Financial Reporting Council

28 June 2019

National Audit Office

2018/19 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.

We review selected aspects of a sample of Companies Act audits performed by the National Audit Office ("NAO"). Additionally, the NAO commission the AQR to adopt a similar programme of work in respect of its non-Companies Act 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.

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.

The most recent reports published are Audit Culture Thematic Review (May 2018) and Other information in the Annual Report (December 2018). This can be found on the FRC's website. Certain of these thematic findings may be of interest to the NAO.

Developments in Audit Quality 2018/19

In addition to reports on our audit quality reviews of the major firms, the FRC intends to publish in 2019 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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Purpose of this report

This report sets out the principal findings arising from the 2018/19 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 within the period from March 2018 to March 2019 ("the time of our inspection"). Our field work concluded in April 2019. 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 and which perform a public function 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, 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 5 February 2019. It included reviewing the performance of the NAO's Companies Act audit work on behalf of the Independent Supervisor (a Statutory responsibility) and the review of the NAO's audit work supporting their opinion on the financial statements of non-Companies Act audits (carried out on a contractual basis). The NAO's audit work supporting its regularity opinion is not within 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 note the co-operation and assistance received from NAO engagement directors and staff in the conduct of our 2018/19 inspection.

Scope of our 2018/19 inspection

We examined selected aspects of seven individual audit engagements, all of which had year-ends dated 31 March 2018. We reviewed four Companies Act audits out of 62 audits performed (prior year: four out of 46 audits) and three non-Companies Act audits out of 346 audits performed (prior year: three out of 333 audits).[1] The NAO audits five public interest entities.

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, where 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. In the year to 31 March 2018, there were no Companies Act audits performed on a contracted-out basis. The reviews covered audits of varied complexity and size.

The Companies Act audits selected comprised one large company and three smaller companies.

The non-Companies Act audits selected comprised:

- A large Department;
- An executive non-Departmental Public Body (NDPB); and
- A charitable NDPB.

We also undertook part of a cyclical review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures") including a review of complaints and allegations arrangements, engagement director and staff matters and a follow-up review of prior year findings. Additionally, we updated our understanding of policies and procedures where there were changes (for example, NAO guidance on information produced by the entity). 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 appear to have contributed to improvements in audit quality.

Given the increased number and complexity of the NAO's Companies Act audits, 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 each year.

We will also continue to consider and evaluate the adequacy of the number of non-Companies Act audit reviewed on a voluntary basis.

[1]The NAO performed:
- 408 audits as of 30 September 2018 comprising 346 non-Companies Act audits and 62 Companies Act audits; and
- 379 audits as of 29 September 2017 comprising 333 non-Companies Act audits and 46 Companies Act audits.

1 Overview

Summary of key findings

Assessment of the quality of audits reviewed

The overall results of our reviews of the NAO's audits have declined from the previous year, with four of seven assessed as requiring more than limited improvements, compared with one of seven in 2017/18. Two Companies Act audits and two non-Companies Act audits were assessed as requiring improvements. Two Companies Act audits and one non-Companies Act audit were assessed as requiring no more than limited improvements. Across the reviews, there are a number of findings that the NAO needs to address.

The NAO should consider if the lessons learned from root cause analysis on the current year's inspection findings could be better communicated and addressed. The root cause analysis should consider why, given the improvements the NAO has made, the overall results have declined from last year.

Our key findings in the current year requiring action by the NAO are elaborated further in section 2 and those relating to processes and procedures supporting audit quality ("firm-wide procedures") are set out in Section 3.

Key findings in the current year requiring action

<u>Individual audit reviews</u>

The key individual review findings related principally to:

- Improving the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates.
- Ensuring substantive testing procedures are appropriate to provide a sufficient level of audit evidence in relation to revenue and inventory.
- Continuing to review internal guidance over group audits, including how the group audit team evidences their direction, oversight and review of a component auditor.
- Improving the testing of high-level controls and ensuring that any weaknesses are compensated by enhanced substantive testing.

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

The firm-wide issues identified concerned:

- Continuing to improve the quality results of delegated audits.
- Continuing to monitor the NAO's response to independence threats, concerning business relationships.

Good practice examples identified

We set out below examples where we noted good practice on audit work on individual engagements:

- Risk assessment and scoping of contracts in the audit of revenue and inventory on one audit. In particular, there was good evidence to support the audit team's judgements in these areas.

- The audit team's consultation and the response received after an internal technical panel on an accounting treatment on one audit.

Progress made in the year against last year's findings

We recognise the NAO's continuing work to enhance its policies and procedures supporting and promoting audit quality. Examples include addressing lessons learnt from previous AQR individual review 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.

The NAO has also increased the number of responsible individuals ("RIs") authorised to perform statutory audits on behalf of the C&AG to seven (2017/18: six).

