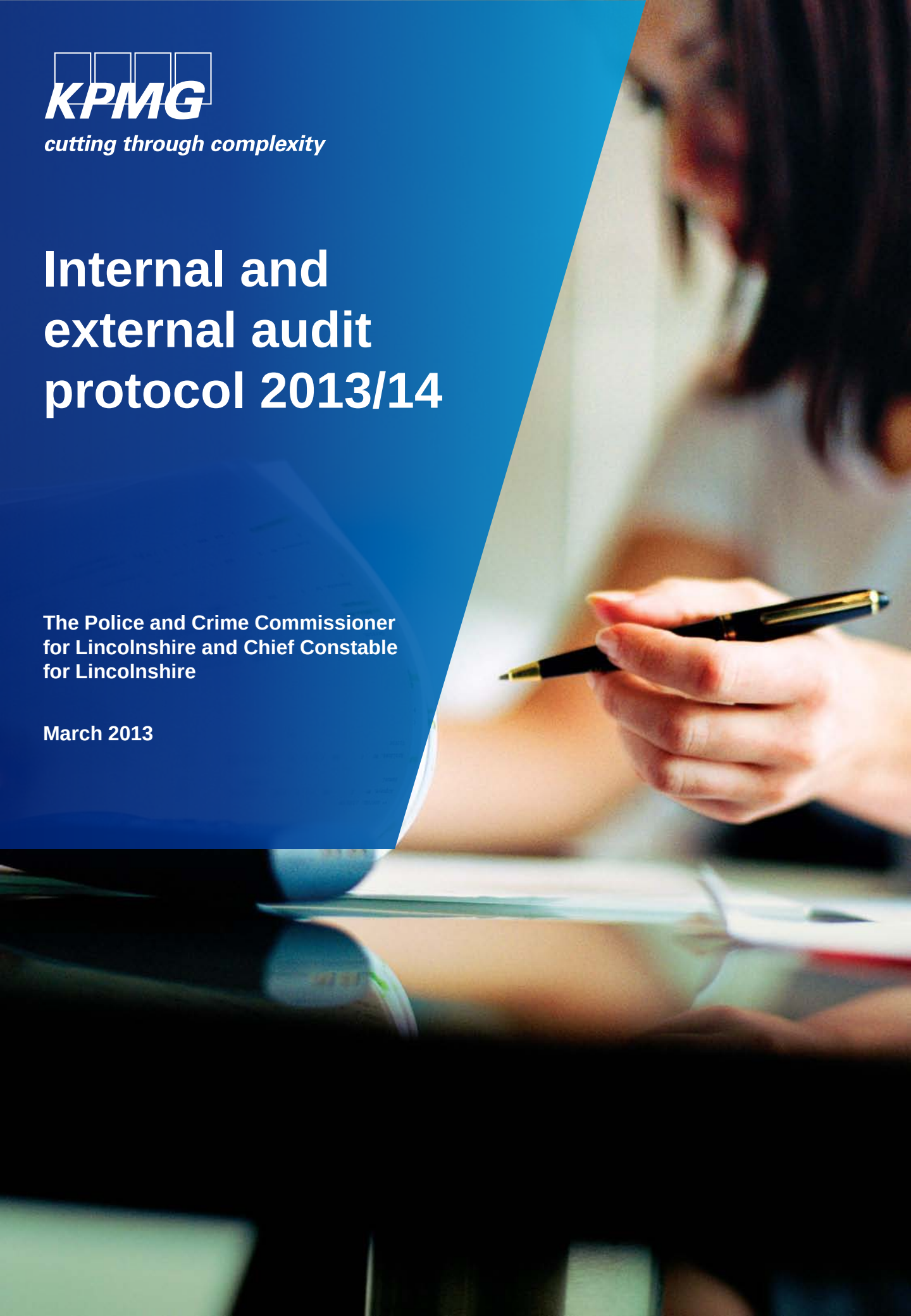
KPMG

cutting through complexity

Internal and external audit protocol 2013/14

The Police and Crime Commissioner for Lincolnshire and Chief Constable for Lincolnshire

March 2013



Content

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This report is addressed to the Police and Crime Commissioner and Chief Constable and has been prepared for their sole use. We take no responsibility to any member of staff acting in their individual capacities, or to third parties. The Audit Commission has issued a document entitled *Statement of Responsibilities of Auditors and Audited Bodies*. This summarises where the responsibilities of auditors begin and end and what is expected from the audited body. We draw your attention to this document which is available on the Audit Commission's website at www.auditcommission.gov.uk.

