Appendix

Protocol for Liaison Between Internal and External Audit

Southampton City Council

Audit 2007/2008

Contents

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 proposed working relationship that should exist between internal and external audit.

4   This protocol will take effect from April 2007 and will be subject to annual review.

Objectives of the protocol

5   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.

6   The protocol aims to:

- clarify the respective roles of external and internal audit;

- highlight areas where external audit are likely to place reliance on internal audit; and

- establish a framework for co-operation in the planning, conduct and communication of audit work.

7   Overall the protocol should promote an effective working relationship, within the bounds of the respective roles of internal and external audit, and maximise the benefit to the Council from available audit resources.

8   This protocol covers all aspects of audit, including IT audit and value for money, and takes account of external audit responsibilities under the International Auditing Standards (UK and Ireland) (ISAs (UK&I)) and internal audit responsibilities under the CIPFA Code of Practice for Internal Audit 2006.

Respective roles of auditors

9 Table 1 below outlines the respective roles of external and internal audit. The roles and objectives are different but complementary. There are therefore benefits to be gained from working together, and from external audit relying on internal audit's work. 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 more general review.

Table 1   Respective roles of auditors

Internal Audit	External Audit
CIPFA's Code of Audit Practice for Internal Audit in Local Government in the United Kingdom 2006 (the Code) defines internal audit 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.*' Internal Audit must have documented terms of reference that accord with the requirements of the Code. The key output from Internal Audit is the annual opinion on the Council's control environment which should be reported to the Audit Committee.	To reflect the special accountability attached to public money and the conduct of public business, external audit in the LG is characterised by three distinctive features. • Auditors are appointed independently by the Audit Commission. • The scope of auditors' work covers the audit of financial statements, probity in the use of public money and value for money in the use of resources. • Auditors may report aspects of their work widely to the public and other key stakeholders.

Internal Audit	External Audit
Internal audit's strategy and plan is agreed between internal audit and management and should be approved by the Audit Committee, and cannot be directed by external audit.	External audit conduct their work in accordance with International Standards on Auditing (ISAs) (UK and Ireland) and with the Audit Commission's Code of Audit Practice.

Areas where external audit are likely to place reliance on internal audit

10 Internal audit has no statutory role in the audit of financial statements, however, may conduct work specifically aimed at providing assurance that systems for the preparation of financial statements are appropriately controlled. Where the work internal audit undertakes for its own purposes overlaps with work that the external auditor would undertake to comply with the Code of Audit Practice, external audit may seek to place reliance upon the work of internal audit.

11 International Auditing Standard (ISA) 315 sets out the requirement for external audit to understand the audited body and its environment, including internal control. This is a key area where internal audit's work is likely to be relevant to the external auditor.

> **ISA (UK and Ireland) 315: Understanding the entity and its environment and assessing the risks of material misstatement (relevant extracts)**
>
> *The auditor should obtain an understanding of internal control and the control environment relevant to the audit.*
>
> *The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.*
>
> *The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting.*

12 Where internal audit's work encompasses controls relating to the production of the financial statements, internal audit has outlined that it will undertake the following and external audit will seek to place reliance on this work:

- systems documentation;

- identification of controls; and

- testing of controls, using, where appropriate, the external audit sampling methodology, with samples covering the whole financial year up to the point of the audit.

13   Where external audit rely on internal audit work, this reliance is governed by International Auditing Standard (ISA) 610, relevant extracts of which are reproduced below. This requires external audit to first evaluate internal audit's work to confirm that it is adequate for external audit's purposes. This is likely to involve external audit reperforming some of internal audit's work.

ISA (UK and Ireland) 610: Considering the work of internal audit (relevant extracts)

The external auditor should consider the activities of internal audit and their effect, if any, on external audit procedures.

The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures.

The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditor's risk assessment.

When the external auditor intends to use specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.

Co-operation and co-ordination

14   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;
- external audit reliance on internal audit work;
- arrangements for sharing documents and information;
- arrangements for pre-Audit Committee liaison; and
- external audit's review of internal audit's work.

15   The principles of co-operation and co-ordination, and suggested agreed actions are set out in Table 2.

Table 2 Co-operation - principles and details

Liaison meetings

Regular meetings should be arranged between the Chief Internal Auditor and the external audit Audit Manager to discuss audit planning and scheduling (in particular, to avoid unnecessary duplication of planned audit work), audit progress, opportunities for joint working and any other issues of mutual interest.

Agreed action: *Schedule regular liaison meetings.*

External audit reliance on internal audit work

Internal Audit prepares its strategic and annual plans independently, on the basis of its assessment of the risks existing at the Council. It is likely that some of this work will be in areas in which external audit will wish to obtain assurance to meet their Code of Audit Practice responsibilities. It is appropriate for external audit to seek to place reliance on internal audit's work, subject to internal audit having complied with internal audit standards when undertaking the work.

