13 September 2021

National Audit Office

2020/21 Audit Quality Inspection

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Purpose of the report

This report sets out the principal findings arising from the 2020/21 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 January 2021 to July 2021 ("the time of our inspection"). 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. The regularity opinion confirms 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 8 January 2021. It included:

- Reviewing the performance of the NAO's Companies Act audit work on behalf of the Independent Supervisor (a statutory responsibility); and

- The NAO's audit work supporting its opinion on the financial statements of non-Companies Act audits (which the FRC carries 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 more than limited 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 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

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

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 of the Companies Act.

- In practice, NAO audits assessed as requiring significant improvements, and some of those assessed as requiring improvements, 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*.*

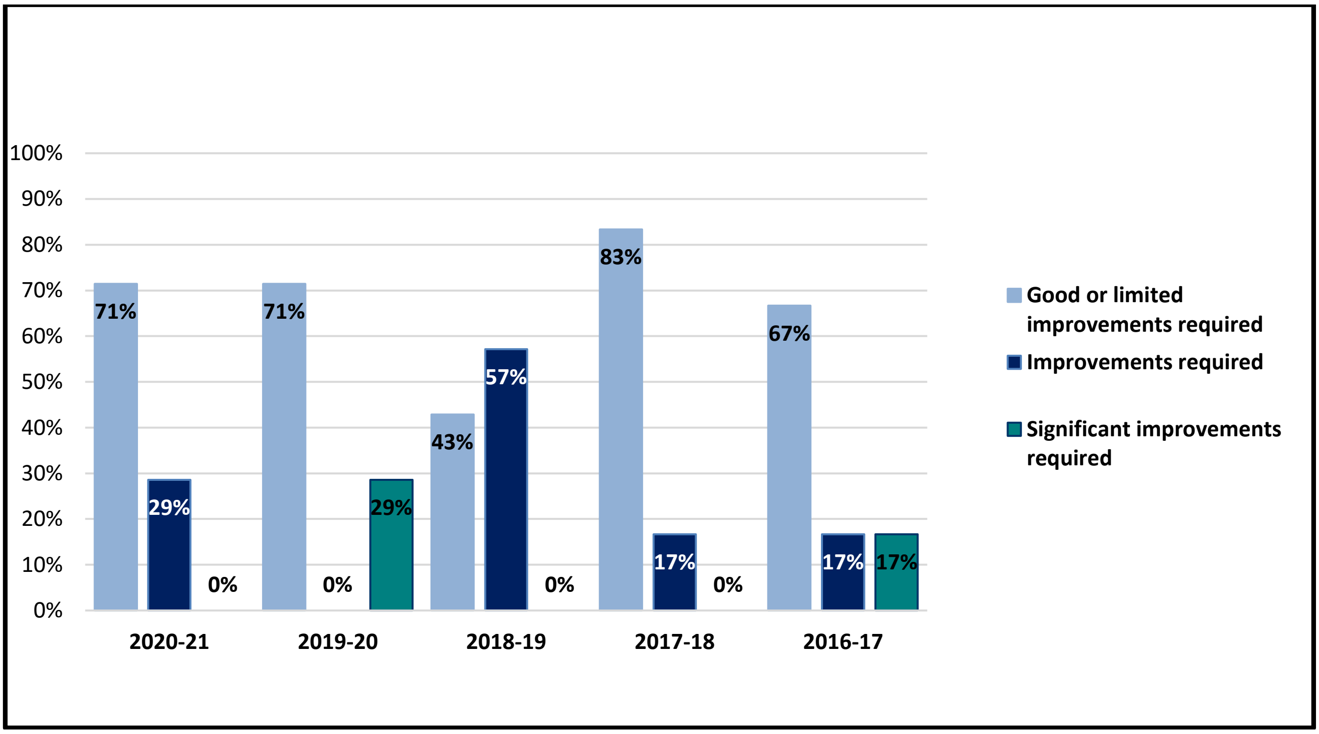
[2] Non-statutory appointments: related to all other audit work undertaken by the C&AG as prescribed under other statute.

