Financial Reporting Council

National Audit Office

2016/17 Audit Quality Inspection

Report to the Independent Supervisor

June 2017

Purpose of this report

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"). The Comptroller & Auditor General leads the National Audit Office ("NAO").

Section 1228 of the 2006 Act requires the Independent Supervisor to report on the discharge of its responsibilities at least once in each calendar year to the Secretary of State, the First Minister of Scotland, the First Minister and the Deputy First Minister in Northern Ireland, and to the First Minister for Wales. The FRC reports on this role in an appendix to its annual report and accounts.

This report sets out the work performed by the Audit Quality Review ("AQR") team, on behalf of the Financial Reporting Council, and their findings which the FRC, as Independent Supervisor, considers as a basis for its report.

1 Overview

Scope of AQR's work

This report sets out the findings arising from our 2016/17 independent quality review of the C&AG and the work of the NAO, carried out by AQR, to monitor the performance of the NAO's Companies Act statutory audit work. Our review was undertaken in accordance with our agreed terms of reference dated 10 February 2017 and was conducted in the period from November 2016 to April 2017 at the NAO's London office.

We reviewed two of the NAO's 37 (2015/16: 26) Companies Act statutory audits and also undertook a follow-up review of the NAO's processes and procedures supporting audit quality ("firm-wide procedures"). We note that the audits reviewed in our inspection are not a representative sample of the Companies Acts audits performed by the NAO. The NAO has three (2015/16: three) responsible individuals (RIs) authorised to perform statutory audits. A fourth RI has recently been appointed and the NAO is considering whether further RIs should be appointed.

Our report focuses on the quality of the audits which we inspected, primarily the key areas requiring action by the C&AG and the NAO to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the C&AG's and 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 acknowledge the co-operation and assistance received from the NAO engagement directors and staff of the NAO in the conduct of our 2016/17 review.

Summary principal findings

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.

Scope of our 2016/17 inspection

We examined selected aspects of two Companies Act statutory audits with 31 March 2016 year-ends. The NAO requested that we select larger audits to review in the 2016/17 inspections cycle.

The reviews covered Companies Act audits of varied complexity and size and comprised:

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

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, 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 (PIEs) 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 information technology ("IT") controls testing and journal testing. However, we continue to identify findings in relation to the challenge of areas of judgment and obtaining sufficient and appropriate evidence.

The NAO 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 and templates, 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.

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

Assessment of the quality of audits reviewed

Both statutory audits reviewed were assessed as requiring improvements in certain areas reviewed and in 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 recommend that the Independent Supervisor discusses the following matters with the C&AG:

- The NAO's plan to perform root cause analysis on the key findings on the two audits reviewed to determine whether any further actions are needed.

- The NAO's plans to ensure they have a sufficient number of suitably qualified and experienced RI's appointed to perform Companies Act audit work.

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

Issues driving lower audit quality assessments

The principal issues resulting in the two audits being assessed as requiring improvement 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.

Key findings in the current year requiring action

Our principal findings in relation to the quality of the Companies Act statutory audits requiring action by the NAO are set out in Section 2 and those relating to processes and procedures supporting audit quality ("firm-wide procedures") are set out in Section 3.

2 Key findings relating to Companies Act statutory audits

Our reviews covered selected aspects of the financial statement audits only. In selecting which aspects of an audit to inspect, we took account of those areas identified to be of higher risk by the auditors, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements.

Each review was undertaken using our standard review methodology and the review process was identical to that used for other inspections undertaken by AQR. However, unlike our inspections of major private sector audit firms, we do not report our findings to the relevant audit committee.

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 been asked to provide a response setting out the actions it has taken or will be taking in each of these areas.

Available for sale (AFS) investments (Company 1)

AFS investments comprised limited partnership (LP) investments and venture capital investments (mainly [redacted] level 3 investments).

Risk assessment of AFS investments

The valuation of Level 3 investments, and particularly the limited partnership investments, is highly judgemental. Management disclosed the valuation of AFS investments as a critical accounting judgement and a key source of estimation uncertainty. The auditor's assessment of the risk of material misstatement in a particular area determines the level of work and extent of auditor reporting required.

The audit team identified the valuation of AFS investments as a normal audit risk and the auditor's report to the audit committee and the auditor's report made no reference to the audit procedures performed in this area for limited partner investments. The audit team should have assessed the valuation of these investments as a significant risk given the significance of the balance; the complexity of key judgements involved; and the risk of material misstatement.

Valuation of AFS Investments

Audit teams should perform appropriate procedures to obtain sufficient evidence that these valuations are not materially misstated.

- *Limited partnership investments* – No audited information was available during the year and the LP investments were valued using fund managers' unaudited interim reports. Insufficient procedures were performed to evaluate the accuracy and completeness of the managers' unaudited interim reports. This finding was similar to that raised in the prior year on a similar entity.

