



National Audit Office

2017/18 Audit Quality Inspection

AQR Report to the Independent Supervisor

19 February 2019

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”). 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. The NAO currently has six (2016/17: three) responsible individuals (“RI”s) authorised to perform statutory audits, three of whom acted as RIs in the 2016/17 audit cycle.

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

This report sets out the key findings arising from our 2017/18 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 1 February 2018 and was conducted in the period from December 2017 to June 2018 at the NAO’s London office.

Scope of our 2017/18 inspection

We reviewed selected aspects of four (2017/18: two) of the NAO’s 46¹ (201/17: 37) Companies Act statutory audits with 31 March 2017 year-ends. As the NAO has increased over time the number of Companies Act entities it audits, we have increased the number reviewed from two to four.

We note however that the number of reviews performed in our inspection is a small, non-statistical sample and may not be representative of the NAO’s Companies Act audit work.

One of the Companies Act audits reviewed was performed on a contracted out basis, whereby another audit firm performs the audit whilst the NAO retains overall responsibility for the audit.

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

- One large financial services audit; and
- Three smaller audits comprising:

¹ The NAO performed 46 Companies Act audits as of 29 September 2017.

- A company providing managed information technology (IT) services;
- A charitable company; and
- A non-profit company which acts as a settlement body for payments.

We also undertook a cyclical review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures") including a review of internal quality monitoring and consultative and engagement quality review ("EQCR") arrangements and a follow-up review of prior year findings. Also, we updated our understanding of policies and procedures where there were changes (for example, concerning the use of "centre of excellence" for pensions audit work). 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 2017/18 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 NAO, including a small number of public interest entity ('PIE') audits, we will continue to consider and evaluate the adequacy of the number of Companies Act audits reviewed in each year.

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 2017/18 review.

Progress made in the year

We recognise the NAO's continuing work to enhance its policies and procedures supporting and promoting audit quality. Examples of this work include addressing lessons learnt from previous AQR reports, improving the scope and coverage of its own internal cold reviews and identifying thematic issues so that these are more effectively embedded within individual audits. Additionally, the NAO has placed more emphasis within its internal training on quality, set quality targets, produced internal guidance on best practice for auditors to apply and dedicated more senior staff involvement across the NAO's audit practice (including for Companies Act audits) and in the NAO's highest risk audits.

The NAO has also increased the number of responsible individuals ("RIs") authorised to perform statutory audits on behalf of the C&AG from three in the 2016/17 cycle to a current establishment of six.

We reviewed the root cause analysis performed by the NAO on the two Companies Act audit reviews assessed as more than limited improvements in the prior year and are satisfied that the NAO has taken appropriate actions. We have seen improvements in relation to certain key findings highlighted in last year's report, in particular aspects of testing of non-IT controls and journal testing. However, we continue to identify findings in relation to the challenge of areas of judgement and obtaining sufficient and appropriate evidence.

The NAO has made a number of improvements to its policies and procedures in the following areas:

- Valuations and estimates: Initiatives and updates included: audit quality initiatives including a training initiative which included a focus on challenging managements' assumptions and revised audit file estimates work programmes.
- IT matters: The NAO has continued to invest in IT specialist resources and expertise, enhanced guidance, methodology, audit procedures, work programmes and templates, training and data analytics tools.
- Establishing centres of excellence for the audit of pensions, property and complex financial instruments to share knowledge and facilitate appropriate challenge.

However, as set out in Section 2, we continue to identify findings in some of these areas.

Summary key findings

Assessment of the quality of audits reviewed

In the 2017/18 inspection cycle we reviewed four Companies Act audits. Of these, three were assessed as good or requiring limited improvements. One audit was assessed as requiring improvements.

We have reviewed the actions proposed by the NAO audit teams, in response to our findings, and are satisfied that these are appropriate.

We have recommended that the NAO continue to perform root cause analysis on the audits where more than limited improvements are required to determine whether any further actions are needed.

Key findings in the current year requiring action

Our key 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.

Individual audit reviews – Companies Act audits

The NAO should:

- Continue to review its internal guidance over contracted out audits, including how the role of the NAO's EQCR is discharged and evidenced so that the responsibility for the direction, supervision and performance of the audit is consistently performed and evidenced on the NAO's files.
- Improve the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates.
- Ensure that IT audit procedures sufficiently evidence work concerning the completeness and accuracy of data.
- Ensure the rationale for judgements made in setting materiality is clearly articulated.

Review of NAO's policies and procedures

The NAO should:

- Enhance the monitoring of its internal system of quality control for CPD, audit fees and audit report practices.
- Continue to monitor the NAO's response to independence threats, concerning outward secondments to audit clients and business relationships.

Good practice identified

Examples of work performed to a high standard that we identified in the course of our work for Companies Act audits included:

- The audit of the financial statement notes was undertaken to a high standard with a working paper for each separate note.
- The audit work performed over the completeness and accuracy testing of employee data used in a pension shortfall provision was well evidenced.

Recommendations to the Independent Supervisor

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 discuss the following matters with the NAO:

- The NAO should continue to review its internal guidance over contracted out audits, including how the role of the NAO's EQCR is discharged and evidenced so that the responsibility for the direction, supervision and performance of the audit is consistently performed and evidenced on the NAO's files; and
- The NAO's continues to perform root cause analysis on the key findings on the audits reviewed requiring improvement to determine whether any additional actions are needed.

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.