External auditors do not act as a substitute for the audited body's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

If you have any concerns or are dissatisfied with any part of KPMG's work, in the first instance you should contact Tony Crawley, the appointed engagement lead to the Police and Crime Commissioner and Chief Constable, who will try to resolve your complaint. If you are dissatisfied with your response please contact Trevor Rees on 0161 246 4000, or by email to trevor.rees@kpmg.co.uk, who is the national contact partner for all of KPMG's work with the Audit Commission. After this, if you are still dissatisfied with how your complaint has been handled you can access the Audit Commission's complaints procedure. Put your complaint in writing to the Complaints Unit Manager, Audit Commission, Westward House, Lime Kiln Close, Stoke Gifford, Bristol, BS34 8SR or by email to complaints@audit-commission.gov.uk. Their telephone number is 0844 798 3131, textphone (minicom) 020 7630 0421.

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Section one
Introduction

Purpose and structure of this document

This document clarifies the working relationship between RSM Tenon ("Internal Audit") and the KPMG LLP audit team ("KPMG") responsible for the audits of the Police and Crime Commissioner for Lincolnshire and Chief Constable for Lincolnshire ("the Client(s)"). Reasons for documenting the relationship are:

- As part of the delivery of a managed audit, KPMG seek to place reliance on the work of Internal Audit where this is relevant to their work, particularly when appraising the controls operated by management over financial systems; and
- To formalise areas of co-operation and assistance that can help to reduce any unnecessary overlap of audit effort.

The remainder of this document presents:

- The principles and general arrangements that are put in place to ensure that Internal Audit and KPMG are able to implement the managed audit approach (section two).
- The specific arrangements that are required to support the managed audit approach for the accounts and systems work at the Clients, VFM work, and fraud requirements (section three).
- Details of KPMG's approach to controls testing, including detailed schedules setting out the key controls for relevant systems (section four supported by appendix one).

Key contacts

For the purpose of clarity, the key contacts between Internal Audit and KPMG will be as follows:

Internal Audit			
Mark Jones	Head of Internal Audit	☏: 07768 952387	🖮: mark.jones@rsmtenon.com
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The way forward

This document formalises the process for the 2013/14 audit year onwards. Regular reviews of these arrangements should ensure that the protocol remains current and accurately reflects the control environment of the Clients as well as KPMG's requirements in response to this.

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Section two
General arrangements

Respective responsibilities

KPMG's responsibility as external auditors is set out in the *Audit Commission Act 1998* and the Audit Commission's *Code of Audit Practice*.

The *Code of Audit Practice* summarises KPMG's responsibilities into two objectives, requiring KPMG to review and report on the Clients':

- financial statements (including the Annual Governance Statement): providing an opinion on the accounts of both the Police and Crime Commissioner and the Chief Constable; and
- use of resources: concluding on the arrangements in place for securing economy, efficiency and effectiveness in the Police and Crime Commissioners and the Chief Constables use of resources (the value for money conclusion).

A professional, independent and objective internal audit service is one of the key elements of good governance, as recognised throughout the UK public sector.

From April 2013, the United Kingdom Public Sector Internal Audit Standards (PSIAS) apply across the whole of the public sector, including local government. These standards are intended to promote further improvement in the professionalism, quality, consistency and effectiveness of internal audit across the public sector. The PSIAS replace the Code of Practice for Internal Audit in Local Government in the United Kingdom, last revised in 2006. Additional guidance for local authorities is included in the Local Government Application Note on the PSIAS.

KPMG expect Internal Audit to comply with the requirements of the PSIAS.

Working together

On an annual basis, KPMG and Internal Audit will discuss the risk assessment underlying the Internal Audit Plan, to determine areas of common interest and therefore reduce any unnecessary overlap of audit effort.

Where KPMG have identified the opportunity to rely on work performed by Internal Audit, KPMG will consider the findings of their report and, if necessary, review the supporting audit files.

The timescales for these reviews will be subject to agreement with Internal Audit at the time. KPMG plan to complete control evaluation work in April each year in preparation for the audit of accounts and therefore expect all of Internal Audit's work on key financial systems to be completed by March.

Final Internal Audit reports for all areas should be sent electronically to KPMG, and specifically to Denise Campbell (denise.campbell@kpmg.co.uk) who will collate these as necessary.

Any detailed review of the Internal Audit files will be conducted at the designated offices of Internal Audit, with files kept in the offices of Internal Audit at all times.

KPMG will share copies of their final reports with Internal Audit as a matter of course to ensure they are aware of the findings from the external audit work.

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Section three
Specific arrangements

Systems of internal financial control

KPMG are required under the *Code of Audit Practice* to form an opinion as to whether the financial statements and transactions give a true and fair view of the financial position and the transactions of each Client.

