

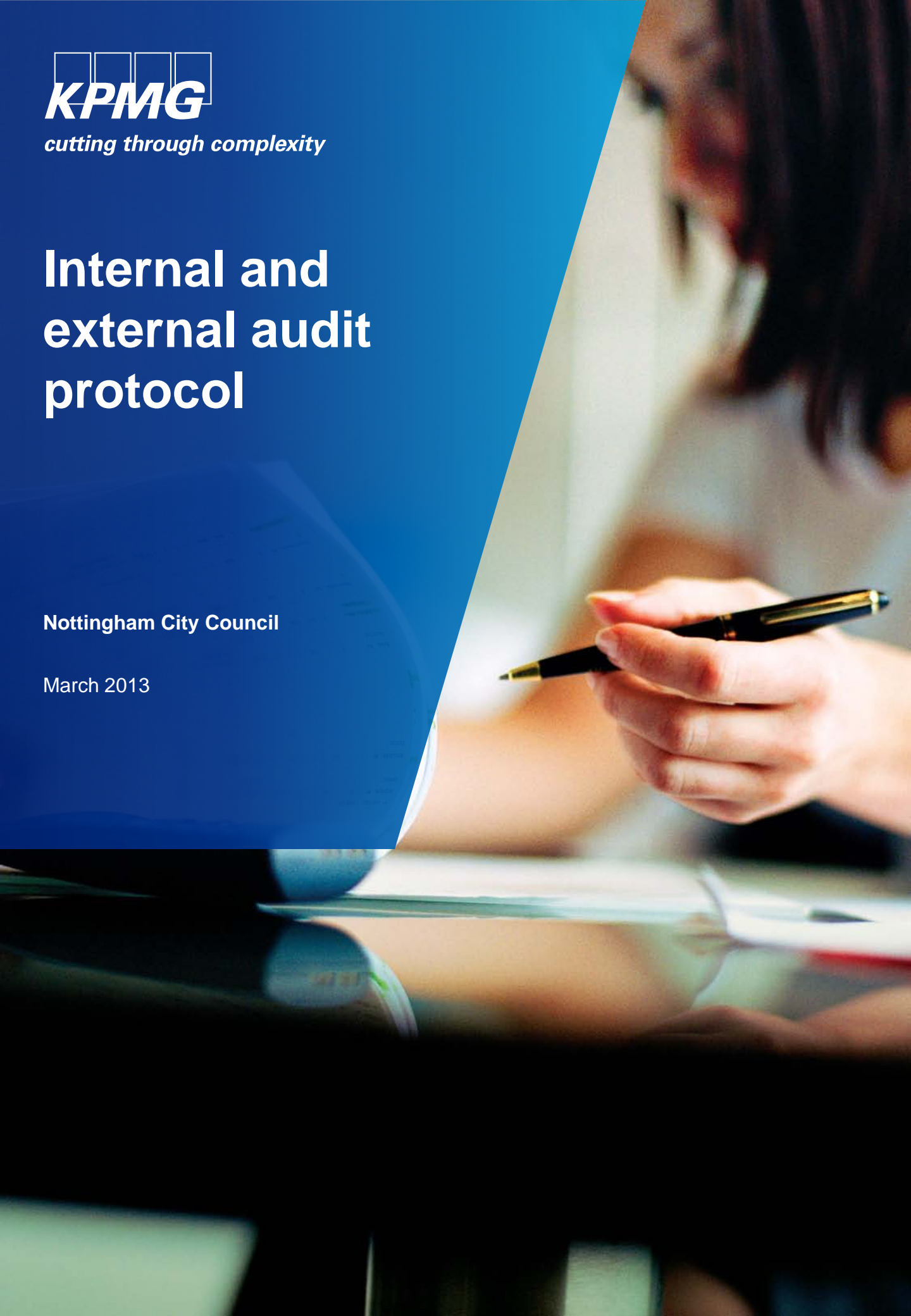


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# Internal and external audit protocol

Nottingham City Council

March 2013



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This report is addressed to the Authority and has been prepared for the sole use of the Authority. 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](http://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 Sue Sunderland, the appointed engagement lead to the Authority, 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](mailto: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](mailto:complaints@audit-commission.gov.uk). Their telephone number is 0844 798 3131, textphone (minicom) 020 7630 0421.

