



National Audit Office

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National Audit Office

Transparency report 2012

Our vision is to help the nation spend wisely.

We apply the unique perspective of public audit to help Parliament and government drive lasting improvement in public services.

The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Amyas Morse, is an Officer of the House of Commons and leads the NAO, which employs some 860 staff. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. Our studies evaluate the value for money of public spending, nationally and locally. Our recommendations and reports on good practice help government improve public services, and our work led to audited savings of more than £1 billion in 2011.

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Introduction

The National Audit Office (NAO) is the auditor of those bodies funded and overseen by the UK Parliament. Our aim is to use public audit to influence lasting improvements in public services. Achieving this aim depends on the quality of our audit work – opinions on the financial statements of government departments and other public bodies, and value for money audit assurance to Parliament.

Parliament, the bodies we audit, and taxpayers, have high expectations of the quality of the NAO's work.

This report explains how the NAO ensures that its audit work meets stakeholder expectations for independence and quality. It describes the importance attached to quality, and the mechanisms used to build quality into our work. It is designed with a wide audience in mind, ranging from colleagues within the audit profession and the public bodies we audit to members of Parliament and the public – all those who have an interest in understanding how the NAO ensures that our work is of the highest quality.

The report also emphasises the NAO's role as a supreme audit institution, acting for Parliament and the public. This encompasses reporting to Parliament on government's financial statements, and on the value for money of programmes and policies; providing analysis, insight and briefing to illuminate key public management issues; responding to Parliamentary and public queries on aspects of expenditure and services; and investigating specific issues, for example connected with the progress of new contractual models of service delivery, for Parliament. This breadth reflects the NAO's requirement to serve the wider public interest in public management.

We constantly seek to improve what we do. The environment where we deliver our audit work is continually evolving – professional practice changes, as does the nature of the public services we audit. We constantly review how we approach our work, including quality, and adapt and change our strategic and technical approach.

Underpinning all of this is something even more important: the culture and values of the NAO, and the emphasis placed on the quality and professionalism of our staff. The report shows the importance of culture and values to quality, and I thank the staff of the NAO for their continuing dedication and professionalism.

Amyas C E Morse
Comptroller and Auditor General

Part One

About the NAO

The role of the NAO

1.1 The NAO scrutinises public spending for Parliament and we play a vital role in supporting Parliamentary and wider public scrutiny of government expenditure. As a supreme audit institution, the NAO has a wide remit to provide assurance to Parliament and the public on public spending and the management of public services. And in public audit, the 'regularity' of expenditure, how well departments have raised income and used funds in line with the authority granted by Parliament, is a crucial feature.

1.2 The NAO and the C&AG are independent of government. In the vast majority of cases, the C&AG is appointed as auditor by statute, and cannot be replaced as auditor by either the management or political leaders of the organisation. This ensures the independence of the C&AG and the audit opinions reached.

What we do

1.3 We fulfil this remit to provide assurance to Parliament through two main streams of audit work. We audit the financial statements of all central government departments, agencies and other public bodies and report the results to Parliament. In 2011-12, we audited expenditure and revenue amounting to over £1 trillion across 458 accounts.

1.4 Our value for money (VFM) audit work provides assurance to Parliament on how government projects, programmes and initiatives have been implemented, and the economy, efficiency and effectiveness of the use of funds by public bodies. Within this work stream, we typically publish around 60 reports a year and provide a range of other inputs to Parliament. We also provide assurance in a wide range of other ways, including landscape briefings and investigations of specific issues in response to requests from the public.

1.5 The Committee of Public Accounts (PAC) draws on our audit work to inform its hearings. The Committee takes evidence from senior government officials and others and publishes reports that make recommendations to secure improvements to public services. Government responds to all the Committee's recommendations through a Treasury Minute.

Who we are

1.6 The Comptroller and Auditor General is an officer of the House of Commons; he is appointed by the Queen on an address proposed by the Prime Minister with the agreement of the Chair of the Committee of Public Accounts. The appointment process reflects the importance of ensuring that the C&AG is independent of government while maintaining the confidence of both Parliament and government. The C&AG is appointed for a fixed, non-renewable, term of ten years. The C&AG has complete discretion in carrying out his functions, and responsibility for all audit opinions and judgements rests with the C&AG alone.

1.7 The National Audit Office was established on 1 January 1984 under the National Audit Act of 1983. Reporting to Parliament, the NAO employs a staff of around 860 to support the C&AG in reaching his audit opinions; it is independent of government and its staff are not civil servants.

1.8 The 1983 Act established the Public Accounts Commission to which the NAO is accountable. The Commission scrutinises the NAO's performance, considers the NAO's strategy and resource estimate on an annual basis, and appoints both the NAO's external auditor and the non-executive members of the NAO Board.

How we are run

1.9 Our governance arrangements seek to balance the need for appropriate oversight and control over the management of the NAO and our use of resources, with the need to preserve the C&AG's independence.

1.10 The Budget Responsibility and National Audit Act 2011 modernised the NAO's governance arrangements. During 2011-12 the NAO worked to bring the Act into effect, and it took full force on 1 April 2012. The Act represented a significant milestone for the NAO, creating it as a corporate entity in its own right, for the first time, with a statutory board. The Act establishes clear responsibility for the board to oversee the management of the NAO's resources, and as a source of support and advice to the C&AG in the exercise of his duties, while protecting the C&AG's independence in terms of his audit opinions and statutory functions.

1.11 The Comptroller and Auditor General is also the CEO and accounting officer of the NAO, with ultimate responsibility for all audit judgements and accountable to Parliament for the operation of the NAO and its use of public money.

1.12 He is supported in this role by a leadership team, containing the chief operating officer and four assistant auditors general. The leadership team is responsible for the executive management and operation of the NAO. The members of the leadership team are:

- Michael Whitehouse (chief operating officer)
- Gaby Cohen (assistant auditor general – stakeholder relations)
- Ed Humpherson (assistant auditor general – economic affairs)
- Lynda McMullan (assistant auditor general – local services)
- Martin Sinclair (assistant auditor general – national services)

1.13 The NAO's values embody the aspirations for the organisation, and underpin our work and the way we engage with the bodies we audit, with other stakeholders and with each other:

- Independent – We are independent and objective, and observe the highest professional and personal standards.
- Authoritative – We carry out work of the highest quality, drawing comprehensively on robust evidence and practice.
- Collaborative – We work collaboratively with colleagues, and with stakeholders, to achieve our goals.
- Fair – Our work, and the way that we treat people, is fair and just.