To support this opinion, it is desirable to place reliance on the Clients' core financial systems. The work of Internal Audit is important in building up an understanding of the systems and controls to achieve this.

In line with the PSIAS, internal auditing is 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.

The PSIAS require Internal Audit to prepare a risk-based audit plan that takes into account the Clients' risk management frameworks, as well as changes in the Clients' businesses, risks, operations, programmes, systems and controls. KPMG therefore expect that this covers all of each Clients' key risk areas, including those related to the financial systems.

KPMG will review the outcome from Internal Audit's work on the financial systems to influence their annual assessment of the overall control environment, which is a key factor when determining the external audit strategy.

Subject to the Clients' financial systems having been assessed as effective by Internal Audit, KPMG have defined only a small number of key systems and key controls which they would expect Internal Audit to cover on an annual basis to support the external audit work on the financial statements. The required scope for these encompasses both assessment of the design and implementation of controls and testing of the effective operation of the controls.

Appendix 1 lists those controls and walkthroughs that Internal Audit should seek to perform as a minimum for external audit purposes as part of the delivery of its Internal Audit Plan.

KPMG's audit strategy is continually revisited, so there may be instances where they do not specifically review and seek to rely on Internal Audit's work on the controls for specific systems in any given audit, depending on our audit strategy at the time. This document therefore sets out the systems and controls where reliance is most likely, but the extent to which KPMG will seek to place reliance on individual areas will vary.

KPMG's fee for the external audit is set on the presumption that KPMG can place reliance on the work of Internal Audit and the core financial systems themselves. If this is not the case, additional work may be required in order to support the audit opinion, which will increase the external audit fee.

Fraud and corruption

Internal Audit's responsibilities over fraud and corruption comprise two main areas:

- Proactive work to assess the quality of controls which prevent and detect fraud and corruption; and
- Investigation of specific allegations.

KPMG's responsibilities under auditing standards are limited to:

- Identifying and assessing the risks of material misstatement of the financial statements due to fraud and designing and implementing appropriate responses to the risks identified; and
- Responding appropriately to fraud or suspected fraud identified during the audit.

As part of their periodic meetings Internal Audit and KPMG will discuss any significant fraud and corruption cases reported to or investigated by Internal Audit.

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Specific arrangements (cont.)

VFM work

The *Code of Audit Practice* requires KPMG to conclude on the arrangements in place for securing economy, efficiency and effectiveness in each Client's use of resources (the VFM conclusion).

As part of the risk based approach set out by the Audit Commission, KPMG consider the relevance and significance of the potential business risks faced by all local authorities, and other risks that apply specifically to each Client. These are the significant operational and financial risks in achieving statutory functions and objectives, which are relevant to auditors' responsibilities under the *Code of Audit Practice*.

In doing so KPMG consider the Police and Crime Commissioner's/Chief Constable's own assessment of the risks it faces, and its arrangements to manage and address its risks. Assurance that a risk is managed effectively can come from a range of sources, including the work of Internal Audit.

KPMG consider that an effective Internal Audit Plan should address any key business risks where gaps in the assurance framework have been identified.

KPMG's external audit fee assumes that they are not required to complete significant detailed audit work to provide assurance against the VFM criteria. Any significant VFM risks not sufficiently mitigated by each Client, may therefore result in additional fees.

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Section four
Approach to controls testing

Systems and controls

Internal Audit will document and test the key financial systems and controls KPMG have specified. These systems are:

- **Financial reporting**: covering maintenance of the general ledger and central processes relating to management and year-end reporting;
- **IT control environment**: with a specific focus on the access to the network, key financial systems and data and first time implementation and ongoing maintenance of the key financial systems;
- **Cash and cash equivalents**: covering cash receipting, cash book maintenance and reconciliations of the cashbook and bank to the general ledger;
- **Property, plant and equipment**: with a specific focus on the maintenance of the asset register, updating of asset values and reconciliations with the general ledger; and
- **Pensions asset/liability**: covering the validity of data provided to the actuary in support of the IAS19 valuation with a specific focus on management's procedures to confirm its accuracy.

The key control schedules for each of these are set out in appendix one.

Sample sizes

To ensure KPMG can place reliance on the work, sample sizes are taken from throughout the financial year although they do not need to cover the entire financial year and are of the following minimum size:

Frequency the control activity	Minimum sample size	
	If the control has a HIGH *Risk of Failure*	If the control has a LOW *Risk of Failure*
Annual	1	1
Quarterly	2	2
Monthly	3	2
Weekly	8	5
Daily	25	15
More than daily	40	25

The *Risk of Failure* is a matter of judgement. Factors to consider include:

- The nature of the control, including the complexity of it;
- Whether the control relies on performance by an individual or is automated;
- The significance of the judgments that must be made in connection with its operation;
- The competence of the individual who performs the control;
- Whether there have been any changes; and
- Whether there is a history of errors.