# Section one

## Introduction

### Purpose and structure of this document

This document clarifies the working relationship between Nottingham City Council Internal Audit (“Internal Audit”) and the KPMG LLP audit team (“KPMG”) responsible for the audit of Nottingham City Council (“the Authority”). 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 Authority, VFM work, grants certification 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	
Shail Shah	Head of Internal Audit	☎: 0115 876 4245	✉: <a href="mailto:shail.shah@nottinghamcity.gov.uk">shail.shah@nottinghamcity.gov.uk</a>
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### The way forward

This document formalises the process, as it exists now. Regular reviews of these arrangements should ensure that the protocol remains current and accurately reflects the control environment of the Authority as well as KPMG’s requirements in response to this.

# Section two

## General arrangements

### Respective responsibilities

KPMG's responsibility as external auditors are 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 Authority's:

- financial statements (including the Annual Governance Statement): providing an opinion on the Authority's accounts; and
- use of resources: concluding on the arrangements in place for securing economy, efficiency and effectiveness in the Authority's 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 March 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 February.

Final Internal Audit reports in areas relevant to this protocol should be sent electronically to KPMG for areas relevant to External Audit, as defined by this document. In addition, all reports which provide 'limited' or 'no' assurance should be sent to KPMG.

Any detailed review of the audit files will be conducted on site, with files kept either in the external audit office or the offices of Internal Audit at all times. Internal Audit will provide KPMG with restricted (read-only) access to its electronic audit system (Galileo) together with browser training (as required).

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.

# 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 Authority's financial statements and transactions give a true and fair view of the financial position and the transactions of the Authority.

To support this opinion, it is desirable to place reliance on the Authority's 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 Authority's risk management framework, as well as changes in the Authority's business, risks, operations, programmes, systems, and controls. KPMG therefore expect that this covers all of the Authority's 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 Authority's 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, with walkthroughs of the system where applicable (testing of a single case to verify the documentation of systems and 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 comprises two main areas:

- Proactive work to assess the quality of controls which prevent and detect fraud and corruption; and
- Investigation / management of specific allegations (including those investigated by other managers in the authority).

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.

## Section three

# Specific arrangements (continued)

In addition, there is an Audit Commission requirement for investigating auditors to complete the Audit Commission's AF70 form for proven financial losses exceeding £10,000 and all cases of tenancy fraud.

KPMG have provided a proforma AF70 form for Internal Audit to capture the key details of these cases for onward submission to the Audit Commission. The Authority's responsible fraud officer should forward completed AF70 forms for all relevant cases in the period to KPMG on a quarterly basis.

Only one submission needs to be made when there are large numbers of:

- housing benefit and council tax benefit frauds that involve a failure to declare correct income or a failure to notify a change of circumstance; or
- tenancy frauds.

### Grant certification

The Audit Commission may, at the request of grant paying bodies and the authorities receiving the grant, make arrangements for claims to be certified by the external auditor. To assist in this certification and help ensure national consistency, the approach auditors must take is specified in Certification Instructions produced by the Audit Commission.

The Audit Commission has set an indicative fixed fee for the certification of grant claims and returns. This fee is based on the expectation that the Authority is able to provide KPMG with complete and materially accurate claims and returns, with supporting working papers, within agreed timeframes. It further assumes that there is an effective control environment in place over the preparation of the claim or return. This may include work completed by Internal Audit.

Internal Audit's work on the management arrangements over grant claims and returns in general, as well as on specific schemes, is an important factor and Internal Audit can add value to the certification process by reviewing the Authority's arrangements to ensure that these are effective.

### VFM work

The *Code of Audit Practice* requires KPMG to conclude on the arrangements in place for securing economy, efficiency and effectiveness in the Authority'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 the Authority. 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 Authority'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 sufficient coverage of the two VFM criteria. Any significant VFM risks not sufficiently mitigated by the Authority, may therefore result in additional fees.

# Section four

## Approach to controls testing

### Systems and controls in scope

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; and
- **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.

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.

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.

# Section four

## Approach to controls testing (continued)

### 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;
- 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 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 the Authority's financial procedures;
- Review system parameters for any reports used to confirm that their design is suitable to achieve the control objectives;
- 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;
  - complies with the Authority's financial regulations and scheme of delegation;
- Obtain a list of leavers during the year and test a sample of leavers to ensure that access has been disabled.



