Financial Reporting Council

June 2017

National Audit Office

2016/17 Audit Quality Inspection

The AQR's objective is to monitor
and promote improvements in the quality of auditing

About the FRC and its Audit Quality Review team

Our objective

The FRC's mission is to promote high quality corporate governance and reporting to foster investment. The FRC's Audit Quality Review team ("AQR") contributes to this objective by monitoring and promoting improvements in the quality of auditing.

What we do

The FRC is responsible for monitoring the audit work of UK firms that audit public interest entities ("PIEs"), and certain other UK entities, and the policies and procedures supporting audit quality at those firms. The monitoring work is undertaken by the AQR team.

The National Audit Office ("NAO") has commissioned AQR to adopt a similar programme of work in respect of its audits. We adopt a risk-based approach to our work and focus our reviews of individual audits on key areas specific to each review.

The AQR team

The AQR team consists of approximately 35 professional and support staff. Collectively, our professional staff have extensive audit expertise (including appropriate professional education, relevant experience in statutory audit and financial reporting, specific training on quality assurance reviews and specialist expertise). Our audit quality review work is subject to rigorous internal quality control reviews. Independent non-executives advise on and oversee our work. Independence requirements for staff and non-executives are set out in Appendix A.

Thematic reviews

In addition to our annual programme of audit inspections of the major private sector audit firms, we undertake one or more thematic reviews each year. We review firms' policies and procedures in respect of a specific aspect of auditing, and their application in practice, enabling us to make comparisons between firms with a view to identifying both good practice and areas for improvement.

This year we have published reports on Root Cause Analysis (September 2016), The Use of Data Analytics in the Audit of Financial Statements (January 2017) and Quality Control Review Processes (March 2017). These reports can be found on the FRC's website. Certain of these thematic findings may be of interest to the NAO.

Developments in Audit Quality 2016/17

In addition to reports on our audit quality reviews of the major firms, the FRC intends to publish later in 2017 an overall report on the quality of audit in the UK, covering work across the FRC in relation to audit quality and other relevant developments. The first such report was published in July 2016 and an update was issued in February 2017.

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1 Overview

Scope of AQR's work

This report sets out the principal findings arising from the 2016/17 independent quality review of the National Audit Office ("NAO") carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted this inspection in the period from November 2016 to April 2017 ("the time of our inspection"). The Comptroller & Auditor General ("C&AG") is the head of the NAO.

The NAO, on behalf of the C&AG, audits the financial statements of all central government departments, agencies and other public bodies and reports its results to Parliament. The C&AG is required to form an opinion as to whether the financial statements of audited bodies are free from material misstatement and comply with the relevant reporting requirements and a regularity opinion as to whether, in all material respects, the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament.

The C&AG also increasingly performs audit work in respect of the financial statements of certain companies registered under the Companies Act for which the C&AG is authorised to conduct audit work by the FRC (in its role as Independent Supervisor). Responsible individuals form an opinion on behalf of the C&AG as to whether the company's financial statements are free from material misstatement and comply with the relevant reporting requirements.

Our review was undertaken at the NAO's request and the scope of our inspection is agreed contractually with the NAO in our agreed terms of reference dated 10 February 2017. It included reviewing the performance of the NAO's Companies Act statutory audit work on behalf of the Independent Supervisor and the review of the NAO's audit work supporting their opinion on the financial statements (which falls outside our statutory responsibilities). The NAO's audit work on its regularity opinion is not included in the scope of our review.

Our report focuses on the quality of the audits which we inspected, primarily the key areas requiring action by the NAO to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the NAO's audit work. Our findings cover matters arising from our reviews of both individual audits and the NAO's policies and procedures which support and promote audit quality.

We are grateful for the co-operation and assistance received from NAO engagement directors and staff in the conduct of our 2016/17 inspection.

