3 August 2020

National Audit Office

2019/20 Audit Quality Inspection

The FRC

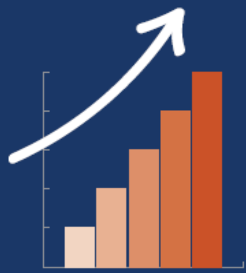
Our purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them.

We have responsibility for the public oversight of statutory auditors.

The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.

AQR

We monitor the quality of UK Public Interest Entity audits.

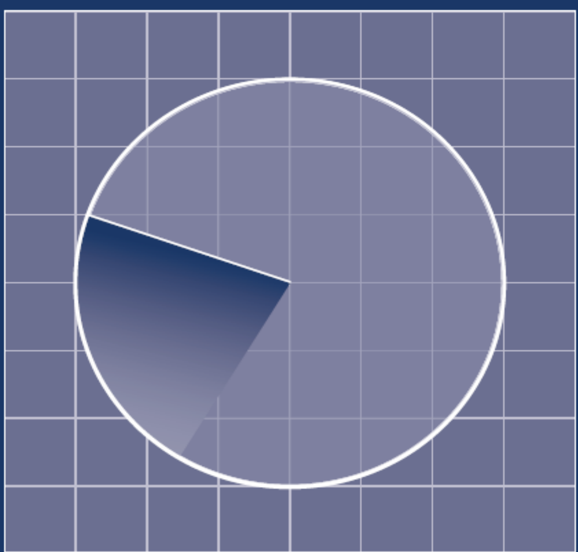


We promote continuous improvement in audit quality.

Our team of over 50 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.

The NAO

We reviewed four out of 70 Companies Act audits performed and three non-Companies Act audits out of 336 audits performed. The NAO audits five public interest entities.

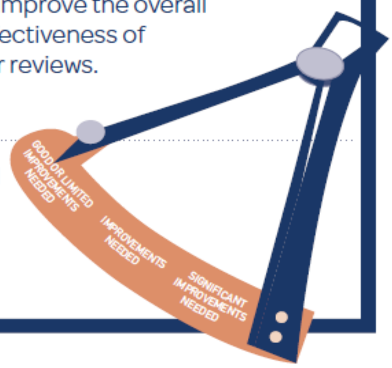


Our inspection process

There are around 3,000 audits within the scope of AQR inspection. Of these, we inspected 130 audits in 2019/20, including seven at the NAO.

We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of the audit work inspected.



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Purpose of the report

This report sets out the principal findings arising from the 2019/20 inspection of the National Audit Office (the “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 2019 to March 2020 (“the time of our inspection”). Our fieldwork concluded in April 2020. We inspect the NAO and report our findings privately to the Comptroller and Auditor General (“C&AG”), as head of the NAO, annually.

The C&AG audits under statute the financial statements of all central government departments, agencies and other public bodies and reports the results of these audits 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 performs audits of the financial statements of certain government-owned companies, registered under the Companies Act, 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 within the NAO form an opinion, on behalf of the C&AG, on 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 12 November 2019. It included reviewing the performance of the NAO’s Companies Act audit work on behalf of the Independent Supervisor (a statutory responsibility) and of the NAO’s audit work supporting its opinion on the financial statements of non-Companies Act audits (which we carry 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 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 consider whether action under the FRC's enforcement procedures is appropriate as follows:

- *Statutory audits*[1]

  If an NAO audit is assessed as requiring improvements or significant improvements, the FRC can consider whether the C&AG is guilty of Relevant Conduct under the Auditor General Disciplinary Rules 2012. Relevant conduct means conduct by the C&AG in the course of the performance of their function as a statutory auditor which demonstrates a level of competence which falls short of that expected of an Auditor General taking into account the relevant circumstances or which falls short of the standard of expected of an Auditor General.

  Under those Rules the FRC's Conduct Committee can impose a Disciplinary Order on the C&AG, which includes any one or more of a Fine, a Reprimand, or a recommendation to the FRC Board in its capacity as Independent Supervisor of the C&AG to consider issuing a Suspension Notice or a report to the FRC Board that the C&AG has failed to comply with an obligation imposed on the office by virtue of Part 42 Companies Act.

