Financial Reporting Council

19 February 2019

National Audit Office

2017/18 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 the 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 40 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.

Recent reports published include The Use of Data Analytics in the Audit of Financial Statements (January 2017), Quality Control Review Processes (March 2017), Materiality (December 2017) and Audit Culture (May 2018). 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 2017/18

In addition to reports on our audit quality reviews of the major firms, the FRC intends to publish later in 2018 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.

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1 Overview

Scope of AQR's work

This report sets out the principal findings arising from the 2017/18 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 December 2017 to June 2018 ("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 to provide 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 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. 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 of non-Companies Act audits. 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 2017/18 inspection.

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 2017/18 inspection

We examined selected aspects of seven individual audit engagements, all of which had year-end dates of 31 March 2017.

In the prior year, we reviewed six audits, including two Companies Act audits. 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. As a result, the NAO requested that we reduce the number of non-Companies Act audits that we review from four to three. Therefore, in the 2017/18 inspection cycle we reviewed seven audits in total: four Companies Act audits out of 46 audits performed (prior year: two) and three non-Companies Act audits out of 333 audits performed (prior year: four).[1]

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 overall quality of the NAO's audit work.

Contracted-out audits, whereby NAO retains overall responsibility but contracts with another audit firm to perform the audit, were excluded from the selection process for non-Companies Act audits, as agreed with the NAO. One Companies Act audit selected for review was performed on a contracted-out basis.

The Companies Act audits selected comprised:

- One large financial services audit; and
- Three smaller audits.

The non-Companies Act audits selected comprised:

- One medium sized audit; and
- Two Non-Departmental Public Bodies (NDPBs).

We also undertook a cyclical review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures") including, in this inspection, 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 pensions "centre of excellence"). 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.

[1] The NAO performed 379 audits comprising 333 non-Companies Act audits and 46 Companies Act audits as of 29 September 2017.

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 for 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 requiring 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, obtaining sufficient and appropriate evidence and other IT matters.

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 seven audits, comprising four Companies Act audits and three non-Companies Act audits. Of these, three Companies Act audits and three Non-Companies Act audits were assessed as requiring no more than 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 the current year requiring action by the NAO, which are elaborated further in section 2.

Individual audit reviews

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 data migration and completeness and accuracy of data.
- Ensure the rationale for judgements made in setting materiality is clearly articulated.
- Ensure substantive testing procedures are appropriate to provide a sufficient level of audit evidence.

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.
- Improve the scrutiny of delegated audits by reviewing managers within their first year of acting in this delegated role and increase the number of reviews for managers with delegated audits.
- 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 included:

- Consultation concerning an error evaluation in accruals where the considerations were well evidenced and well documented.
- 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 of employee data used in the pension shortfall provision was well evidenced.
- The audit of the transfer of assets to the Scottish Government which clearly explained and evidenced the considerations made and the conclusions reached on the transfer of Scottish assets and business.

Report to the Independent Supervisor

A separate report was provided to the FRC Board in draft in June 2018 in its capacity as Independent Supervisor of the C&AG's Companies Act statutory audit work and included the following:

Issues for improvement were identified in one of the four statutory audits that we reviewed.

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:

- 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 continues to perform root cause analysis on the key findings on the audits reviewed requiring improvement to determine whether any additional actions are needed.

Future inspections – reporting

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 the 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 those Companies Act audits of public interest entities, we would like our reporting to be consistent with our inspections of major private sector audit firms. 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.

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 the overall responsibility for the audit.

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 to 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.

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

The audit of the largest Companies Act audit that we reviewed this year 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 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.

On three audits, 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 to support the valuation of significant assets or the calculation of an estimate. In particular:

- 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.

- 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.

- The audit team did not obtain valuation reports or evidence their assessment of the external valuers who performed the valuation of certain properties covering four percent of the value of the portfolio.

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

An entity's accounting system plays a key role in the recording of transactions and production of accounts.

We identified findings concerning IT related matters as listed below.

Data reconciliations for the transfer of information to a new system

On one audit, where data was migrated to a new financial accounting system the audit team did not clearly evidence its underlying independent testing of the data reconciliations for financial data that had not been automatically entered into the new accounting system.

Testing the completeness and accuracy of system data

On one audit there was insufficient justification to support the low risk assessment for data inputs and the audit team performed insufficient procedures over the assessment of the completeness of the data inputs to a model which calculated the impairment provisions.