Summary principal findings

Issues were identified on each of the six audits reviewed. Both of the Companies Act statutory audits reviewed required improvement in certain areas and, for one of these audits, issues of significance were identified. We note, however, that this is a small, non-statistical sample which is not representative of the overall quality of the NAO's audit work.

Structure of our report

Section 2 sets out the principal findings arising from our reviews.

Appendix A sets out our objectives, scope and basis of reporting.

Appendix B explains how we assess audit quality.

Scope of our 2016/17 inspection

We examined selected aspects of six individual audit engagements. The NAO requested that we select larger audits to review in the 2016/17 inspections cycle while maintaining the number of audits reviewed (six in total). Our selection was made with a view to inspecting two Companies Act statutory audits, two large and two medium non-Companies Act audits. Contracted-out audits were excluded from the selection process, as agreed with the NAO. All audits reviewed were for 31 March 2016 year-ends.

The reviews covered audits of varied complexity and size.

The Companies Act audits selected comprised:

- A significant company (larger than Company Act audits previously reviewed); and
- An entity that invests in small businesses.

The non-Companies Act audits selected comprised:

- A major departmental resource account;
- A large executive agency; and
- two Non-Departmental Public Bodies (NDPBs).

We also undertook a follow-up review of the NAO's policies and procedures supporting audit quality. In addition, we updated our understanding of policies and procedures where there were changes (for example, information technology ("IT") audit). In response to the findings from our last inspection, the NAO committed to undertake certain actions. We reviewed these actions and the extent to which they have contributed to improvements in audit quality.

Our key findings arising from our 2016/17 reviews, together with an update of how the NAO has responded to our prior year findings, are set out in Section 2.

Given the increased number and complexity of Companies Act statutory audits performed by the C&AG, including a small number of public interest entity ("PIE") audits, the number of audits reviewed in each year will be subject to further consideration.

Progress made in the year

We recognise the NAO's continuing work to enhance its policies and procedures supporting and promoting audit quality, such as addressing lessons learnt from its internal cold reviews and previous AQR reports, identifying thematic issues so that these are embedded within individual audits, focusing internal training on quality, setting quality targets, and dedicating more senior staff involvement across the NAO's audit practice (including for Companies Act audits). We have seen improvements in relation to certain key findings highlighted in last year's report, in particular aspects of IT controls testing and journal testing. However, we continue to identify findings in relation to the challenge of areas of judgement, obtaining sufficient and appropriate evidence and non-IT controls testing.

The NAO has made a number of improvements to its policies and procedures in the areas listed below. However, as set out in Section 2, we continue to identify findings in these areas.

- IT methodology, guidance and training: the NAO has continued to enhance its internal guidance, along with training in testing IT controls. Efforts are focused on using IT specialist resources and data analytics tools more effectively, particularly where a controls-based audit approach is adopted.

- Audit of journals: the NAO's training and guidance continues to be enhanced for the identification of appropriate fraud criteria used to test journals.

- Audit quality initiatives: the central audit quality team have built on existing quality procedures to provide teams with additional support in respect of audit planning and technical consultations. In November 2016, the NAO launched the Quality Campaign focusing on the areas listed below to enhance the quality of audit files:

    - Challenging assumptions in management's estimates and judgements;

    - Testing controls;

    - Substantive analytical procedures; and

    - Financial statement disclosures.

- Follow-up of review points: all audit teams subject to external (and internal) review are required to follow-up on points raised and document how these have been addressed.

- Group scoping: the group audit scoping memorandum was revised to ensure that audit teams specifically consider alternative benchmarks (e.g. revenue, expenses and net assets) for scoping the group audit approach to components.

Two prior year findings have not recurred in the current year. These are:

- Improve the scoping of group audits and the audit evidence obtained in respect of components.

- Strengthen the extent and depth of challenge from Engagement Quality Control Reviewers (EQCRs) and consider whether the scope of their work should include significant components.

Two audits in our sample had an EQCR appointed and we considered group matters on three audits. We have no EQCR or group findings in the current year and we encourage the NAO to continue to focus on these areas.