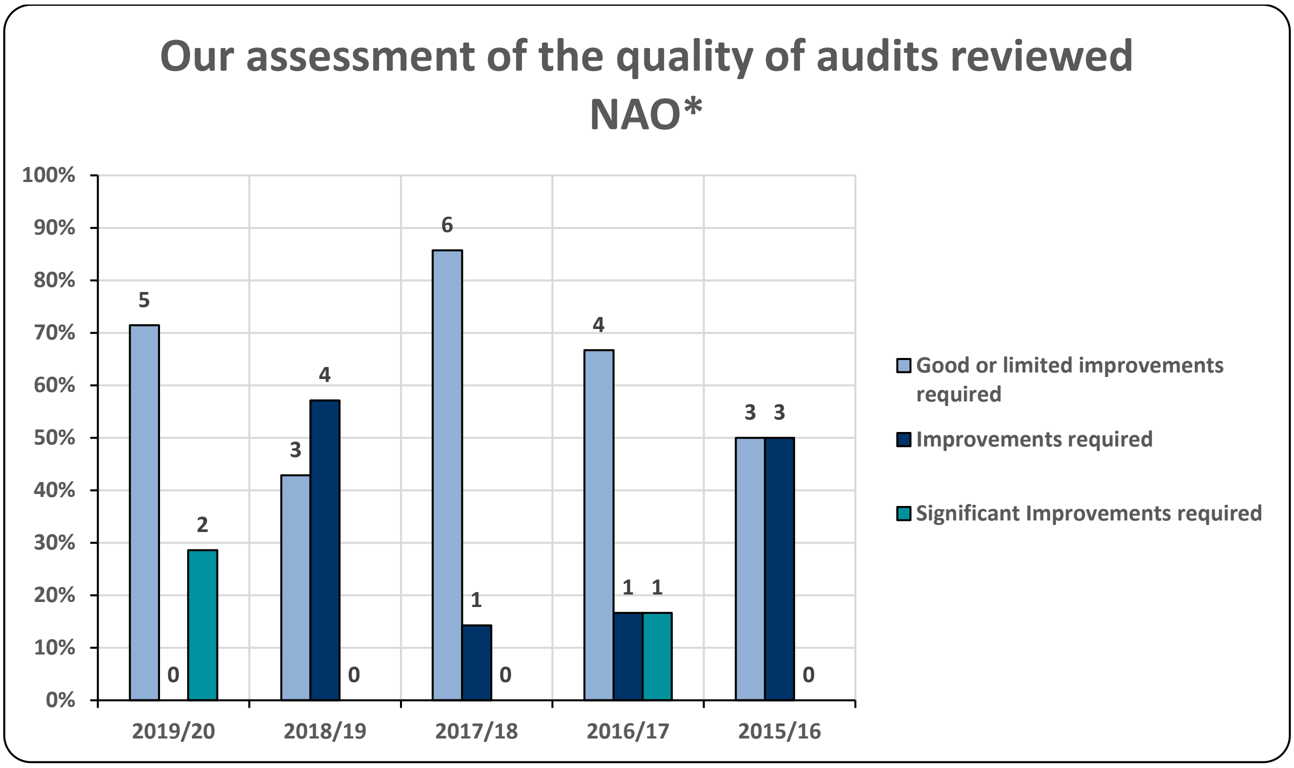
  In practice, NAO audits assessed as requiring significant improvement, and some of those assessed as requiring improvement, are referred to the FRC's Case Examiner for consideration of further appropriate action. This can include either or both of action against the C&AG under the above Rules or action against relevant statutory auditors in the NAO under the Audit Enforcement Procedure.

- *Non-statutory audits*[2]

  The FRC monitors the audit quality of non-statutory audits performed by the NAO, by arrangement. Those arrangements are limited to providing audit quality monitoring and do not extend to providing enforcement or disciplinary measures.

[1] Statutory audit appointments: statutory audit appointments as defined by the Companies Act.

[2] Non-statutory appointments: related to all other audit work undertaken by the C&AG as prescribed under other statute.



*An audit is assessed as good or limited improvements required where we identified either no or only limited concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more issues. Significant improvements required indicate we had significant concerns, typically in relation to the sufficiency or quality of audit evidence or the appropriateness of key audit judgements.

The number of audits reviewed increased from six to seven in the 2017/18 inspection.

The table refers to the FRC inspection year, rather than the financial year being audited (for example, the 2019/20 column refers to the NAO's audits of 2018/19 financial statements)

Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across the NAO's entire audit portfolio; nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at the NAO. Nonetheless, any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

1. Overview

NAO overall assessment

We reviewed seven individual audits this year (four Companies Act and three non-Companies Act audits) and assessed 71% of them as requiring no more than limited improvements, compared with 43% in 2018/19. One Companies Act audit and one non-Companies Act audit were assessed as requiring significant improvements.

The NAO has taken steps to address the key findings we highlighted in our 2018/19 report. These steps included enhancing guidance over group audits, including how the group audit team evidences their direction, oversight and review of a component auditor, clarifying audit work programmes so that audit teams do not deviate from the NAO's approved methodology and removing the concept of reliance on high-level controls. In the current year's inspection, there were no significant findings in these areas. The NAO has also increased the depth and extent of planning consultations to enhance the risk identification and the audit response. We have however, identified unclear or inadequate risk assessments on two audits and, in response, these have consequently impacted on audit work and our key findings. We also recommended that the NAO perform root cause analysis on the audits reviewed and assessed as requiring more than limited improvements and the NAO has undertaken such reviews.