National Audit Office redaction note:

In the two paragraphs below X refers the contractor carrying out the audit work on behalf of the NAO. The NAO retains overall responsibility for the audit.

Continue to review its internal guidance over contracted out audits, including how the role of the NAO's EQCR is discharged and evidenced so that the responsibility for the direction, supervision and performance of the audit is consistently performed and evidenced on the NAOs files

The audit of the largest Companies Act audit that we reviewed was performed on a “contracted out” basis with a partner audit firm. Under this arrangement, the partner audit firm performs the audit and issues an audit opinion to the NAO, whilst the NAO retains overall responsibility for the audit. We note that the NAO has no current intention to contract-out other Companies Act audits.

We identified of the following findings where improvements should be made:

In a number of areas, there was insufficient evidence on the NAO audit file of the NAO taking sufficient responsibility for the direction, supervision and performance of X's audit work. In particular, there was no evidence that the NAO team directly scoped or supervised the quality control reviews performed by the X team and the X QRP; the NAO audit team's working papers were insufficiently detailed to evidence their challenge and review of X's audit work on critical judgement areas and the conclusions reached; the X audit file was only signed off as reviewed by the X audit team. There was no evidence on this audit file to show which workpapers were reviewed by the NAO audit team; and there was insufficient evidence that the NAO audit team adequately challenged X's audit work in certain areas, [REDACTED]

In addition, the NAO team should not have relied on X's own quality control procedures. Given the nature of this audit and its risks, the NAO engagement partner and the NAO EQCR should have concluded that it was inappropriate to rely on X's own quality control procedures. The NAO team, including the NAO EQCR should have taken direct responsibility for the quality of the audit work performed by X. In this respect, the audit therefore did not fully comply with the underlying principles and specific requirements of ISA (UK) 220, Quality Control for an Audit of Financial Statements.

Improve the extent of challenge in areas of judgement, in particular 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 identified findings where improvements should be made, in particular the extent to which key assumptions had been adequately identified, considered and challenged to support the valuation of significant assets or the calculation of an estimate:

- There was insufficient evidence of the audit team's assessment and challenge of the reasonableness of certain valuation assumptions and growth rates used to calculate a provision.
- There was insufficient evidence to support aspects of the valuation of certain provisions, including evidence to support the data inputs and to challenge certain assumptions.

Ensure that IT audit procedures sufficiently evidence work concerning the completeness and accuracy of data

An entity's accounting system plays a key role in the recording of transactions and production of accounts. The audit team should perform and evidence sufficient and appropriate procedures over completeness and accuracy of data.

On one audit the audit team performed insufficient procedures over the assessment of the completeness and accuracy of the data inputs to a model which calculated the impairment provisions.

Ensure the rationale for judgements made in setting materiality is clearly articulated

Materiality has a pervasive impact on the audit process, including the auditor's assessment of risks of material misstatement and the extent of audit evidence required in respect of those risks.

On one audit, there was insufficient evidence of consideration of the benchmark used for the materiality calculation given the KPIs used by the audited entity to measure financial performance, notably underlying PBT. The audit team should have evidenced consideration of whether their chosen benchmark was appropriate for the needs of users of the financial statements in the context of management's KPIs.

3 Firm-wide findings

Scope of AQR's work

Our review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures") included a cyclical review of internal quality monitoring, consultation and engagement quality review ("EQCR") arrangements and a follow-up review of prior year findings.

We set out below the key areas where we believe improvements are required to safeguard and enhance audit quality and safeguard auditor independence.

Enhance the monitoring of the NAO's systems of quality control

The NAO have undertaken multiple initiatives to address the ISQC 1 requirement to perform an annual evaluation of the NAO's systems of internal quality control. However, other than through the engagement hot and cold review process, there is a lack of independent testing of firm level processes, particularly regarding meeting ethics, independence and CPD requirements. For example, an individual's CPD is reviewed by their line manager as part of the annual appraisal process but there is no central record or testing that the line manager has reviewed the individual's CPD record and that the required level of CPD has been achieved.

The NAO independently performed a review on their monitoring of the internal system of control in 2017 and identified actions for improvement which were approved in January 2018. We will revisit this area when we assess updates in the next inspection cycle.

Continue to monitor the NAO's response to independence threats

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 inward secondments from audited entities to audit teams have ceased (as of August 2017) 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

Three of the Companies Act statutory audits reviews were assessed as good or required limited improvements.

One of the Companies Act statutory audits reviewed required improvement in certain areas.

We note however that the number of reviews performed in our inspection is a small, non-statistical sample and may not be representative of the NAO's Companies Act audit work.

Our recommendations are set out in Section 1.

5 Future inspections – reporting

As instructed, we 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 overall inspection findings. We are encouraging FTSE 350 audit committees to use the information contained in our private reports to report to shareholders.

The reporting on our inspection work is subject to our agreed terms of reference. We encourage NAO, however, to consider ways in which to increase the transparency of our work, by improving both the communication of our inspection results and related engagement with Audit Committees. In particular, for Companies Act audits of public interest entities, our reporting should be consistent with our inspections of major private sector audit firms, including the addition of actions to our findings to be part of this report. More broadly, we would like to discuss with the NAO the scope for sharing our overall findings with other stakeholders, such as the Public Accounts Commission, the parliamentary body which oversees the activities of the C&AG and the NAO. We will continue to discuss these issues with the NAO.

Audit Quality Review

FRC Audit Division

19 February 2019