# Appendix one

## Key control schedules

### Financial reporting

*System notes, walkthroughs and testing of the following key controls, or compensating controls where these are not in place:*

- Bank reconciliations: periodic reconciliation of the main bank accounts to the general ledger;
- Budgetary control: senior management and member 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.
- Feeder system reconciliations: periodic reconciliation of the fixed assets, payroll and pensions systems to the general ledger

### Access to systems and data

*System notes, walkthroughs and 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, fixed assets, payroll and pensions systems;
- 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;
- Regular evidenced, independent review of the appropriateness of access rights of 'super users' (ie. those with administrator system access).

### System changes

*System notes, walkthroughs and testing of the following key controls, or compensating controls where these are not in place:*

*For the general ledger and fixed assets, payroll and pensions systems:*

- 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;
- Authorisation and documentation/ review of the initial system configuration and report parameters.

# Appendix one

## Key control schedules (continued)

### Non-pay expenditure and creditors

*System notes and walkthrough to cover the following aspects:* Setting up a new supplier, raising orders, invoice processing, interface between AP system and general ledger.

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

- Periodic reconciliation of the AP system to the general ledger (if standalone) – or – Automatic interface between AP system and the general ledger (if integrated); and
- Independent review of exceptions – e.g. payments to new suppliers, potentially duplicated payments, unrepresented cheques; – or – Automatic three way matching by the system.

### Payroll

*System notes and walkthrough to cover the following aspects:* new starters, permanent amendments, leavers, payroll payments and processing of payroll transactions into the general ledger.

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

- Periodic reconciliation of the payroll system to the general ledger;
- Periodic reconciliation of the payroll system to the HR system (if standalone) – or – Automatic interface between the payroll system and HR system (if integrated);
- Periodic circularisation of establishment lists to Chief Officers; and
- Periodic production and independent review of exception reports e.g. new starters, movement in net pay >20%.

### Housing and Council Tax Benefits

*System notes and walkthrough to cover the following aspects:* new claims, posting to the rents system (rent rebates), posting to the council tax system (council tax benefit), payments (rent allowances), interface between benefits system and general ledger, change of circumstance, recovery of overpayments.

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

- Periodic reconciliation of the benefits system to the general ledger; and
- Periodic production and independent review of exception reports (e.g. payments over certain amounts).

# Appendix one

## Key control schedules (continued)

### Capital additions and disposals

*System notes and walkthrough to cover the following aspects:*

- Additions: approval of capital scheme, contract monitoring procedures, recording of capital expenditure, determining the accounting treatment, updating of fixed asset register.
- Disposals: identifying surplus assets, valuation, disposal, capital receipt, accounting treatment, updating of fixed asset register.

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

- Periodic review of capital expenditure against the capital programme;
- Periodic reconciliation of fixed asset register to the general ledger;
- Periodic reconciliation of corporate property and the fixed asset register (if standalone);
- Periodic verification of fixed assets; and
- Contract review – maintenance of a central contracts register and review of significant new contracts to identify service concession arrangements and embedded leases.

### Council tax

*System notes and walkthrough to cover the following aspects:* new properties, valuation, identifying and calculating liability, billing process, review of exception reports, arrears monitoring and chasing, income receipting, system interfaces.

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

- Periodic reconciliation of the council tax system to the Valuation Office listing;
- Periodic reconciliation of the council tax system to the cash receipting system (if standalone) – or – Automatic interface between council tax system and the cash receipting system (if integrated); and
- Periodic reconciliation of council tax system to the general ledger.

### NNDR

*System notes and walkthrough to cover the following aspects:* new properties, valuation, identifying and calculating liability, billing process, review of exception reports, arrears monitoring and chasing, income receipting, system interfaces.

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

- Periodic reconciliation of the NNDR system to the Valuation Office rateable value listing;
- Periodic reconciliation of the NNDR system to the cash receipting system – or – Automatic interface between NNDR system and the cash receipting system (if integrated); and
- Periodic reconciliation of the NNDR system to the general ledger.

### Housing rents

*System notes and walkthrough to cover the following aspects:* changes to housing stock system (additions/ disposals), new tenancy, calculation of rent debit, receipt of rental income, reconciliation of rents system to cash receipting system, posting of information from the rents system to the general ledger, reconciliation of the rents system to the general ledger, termination of tenancy.

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

- Rent roll generated annually and reconciled to property record;
- Periodic reconciliation of the rents system to the cash receipting system; and
- Periodic reconciliation of rents to general ledger.



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