Part Two

Audit independence and quality

Introduction

2.1 The quality of our work is central to our ability to influence improvement in public services. Our stakeholders in Parliament and government departments have high expectations of us. Maintaining high quality in our work is crucial to ensure that the NAO provides credible and authoritative commentary on the use of public funds.

Independence

2.2 As a public audit body the NAO provides audit opinions to Parliament. It is essential that Parliament has confidence that we are entirely independent of government and form audit opinions in an impartial and objective way.

2.3 The core of our ability to meet these stakeholder expectations is the NAO's independence from government and political affiliations. This independence means that stakeholders can rely on the NAO to reach objective, impartial opinions.

2.4 There are two central components to the NAO's independence. The first is the statutory appointment of the C&AG. This means he cannot be removed as auditor by the government entities he audits. The C&AG also has complete discretion over his programme of value for money (VFM) audit work, subject only to the constraint that the work cannot question the merits of policy objectives.

2.5 The second is the 'independence of mind' exercised by NAO auditors in their work, allowing them to exercise objectivity and professional scepticism, which permits the provision of an audit opinion which is not subject to the influences which might otherwise compromise professional judgement.

Quality framework

2.6 The NAO has a rigorous quality framework.

2.7 The responsibility for the NAO's system of quality control and assurance ultimately sits with the C&AG, though the chief operating officer is nominated as the board member responsible for the quality of all of the NAO's work. The leadership team's audit practice and quality committee (APQ) sets the overall policy on quality, and establishes the principles of the NAO's quality framework. It aims to set clear quality expectations, which include the strategic alignment and impact of the NAO's work as well as pure technical quality.

2.8 APQ has established a framework (see overleaf) designed to support the NAO in producing independent and authoritative work. The framework covers four areas to support audit products that meet the standards of quality required:

- Strategic alignment – Focusing on the right topics and areas supported by NAO's strategic insight into the challenges and risks facing our audited entities.
- Technical quality – Carrying out technically compliant audits that support high quality audit recommendations and opinions.
- Influence and impact – Securing influence and impact with the end users of our opinions and recommendations, and communicating effectively with them.
- Tone from the top – Our culture is one that encourages constructive and robust challenge and recognises and rewards quality in line with the NAO's values.

2.9 The directors general for financial and VFM audit have operational responsibility for designing and implementing audit methodologies and quality assurance frameworks to deliver the policy set by the leadership team.

Culture

2.10 Robust frameworks and controls are an important part of quality, but equally important is the NAO's culture. APQ and the leadership team champion a culture that recognises and rewards quality in line with the NAO values, and places that quality at the heart of NAO strategy.

APQ framework

The role of APQ is to set clear quality expectations, which include the strategic alignment and impact of our work, as well as pure technical quality. APQ will shape its work in 2012-13 to support the delivery of audit products that achieve:



In doing all of this we will support the NAO's values. The current frameworks for quality emphasise work which is **independent** and **authoritative**. For the current year we will emphasise the need for **independent challenge** and **collaborative** work across the office.

2.11 An important part of ensuring quality at the NAO is the ability to learn and improve, so the NAO's approach continues to evolve in-line with best practice and enables the organisation to identify and respond to issues. This creates a cycle where the NAO's approach to quality evolves, informed by the findings of internal and external reviews. This transparency report highlights areas where the NAO has acted to improve the quality of our work.

2.12 The C&AG and his leadership team recognise the importance of a culture that supports openness and challenge, where ethical standards enable staff to support the NAO to meet high stakeholder expectations for the quality, independence and authority of its work. The leadership team sets clear expectations of quality and supports staff in meeting them.

Impact and influence

2.13 An important measure of the quality of the NAO's audit work, both financial and VFM audit, is how far it supports the NAO's objective to help Parliament and government to drive a lasting improvement in public services. The NAO measures and reports annually on the impact of its work. These impacts are agreed with the audited bodies concerned and subject to the assurance of the NAO's external auditor.

2.14 In 2011-12 the NAO reported a financial impact of over £1 billion from its work with government departments. Of this over £600 million arose from the NAO's VFM audit work, and over £100 million from our financial audit work. In addition to financial impacts, the NAO also engages with government to improve financial management, leading to changes in the management and delivery of public services.

2.15 However, we recognise that we need to develop further our measures of impact and influence. This is a development area for 2012-13.

Emerging issues

2.16 The leadership team keeps emerging issues under regular review. The key emerging issues relating to audit quality include the following:

- **Independence and ethics.** The board and leadership team constantly review risks to the NAO's independence. We are satisfied that there are no significant threats to the NAO's independence. Because we see independence and ethics as important, we have started discussions with other public auditors in the United Kingdom and the Financial Reporting Council on the need to develop formal ethical standards for public auditors. This issue is considered further below at paragraphs 2.26 and 2.27.
- **Changes to local accountability.** As public services are increasingly delivered differently, more of our VFM audits will require us to consider new fields of government activity and examine performance involving private and third sector bodies. Changes to our remit also mean we will do more work involving local government bodies. As we undertake this work we will continue to ensure that our controls provide assurance that our new work meets NAO quality standards, for example by ensuring that relevant specialists review draft reports.
- **Policy reforms.** There are two significant areas of reform affecting the work of auditors. First, the European Union is developing policy proposals on the role of auditors for publicly listed entities. While these changes focus on commercial auditors, the leadership team reviews them regularly because some of the principles emerging from European Union policies may also have an implication for public audit. Second the Financial Reporting Council, the principal regulator of the audit profession in the United Kingdom, has been reformed, which has changed its committee structure. We have talked with the FRC in order to understand any implications for public audit.
- **Financial reporting in the public sector.** In our financial statement audit for 2011-12, we audited fully consolidated financial statements for the first time. While we completed this major undertaking successfully, it did highlight how complex government financial statements are, which we are keen to explore with audited entities and HM Treasury. In addition, we continue to support the preparation of the *Whole of Government Accounts*,¹ which provides a new and important perspective on the public sector's aggregate financial statements.