The recurring finding that most contributed to this year's inspection results on individual audits related to the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates, including the audit work on the valuation of financial instruments and the allowance for expected credit losses for loans. In two instances, this contributed to our assessment of the audits requiring significant improvement. Efforts have been made by the seven largest audit firms that we inspect to embed further a culture of challenge. We would encourage the NAO to consider what cultural changes are needed within the NAO to improve challenge in areas of judgement and estimates.

We have also highlighted in this report aspects of the NAO's firm-wide procedures which should be improved, including improving the quality of the NAO's delegated audits following the results of its own internal quality monitoring.

In December 2019, we published on our website a letter that was written to the major audit firms setting out elements that we observe consistently on high quality audits, especially on high risk engagements. The hallmarks of such audits include:

- Significant involvement of partner and other senior team members.
- Good use of specialists.
- Consultation on complex areas.
- Challenge of management leading to changes where assumptions are too optimistic.
- Robust quality control procedures.
- Clear and timely communication to Audit Committees.

This letter is relevant to the NAO's audits and our recurring findings. We have identified issues in these areas on audits needing improvement in the current and prior year inspections, including use of specialists, challenge of management's assumptions and quality control procedures.

In respect of the two audits requiring significant improvement, the NAO needs to undertake a deep and robust root cause analysis to identify and address the causes of our findings. We will closely monitor and assess the promptness and effectiveness of the NAO's actions to address the findings raised.

Scope of our 2019/20 inspection

We examined selected aspects of seven individual audit engagements, all of which had year-ends dated 31 March 2019. We reviewed four Companies Act audits out of 70 audits performed (prior year: four out of 62 audits) and three non-Companies Act audits out of 336 audits performed (prior year: three out of 346 audits).[3] The NAO audits five public interest entities and one of these was included in our sample.

Contracted-out audits, where the 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 2019, there were no Companies Act audits performed on a contracted-out basis.

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 Agency and a charitable non-Departmental Public Body (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 acceptance and continuance, methodology changes and training, and ethics and independence matters.

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.

We currently 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 also report to the FRC Board (in its capacity as the Independent Supervisor).

As noted in previous reports, because of the statutory position of the C&AG, our reporting to the NAO differs from that to the major audit firms where we send private reports on each inspection directly to the chair of the audit committee and issue a public report on our overall inspection findings. Our more limited reporting to the NAO on our inspection work is subject to agreed terms of reference.

We continue to encourage the NAO to increase the transparency of our reports, by improving both the communication of our inspection results and related engagement with audit committees. In particular, for those Companies Act PIE audits, we would recommend that our reporting is consistent with our inspections of major audit firms.

As part of our inspections of major audit firms we are moving ahead with plans to increase the transparency of our audit quality assessments by publishing the scope and key findings of each of our individual audit inspections. We plan to publish our first set of these reports next year, where we

[3] The NAO performed:
- 406 audits as of 3 October 2019 comprising 336 non-Companies Act audits and 70 Companies Act audits; and
- 408 audits as of 30 September 2018 comprising 346 non-Companies Act audits and 62 Companies Act audits.

have obtained the consent of the audit firm and the audited entity, alongside these annual reports on each of the largest audit firms.

In this context, we will continue to discuss with the NAO the scope for sharing our overall findings with other stakeholders, such as the Public Accounts Commission, the Parliamentary select committee which oversees the activities of the C&AG and the NAO. We will continue to discuss these issues with the NAO, as part of the Government's response to the recommendations made by Sir John Kingman in December 2018 and the Redmond review when published.

In the meantime, the NAO has already taken steps to enhance further the transparency of its work. It continues to publish the overall results of our inspection within its annual Transparency Report and also makes available our annual report to the C&AG on its external website. We understand it will also consider a timeline to determine whether it is appropriate to report the results of individual inspections to the relevant audit committee, taking into account the independence of the C&AG from the bodies he audits on behalf of Parliament, and from when this might be implemented.

We recognise the challenges posed currently by the Covid-19 pandemic, both in relation to the level of uncertainty surrounding forward estimates and projections, and the inability to carry out physical procedures (for example, stocktakes). We will consider such matters carefully during our 2020/21 inspection cycle.

Developments in audit regulation

The past year has seen a number of reports published, including those from Sir Donald Brydon, Sir John Kingman, on the future of the audit profession and the FRC. In addition, Sir Tony Redmond is due to issue recommendations in Autumn 2020, and his review may contain findings relevant to more than his initial brief.

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

Reviews of NAO individual audits

Our key findings related principally to the need to:

- Improve the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates, including the audit work on the valuation of financial instruments and the allowance for expected credit losses for loans.

- Strengthen the assessment of and evaluation of work performed by internal/external experts and specialists.

- Ensure testing procedures provide a sufficient level of audit evidence in relation to the balance or transactions being tested.

- Review the application of internal guidance over quality control so that quality control is consistently performed and evidenced.