We recommended, in our previous report, that the NAO perform root cause analysis on the Companies Act audit review assessed as requiring more than limited improvements. The findings on this review included how the role of the NAO's EQCR was discharged and evidenced so that the responsibility for audit direction, supervision and performance is consistently performed and evidenced on the NAO's files for contracted-out audits.

The NAO performed root cause analysis on this and carried out reviews on three wider thematic areas:

- Contracted-out audits, in consideration of the prior year AQR review findings on a Companies Act contracted review and to address internal concerns raised by the NAO over contracted-out audits.

- Delegated audits for non-Companies Act audits, given the lower NAO internal cold review scores.

- What leads to a "good" audit.

We reviewed the NAO's root cause analysis performed on the prior year findings and are satisfied that the NAO has taken appropriate actions based on that root cause analysis.

Report to the Independent Supervisor

A separate report dated 28 June 2019 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:

- Issues for improvement were identified in two 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 NAO:

- The NAO's response to the principal issues resulting in Companies Act audits being assessed as requiring improvement in the 2018/19 inspection.

- The need for the NAO to continue to perform root cause analysis on the key findings on the audits reviewed, in particular those requiring improvement to determine whether any additional actions are needed.

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

Reporting and future inspections

Developments in Audit

There are a significant number of emerging developments in the public and private audit market, including:

- An independent review of the FRC led by Sir John Kingman published in December 2018;

- A study of the statutory audit market by the Competition and Markets Authority published in December 2018;

- An independent review led by Sir Donald Brydon focusing on the quality and effectiveness of audit; and

- A report on the future of audit published by the BEIS Parliamentary Strategy Committee.

Recommendations from these reviews will be considered by Parliament which may impact the scope and reporting of our future inspections.

Future inspections – reporting

We report privately to the NAO on each audit reviewed and on our overall inspection. In respect of our statutory work on Companies Act audit inspections, we will continue to report to the FRC Board (in its capacity as the Independent Supervisor).

As noted, for a number of years, 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 continue 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, especially as responses to various review recommendations, such as those made by Kingman, develop.

2 Key findings for Companies Act statutory audits and non-Companies Act audits

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 and in relation to certain less significant matters.

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 of areas of judgement. Effective audit teams will critically evaluate management's key assumptions, comparing them to available audit evidence and, where appropriate, challenging management to justify the basis of those assumptions. Audit teams should also consider contradictory evidence in assessing valuations and estimates.

We identified findings on two audits 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.

On one audit, there was insufficient evidence that appropriate procedures were performed on the year-end valuation of financial investments. In particular:

- Further roll-forward evidence should have been obtained to assess potential volatility of the fair value of investments between 31 December 2017 (the date of the last audited financial statement) and 31 March 2018 (the year-end date). Also, where the audit team relied on audited information which did not include signed audit reports, the audit team should have evidenced why it was appropriate to rely on that information.

- There were weaknesses in the impairment assessment of loans and receivables. In particular, the audit did not appropriately corroborate and challenge the facts, information and assertions used by management in their impairment assessment on the recovery for certain loans. There were also insufficient audit procedures performed over the completeness and valuation of certain loan provisions.

On one audit, where reliance was placed on valuations performed by external fund managers, in the role of management's experts, there was insufficient evidence to support the year-end valuation of financial assets in several areas, including:

- There was insufficient evidence of the audit team's assessment of the nature of the underlying fund investments and the related valuation risks.

- The assessment of the managers' significant assumptions and valuation methods was insufficient.

- Insufficient procedures were performed over the valuation movement from 31 December 2017 to the year-end in two cases. Insufficient evidence was obtained for two managers where no audited financial statements were available.

- There were weaknesses in the impairment assessment of financial assets. In particular, the audit team did not sufficiently challenge management as to whether they should have impaired any of the financial assets. Testing for objective evidence of impairment should have been performed at a more disaggregated level.

Ensure substantive testing procedures are appropriate to provide a sufficient level of audit evidence in relation to revenue and inventory

Audit teams should obtain sufficient evidence and design and perform appropriate procedures to conclude whether risk of material misstatement has been sufficiently mitigated. We identified a number of weaknesses in revenue and inventory audit procedures, including the following on one or more audits:

Revenue

- *Evaluation of the revenue population* – the audit team did not evaluate the population of income with significant risks appropriately by not identifying that four of 75 samples unrelated to true income transactions were selected and tested.

- *Cut off testing* – the audit team did not perform sufficient audit procedures over year-end revenue cut-off.

- *Completeness testing* – insufficient audit procedures were performed to confirm the completeness of revenue as the audit team's testing focused on year-end balances.

- *Testing of revenue accounting policies* – insufficient testing was performed on revenue transactions subject to a specified recognition policy to assess whether the policy was appropriately applied.

Inventory

- *Existence testing* – the audit team did not perform sufficient procedures over the existence of stock.