Good practice identified

Examples of good practice we identified in the course of our work include:

- Substantive analytical review procedures which clearly evidenced the audit team generating sufficiently precise independent expectations and using good quality third party data;

- Verification of journals;
- Assessments of going concern, specifically within the public sector context;
- Scoping and communication with other auditors; and
- Assessment and evaluation of property valuation assumptions.

Key findings in the current year requiring action

Our key findings in the current year requiring action by the NAO, which are elaborated further in section 2, are that the NAO should:

<u>Individual audit reviews</u>

- Improve the extent of challenge in areas of judgement, in particular, for key assumptions used in valuations and estimates.
- Ensure that sufficient and appropriate audit evidence is obtained for judgemental areas.
- Improve the testing of controls and ensure any identified weaknesses are compensated by enhanced substantive testing.
- Ensure substantive testing procedures are appropriate to provide a sufficient level of audit evidence.
- Improve the procedures to evaluate the accuracy of disclosures in the financial statements.
- Ensure significant risks are assessed appropriately.

<u>Review of NAO's policies and procedures</u>

- Embed the NAO's response to independence threats.

Assessment of the quality of audits reviewed

We identified some improvement in the extent and quality of audit evidence on the non-statutory four audits and there was evidence of a good level of involvement of senior team members in key aspects of the audit. These improvements and the exercise of good practice contributed to these audits being assessed as requiring no more than limited improvements in the 2016/17 inspection.

Both of the Companies Act statutory audits reviewed required improvement in certain areas and for one of these audits issues of significance were identified.

The NAO has responded positively to our findings. We have reviewed the actions proposed by the NAO audit teams and are satisfied that these are appropriate to respond to our findings.

As the complexity and number of Companies Act audits performed by the NAO increases, there is a greater risk of audit quality issues arising. We have recommended that the NAO performs root cause analysis on the audits where more than limited improvements are required to determine whether any further actions are needed.

Issues driving lower audit quality assessments

- The principal issues resulting in one audit being assessed as requiring improvement in certain areas and another identifying issues of significance in the 2016/17 inspection included the following (where relevant, further details for our key findings are set out in section 2): Insufficient consideration and challenge of management in relation to key assumptions used in valuations and estimates and insufficient appropriate audit evidence obtained for judgemental areas.

- Weaknesses in the testing of controls around system generated reports used in audit procedures.

Report to the Independent Supervisor

A separate report dated [30 June 2017] has been provided to the FRC Board in its capacity as Independent Supervisor of the C&AG's Companies Act statutory audit work and included the following:

Both statutory audits reviewed were assessed as requiring improvements in certain areas reviewed and in one of these audits issues of significance were identified. We note however that this is a small, non-statistical sample and is therefore not representative of the overall quality of the C&AG's audit work.

As the complexity and number of Companies Act audits performed by the NAO increases, there may be a greater risk of audit quality issues arising. We recommend that the Independent Supervisor discusses the following matters with *the C&AG:*

- *The NAO's plans to perform root cause analysis on the key findings on the two audits reviewed and determine whether any additional actions are needed*;

- *The NAO's plans to ensure they have a sufficient number of suitably qualified and experienced responsible individuals ("RI's") appointed to perform Companies Act audit work; and*

- *Whether, for the largest audits, additional senior, experienced resource should be added to the audit team to support the RI.*'

Future inspections – reporting

As instructed, we continue to report privately to the NAO on each audit reviewed and on our overall inspection. In respect of our statutory work we will continue to report to the FRC Board, in its capacity as the Independent Supervisor.

As noted last year, this approach differs from our inspections of major private sector audit firms, where we send private reports on each of the audits reviewed directly to the chair of the audit committee and issue a public report on our inspection findings as a whole. We are encouraging FTSE 350 audit committees to use the information contained in our private reports to report to shareholders on our findings.