Good practice observations

We identified examples of good practice in the audits we reviewed, including the following:

- NAO IT audit specialist involvement in revenue reconciliation testing.
- Evidence of interaction between the core audit team and internal experts in the audit of defined benefit pension obligations.

Further details of our findings on our review of individual audits are set out in section 2, together with the NAO's actions to address them, as well as details of good practices identified in those audits.

Review of central policies and procedures to ensure audit quality ("firm-wide")

This year, our firm-wide work focused primarily on the following areas:

- Acceptance and continuance ("A&C") procedures
- Methodology changes
- Training
- Ethics and independence matters

Our key firm-wide findings in these areas related principally to:

- More closely monitor independence threats, concerning business relationships and develop improved responses
- Further consider actions where NAO staff members covered by the Ethical Standard join an entity audited by the NAO
- Improve the results of delegated audits reviewed in internal quality monitoring

Good practice observations

We identified examples of good practice in our review of firm-wide areas, including the following:

- Follow-up actions in cases of non-compliance of training.
- Embedded annual A&C processes within the NAO's audit files.

Further details of our findings of these firm-wide areas are given in section 3, together with the NAO's actions to address them.

Root Cause Analysis

Thorough and robust Root Cause Analysis (RCA) is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

The NAO has been performing RCA for a number of years on AQR reviews. The NAO is planning to perform root cause analysis in respect of our current year findings, and we will consider the outcome in our next year's report.

Our observations include:

- In comparison with the seven largest firms that we inspect annually, the NAO's RCA process is slower. The NAO should develop their vital root cause analysis processes to identify areas for improvement and implement change on a more timely basis.
- The NAO should perform RCA on reviews that are identified as needing improvement from its own internal quality monitoring process.
- RCA should be performed on individual internal and external reviews that were identified as good audits to promote consistency of good practices.
- Further analysis should be undertaken where the RCA identifies that the cause for the finding related to lack of staff resource.

NAO's internal quality monitoring results

This year we have included summary results of the NAO's internal inspection results. We consider that these results provide additional relevant information in relation to the assessment of the NAO's audit quality.

The results of the NAO's internal inspection results are set out in appendix 1.

2. Review of individual audits

We set out below the key areas where we believe improvements are required to enhance audit quality. We asked the NAO to provide a response setting out the actions it has taken or will be taking in each of these areas.

Improve the extent of challenge in areas of judgement, in particular for key assumptions used in valuations and estimates, including the audit work on the valuation of financial instruments and the allowance for expected credit losses for loans

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.

The valuation of loans, financial instruments, and expected credit loss in financial services entities, involves significant management assumptions and estimation uncertainty. Audit teams should perform audit procedures responsive to the judgements made, including reviewing key assumptions and inputs into the valuation process.

Key findings

We identified findings on three audits where improvements were required, in particular the extent to which audit teams had adequately identified, considered and challenged the key assumptions to support the valuation of significant assets or the calculation of an estimate.

- On one audit, the audit team did not perform appropriate procedures over the key judgements, assumptions and valuation methodology used for loans held to fair value and the valuation models used by management to verify the appropriateness of loan valuations.

- On the same audit, the audit team did not appropriately understand and assess the provision recorded and key assumptions used in setting the provision for expected payments to be made under financial guarantees.

- In one instance, the audit team did not obtain sufficient evidence, including work over key assumptions used, to conclude on the valuation of certain plant, property and equipment assets, given the degree of judgement involved in determining the value of these assets.

- On two audits the audit team did not adequately justify the basis for its risk assessment or why a significant risk was not identified, given the size of the relevant balance and degree of judgement and estimation uncertainty of the asset or estimate.

- In estimating expected credit losses on two audits, there were insufficient audit procedures or evidence retained to assess the reliability of some of the models used to calculate the provision or the appropriateness of certain assumptions.

- We identified on one audit, a number of concerns with the audit of key aspects of the entity's allowance for expected credit loss. The audit team did not perform appropriate procedures to assess management's methodology and did not perform procedures over management's models, key inputs and assumptions used to verify the appropriateness of the provisions. On the same audit, we identified issues relating to risk assessment and testing performed over the classification and measurement of loans.

- On one audit, there was insufficient evidence to support the audit team's consideration of the expected credit loss for intra-group receivables when assessing their recoverability.

  The NAO needs to strengthen its methodology, including in relation to IFRS 9, and guidance to audit teams to achieve consistent, high quality audit work, in particular to ensure a consistent and robust approach to the audit of larger, more complex entities.

NAO's actions

We agree we need to do more to further strengthen our methodology and guidance to audit teams. We will produce a Quality Plan to consider additional measures we will need to take forward to instil more of a cultural shift in embedding quality across all our financial audit work and within our teams and to address any barriers which might impede us achieving this aim.