- *Valuation testing* – the audit team did not perform sufficient procedures over the valuation of stock to conclude that stock was appropriately held at the lower of cost and net realisable value.

Other areas

We identified other discrete substantive testing issues in the following areas on one or more audits:

- *Expenditure testing* – the audit team did not clearly evidence reconciling adjustments to the population subject to detailed testing. Furthermore, the audit team did not appropriately consider the timing of payments around the balance sheet date when assessing and responding to cut-off risk for expenditure.

- *Substantive analytical review* – there was insufficient verification of the current year HR data provided to the third-party payroll provider that was used as a basis for the independent expectation.

- *Journal testing* – the audit team did not perform sufficient procedures to assess the completeness of manual journals. On one of these audits, the audit team did not evidence their rationale for selecting a sub-sample of 20 journals from the population of journals that were identified to be higher risk. On one of these audits, there was insufficient evidence that the selection of journals adequately considered attributes demonstrating characteristics of fraud.

Continue to review internal guidance over group audits, including how the group audit team evidences their direction, oversight and review of a component auditor

On one audit, there was insufficient evidence of the group audit team's direction of the component audit team and there was a lack of clarity of the group audit team's oversight. In particular:

- The group audit team did not appropriately calculate and communicate a component materiality to the component audit team.

- There was no evidence of the group audit team's challenge of the component audit team's risk assessment (in particular, the significant risk of revenue cut-off).

- There was no evidence of the group audit team's discussions with, and challenge of, the component audit team during audit.

- The group audit team did not fully evidence their consideration of why it was appropriate not to review work papers for a significant component.

Improve the testing of high-level controls and ensure that any weaknesses are compensated by enhanced substantive testing

We identified the weaknesses in the testing of the operational effectiveness of higher-level controls on more than one audit:

- The audit team should have evidenced consideration of the completeness and accuracy of information used in the controls; the judgements, criteria and thresholds applied when performing monthly reviews; what types of errors and misstatements were expected to be identified and how these would be investigated and corrected.

- There was insufficient evidence to support the effectiveness of the control for the three months selected for testing. The substantive testing performed at minimum assurance levels therefore provided insufficient assurance over expenditure.

3 Firm-wide findings

We set out below the key areas where we believe improvements are required to safeguard and enhance audit quality and safeguard auditor independence identified from our firm-wide procedures.

Continue to improve the quality results of delegated audits

The NAO allows internal delegation of the engagement director role responsibility to an engagement manager on certain non-Companies Act Audits. There has been some improvement in the results of delegated audits on internal cold reviews. The internal quality review results for delegated audits, however, continue to be lower than the results for non-delegated audits for audits reviewed with year-ends ending March 2018 (and in particular, for follow-up reviews). In response, the NAO provided additional training and guidance for those directors and managers with delegated audits in their portfolio.

The NAO introduced a requirement that an audit may not be delegated to an individual until they have been in the relevant grade for a year. This policy will impact audits with a year-end of March 2019 and did not apply to the 2017-18 audits. Other actions for delegated audits included:

- Updating the categorisations which the NAO use for segmenting its client portfolio which will feed into decisions around the delegation of audits.

- Expanding the range of models available for delegated audits, including delegating parts of an audit.

The NAO reviews all engagement directors within the cold review process annually. The NAO reviews managers within their first year of acting in this delegated role. However, audit managers, including those with delegated responsibilities, are reviewed at least every three years.

The NAO should also consider continuing to increase the number of cold reviews for audit managers with delegated audits, particularly for those where quality issues have been identified.

For 2017-18 audits, the NAO introduced an additional consideration in respect of follow-up action on poor quality audits. Where an audit manager had delegated responsibilities on a review with an unsatisfactory rating in the prior year, the NAO included a specific consideration whether to perform a full cold review on another of their audits in the current year. These reviews were in addition to the follow-up review on the audit that received the unsatisfactory rating.

Continue to monitor the NAO's response to independence threats, concerning business relationships

The NAO should have policies and procedures to maintain auditor objectivity and independence in compliance with the Ethical Standard. Insufficient or inappropriate safeguards could compromise the NAO's objectivity and independence.

Business relationships

There has been no change in the existing business relationships that the NAO has with three tenants which lease part of the NAO building and which are audited by the NAO. The NAO continues to disclose leasing arrangements of its London headquarters building in its Annual Report and Accounts. In May 2018, however, the NAO let a further part of its building to an operational hub managed by a Government department. None of these leases are significant to the NAO, but one is for the client and is therefore a breach of the Ethical Standard.

We have previously brought this matter to the NAO's attention 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 an ethical breach as there is no provision for permitting the transaction within the Ethical Standard. However, the NAO has disclosed these arrangements in the one audit certificate where these arrangements are material to the counterparty (from 2016/17 onwards).

The NAO has confirmed that it will only enter into such arrangements 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

28 June 2019