1. Overview

NAO overall assessment

We reviewed seven individual audits this year (four Companies Act and three non-Companies Act audits) and assessed five of them (71%) as requiring no more than limited improvements, which is consistent with the prior year inspection cycle. One Companies Act audit and one non-Companies Act audit were assessed as requiring improvements. No audits in the current year were identified as requiring significant improvements (compared to two last year).

*Our assessment of the quality of audits reviewed - NAO**



* The table includes results of both Companies Act and Non-Companies Act Audits inspected. 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 judgments.

* The table refers to the FRC inspection year, rather than the financial year being audited (for example, the 2020/21 column refers to the NAO's audits of 2019/20 financial statements). The number of audits reviewed increased from six to seven in the 2017/18 inspection and has remained consistent for the past four FRC inspection years.

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 the NAO to take action to achieve the necessary improvements.

We have identified an unacceptable trend of poorer audit quality in those higher risk and more complex audits inspected relating to financial services and audits of financial services-related balances on other entities. We have raised concerns in this area for the past six years. The NAO should urgently consider these issues and identify what steps can be taken to improve the quality of this work.

Given the recurring findings over these larger and more complex financial services related audits, where valuation models are frequently used in the determination of loan loss provisions and fair value estimates, the NAO needs to urgently re-assess its skills and expertise in this specialist sector. The NAO needs to have an appropriate financial services audit action plan to address our recurring findings around these audits.

In respect of the two audits assessed as requiring improvements, the NAO is planning to undertake a thorough Root Cause Analysis ("RCA"). We will closely monitor and assess the promptness and effectiveness of the NAO's actions to address the findings raised.

It is encouraging to see that the NAO has taken steps to address the key findings we highlighted in our 2019/20 report, such as enhancements to the Audit Planning Consultation Meeting ("APCM") protocols, including that APCMs for all high-risk audits should be led by an NAO Executive Director and more recently, the introduction of Director-led APCMs for all medium-risk audits.

The most common finding reported in last year's AQR inspection report was around the extent of challenge of management, especially in areas of judgment and estimation. We note that in January 2021 the NAO launched a Quality Plan, which sets out the additional measures the NAO is taking to affect a cultural shift to embed quality further across all financial audit work. The plan covers the measures being taken to support the 2020-21 financial year-end audits and also outlines the interventions being taken in the medium to longer term. We understand the plan will be updated at least annually. The finding that contributed most often to this year's inspection results related to reliance placed by audit teams on (and the challenge of) the work performed by others. This included management's experts, but also external information sources in areas of judgment, particularly for key assumptions used in valuations and estimates. We identified several instances where the audit team did not sufficiently assess this work as required (for example, not sufficiently assessing and challenging the process and assumptions used by management's expert).

We also reviewed aspects of the NAO's firmwide procedures, including the RCA process, where we identified several areas of good practice, such as the wide coverage of entities subject to the review. We have also highlighted in this report aspects of the firm-wide procedures which should be improved. This includes enhancing the depth of RCA processes over audit issues, and improving the methodology and guidance provided to audit teams around IFRS 9.

Scope of our 2020/21 inspection

We examined aspects of seven individual audit engagements, all of which had year-ends dated 31 March 2020. We reviewed four Companies Act audits out of 71 audits performed (prior year: four out of 70 audits) and three non-Companies Act audits out of 331 audits performed (prior year: three out of 336 audits)[3]. The NAO audits three public interest entities and one of these was included in our sample.

In the year to 31 March 2020, we excluded 110 contracted-out non-Companies Act audits from selection, as agreed with the NAO. This is where the NAO retains overall responsibility and issues the audit opinion, but contracts with another audit firm to perform the audit. During this period, there were no Companies Act audits performed on a contracted-out basis.

The Companies Act audits selected comprised three medium-sized companies and one smaller one.