¹ Available at: www.hm-treasury.gov.uk/d/whole_of_government_accounts_31-03-2011.pdf

Assurance to Parliament

Introduction

2.17 The NAO provides assurance to Parliament on the use of public funds. There are two main types of assurance: on financial reports made by government entities (financial audit assurance) and on the value for money achieved in the use of public funds (value for money audit). The quality approach we apply to these streams of work is set out in this section, based on the four pillars of the APQ framework:

- Strategic alignment
- Tone from the top
- Technical quality
- Impact and influence

Financial audit

2.18 The C&AG, supported by the NAO, undertakes around 440 financial statement audits each year, varying in size from large government departments such as the Ministry of Defence to small incorporated trading subsidiaries of government-owned charities. The C&AG is appointed by statute to audit all government departments, agencies and the vast majority of non-departmental public bodies. This means that he is the sole auditor of central government bodies.

2.19 As well as reporting on the truth and fairness of the financial statements in accordance with the relevant financial reporting framework, the majority of our audit reports also express an opinion on regularity. In public audit, the 'regularity' of expenditure refers to how far departments have raised income and used funds in-line with the authority granted to them by Parliament.

Strategic alignment: leadership and governance

2.20 The leadership and governance of the NAO is designed to ensure high quality financial audit work. The leadership team, consisting of the C&AG, chief operating officer and the assistant auditors general, lead the strategic alignment of the NAO's financial audit work: ensuring that we focus appropriate resources on the right entities and biggest risks facing the public sector, and that our financial audit focus supports the NAO's strategic goal of improving public services. As well as providing assurance on the financial reports themselves, the leadership team ensures that insights generated in the course of financial audit work help support VFM work

2.21 The key operational responsibility for leading on quality lies with the director general for financial audit, as head of practice. She reports formally to the C&AG on significant issues affecting the quality of our audit work, and her line manager is the chief operating officer. The director general is guided by the framework established by the APQ and is advised on matters relating to audit policy and quality by the financial audit development group, consisting of a number of financial audit directors.

2.22 The leadership team and director general for financial audit support audit directors, providing a framework to identify those audits with a higher risk profile or greater stakeholder sensitivity, enabling the NAO to focus attention and resources where they are needed. The NAO's financial audit work sits in the context of the NAO's wider strategic objectives. It supports Parliament in holding government bodies to account and provides wider insight into the key issues and risks within the bodies we audit, to develop the VFM audit programme.

2.23 Audit quality forms a key part of our financial audit performance management framework for individuals. Failings in audit quality will have an adverse effect on the performance assessments of directors and their teams.

Tone from the top: independence, scepticism and ethics

2.24 The C&AG has adopted the International Standards for Auditing (ISAs) (UK and Ireland) for financial audits and has opted to apply the Ethical Standards for Auditors published by the Financial Reporting Council. The C&AG is the NAO's Ethics Partner (as defined by APB Ethical Standard 1). Although his independence is enshrined in statute, the NAO is alert to areas where engagement teams' independence and objectivity could be, or could be perceived to be, threatened.

2.25 There are strong safeguards against threats to the NAO's independence. The NAO is appointed to most audits by statute. This means that the audited entity cannot replace the NAO as auditor in the face of unwelcome audit opinions. Moreover, the NAO does not seek to secure revenue-generating business from providing non-audit services to clients, virtually eliminating threats to independence that could arise from an auditor seeking to protect non-audit income. Where appropriate, the NAO will implement fully the standards' safeguards: for example, on over-familiarity of audit staff with the client, where the NAO implements a rotation policy for senior staff in line with the standards. And procedures for identifying potential threats to independence and establishing appropriate safeguards are in the financial audit methodology.

2.26 There are, however, some areas where the ethical standards, designed to address issues of auditor independence in commercial practice, do not naturally align to the NAO's circumstances. The two main issues surround auditor resignation and secondments. The C&AG cannot resign from an audit to which he is appointed by statute. There are, however, some situations where the ethical standards require resignation (for example, when a senior individual within the auditor joins an audited entity).

2.27 Similarly, the ethical standards prohibit senior secondments. But the NAO is the largest source of financial management expertise within government, and it is important that we make this expertise available to develop management capacity in government. Secondments also develop staff management skills as part of career development. As auditor of the entire central government sector, this means that sometimes it is inevitable that the NAO will second staff to the entities we audit. When the NAO considers the case for a senior secondment, we consider all the potential threats and put in place enhanced safeguards, including additional independent review of the relevant audits.

Technical quality: review and assurance

2.28 The NAO's audit opinions must be rigorous, supported by appropriate and relevant evidence, and aligned with the highest standards of professionalism recognised within the audit community.

2.29 To achieve this, the NAO ensures that our audit work complies with auditing standards. The C&AG is required to perform certain, discretionary audits under the ISAs (UK and Ireland), and he has chosen to adopt these standards for all financial audits. These standards include International Standard on Quality Control 1 (ISQC 1). Compliance with these standards means that the NAO's financial audit work also complies with the relevant International Standards for Supreme Audit Institutions established by the International Organisation for Supreme Audit Institutions.

2.30 We engage widely with the accountancy and auditing professions, through the professional institutes, with other UK and international public audit bodies and through our private sector partnership firms. This enables us to share good practice and learn from other practitioners. During 2011-12 we reviewed the audit methodologies of our partnership firms. It assured us on the quality of the audit work we contract out to those firms and also identified some areas we could learn from to increase audit efficiency.

2.31 Our financial audit manual is the articulation of the NAO's audit methodology. It encompasses the requirements of the ISAs and provides guidance on interpreting and implementing those standards within the central government sector. Further details of the manual and associated audit tools can be found in Appendix Two.

2.32 To ensure that our financial audit work is of the highest technical quality, we build in quality control to all stages. We extensively review the work undertaken, with a number of review stages. All work is subject to review by the engagement manager and engagement director. Certain audits (primarily those involving significant audit judgements, for example where there is likely to be a qualified audit opinion) are engagement quality control reviewed by an independent director. Some audits are subject to an independent quality review by the NAO's compliance and quality unit prior to the issue of the audit report.