It is good practice to identify what work external audit will be seeking to place reliance upon during planning. This ensures that the proposed work meets the timetable and requirements to enable external audit to place reliance upon it, for example, that appropriate sampling is used.

If following review external audit is unable to rely on internal audit's work because it does not meet the required standard or because it is late, this will result in additional audit work being undertaken by external audit, which may lead to an increased external audit fee.

Agreed action:

- *Internal audit will inform external audit of any changes to or delays to audit work included in the agreed areas of reliance.*

- *External audit will discuss promptly with internal audit any issues arising that would prevent it from placing reliance on internal audit's work.*

Arrangements for sharing documents and information

It will enhance understanding and effectiveness if audit reports and other audit information is shared promptly.

Agreed action:

- *Internal audit will provide external audit with:*
  - *details of all audit reports produced and, if required, copies with associated working paper files of those of significance for external audit's work;*
  - *details of any significant changes to the audit plan; and*
  - *key documents, in particular the terms of reference, audit strategy and audit plan.*
- *External audit will provide internal audit with copies of:*
  - *final reports; and*
  - *details of any significant changes to the audit plan.*
- *External and internal audit will communicate promptly to the other auditor any significant concerns arising that the auditor feels should be dealt with other than through the usual reporting arrangements set out in this protocol.*

Arrangements for pre-Audit Committee liaison

It is important that an audit committee meeting focuses on dealing effectively with the issues set out on the agenda.

Agreed action:

- *Consider whether prior to an audit committee meeting there is a need for auditors to liaise to address any issues that may inhibit an effective audit committee meeting.*

External audit's approach to its review of Internal Audit

Undertaking the reviews

External auditors review the work of Internal Audit for two main purposes:

- to establish if Internal Audit is undertaking its role effectively in accordance with internal audit standards; and
- to determine what reliance can be drawn from internal audit work in relation to the external auditor's Code of Audit Practice responsibilities.

The Accounts and Audit (Amendment) (England) Regulations 2006 require that a Council review the effectiveness of the systems of internal audit. This review is the responsibility of the Council and is not intended to be a review carried out by the external auditor, although the external auditor may inform this review. Guidance on how the Council discharges this responsibility is being developed by IPF and should be available in early 2007.

Agreed action:

External audit will undertake an annual review of the internal audit work that it intends to place reliance upon and a triennial review of internal audit against audit standards.

Arrangements in respect of fraud and corruption

Responsibilities

The Council is responsible for putting in place arrangements for preventing and detecting fraud and corruption and for investigating any such instances, with appropriate oversight and guidance from Internal Audit.

External audit will consider whether the Council has put in place adequate arrangements and will be alert in all aspects of their work to the possibility of fraud and corruption. If weaknesses in arrangements, which might facilitate such instances, are identified, the external auditors will draw them to the attention of the Council.

The Audit Commission asks for details of all frauds exceeding £10,000 and any cases of corruption, and of any fraud cases of particular interest or complexity, in a standard format (AF70 pro-forma).

Agreed action:

Internal Audit will notify external audit promptly of all frauds exceeding £10,000, any other fraud cases of particular interest or complexity and any cases of corruption, and will set-out the details on an AF70 for submission to the Audit Commission.

In the event that external audit suspects a fraud, they will pass details to Internal Audit for their management and oversight and will expect to be updated on developments.

Use of resources

External audit have a responsibility to review and, where appropriate, report on the arrangements that the Council has put in place to secure economy, efficiency and effectiveness in its use of resources. They will provide a Use of Resources (VFM) Conclusion in their Annual Governance Report, based on 12 criteria specified by the Audit Commission. They may also carry out inspections of services under the Local Government Act 1999.

External audit's sources of assurance in discharging these responsibilities include the Council's whole system of internal control as reported on in its statement on internal control (SIC). They will seek to rely upon Internal Audit's role in contributing to the Council's assurance framework.

Agreed action:

External audit will keep Internal Audit informed of any forthcoming performance and inspection work, including its scope and timing.

External audit will seek to rely upon Internal Audit's work to support the SIC.

Grant claims and performance indicators

External audit review annually the Council's arrangements for ensuring the quality of its performance data, and are responsible under the Best Value legislation for checking the Council's performance indicators.

At the Council's request, external audit examine and certify the Council's claims for various central government grants and subsidies.

At present there are no formal arrangements for joint working between external and internal audit in respect of grant claims or performance indicators. However, external audit may seek to place reliance on the work of internal audit where appropriate.

Agreed action:

External and internal audit will maintain a dialogue in order to share matters of concern, so that both parties can consider them when planning work in these areas.

Appendix 1 – Contact details

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