We are also taking steps to further improve the quality of our work, for example:

- Audit Planning Consultation Meetings (APCMs) are a key component of our quality process for our more risky and complex audits and provide an early opportunity for engagement teams to consult on aspects of the audit. In previous years, APCMs were organised for each Director portfolio and typically focused on the significant components of a departmental group. In 2019/20, this process was enhanced so that the NAO's Executive Directors led APCMs for all our high-risk audits. Also, for these audits, the prior period financial statements and the current period external audit plan were reviewed by our Financial Audit Practice and Quality Team.

  In addition, Director led APCMs were introduced during 2019/20 for all medium-risk audits. which cover a review of the prior period financial statements and the current period audit plan by an Engagement Director and Manager independent of the audit team. All APCMs specifically considered the identification of risks and the team's planned response to identified significant risks (including planned use of specialist support and engagement with centres of expertise).

- In response to the AQR's findings relating to our evidence around expected credit losses, we issued further guidance to those teams which audited material receivables, contract assets or other amortised cost financial assets. This guidance supports audit teams in challenging management, evidencing their challenge and obtaining sufficient appropriate audit evidence to support the conclusions reached.

- Our Estimates Centre of Expertise is developing our approach for adopting the revised ISA (UK) 540 from the 2020-21 audit cycle which, in itself, will lead to greater challenge of assumptions underpinning estimates.

- Our autumn and spring financial audit updates, which are mandatory for all staff, covered several topics focused on enhancing the quality of our audits, including:

  - Internal and external quality findings and areas for improvement;
  - Specialist support for teams relating to IT, property, pensions and estimates;
  - Emphasis on the importance of audit quality and the need to be sceptical in evidencing our challenge of management;
  - Discussions and exercises focusing on materiality, risk assessment, non-coterminous year-ends, estimates, revenue, group audits, controls and use of managements experts.

Strengthen the assessment of and evaluation of work performed by internal/ external experts and specialists

Audit teams often use internal specialists (working as part of the audit team) or experts (reporting to the audit team) in technical areas or those requiring estimation or judgement. Management often engage external experts in similar areas to provide independent valuations. Audit teams should assess and evaluate the objectivity and capability of the specialist/expert and determine if the conclusions and outcome of their work addresses the risks identified.

Key findings

We identified issues regarding the assessment and evaluation of the work performed on two audits reviewed, where the audit teams engaged internal specialists/experts or relied on management's experts (in areas including inventory and property valuations):

- In one case, the audit team's procedures around inventory assets were not appropriate and did not provide sufficient evidence to conclude that the valuations were materially correct. In particular, the audit team did not evidence how it considered the impact of the methodology shortcomings identified by the auditor's expert.

- We identified on one audit that the audit team did not perform sufficient procedures to evaluate the work of management's external expert over the appropriateness of the property, plant and equipment valuation. In particular the team did not demonstrate sufficient challenge over the expert's work or assess the results of the accreditation test and inspections over the machinery used in formulating a key assumption in determining the value of the asset.

  In addition, the audit team did not demonstrate that it had the necessary skills and expertise to evaluate the expert's work, specifically the data inputs and key assumptions used, and therefore did not perform sufficient work to rely on the data in the report issued by the expert.

Ensure testing procedures provide a sufficient level of audit evidence in relation to the balance or transactions being tested

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 operating income, property, pension assets, project finance contracts and credit loss disclosure audit procedures, including the following on one or more audits:

- On one audit, the audit team did not perform adequate substantive audit procedures over operating income, a material account area.

- On one audit, there was insufficient evidence to support the audit team's conclusions on property valuations.

- In one case, the audit team did not perform any testing over the valuation of the pension assets and on another audit did not obtain sufficient evidence to confirm that the controls at the manager of pension assets were operating effectively throughout the year. The audit team did not obtain, review and conclude on the manager's up-to-date service control reports before placing reliance on their internal controls.

- There was insufficient evidence on one audit as the audit team did did not consider or assess the total impact of management's methodology error across the population of all project finance contracts. In addition, insufficient evidence was obtained to conclude on the valuation of the remaining project finance contract obligations, in particular the impact of the management's methodology error.

- In another case, the audit team did not sufficiently evidence its consideration of the accuracy and completeness of expected credit loss disclosures in the financial statements.

NAO's actions

We issued guidance to audit teams setting out emerging quality findings from both internal and external quality reviews. This set out important actions that engagement teams must take to ensure audits currently underway meet the required quality standards in relation to material account areas assessed as low risk and service control reports where reliance is being placed on their internal controls.

A new mandatory work audit work programme was issued for all financial auditors setting out the minimum expected level of work for material accounts areas considered to be low risk and additional guidance was included in our Spring 2020 Assurance Training, mandatory for all financial staff.

In response to quality monitoring findings on the use of experts, we issued further guidance regarding when an expert is to be considered and what to do if an expert identifies issues. All Engagement Directors were required to consider its requirements and report to the NAO's Financial Audit Practice and Quality Team (FAPQ) to confirm their consideration of potential issues.