The reporting on our inspection work is subject to our agreed terms of reference. We encourage you, however, to increase the transparency of our work, by improving both the communication of our inspection results and our engagement with Audit Committees. In particular, for those Companies

Act audits of public interest entities, the reporting on our inspection should be consistent with our other inspection work (e.g. inspections of major private sector audit firms).

We also would encourage the inclusion of actions to our findings to be part of this report.

2 Key findings requiring action and the NAO's response

We set out below the key areas where we believe improvements are required to safeguard and enhance audit quality and safeguard auditor independence. The NAO has separately provided a response setting out the actions it has taken or will be taking in each of these areas.

Improve the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates

An appropriate level of challenge of management is important in achieving a high quality audit in areas of judgement. Effective audit teams will evaluate management's key assumptions, comparing them to available audit evidence and, where appropriate, challenging management to justify the basis of those assumptions.

We considered the audit of valuations and estimates on four of the six audits inspected. We identified a number of findings where improvements should be made, in particular:

- *The extent to which key assumptions had been adequately identified, considered and challenged.*

  On four audits, insufficient audit procedures were performed in relation to key assumptions to support the valuation of significant assets or the calculation of an estimate. Key assumptions were not adequately corroborated and whilst the audit team held discussions with management, details were not always available and there was no or insufficient evidence of an appropriate level of challenge.

- *The approach to specialist areas of the audit*.

  On three audits, management had used specialists to calculate a valuation or an estimate. In each case, the audit team did not involve their own experts or engage an external expert to assess the reasonableness of the valuation or estimate. The audit teams did not adequately justify why assistance from an expert was not needed or how the team had sufficient expertise. Furthermore, on one audit there was insufficient evidence of whether entity's management had the appropriate in-house knowledge, expertise and ability to perform the specialist valuation.

Ensure that sufficient and appropriate audit evidence is obtained for judgemental areas

Obtaining sufficient and appropriate audit evidence is important to ensure that that judgemental balances are not materially misstated.

We identified a number of findings where improvements should be made on one or more audits, in particular:

- There was no evidence available for testing certain investment valuations, which were a significant part of the total investments. In this case, procedures should have been performed such as obtaining fund manager control reports or testing the effectiveness of the entity's valuation controls. This finding was similar to that raised in the prior year on a similar entity.

- The audit team did not obtain sufficient evidence of management's assessment of the third party judgements as a basis for the valuation of a significant asset.

- Insufficient procedures were performed to assess whether management's forecast costs were appropriate in assessing the valuation of certain provisions.

Improve the testing of controls and ensure any weaknesses are compensated by enhanced substantive testing

Testing the operational effectiveness of controls allows the auditor to reduce the extent of substantive testing required. Controls testing should be appropriately designed to provide the auditor with a reasonable basis on which to conclude on the operating effectiveness of those controls. Where controls testing identifies weaknesses, further compensating substantive procedures should be performed.

We identified shortcomings in audit procedures to confirm that controls operated effectively and could be relied upon (including the testing of manual and IT general controls) on one or more audits:

- There was insufficient testing of certain controls which were relied upon. One audit placed reliance on management's review of monthly management accounts without adequate testing of the process. In this case, there was insufficient evidence that the control was sufficiently robust to identify and correct errors and misstatements.

- There was insufficient testing of IT general controls or direct testing of reports, given the reliance placed on the completeness and accuracy of system reports. Substantive procedures alone would not provide sufficient assurance.

- It was unclear whether the procedures performed demonstrated that all aspects of the inventory count controls were operating effectively and that all inventory had been counted at each site.

Ensure substantive testing procedures are appropriate to provide a sufficient level of audit evidence

On one audit, we identified flaws in the selection of items for substantive testing which meant that insufficient audit evidence was obtained to conclude on the population as a whole. These included:

- Selection of highest value items did not consider qualitative risk factors or whether it was a representative audit sample.

  - Selection of sample items to test inventory population from certain sections of the population such that the sample selected is not representative of the whole population.