2.33 Further details on review and assurance processes for financial audit can be found in Appendix Two.

Technical quality: monitoring and metrics

2.34 In addition to the quality control built into each audit through the review process described in paragraph 2.32, we are assured on the technical quality of our audit work through independent monitoring and review. This quality assurance and monitoring should happen outside the core team for an individual audit, and should provide a flow of information and analysis that not only provides clear evidence on the technical quality of individual financial audits, but also provides opportunities for learning, improvement and development.

2.35 To deliver this independent assurance, the NAO completes an annual quality assurance programme to make sure we comply with the financial audit manual and ISQC 1. The compliance and quality unit of the NAO, which reports to the chief operating officer, coordinates this programme. The programme consists of:

- internal quality reviews (pre-certification);
- internal compliance reviews (post-certification); and
- external review (performed by the Audit Inspection Unit of the Financial Reporting Council).

2.36 The findings of these reviews are largely qualitative and indicate where audit quality has improved as well as further areas to address. Areas for improvement are communicated to all financial audit staff through timely bulletins and, where appropriate, incorporated within further guidance or training, or both.

2.37 The director general for financial audit reports to the C&AG and the leadership team on the results of the quality assurance process. The C&AG discusses the quality assurance results with the NAO board annually.

2.38 We also seek feedback from the entities we audit, through questionnaires and externally commissioned feedback. This gives us insight into our service and how we can better help them improve public services. However, we recognise that we need to develop more comprehensive measures of the impact and influence of our financial audit work and this is an area to develop for 2012-13.

Issues that we addressed in 2011-12

2.39 The NAO seeks to ensure that its approach to the quality of its audit work remains consistent with the best practice expected of professional audit firms and other supreme audit institutions. During 2011-12 we identified the following issues picked up by both the Audit Inspection Unit (AIU) review of six audits, reported during 2011-12, and by our own review and assurance.

- The internal cold review process found potential improvements in the way NAO teams documented the procedures that underpinned their reliance on the work of other auditors, to reduce inconsistencies and ensure that the NAO documented the basis for its reliance on the work.
- Secondments: The NAO recognises that there is a risk, actual or perceived, to the independence of its audit work, where staff are seconded to the organisations we audit. During 2011-12 we reviewed our policy on secondments and strengthened the mechanisms in place. The NAO will continue to consider what further safeguards may be needed to address this issue, and how the ethical standards apply to the context in which the NAO operates.
- In 2011 the AIU reviewed six of the NAO's audits, and we responded to the findings. The AIU also reviewed the financial audit manual, our training and guidance available to teams, and the NAO's audit support tool. They highlighted areas where we could improve methodology, which we acted upon during 2011-12.

Our people

2.40 The NAO is an expert in financial audit because we invest in recruiting, developing and retaining the right people. The vast majority of staff working in financial audit are either CCAB-qualified or in training for a CCAB qualification, although we recognise the specialist expertise that others, for example statisticians, can bring to audit.

2.41 Professional accountancy training is supplemented by financial audit training. For those working towards ICAEW membership, this is practical audit training in the NAO's audit methodology. Qualified staff receive a mandatory annual technical update, with a range of specialist courses, run in-house, often on specific central government audit.

Value for money audit

2.42 The C&AG provides audit assurance to Parliament on government organisations' efficiency, effectiveness and economy in using their resources. These VFM audits that we produce support Parliamentary scrutiny of major departments and programmes, hold government to account and help it to improve. The VFM audits also inform and assure the public on how public money is managed and spent. VFM audit is therefore a cornerstone of democratic accountability and a crucial part of what makes public audit unique.

2.43 While financial audit work follows a standardised format, the format of assurance to Parliament that emerges from VFM audit is varied. It can range from formal 'value for money reports' to landscape reviews and briefings on specific issues, and includes investigations of specific problems as they come to our attention.

2.44 As with financial audit, we structure our approach to quality for VFM around the four pillars established by APQ:

- Strategic alignment
- Tone from the top
- Technical quality
- Impact and influence

Strategic alignment: leadership and governance

2.45 The NAO leadership team ensures the quality of our VFM audits, and members of the team provide advice and support on VFM quality matters to NAO directors. The C&AG and the leadership team ensure VFM audit sits within the wider NAO strategy. They do this through considering and scrutinising the planned programme of studies, providing guidance to the C&AG on the balance of the programme and the extent of its focus on bodies' greatest risk areas, and reflect the concerns of Parliament.

2.46 The APQ oversees the NAO's wider policy on the technical quality of audit work, including VFM – encouraging methodologies that ensure audit approaches are fit for purpose and comply with good practice, and scrutinising quality assurance arrangements. The APQ also sets the policy for pre-publication review of our VFM reports.

2.47 The director general of VFM audit holds operational responsibility for quality within VFM audit and reports to the C&AG and the chief operating officer. He is supported by the VFM audit development group, which acts as the senior technical VFM audit committee in the NAO. Chaired by the director general of VFM audit, the group of experienced directors advises APQ on methods and quality assurance, as well as improving the effectiveness of our VFM work.

Tone from the top: ethics and values

2.48 For the NAO's VFM work to secure the impact and influence required, it is essential that we are seen to uphold high standards of ethics and probity, and to conduct our work within a framework of values that preserve the independence of the audit.

2.49 In carrying out our VFM work we seek to adhere to the NAO's values:

- Independent – to be independent and objective, observing the highest professional standards.
- Authoritative – to carry out VFM work of the highest quality, drawing comprehensively on robust evidence and practice.
- Collaborative – to work collaboratively with colleagues and stakeholders to achieve our VFM goals.
- Fair – to carry out our VFM work fairly.

2.50 In planning our audit work we take care to identify and manage any potential conflicts of interest, to ensure that the independence and authority of our work is preserved.

2.51 NAO expects staff to adhere to relevant internal and external quality standards set for VFM and to wider UK and international standards on quality control for audit. The director general for VFM audit is responsible for delivering compliance with these expectations by all VFM audit staff and for creating a culture of professionalism, rigour and openness to challenge through regular progress meetings and feedback.

Technical quality: review and assurance

2.52 Our stakeholders expect that the technical quality of the NAO's VFM work will be of a high standard. The VFM audit process includes clear requirements for quality review within audit teams.