In response to the potential impact of Covid-19, we have issued guidance setting out judgements made on Covid-19 that might impact audits, reporting implications, macroeconomic implications arising from Covid-19, guidance on the audit of pensions, property, investments, going concern and disclosures and direct intervention by FAPQ on audits with material inventory balances.

Review the application of internal guidance over quality control so that quality control is consistently performed and evidenced

A clear and detailed quality review should be performed to enable the audit team to conclude that it has performed an appropriate level of audit work to support its conclusions. The audit team should clearly evidence the audit procedures performed, the key judgements made, and conclusions reached. These requirements are a hallmark of a quality audit.

Key findings

On one audit, given the number the issues identified across a number of audit areas, the quality control and review procedures applied were not effective in ensuring that the audit work, as evidenced, fully supported the conclusions reached.

Shortcomings in quality control procedures failed to identify and address a number of our concerns in relation to the audit approach, evidence obtained and the retention of evidence to support the audit team's conclusions.

NAO's actions

As noted above, the nature and extent of the NAO's Audit Planning Consultation Meetings Process has been expanded and additional guidance and support has been issued where quality findings have been identified. We have developed Covid-19 support pages to set expectations of audit teams and assist with the delivery of a high-quality audit.

With regards to the audit referred to in this report, a root cause analysis will be performed and an ECQR has been appointed for the group. We will also review our internal guidance over quality control.

Good practice

We identified examples of good practice in the audits we reviewed, including the following:

- *NAO IT audit specialist involvement in revenue reconciliation testing* – In one case, the audit team enhanced the quality of its work by using IT audit specialists to reconcile revenue transactions between management's systems.

- *Evidence interaction between core audit team and internal experts in the audit of defined benefit pension obligations* – We identified a good example of an audit team's interaction with internal experts and the work included a high standard of documentation of the consultation with internal experts.

3. Review of central policies and procedures to ensure audit quality ("firm-wide")

We reviewed the firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 ("ISQC 1"), as well as certain other key audit initiatives. We review some areas on an annual basis, and others on a three-year rotational basis. This year, our firm-wide work primarily focused on the following areas:

- Acceptance and continuance ("A&C") procedures
- Methodology changes
- Training
- Ethics and independence matters

Acceptance and continuance procedures

Background

Audit quality control processes incorporate risk management procedures and are undertaken at various stages of the engagement. In accordance with the requirements of ISQC1, the NAO has detailed policies and procedures relating to acceptance and continuance decisions for audited entities. We have reviewed these processes and their application within our firmwide inspection activity this year.

Given that the NAO's public sector audit portfolio increasingly includes commercial entities, we assessed A&C processes as at January 2020.

Key findings

We had no significant findings to report.

Good practice

- *Embedded annual A&C processes within NAO audit files:* There is a robust A&C process whereby audit teams are required to obtained approvals prior to the commencement of audit. This process is embedded within the NAO's audit files.

NAO's response

We will develop our engagement acceptance and continuance procedures so that they continue to demonstrate good practice.

Methodology changes

Background

The NAO adopts an iterative approach to mapping the requirements of the ISAs back to its audit methodology, focussing on the changes made to the ISAs for each audit cycle. There were no significant changes to the ISAs relevant to the NAO's 2019-20 audit cycle. The NAO is currently completing a similar exercise in respect of the new ISAs which are effective in December 2019 and

January 2020 with a view to updating its Financial Audit Manual ("FAM") in time for the 2020-21 audit cycle.

Key findings

We had no significant findings to report.

NAO's response

We have completed our review of the changes to the ISAs which impact on our audits in the 2020-21 audit cycle. We are in the process of finalising our Financial Audit Manual which will be issued in August 2020 ahead of planning for the 2020-21 audit cycle. We will continue to review changes to the ISAs as and when they come into force.

Alongside this, we have currently commenced a wholescale review of our audit methodology which will incorporate the implementation of the revised ISA 315 in time for the 2022-23 audit cycle.

Training

Background

An appropriate level of continuing professional development is central to the continuing auditor competence. Effective policies and procedures provide the necessary training resources to enable personnel to develop and maintain the required competence and capabilities.

Key findings

The NAO has provided specific training on effective challenge when auditing the valuation of significant assets or an estimate.

Our recurring inspection findings over areas of audit judgement and challenge of management indicate that the NAO has not successfully instilled a culture of challenge in its audit staff. To improve audit quality, there should be more emphasis on challenge of management in the values and expected behaviours of audit teams.

Good practice

We identified the following area of good practice:

- *Follow-up actions for non-completion of training* – In cases of non-completion of training, follow-up actions included contacting the individuals involved, reminding them of the need to attend the courses and contacting their line managers to advise of non-compliance and an individual's responsibility to undertake the training. In addition, where necessary, non-attendance rates are reported to NAO Executive Directors.