Improve the procedures to evaluate the accuracy of disclosures in the financial statements

Auditors need to consider whether material financial statements disclosures are accurate and that appropriate audit evidence is obtained to support them. We identified findings in the following cases:

  - The financial statements disclosed impairment losses related to certain investments. The audit team did not, however, adequately evidence its challenge of the disclosure of fair value adjustments.

- There was insufficient challenge of whether the valuation disclosures in the financial statements were appropriate, given that the disclosure incorrectly implied that actuarial experts were used during the year.

Ensure significant risks are assessed appropriately

The auditor's assessment of the risk of material misstatement in a particular area determines the level of work required and the extent of auditor reporting. If a significant risk is not appropriately identified, the matter will not be reported to the audit committee or included in an extended auditors' report (where required).

We identified findings on two audits:

- The financial statements disclosed that management identified the valuation of certain investments as a critical accounting judgement and a key source of estimation uncertainty. Given the significance of the balance, complexity of key judgements involved and risk of material misstatement, the audit team should have assessed the valuation of these investments as a significant risk.

- It was unclear why provision valuation was not identified as a significant risk, given the complexity and degree of subjectivity of key judgements involved

Further strengthen the NAO's response to independence threats

The NAO is required to have policies and procedures in place to maintain auditor objectivity and independence in compliance with Ethical Standards. Insufficient or inappropriate safeguards could compromise the NAO's objectivity and independence. During the year, the NAO amended its procedures in the following areas:

- Secondments to and from audit clients: in our previous inspections we have raised issues of significance relating to secondments (for example, short term loans of staff) to and from audit clients. An issue in relation to an existing inward secondment has been resolved from 31 March 2017. The NAO's secondment policy now meets the requirements of the revised Ethical Standards from 31 March 2017.

- For outbound secondments to audit clients, and where appropriate to meet the requirements of ethical standards, all secondments will be disclosed in audit certificates issued by the NAO from 2017/18.

- Business relationships: as noted in our previous inspections, three NAO business relationships relate to the sub-letting of part of the NAO building, two of which are not significant.

  The NAO continues to disclose leasing arrangements of its London headquarters building in its Annual Report and Accounts.

  One of the sub-leases is material to the audited entity and is therefore a breach of Ethical Standards. This matter was previously brought to the attention of the NAO but we understand that no change will be considered until the end of the lease (due to the cost implications for public funds). This will therefore remain a breach until this time, as there is no provision for permitting the transaction within Ethical Standards. However, from the 2016/17 financial statements, the NAO discloses these arrangements in the one audit certificate where these arrangements are material to the counterparty

We will continue to review the NAO's revised procedures in respect of the above findings and their impact on audit quality in the next relevant inspection.

Audit Quality Review

FRC Audit Division

June 2017

Appendix A – Objectives, scope and basis of reporting

Matter	Explanation
Objectives of our inspection	The overall objective of our work is to monitor and promote improvements in the quality of auditing. Relevant Requirements as defined in the Statutory Audit and Third Country Auditor Regulations 2016 (SATCAR). A full list of the Relevant Requirements is set out at Regulation 5(11) SATCAR, and includes amongst other requirements, applicable legislation, the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC and other requirements under the Audit Regulations issued by the relevant professional bodies. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.
Audits in the scope of our inspection	Our Audit Quality Review (AQR) team monitors the quality of the audit work of statutory auditors in the UK that audit Public Interest Entities (PIEs) and certain other entities within the scope retained by the FRC (these are currently large AIM/Lloyd's Syndicates). Monitoring of all other statutory audits is delegated by the FRC to Recognised Supervisory Bodies under a series of Delegation Agreements. The overall objective of our work is to monitor and promote continuous improvement in audit quality in the UK. The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc.) Order 2012 names the Financial Reporting Council ("the FRC") as the Independent Supervisor of the Comptroller and Auditor General ("C&AG") and the other Auditors General, in respect of their work as statutory auditors of companies under the Companies Act 2006 ("the 2006 Act"). We have also agreed contractually with the NAO to review the NAO's audit work which falls outside our statutory responsibilities supporting their opinion on the financial statements. The NAO's audit work on the regularity opinion is not included in the scope of our review.
Impact of our risk-based inspection approach	Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the NAO's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected for review and cannot be relied upon for this purpose.
Key audit areas we inspect	In selecting which aspects of an audit to inspect, we take account of those areas considered to be higher risk by the auditors and audit committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements. The rationale for including each area of audit work (or excluding any area of focus listed in the auditors' report) is explicitly documented as part of the planning process for each audit inspected.
Our reports on individual audits	We issue a report on each individual audit reviewed during an inspection to the relevant audit engagement director.
Our focus on achieving continuous improvement in audit quality	We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with Relevant Requirements and to agree an action plan with the NAO designed to