2.53 The NAO's VFM Standards set out the mandatory standards that all VFM studies must meet, together with guidance on current approaches to implementing the standards. These standards are based on best NAO practice and international standards developed for performance audit by, for example, INTOSAI (International Organisation of Supreme Audit Institutions), although they are tailored to meet the specific expectations and requirements of the UK public sector environment and Parliament. The standards themselves are designed to be a timeless statement of our expectations, which should not need regular updating. They are accompanied by a more detailed explanation of current approaches to implementing the standards. In 2011 we reviewed and updated the standards to take account of recent developments in VFM audit. Further details of the standards are set out in Appendix Two.

2.54 VFM studies are subject to a multi-stage quality assurance process involving both internal and external review (see Appendix Two for further information). This process is designed to check adherence with the VFM standards and identify and disseminate lessons for improving our VFM work.

Technical quality: monitoring and metrics

2.55 The high technical quality of our reports lies in their rigour, logic and clarity. In addition to the quality review within the audit team, we obtain independent assurance on the technical quality of our audit reports.

2.56 The technical quality of our VFM reports is monitored in a number of ways. These include the following:

- External review of our VFM reports by external specialists (currently Oxford University Saïd Business School (trading as ISIS); and Risk Solutions) against a set of ten technical criteria to determine whether we are achieving what are considered to be professional standards.
- External reporting (currently by Oxford University and Risk Solutions) on specific VFM quality themes, which are relevant to all VFM work. These reports are considered by APQ.
- Internal review of a sample of ten completed VFM audits a year to check whether teams have complied with the VFM standards at each stage of the study cycle.
- Formal feedback from clients on all VFM studies.
- Internal post-project reviews shortly after the VFM report is published.

2.57 Further details of these monitoring arrangements can be found in Appendix Two. The results of the external reviews, the feedback from departments and other information on a study are captured by the VFM practice and quality team. They are then reported by the director general of VFM audit to the APQ. This report highlights trends and makes recommendations for improvements. The director general of VFM audit also reports annually on the results of the quality assurance processes to the leadership team, and the NAO board, on key quality issues.

Issues that we addressed in 2011-12

2.58 During 2011-12 we identified and addressed issues identified by our internal and external quality assurance:

- Our external reviews highlighted that on average our VFM studies scored lowest against the 'Financial analysis and quantitative information' criteria. To address this, during 2011-12 we supported study teams through our financial analysis network and the economics network to help teams make better use of the quantitative data, and in particular financial information, in the analysing of issues in our reports. Internal specialists are assisting study teams where more sophisticated analysis is required.

- Internal and external reviews identified that our reports could be more clearly set out and logical. In 2011 we employed a copy editor, initially on a trial basis to work with teams to address drafting issues, provide training on plain English and promote good practice. This has proved a success and the editor is now permanent.
- To challenge report quality internally, in 2011 we introduced the role of ‘partner director’ to our studies, an NAO director from elsewhere in the organisation who could challenge and comment on our reports.

Our people

2.59 Many VFM audit staff are trained at the NAO as accountants. In parallel with their financial audit training, they gain experience of VFM audit working on studies. They also receive basic VFM audit training, including an introduction to VFM, and courses on interview techniques, statistics and research methods. On qualification they have the opportunity to specialise in VFM audit and then undergo further, more specialised training. This may include more complex technical courses, as well as workshops on VFM audit practice and e-learning modules. We also recruit researchers and senior analysts in a range of specialist disciplines, including economics, statistics, social sciences and modelling. Both our trainee accountants and specialist staff follow clearly defined development paths to gain the necessary experience in VFM audit.

Impact and influence

2.60 An important measure of the quality of the NAO’s audit work, both financial and VFM audit, is how much it supports the NAO’s objective to help Parliament and government improve public services. The NAO measures and reports annually on the impact of its work. These impacts are agreed with the audited bodies concerned and subject to the assurance of the NAO’s external auditor.

2.61 In 2011-12 the NAO reported a financial impact of over £1 billion from its work with government departments. Of this over £600 million arose from the NAO’s VFM audit work, and over £100 million from our financial audit work. In addition to financial impacts, the NAO also engages with government to improve financial management, thereby improving public services.

2.62 However, as with financial audit, we recognise that we need to develop further our measures of impact and influence. This is an area to develop for 2012-13.

Appendix One

The NAO's governance and structure

Governance and accountability

1 Effective governance is vital to the success of an organisation. We aim to practise what we preach by upholding high standards of governance in our operations and decision-making. It is also an essential part of the development and delivery of our audit programme. The board supports and advises the C&AG in his statutory responsibilities, and oversees how the NAO manages and uses resources.

2 The Budget Responsibility and National Audit Act modernised the NAO's governance arrangements, establishing the NAO as a corporate entity. The new governance arrangements reflect the statutory position of the NAO and the wish of Parliament that the NAO's governance should provide independent controls and oversight of its own operations, while preserving the independence of the C&AG in respect of audit judgements.

3 The Act formally established the NAO board, with a majority of non-executive members including the chairman. The non-executive members are appointed by the Public Accounts Commission, with the exception of the chair, who is appointed by the Queen under letters patent, upon the recommendation of both the Prime Minister, and the Chair of the Committee of Public Accounts. This ensures that the non-executive members are independent of the NAO's management, and that the Chair has the confidence of both the government and opposition in Parliament. The exercise of audit judgements and the opinions he reaches is the sole preserve of the C&AG.

4 The Act also requires that the C&AG, who is appointed by the Queen under letters patent upon the recommendation of the Prime Minister and the Chair of the Committee of Public Accounts, sits on the board, with three other executive members, to be nominated by the C&AG, and appointed by the non-executive members.