NAO's response and actions

We will take forward the issues raised by the AQR and note the area of good practice identified. We have recently launched our corporate Values which reinforce our commitment to "act with courage and integrity" in how we go about our work and to "strive for excellence" in the way we do this.

Against this background, we will continue to develop our training so that staff have suitable knowledge and skills to be effective in their role. We will continue to emphasise the need for auditors to evidence their scepticism in their challenge of management.

We will continue to follow-up with those staff who do not attend training to ensure that mitigating actions are put in place.

Independence and Ethics matters

Background

Policies, procedures and safeguards maintain auditor objectivity and independence in compliance with the Ethical Standard.

Key findings

Our key findings are set out below and have been communicated to the audit leadership during the year so that relevant actions could be taken on a timely basis:

- *More closely monitor independence threats, concerning business relationships and develop improved responses*

  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. None of these leases are significant to the NAO, but one is for the client and is therefore a breach of the Ethical Standard.

  As in prior years, we have 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. The NAO has, however, disclosed these arrangements in the one audit certificate where these arrangements are material to the counterparty.

- *Further consider actions where NAO staff members covered by the Ethical Standard join an entity audited by the NAO*

  Ethical Standards, extant at the time of our inspection, preclude a firm from auditing an entity for two years from the date when a partner has joined the audited entity (a "covered person"). There is nothing in the Standard that excludes the NAO from the definition of 'firm'.

  A former NAO staff member was appointed as Chair of the Audit Committee of an audited entity in 2019, less than two years after leaving the NAO (18 days short of two years), a breach of the Ethical Standard.

  In such circumstances, the Ethical Standard requires the audit firm to resign from the engagement where possible under applicable law or regulation. However, as the C&AG is appointed as auditor of audited entity by statute, resignation is not possible.

Therefore, in line with the Ethical Standard, the NAO has considered what safeguards may be implemented to mitigate the perceived or actual threat to independence of the NAO's audit. These safeguards included a disclosure of the conflict of interest by the client with the Governance Statement and also within the C&AG's audit certificate.

Whilst audit firms have the option to resign from an audit or restrict partners from joining audited entities, we understand that the NAO does not. Therefore, we would encourage the NAO to further explore further possible actions to prevent similar breaches of the Ethical Standards.

NAO's response and actions

We note the AQR's on-going concerns in this area.

We have introduced a new process so that the NAO's Finance and Facilities teams will contact the NAO's Ethics Function in advance of entering into any lease arrangements with us. The NAO is then able to undertake a full ethical risk assessment so that we comply with the requirements of the FRC Ethical Standard going forward.

For the one significant lease highlighted, we will review the existing contract at the lease's termination in 2021 and perform a full ethical risk assessment should there be any proposal to extend the lease. In the meantime, we will continue to disclose these arrangements.

Our options for preventing former members of staff from taking up positions at audited entities are limited by contract law. However, these requirements are now embedded within our Financial Audit Manual and we are working with our HR Team to consider what measures we could take to prevent further breaches of the Ethical Standard in this regard. It is important to note that this breach was for a period of 18 days.

Delegated audits

Background

The NAO allows internal delegation of the engagement director role from an NAO Director to an Audit Manager.

Key finding

The NAO's 2018/19 and prior year internal quality monitoring identified a higher percentage of unsatisfactory audits where the engagement director role had been delegated.

Given the recurring poorer results for delegated audits reviewed in the internal quality review process, more emphasis should be placed on addressing the issues that have been identified to improve quality results on these reviews. In particular, the NAO should enhance the training that it provides to managers taking on the engagement director role and provide additional support to managers in this role.

NAO's response and actions

Building on training previously given, we will continue to refresh this so all parties are aware of their responsibilities when roles are delegated. We will review our training offer for staff undertaking delegated audits. We will also perform further Root Cause Analysis to understand the underlying drivers of these quality scores.

We will continue our policy of needing Director/FAPQ approval of any delegations and for this person to challenge robustly any delegations which may not support the delivery of a high-quality audit.