Matter	Explanation
	achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified which require action by the NAO than areas of strength and are not intended to be a balanced scorecard or rating tool. However, we also seek to identify examples of good practice.
Basis of our reporting	The findings reported for the NAO in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review (which, in turn, reflects the NAO's client base). Also, only a small sample of audits is selected for review and the findings may therefore not be representative of the overall quality of the NAO's audit work.
Inspection findings included in our report	We exercise judgment in determining those findings to include in our report on each inspection, taking into account their relative significance in relation to audit quality, in the context of both the individual inspection and any areas of particular focus in our overall inspection programme for the year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.
Purpose of this report	This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice. To the full extent permitted by law, the FRC and its employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.
Independence	In line with legal requirements for the Competent Authority's independence from the audit profession, the FRC's funding is secure and free from undue influence by statutory auditors. All Board members, FRC decision-makers and AQR inspectors are subject to appropriate cooling-off periods from individual audit firms or the audit profession as a whole, depending on the nature and seniority of their roles. Our non-executives and staff are subject to requirements to avoid conflicts of interest by way of the FRC Code of Conduct and applicable staff terms and conditions and AQR inspectors are additionally required to declare that there are no conflicts of interest between them and the statutory auditor under inspection.
Purpose of this report and Disclaimer	This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice. To the full extent permitted by law, the FRC and its employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

Appendix B – How we assess audit quality

We assess the quality of the audit work we inspect using the following four categories:

- Good (category 1);
- Limited improvements required (category 2A);
- Improvements required (category 2B); and
- Significant improvements required (category 3).

This four-tier structure has been used consistently since 2008, although there have been some minor refinements to the category descriptions over the years. We expect the auditor to make appropriate changes to its audit approach for subsequent years to address all issues raised.

An audit is assessed as good where we identified no areas for improvement of sufficient significance to include in our formal report. Category 2A indicates that we had only limited concerns to report. Category 2B indicates that more substantive improvements were needed in relation to one or more issues reported.

An audit is assessed as requiring significant improvements (category 3) if we have significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key audit judgements or other matters identified. In such circumstances we may request some remedial action by the firm to address our concerns and to confirm that the audit opinion remains appropriate. We may review a subsequent year's audit to confirm that appropriate action has been taken.

We exercise judgement in assessing the significance of issues identified and reported. Relevant factors in assessing significance include the materiality of the area or matter concerned, the extent of concerns regarding the sufficiency or quality of audit evidence, whether appropriate professional scepticism appears to have been exercised, and the extent of non-compliance with Standards or the NAO's methodology.

Our inspections focus on how selected aspects of a particular audit were performed. They are not designed to assess whether the information being audited was correctly reported. An assessment that an audit required significant improvements, therefore, does not necessarily mean that an inappropriate audit opinion was issued, the financial statements failed to show a true and fair view or that any elements of the financial statements were not properly prepared.

Equally, where we have assessed an audit as requiring significant improvements, this does not necessarily imply potential misconduct on the part of an individual or audit firm which may warrant investigation and/or enforcement action by the FRC.