5 During 2011-12 the members of the NAO board were:

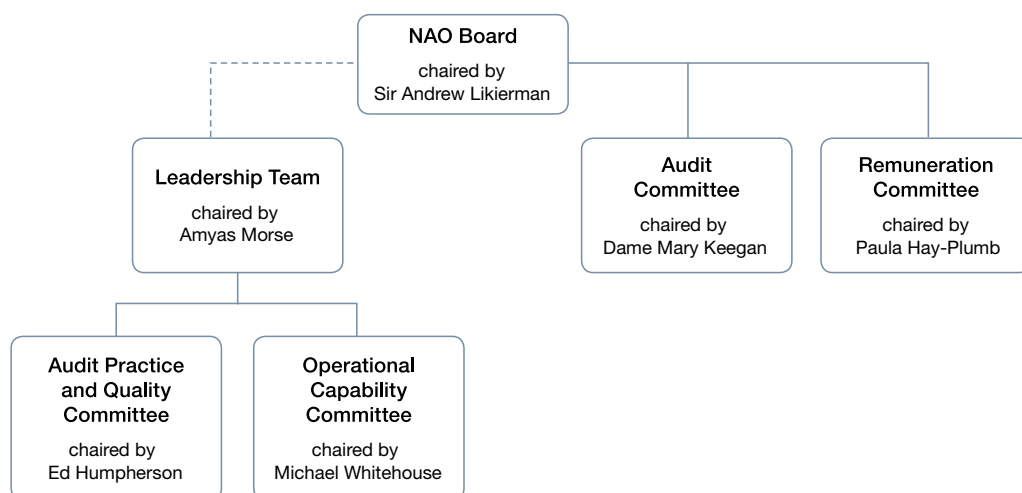
- Sir Andrew Likierman (chairman)
- Amyas Morse (C&AG)
- Gabrielle Cohen (assistant auditor general – stakeholder relationships)

- Ruth Evans (non-executive member, chair of remuneration committee) (term of office ended on 30 June 2012)
- Richard Fleck (senior independent member) (term of office ended on 30 June 2012)
- Paula Hay-Plumb (non-executive member)
- Ed Humpherson (assistant auditor general – economic affairs)
- Dame Mary Keegan (non-executive member, chair of audit committee)
- Michael Whitehouse (chief operating officer)

6 On 1 July 2012 terms of office ended for Ruth Evans and Richard Fleck and they were replaced as non-executive members of the NAO board by Naaz Coker and Gillian Guy, appointed by the Public Accounts Commission for a term of three years.

7 The board is supported by two committees, both of which consist solely of non-executive members:

- **The audit committee.** The committee supports the board by reviewing the internal controls, risk management processes and governance arrangements of the NAO, as well as the quality and reliability of our financial reporting. It is also responsible for considering the external auditor’s annual VFM report on the NAO.
- **The remuneration committee.** The committee determines the framework for the remuneration of the three executive members of the board. It also oversees any major changes in NAO employee benefits. The remuneration of the C&AG is set by Parliament.



8 There is a clear division of responsibility between the chairman and the C&AG: the chairman is responsible for the leadership and effective working of the board and the C&AG is responsible for implementing the strategy, making audit judgements, deciding a programme of VFM examinations and reporting the results of his work to Parliament.

9 The relationship between the board and the C&AG is set out in more detail in the **Code of Practice**. The board provides effective support and challenge in improving in the NAO's operations, providing additional rigour and discipline in decision-making. It brings insight from the wider experience of the non-executive members to inform the thinking of the NAO and support improvement.

10 The board meets eight times a year to discharge its responsibilities which are set out in the Act and which complement the responsibilities of the C&AG. The board prepares, with the C&AG, a strategy for the NAO, an estimate of the NAO's resources for each financial year, and an annual report on the NAO's activities. The board must also recommend the external auditor for appointment by the Public Accounts Commission.

11 The board has a specific responsibility for the programme of work outside of the C&AG's statutory responsibilities. This programme of work includes the financial audits undertaken under the Companies Act 2006, the VFM review of the BBC, and the NAO's work with international organisations such as the United Nations. It approves this programme of work and resources required annually.

12 The leadership team supports the C&AG. The leadership team's role is to help the C&AG develop and implement strategy, provide leadership for staff, set work priorities, monitor performance and manage risk.

13 The NAO is accountable to Parliament, via the Public Accounts Commission. The role of the Public Accounts Commission is defined by both the National Audit Act 1983 and the Budget Responsibility and National Audit Act 2011. The commission's principal duties under the acts are to examine the NAO estimate and lay it before the House, to consider the NAO's strategy, to appoint the auditor of the NAO and receive the reports of the auditor. Also, to appoint non-executive members of the NAO board, and to report from time to time.

Structure

14 Each assistant auditor general manages a portfolio of clients. There is typically one director for financial audit and one director for VFM for each major client, but there may be several directors for more complex clients. Details of each portfolio are available on our [website](#).

15 The chief operating officer manages three directors general: for financial audit, VFM audit, and finance and commerce.

People

16 The NAO employed an average of 857 full-time equivalent staff during 2011-12. As a professional audit organisation the majority of our staff are qualified or trainee accountants and over 60 per cent of NAO staff are members of, or trainees with, the main accountancy institutes. This expertise is supported by other staff with specialisms in areas such as economics, statistics and information technology.

17 The NAO is a registered trainer for the ICAEW. In addition, it provides professional training for employees undertaking the ACCA, CIMA and CIPFA qualifications. The NAO recruits and trains 80 trainees a year (70 graduates and ten school leavers) who undertake structured training towards becoming chartered accountants.

18 In 2011-12, our trainees achieved a high level of success at the ICAEW examinations again, with pass rates continuing to exceed the national average. This year our trainees were again awarded prizes for their performance, including first place in the business strategy paper, first place in the financial management paper, and first place in the financial accounting top up paper.

19 We provide all staff with suitable training opportunities to ensure continuing professional development (CPD). In addition to the flexible and efficient approach to learning of our online and e-learning tools, we run development programmes for high-potential staff to prepare them for leadership positions.

20 A programme of staff secondments into government bodies and other organisations continually develops our staff. Secondments can provide different experiences for staff, for example of the pressures of the delivery of services or different approaches to assessing performance. This is valuable in increasing insight into how government works and helps in providing useful and practical recommendations for our reports. Care is taken when redeploying staff on return to avoid conflicts of interest.

21 There is managed progression through the grades, and the NAO has two development programmes to identify and support individuals of high potential, the future leaders programme, aimed at those at an earlier stage in their career, and the direct programme, aimed at managers with the potential to become directors.

22 In 2011-12 the distribution of staff by grade was as follows:

Distribution of staff by grade

Grade	Percentage
Leadership	< 1
Director	8
Manager	18
Lead	40
Trainee/Others	34

We train all staff to ensure continuing professional development. Our staff have clear objectives against which their performance is measured. Pay is directly linked to performance and all staff are expected to seek and provide feedback on performance in order to manage their own development.