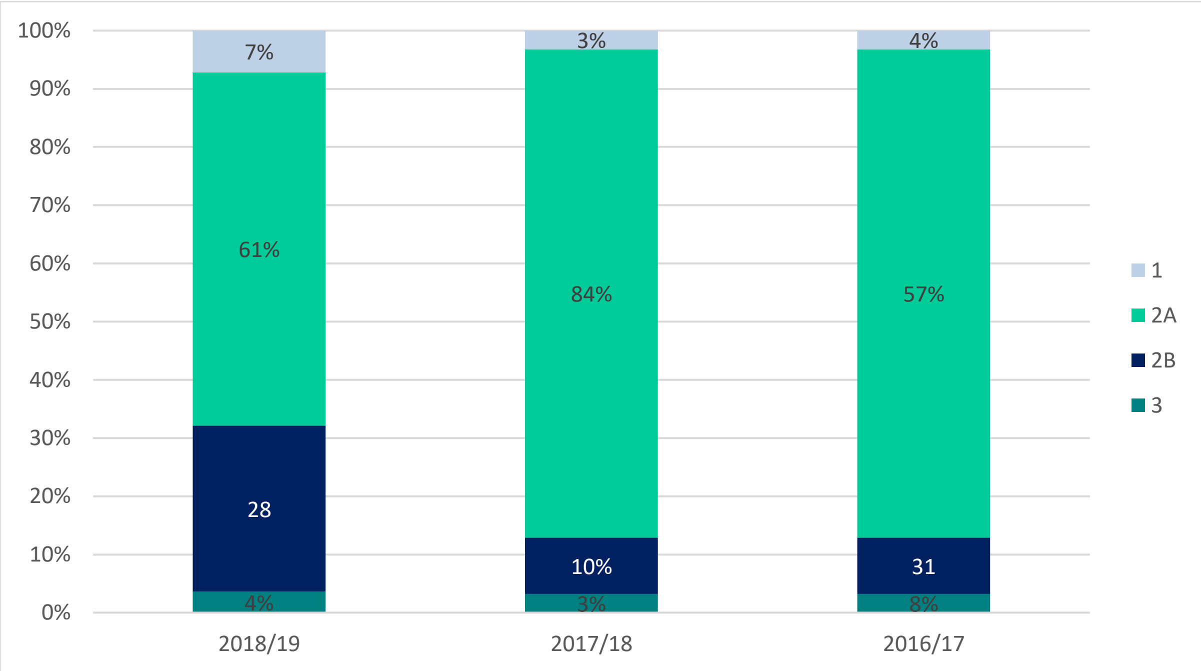
Appendix 1: NAO's internal quality monitoring results

This appendix sets out information relating to the NAO's internal quality monitoring for individual audit engagements. It should be read in conjunction with the NAO's Transparency Report to be published in 2020, which provide further detail of the NAO's internal quality monitoring approach and results and its wider system of quality control. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results.

Due to differences in how inspections are performed and rated, the results of the NAO's internal quality monitoring may differ from those of external regulatory inspections and should not be treated as being directly comparable to the results of other firms.

Results of internal quality monitoring

The results of the NAO's most recent internal quality monitoring (or "cold review programme"), which comprised internal inspections of 28 individual audits with periods ending between 31 March 2018 and 31 March 2019, are set out below along with the results for the previous two years.



Given the sample size, changes from one year to the next in the proportion of audits falling within each category cannot be relied upon to provide a complete picture of a firm's performance or overall change in audit quality.

* The graph above includes minor rounding. The grading categories used in the graph above are as follows:

1 - Good	The review found that the audit was consistent with the standards and principles of the ISAs and the NAO Financial Audit Manual ("FAM").
2A - Limited improvements required	The review identified only limited improvements were needed to the audit approach.
2B - Areas for improvement	The review identified that more substantive improvements were needed to the audit approach in one or more areas.
3 - Significant areas for improvement	The review identified significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key judgements or other areas of significant non-compliance with the ISAs or the FAM. These concerns may indicate there is a risk the audit opinion is not appropriate.

NAO’s approach to internal quality monitoring

A sample of audits are selected from the NAO’s audit population taking into account a number of criteria. The cold review programme aims to cover each financial audit Director each year, subject to consideration of individuals being subject to an AQR review for that cycle. The cold review programme also aims to include every Audit Manager every three years and Audit Managers new to the grade in their first year. Follow up reviews are performed on audits that fell below the required standard in the previous year.

The NAO performs Root Cause Analysis (“RCA”) for all audits reviewed by the AQR that do not meet the required standard. It has also performed analysis with teams where their audits were assessed as meeting quality expectations to understand how good practice could be promoted more widely.

NAO’s response and actions

Our approach to cold reviews was refreshed for the 2018-19 cycle of reviews. We moved the cold review process to a more risk-based approach, rather than a purely compliance-based review. The scope of the risk-based part of each review was tailored to the audit and approved by the NAO’s Compliance and Quality Unit.

We reviewed 28 (2018/19 31) audits during 2019/20 for the financial year 2018/19. The proportion of internal quality reviews grading 2018/19 audits as 1 or 2A (68%) is relatively consistent with that of that of AQR (71%). We note that 7% (AQR 43%) of 2018/19 audits received a category 1 grade. However, the results indicate a fall in quality ratings when compared to the reviews of our 2017/18 audits (87%).

The most significant findings identified relate to our risk assessment documentation, the sufficiency of audit evidence and elements of procedural compliance. Each audit failing to meet quality standards has an agreed set of actions to complete within the 2019/20 audit cycle.

A Bulletin was issued for the attention of all financial audit staff highlighting emerging quality findings from the internal monitoring review process. We will also perform Root Cause Analysis on the poorer rated audits.