The non-Companies Act audits selected comprised a large Department, an Executive Agency and a 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 focused review of IFRS 9 methodology, other methodology changes and RCA processes.

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 audits reviewed on a voluntary basis.

We currently report privately to the NAO on each audit reviewed and on our overall inspection cycle. 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 of 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 at each major firm. 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 around our reports, by improving both the communication of our inspection results and related engagement with Audit Committees. For Companies Act PIE audits, we would recommend that our reporting is consistent with our inspections of major audit firms.

The NAO has already taken steps to enhance further the transparency of its work. It continues to publish the results of our inspection within its annual Transparency Report on its external website, together with our annual report to the C&AG. In addition, as part of its commitment to further improve its transparency and accountability, we have been informed that the NAO is taking forward its response to the Government's recent consultation paper *Restoring Trust in Audit and Corporate Governance.* We understand it is working with Parliament, through the Public Accounts Commission, so that the Commission has greater scrutiny over the quality of the NAO's work.

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[3]The NAO performed:
- 406 audits as of 13 November 2020, comprising 331 non-Companies Act audits and 71 Companies Act audits; and
- 408 audits as of 3 October 2019, comprising 336 non-Companies Act audits and 70 Companies Act audits.

We further understand that the NAO is considering (in response to the Government's reforms and the role of the C&AG) whether it is appropriate to report the results of individual AQR inspections to the relevant Audit Committee given the C&AG's statutory independence from the bodies he audits on behalf of Parliament, and from when this might be implemented. We continue to support sharing the results of our inspections with Audit Committees, to help them to have more informed discussions with their audit teams and to fulfil and discharge their responsibilities effectively.

Covid-19

We recognise the challenges posed to the NAO by the Covid-19 pandemic, both in relation to the level of uncertainty surrounding forward-looking estimates and projections, and the difficulties in carrying out observational procedures (for example, stocktakes). It is pleasing that we identified no specific concerns around NAO audit quality as a result of the Covid-19 pandemic, which reinforces the strong processes actioned at the start of the pandemic to ensure employees and audits continued without significant disruption.

Covid-19 is likely to remain a significant issue for the audit profession going forward, particularly around judgments and forward-looking estimates, and we will continue to consider such matters carefully during our next inspection cycle.

Developments in audit regulation

The Government is currently considering responses to its consultation on *Restoring Trust in Audit and Corporate Governance*. The outcome may affect the scope and reporting of our future inspections.

Reviews of NAO individual audits

Our key findings related principally to:

- Reliance on work performed by others, including primarily management's experts, but also external information sources;

- Challenge of the management of audited entities in areas of judgment, in particular for key assumptions used in valuations and estimates; and

- Quality of more complex financial services audits and more complex financial services-related balances on other audits.

Good practice observations

No specific good practice examples were raised in the audits we reviewed. We reviewed several routine areas of individual audits, including revenue recognition and expenditure testing, where the audit work was generally performed to a high standard. However, given the routine nature of these procedures, we expected them to be performed to a high standard.

We encourage the NAO, from within its own quality review programme, to continue to identify and communicate examples of good practice across audit teams, particularly focussing on examples of good challenge of management and audit team's reliance on work performed by others.

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

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

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

- Review of IFRS 9 methodology;
- Other methodology changes;
- Other firm-wide procedures (including training and staff matters); and
- RCA processes.

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

- Enhancements to certain aspects of IFRS 9 guidance, in particular relating to risk assessment as well as Expected Credit Loss ("ECL") modelling considerations, specifically regarding the use of model code reviews, model re-builds, and the extent of reliance on monitoring controls.
- Improving the depth of RCA processes to ensure that the key root causes for audit inspection findings are consistently identified and formalising a process for identifying themes to ensure that the key root causes from all RCA reviews are appropriately weighted and considered.
- Ensuring that the appraisal system sufficiently incentivises audit staff to prioritise audit quality.