23 We constantly review whether our cohort of staff has the right mix of skills and experience to meet the challenges that financial audit will bring. For example, the closure of the Audit Commission will mean a wider role for the NAO in public sector financial audit. Lynda McMullan, who has extensive experience in local government finance, was recruited as an assistant auditor general in 2011. She now oversees the NAO's work on local government, education and health. We have also recently recruited a financial audit director with many years' local government and audit experience, to lead a portfolio of probation trust audits which the C&AG has taken over from the Audit Commission.

24 The NAO is independent of government pay policy, though considers wider public sector pay issues, and operates performance related pay with a focus on base pay increases; there is not a system of bonuses. In addition to salary the largest non-pay benefit (aside from professional training) is the civil service pension scheme.

25 All staff sign up to our code of conduct annually. The code emphasises the importance of our independence and ensures that we maintain the highest standards of integrity and probity in all our work.

Financial information

26 The NAO is conscious of the need to practise what it preaches on financial management. The Public Accounts Commission recently asked the NAO's external auditor to assess our financial management against our own model of financial management maturity. The auditor concluded that financial management processes in the NAO are sound and are owned by the board and leadership team, with good levels of engagement by other managers and staff. In addition the review found that the NAO manages and reports its finances in a way that is consistent with the standards we promote.

27 The NAO's full financial information is contained in its **Annual Report and Resource Accounts**. In summary

National Audit Office operating segments 2011-12

	Financial audit £000	Value for money £000	Performance improvement £000	Support to Parliament, the public and other organisations £000	Comptroller function £000	Total £000
Gross expenditure	51,316	19,667	7,708	9,036	158	87,885
Income	(17,866)	(278)	(139)	(1,582)	–	(19,865)
Net expenditure	33,450	19,389	7,569	7,454	158	68,020

Appendix Two

Assurance and controls

Financial audit

Client and engagement acceptance

1 Many of the audits that the C&AG undertakes are by statutory appointment, so he cannot withdraw or decline the appointment. However the C&AG can report to Parliament on matters that might otherwise have caused him to withdraw from the engagement. No such instances arose during 2011-12.

2 Where the C&AG is appointed as auditor other than by statutory appointment, the NAO board agrees and approves the programme of work and the resources used. The C&AG must be confident that the terms and scope of the work are appropriate and that adequate resources are available. He has sole responsibility for audit judgements and conclusions reached, including the right to decline or withdraw from any of these engagements. He is advised by the relevant engagement director and the director general for financial audit in engagement acceptance matters.

3 For all of its audits the NAO considers, on appointment and in each successive year, issues which might increase or decrease the risk of an audit. These issues include the integrity and competence of the client's board members and senior managers, as well as the ability of the NAO and the specific team to undertake the audit. These procedures aim to ensure that the team meets the ethical and professional requirements stipulated by both the NAO and the auditing profession.

Policies and procedures

4 The NAO's financial audit manual is issued by the director general, financial audit, and is the main reference source for audit policy and guidance. It sets out the requirements of International Standards on Auditing (UK and Ireland) and how these are to be applied within the NAO. The manual is updated annually to incorporate any changes to professional standards and internal policy changes, which are agreed by the NAO leadership team.

5 The NAO's audit methodology, as set out in the financial audit manual, is fully integrated with the software package we use to document audit work. The software, along with other tools and templates, makes it straightforward for engagement teams to comply with standards and internal policy. They also encourage efficient working by increasing standardisation across the NAO, and reducing the need for individual teams to recreate standard audit approaches.

Control framework

6 Overall responsibility for a financial audit rests with the engagement director. The NAO adopts a two-stage internal review process for all audits to ensure the quality of its financial audit work:

- **First stage review.** All audit tests and supporting working papers are reviewed first by a senior member of the engagement team. This detailed review is the responsibility of the engagement manager.
- **Second stage review.** The engagement director reviews again to confirm that sufficient and appropriate evidence has been obtained to support the recommended audit opinion. This review focuses on the risks of material misstatement and key judgements made by the engagement team.

7 Where an engagement director identifies a matter that involves significant professional judgement, they must consult the financial audit practice and quality team, which is led by the director general for financial audit, before concluding on that matter.

8 Some engagements are assigned an engagement quality control reviewer (EQCR), who is a financial audit director independent from the engagement team. The EQCR's role is primarily to challenge key audit judgements and review evidence supporting the engagement team's conclusions on significant matters. EQCRs are assigned to most audits where a qualification of the audit opinion seems likely or where the audit risk is particularly high. EQCRs were appointed for 29 financial audits in 2011-12.

9 The NAO's internal compliance and quality unit reviews the files of certain audits (mainly those which are of high stakeholder interest) prior to the audit report being issued (hot reviews). These reviews focus on the evidence to support conclusions on each of the significant audit risks, the work performed on material audit areas and compliance with the ISAs in key areas.

10 The NAO's internal compliance and quality unit also reviews the audit files of a sample of completed audits each year. This covers each engagement director every year and each engagement manager over a period of three years. These are more detailed than 'hot reviews'. Their purpose is to assess:

- Whether the audit is compliant with professional standards and NAO audit policy – including a focused review of the planned response and work completed to address the key audit risks;
- the quality of evidence collected by the team to support the key audit risks;
- any opportunities for improvements in documentation and for efficiencies in the audit approach for the following audit cycle; and
- whether the message is consistent and how client-facing documentation appears.

Training and technical competence

Training

11 Supporting the professional accountancy training received by all trainee auditors, the director general for financial audit is responsible for ensuring appropriate in-house training relevant to financial audit staff.

12 Staff working towards an accountancy qualification participate in practical audit training, which provides real-life audit scenarios. This reinforces the NAO's audit methodology and encourages a sceptical approach to audit evidence.

13 As part of their annual CPD requirement, qualified staff are required to attend an annual technical update session each year. This covers:

- financial reporting developments;
- auditing developments and changes to the NAO audit methodology; and
- key findings from the quality assurance process, emphasising priorities for improving audit quality.

14 All financial audit staff have access to a wide range of financial audit training, which can be selected based on the individual's role and prior experience. For example, in 2011-12 we provided new and targeted training in:

- identifying audit risk;
- parliamentary supply and resource accounting (incorporating the revisions to financial reporting from the government's Clear Line of Sight project);
- auditing pension scheme disclosures under IAS 19; and
- improving quality through leading audits (a refresher course for audit supervisors).