Sample size requirements relate to sets of controls, e.g. five of each type of exception report for a weekly payment run, not five exception reports in total. For some controls, such as reconciliations, we will test the final control for the year as part of the year-end audit.

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Approach to controls testing (cont.)

Many controls are now either automated or have a significant IT component. Automated controls may include activities such as calculations, posting to accounts, system-generated reports, and edit and control routines performed within applications. KPMG are required to test these on a cyclical basis, every 3 years, using a sample size of one, alongside a detailed walkthrough.

Internal Audit, however, may consider it necessary to increase sample sizes to meet their own objectives.

Testing approach for common types of controls

The approach to testing three of the main types of controls, reconciliations, exception reports, and access controls, is set out below.

Reconciliations

- Confirm that all reconciliations that should have been produced in the year to date have been produced;
- Review system parameters for any reports used to complete the reconciliation and confirm that their design is suitable to achieve the control objectives; and
- Review the appropriate number of reconciliations (in line with sample sizes on the previous page), confirming that:
  - System balances agree to the systems that are being reconciled;
  - All significant reconciling items are explained and supported; and
  - The reconciliation casts, has been signed by preparer and reviewer and was performed in a timely fashion.

Exception reports

- Scan review exception reports produced in the year to date to verify that they have been produced with the frequency required by each Client's financial procedures;
- Review system parameters for any reports used to confirm that their design is suitable to achieve the control objectives; and
- Review the appropriate number of exception reports (in line with sample sizes on the previous page), confirming that:
  - There is evidence, such as formal sign off, that exceptions were reviewed and, if appropriate, investigated; and
  - For any errors identified confirm that these were subsequently corrected.

Access controls

- Obtain a list of access rights to the network/ system;
- For a sample of system users, confirm that their system access:
  - has been appropriately authorised;
  - is suitable to the post held by the member of staff; and
  - complies with each Client’s financial regulations and scheme of delegation; and
- Obtain a list of leavers during the year and test a sample of leavers to ensure that access has been disabled.

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Appendix one
Key control schedules

Financial reporting

Testing of the following key controls, or compensating controls where these are not in place:

- Budgetary control: senior management and PCC/CC review of revenue income and expenditure against budget;
- Ledger mapping: annual update and review of the general ledger mapping to SERCOP headings;
- Journals: system restrictions to inputting one-sided journals;
- Journal authorisation: periodic production and independent review of journal exception reports – **or –** Independent preparation, authorisation and input of journals;
- Suspense accounts: periodic review and clearance of suspense and control accounts; and
- Feeder system reconciliations: periodic reconciliation of the cash receipting system to the general ledger.

Access to systems and data

Testing of the following key controls, or compensating controls where these are not in place:

- Maintaining and publicising a comprehensive IT security policy;
- Adequate password-based access restrictions to the network;
- Adequate password-based access restrictions to the general ledger system;
- Regular evidenced, independent review of user access rights to these systems, including user roles to ensure segregation of duties as set out in financial procedures; and
- Regular evidenced, independent review of the appropriateness of access rights of 'super users' (ie. those with administrator system access).

System changes

Testing of the following key controls, or compensating controls where these are not in place:

For the general ledger and cash receipting system:

- Authorisation and documentation / review of changes to the system configuration and report parameters.

Where a new system has been implemented in year:

- Approval of the business case and go live decision for the new system;
- Evidenced and reviewed reconciliation of data transferred from old to the new system; and
- Authorisation and documentation / review of the initial system configuration and report parameters.

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Key control schedules (cont.)

Cash and cash equivalents
Testing of the following key controls, or compensating controls where these are not in place: ■ Periodic reconciliation of the cash receipting system to the general ledger; ■ Posting of receipts to correct accounts/ledger codes; and ■ Periodic reconciliation of the bank accounts and cash book to the general ledger and associated review by management.
Property, plant and equipment
Testing of the following key controls, or compensating controls where these are not in place: ■ Periodic reconciliation of fixed asset register to the general ledger; ■ Revaluation of assets within required period, application of correct valuation basis to assets and correct updating of the fixed asset register; and ■ Annual impairment review of assets.
Pensions asset/liability
Testing of the following key controls, or compensating controls where these are not in place: ■ Agreement of source data provided to the actuaries to underlying systems and reports; and ■ Management procedures undertaken to establish the sufficiency, relevance and reliability of source data.

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