On another audit, we identified an issue concerning the audit procedures to test the completeness of certain report data.

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.

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

Audit teams should obtain sufficient evidence and design and perform appropriate procedures to conclude whether risks have been sufficiently mitigated. We identified a number of discrete issues:

- *Audit approach to revenue* – On one audit a fully substantive approach was performed for recurring revenue from recurring registrations, which the audit file suggests, is highly automated. The audit team did not sufficiently consider volume of income derived from automated processes and the potential impact on the audit approach.

- *Data used in external investment valuations* – On one audit, whilst the auditor's expert performed procedures to confirm the actual valuations used, there was no evidence to demonstrate that audit procedures were performed by the auditor's expert or the audit team to verify the integrity and functionality of the external valuers' models. Further the analytical procedures were performed at too high a level to provide sufficient audit evidence.

- *Selection of sample covering an entire population* – Where an audit sampling approach is adopted, each item should have a chance of selection and should provide the auditor with a reasonable basis on which to draw conclusions about the entire population. On one review, we identified matters relating to assessing the appropriateness of populations selected for testing the testing of investment properties covering four percent of the value of the portfolio.

- *Service organisations* – On one audit there was insufficient evidence of the audit team's assessment of the arrangements in place between the audited entity and the service organisations, including evaluation of service level agreements and other contractual arrangements.

- *Journal testing* – On one audit the audit team used data analytics as part of the work to evaluate journals. The data analytics tool highlighted potentially unusual journals. The audit team should have more clearly justified why potentially unusual journals highlighted by the data analytics tool were not selected for further investigation and testing.

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.

Improve the quality results of delegated audits

The 2016/17 and prior year internal cold reviews identified a higher percentage of unsatisfactory audits where the engagement director had delegated responsibility to an engagement manager. In response, the C&AG met with the teams to discuss these issues and the action needed to address them and the NAO provided additional training and guidance for directors and managers with delegated audits within their portfolio.

The NAO reviews all engagement directors within the cold review process annually. However, audit managers, including those with delegated responsibilities, are reviewed triennially.

The NAO is considering supplying additional support to managers performing delegated audits. Also, in view of the relatively poor audit quality identified for audit managers with delegated portfolios, in addition to the actions the NAO has already taken which include increasing the sample of reviews undertaken, we recommend that the NAO reviews managers within their first year of acting in this delegated role. The NAO should also consider increasing further the number of cold reviews for audit managers with delegated audits, particularly for those where quality issues have been identified.

Continue to monitor the NAO's response to independence threats

The NAO should 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 significant issues relating to secondments (for example, short term loans of staff) to and from audit clients.

  Inward secondments from clients

  An issue in relation to an inward secondment ceased from the end of August 2017 and, as a result, no staff on inward secondment from clients have been engaged within engagement teams relevant to their employer for the 2017/18 audit cycle.

  Outward secondments to audit clients

  We were informed that the NAO uses outward secondments to provide a development opportunity to its staff to expand their skills and experiences. The NAO believes that this enhances skills, supports the quality of its work and helps NAO staff better understand the challenges facing organisations.

  The NAO recognises, however, that there may be a perception that secondments could, in some cases, give rise to potential threats to its objectivity and independence. The NAO has therefore, in light of the revised Ethical Standard, strengthened its review and approval process for all secondments.

We have previously recommended to the NAO to disclose all secondee arrangements in audit certificates unless there are significant reasons not to do so. We were informed that the NAO will disclose in its audit certificates any outward secondments that it considers to be in breach of the ethical standard. Since this time, we were informed that the NAO has had only one outward secondment to a client body. As the NAO considered the nature of this secondment to be low-risk, it did not consider this was an ethical breach, which required disclosure in the audit certificate.

- Business relationships

  As noted in our previous inspections, three NAO business relationships relate to the sub-letting of part of the NAO building. None of these are significant to the NAO, but one is for the client.

  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 and 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.

  Further, during 2018, we were informed that the NAO has received a number of enquiries from clients to lease office space from the NAO which had become free following restructuring. The NAO has confirmed that it will only enter into such arrangements where they are entered into on an arm's length basis and where the amounts involved are not material to either party. Where such arrangements are entered into, the NAO's policy is to ensure that appropriate safeguards are implemented to mitigate any perceived residual threat to independence.

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

19 February 2019

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 are 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.