Good practice observations
We identified examples of good practice in our review of firm-wide areas. These included the coverage of RCA reviews, the use of a small, consistent team of facilitators to perform these reviews, the level of communication and sharing of RCA findings within the audit practice and the quality plan improvements in response to RCA findings.

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

NAO's internal quality monitoring results

We continue to include summary results of the NAO's internal inspections, as set out in appendix 1. We consider that these results provide additional and relevant information on the NAO's audit quality.

The results of the NAO's internal monitoring are broadly in line with the AQR's results, although higher and lower quality results have been identified through the NAO's internal processes due to the larger sample of audits reviewed. The NAO performs RCA on the higher and lower quality results to identify the causes of good and poor audit quality and plans to implement further actions to prevent poor work recurring and encourage good quality work to continue.

2. Review of individual audits

We set out below the key areas where we believe improvements are required to enhance the NAO's 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.

Reliance on work performed by others, including management's experts and external information sources

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 judgment. Management often engages external experts in similar areas to provide independent valuations or uses external information sources to form their judgments and estimates. Audit teams should assess and evaluate the objectivity and capability of the specialist/expert and evaluate the work and conclusions to assess whether their work addresses the risks identified and provides sufficient audit evidence which can be relied upon. Where the NAO obtains evidence through its own procedures or by others, the NAO should use that evidence to challenge management directly.

Key findings

- On one audit, the audit team did not sufficiently assess and challenge the process and assumptions used by management's experts in assessing whether expected credit loss allowances were appropriate, including how the audit team evaluated that the expert's procedures were reasonable. Furthermore, the audit team did not sufficiently assess whether the management's experts' services were akin to being management's experts, rather than those of a service organisation, for which auditing standards require a different response.

- On another audit, the audit team did not perform sufficient procedures to conclude on the valuation of pension scheme assets, including to understand and evaluate the work undertaken by management's experts when relying on valuations of directly-held property investments.

- On a further audit, the audit team did not sufficiently evidence its assessment of the relevance and reliability of inputs and assumptions used within its reasonable ranges. Specifically, in the context of external information sources, the audit team did not adequately evidence the relevance and reliability of the underlying assumptions used by external information providers.

- Furthermore, on another audit, the audit team did not evidence its assessment of external parties as management's experts, and did not evaluate the competence, capabilities and objectivity of the experts before placing reliance upon these experts.

NAO's actions

We have already implemented a number of changes for our 2020-21 audits in this area. We have undertaken significant work to review our audit approach to valuations and estimates as part of our implementation of the revised ISA (UK) 540 (and the corresponding amendments to ISA (UK) 500) for 2020-21 audits. This included providing further guidance in relation to using and evaluating the relevance and reliability of information from external information sources and the need to appropriately challenge the work of management experts.

We have also highlighted to audit teams through our 2020-21 review guide the importance of bringing forward and re-evaluating evidence from previous audits regarding our assessment of valuation approaches, inputs and assumptions.

We are also taking these findings into account when designing our technical update training programme (‘Audit Skills’) to be run later in 2021. We intend to include a module on Audit Evidence which will recap the key definitions of management experts, service organisations and external information sources, the other relevant standards which apply when using evidence from these sources and practical guidance on evaluating the sufficiency and appropriateness of audit evidence.

In the context of the significant changes implemented for 2020-21 audits and planned for later this year, we will review the results of our Root Cause Analysis work to highlight where further actions are required.

Challenge of the management of audited entities in areas of judgment, 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 judgment. Effective audit teams will critically evaluate management’s key assumptions, comparing them to available audit evidence (including external benchmarks, where available) and, where appropriate, challenge management to justify the basis of those assumptions. Audit teams should also look for contradictory evidence in assessing valuations and estimates.