- [redacted] *Funds* – The income statement included impairment losses of [redacted] relating to [redacted] investments. No fair value adjustment was recorded in other comprehensive income for these investments. There was no evidence to support the audit team's conclusion that the entire fair value movement in [redacted] investments related to impairment losses.

- *Embedded derivatives* – A number of investments included equity kickers (incentives to improve the investment return above a stated level). Management assessed the existence of embedded derivatives investments and concluded that they were immaterial. There was insufficient evidence to support the audit team's conclusion that the fair value of embedded derivatives was immaterial, in particular the movement during the year.

Disclosures for loans and receivables and [redacted] investments (Company 1)

Auditors should sufficiently challenge management on the accuracy and reliability of disclosures in the financial statements so that users have appropriate information to inform their decisions.

- *Loans and receivables* – The financial statements stated that the carrying amount of certain loans and receivables assets approximated to their fair value. The entity generally offers loans with returns that are below the market rate of interest. The audit team did not obtain sufficient evidence to assess the fair value of the loans and receivables and conclude that this approximated to the carrying amount.

- [redacted] *investments* – The consolidated statement of comprehensive net income excluded [redacted] and other fair value adjustments from operating income. There was insufficient evidence of the audit team's challenge of this disclosure.

Capital additions (Company 2)

Capital additions relating to the group's infrastructure asset renewal and enhancement programme typically span multiple accounting periods and involve estimation. Auditors should perform appropriate audit procedures to ensure that any material misstatements of the financial statements would be identified.

The group recorded significant capital additions during the year. The audit team identified the valuation of capital accruals as a significant risk, and adopted a substantive audit approach, including site visits and sample testing of capital projects.

- *Testing capital projects* – The audit team substantive tested a sample of capitalised projects. An inappropriate audit approach was used as part of the audit approach to test capital additions. In particular, the selection of the highest value addition within the capitalised projects did not consider qualitative risk factors or whether it was a representative audit sample.

- *Reliance on system reports* – A key component of the valuation of accrued capital expenditure was the treatment of internal staff costs. The audit team agreed capitalised costs to a sample of timesheets but did not test IT general controls in relation to the time system or the general ledger. There was insufficient testing of timesheet and project cost reports as substantive procedures alone were not appropriate to provide sufficient audit evidence.

- *Residual Capital Projects testing* – The audit team performed a substantive analytical procedure over the costs of work done, invoiced capital costs, accrued capital costs and anticipated final costs. The audit team set expectations based on period 11 balances. The audit team investigated all individually significant variances, obtained explanations from management, and concluded that these variances were reasonable. The audit team, however, did not obtain sufficient audit evidence to corroborate management's explanations around individually significant variances.

Infrastructure asset valuations (Company 2)

The valuation of infrastructure assets is complex and involves significant assumptions and judgements. Auditors should obtain sufficient evidence to determine whether the valuation is materially misstated.

The group had significant infrastructure assets. [redacted]

- *Management's valuation* – The audit team identified the valuation of the infrastructure asset as a significant risk and adopted a substantive audit approach. [redacted] The audit team did not sufficiently challenge management over the on-going validity of the income based valuation proxy assumption. While the audit team assessed the theoretical reasonableness of the assumption, there was insufficient audit evidence to demonstrate its continued validity in practice ([redacted]).

  There was also insufficient evidence of the audit team's consideration of the disclosures of this assumption within the financial statements.

- *Indicators of impairment* – Management concluded that there were no significant indicators of

---

[redacted]

impairment. The audit team assessed this conclusion as reasonable given the regulatory model is designed to ensure that there is sufficient investment to maintain the asset in a steady state. There were insufficient procedures performed to identify indicators of impairment. In particular, the audit team did not sufficiently evidence their consideration of potential performance adjustments, [redacted]

- *Forecast* [redacted] *Cash Flow Adjustment* – The level of expected operating costs was significantly higher [redacted], due to management recognising [redacted] under-performance in the current year. The audit team did not sufficiently challenge management as to whether the [redacted] underperformance included within operating costs represented a material prior period error, in line with IAS 8, and therefore required a prior period adjustment.

3 Firm-wide findings relating to independence matters

Scope of AQR's work

Our review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures") including consideration unresolved prior year findings. In addition, we updated our understanding of processes, policies and procedures where there were changes, such as within IT audit.

Independence matters

Whilst no secondments or sub-leases involve Companies Act entities, certain independence threats were identified in respect of secondments to and from audit clients and sub-leases of part of the NAO building. It is essential that appropriate secondment and business relationship policies are applied for all clients to safeguard auditor independence.

The NAO has revisited its independence policies and concluded that inward secondments from audited entities to audit teams will cease and will disclose secondments in audit certificates where relevant. The NAO now also discloses any material business relationships in its audit certificates of the counterparty, where relevant.

4 Our assessment of audit quality

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.

Our recommendations are set out in Section 1.

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

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

Audit Quality Review

FRC Audit Division

June 2017