Audit licences

15 Individuals supervising, managing or directing a financial audit will usually hold the relevant audit licence. General audit licences are issued by the director general for financial audit to all staff who:

- have an appropriate level of recent financial audit experience;
- have an appropriate level of CPD in the previous year;
- have signed the NAO Code of Conduct; and
- are CCAB-qualified or exam-qualified.

16 We grant specialist licences to staff whose work involves the audit of companies, pension schemes, charities and accounts prepared under International Public Sector Accounting Standards, provided they have a general audit licence, have an appropriate level of recent experience in the specialist area, and have attended any relevant technical updates.

17 Members of staff who do not hold the appropriate licence are able to hold senior roles within the engagement team, provided supervision arrangements are put in place. For example, a pension scheme audit where neither the engagement director nor engagement manager holds a pensions licence will be assigned a second director who does hold a pensions licence. The engagement director must consult with the second director at regular points during the audit and prior to issuing the audit report.

18 The director general for financial audit annually reviews the quality of CPD on a sample of financial auditors who hold audit licences. In 2011-12, 20 individuals were sampled. In all cases the individuals had undertaken training and other learning interventions which were appropriate to their roles.

Value for money audit

Policies and procedures

19 Core policies and procedures for VFM work are set out in the NAO's *VFM Handbook*. The Handbook describes our approach to VFM audit, so that it can help us meet our objectives of providing independent analysis and assurance to Parliament on the ways public money has been spent, and making recommendations that lead directly to service improvements. The handbook is now held electronically and updated whenever a change is made to VFM arrangements. It is supplemented by more detailed guidance relating to specific stages in the life cycle of a VFM study, and by analytical and technical guidance on VFM methods and approaches.

20 These policies and procedures are underpinned by the NAO's VFM standards, which set out the mandatory expectations that all VFM studies must meet. VFM staff are expected to meet the standards and adherence is considered as part of the internal quality assurance arrangements. There are ten standards covering:

- quality assurance;
- study selection and engagement;
- study design;
- evidence reliability and documentation;
- objective analysis;
- balanced and persuasive reporting;
- project management and reporting;
- client engagement;
- report delivery; and
- learning and disseminating lessons from the conduct of VFM studies.

Control framework

21 We assign each VFM study a partner director and case manager who act as a constructive critic and a provider of technical and practical advice and guidance respectively throughout the study. The quality of our VFM work is controlled using the following framework:

- **Study selection.** The C&AG and leadership team select VFM studies following a defined process of information gathering, proposal development and review, to ensure proposals fit with NAO objectives and the needs of Parliament.
- **Approving the study concept.** The C&AG examines and approves the rationale, scope and strategic fit of proposed studies.
- **Budget approval.** The chief operating officer scrutinises and approves the budget and timetable for studies approved by the C&AG, following review of the study plan by the partner director and case manager.
- **Methods meeting.** Case managers discuss potential methods to be used with the study team.
- **Proof of concept.** The C&AG challenges the study team, on how the evidence collected supports the logic of the intended report.
- **Internal hot review.** The draft provisional audit findings are challenged by an internal panel, chaired by the partner director and attended by a small number of experienced colleagues.

- **Director general of VFM/copy editor review.** Following sign-off of the draft provisional audit findings by the partner director, the director general of VFM reviews the draft alongside the copy editor before they submit it to the C&AG. This is designed to confirm adherence to NAO standards and readability.
- **C&AG review.** The C&AG reviews the draft provisional audit findings and the draft final report. Once he is content the draft will be sent to the client for consideration and comment.
- **Post-project review.** After we publish the report, the study team reviews the conduct of the study to identify examples of good practice and lessons learnt which are disseminated more widely across the NAO.
- **Internal cold review.** A sample of ten audits a year are peer-reviewed against a standard set of criteria to identify how well they have met the VFM standards. Each VFM team is examined every two years. A director and a manager independent of the team conducts the reviews, and they gather evidence to allow them to reach a judgement on whether the standards have been met.

Training and technical competence

22 VFM staff are qualified accountants (or training in accountancy) or specialists qualified in other disciplines such as economics, statistics, social sciences and modelling. To maintain the technical competence of our VFM staff, we give a full and varied training programme, ranging from introductory courses for trainees and new researchers to technical courses for experienced practitioners. Courses for trainees include an introduction to VFM; interview techniques; and statistics and research methods. On qualification, staff can specialise in VFM audit and will then undergo further, more specialised training. This may include more complex technical courses. Trainees also gain experience of VFM audit by working on studies alongside their financial audit training.

External monitoring

External review of financial audit

23 The C&AG has invited the Audit Inspection Unit (AIU) of the Financial Reporting Council² to perform an external voluntary review of the NAO's whole of office procedures and a selection of audit files. In 2011-12 the AIU reviewed six completed audit files (2010-11: six), of which two (2010-11: two) were performed under the Companies Act 2006.

² The Audit Inspection Unit was formerly part of the Financial Reporting Council's Professional Oversight Board. From 2 July 2012 it is now named the Audit Quality Review Team.

External review of VFM reports

24 For nearly 20 years external specialists have reviewed each report. Currently, our published reports are reviewed by independent experts from Oxford University Saïd Business School (trading as ISIS); and Risk Solutions. They assess the report against a set of ten criteria:

- Scope.
- Structure and presentation of the report.
- Administrative and managerial context.
- The extent to which systemic issues are brought out.
- Methodology.
- The adequacy of financial analysis and the use of quantitative information.
- The adequacy of qualitative analysis.
- Graphics and statistics.
- The synthesis of analyses and whether this supports the conclusion on VFM.
- The appropriateness of recommendations.

25 They provide a written review assessing how each report meets professional standards against each criteria and an overall assessment. Since September 2010 they have done this on a sample basis and have also reported to the NAO on specific quality issues such as the quality of drafting and the use of evidence. These reviews have been used by APQ as the basis of discussions on quality.

26 Study teams also seek formal feedback from clients on individual studies on a range of issues, including the conduct of the study, the professionalism of NAO staff, engagement with the client and the knowledge of the team.

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