Key findings

- On one audit, the audit team did not:
    - Sufficiently evidence its assessment and challenge of the application of certain assumptions. The audit team did not perform sufficient substantive procedures to conclude on the staging of loans, including challenge over the appropriateness of the cure period.
    - Adequately challenge the assumptions used in the determination of discount rates used in the fair value calculation of loans. The audit team did not adequately challenge management’s rounding assumptions and proxies used for cost of equity calculations and consider and challenge expected market participants’ perspectives for cost of debt calculations.
- On another audit, the audit team did not adequately challenge and corroborate the valuation of unquoted pension assets to supporting evidence at year-end.
- In addition, on another audit, the audit team did not sufficiently challenge management on the impact of potential adjustments to contractual terms, which could have materially altered the valuation of significant liabilities.

NAO’s actions

We made a number of changes for 2020-21 audits as part of our implementation of ISA (UK) 540. These included revisions to the standard audit work programmes for these areas, providing supporting guidance and mandatory training, which included specific elements on exercising professional scepticism when auditing estimates.

In 2020, our Financial Instruments Centre of Expertise identified the audit of investments in funds and expected credit losses as areas where further support to teams should be prioritised to support high quality work. This included the provision of specific guidance on auditing investments in funds and expected credit losses. We also issued a new investments risk assessment tool and made updates to our working paper templates to help auditors better evaluate the sufficiency of evidence over valuation from the range of sources available.

As with the finding above, given the significant changes already implemented for 2020-21 audits, we intend to review the results of our Root Cause Analysis to evaluate where further actions are required.

Quality of more complex financial services audits and more complex financial services-related balances on other audits

Financial services audits typically involve significant management judgment and estimation uncertainty. This often requires complex models and large volumes of data to develop key estimates, for example around ECL. Financial services audits represent a specialised area of auditing and require comprehensive audit approaches to ensure methodologies are developed in line with best professional practice and financial reporting standards.

Key findings

- We have identified significant issues in more complex financial services audits, or audits of more complex financial services-related balances on other audits, in the past six inspection cycles. We have yet to see appropriate actions be implemented to improve the quality of such audits. In multiple instances, audit teams have failed to assess appropriately and challenge the methodologies used by entities to calculate, more recently, ECL provisions and previously, IAS 39 loan loss provisions. The audit teams failed to perform sufficient testing over models, and relevant coding within models, to ensure that the provision calculations were appropriate and performed in line with the developed methodology. We have also seen reliance on sensitivity analysis to audit key judgments, without properly considering the estimation uncertainty which is present in these complex assessments.

- In these reviews, we have also identified:

    - Insufficient procedures being performed over the data used within the calculation of loan loss provision models. Audit teams have not appropriately tested the completeness and accuracy of the underlying loan portfolio information before using this data within the provision calculation. We have also found a lack of evidence of audit teams assessing the relevant inputs in data and ensuring testing is focused on the key data elements relevant to the provision calculations.

    - Insufficient audit procedures performed over the fair value of financial instruments. Insufficient testing was performed over the assumptions and calculations of internally-generated models used by the entity to value financial instruments, or insufficient third-party evidence was obtained to support the year-end fair values where these were externally valued.

NAO's actions

We take the AQR's findings seriously and recognise that we need to do more so that the quality of our work in these areas is consistently high. We will ensure the lessons learnt from these reviews are addressed within our revised Quality Plan. Also, as part of our firmwide response to previous quality monitoring findings, we established a Financial Instruments Centre of Expertise in late 2020 to support relevant teams as they audit complex transactions and valuations. The Centre has already published guidance, including a series of illustrative case studies, to support high quality audit in the areas of the audit of investments in funds and in expected credit losses, and provides direct technical support to teams in their work. The Centre also plans to establish a relationship with one of our new framework partner firms to give us access to a wider range of financial instruments expertise and draw on their wider sector knowledge and best practice. We expect these measures to lead to a measurable improvement in the quality of our financial services work.

We recognise the need to build on, and strengthen, these actions and others already in progress to support the quality of work in these areas. To support this ambition, and to supplement our comments in section 3 of this report in respect of IFRS 9, we responded promptly to the AQR's findings as they evolved so that teams could address these as soon as possible. Our hot review programme for 2020-21 includes a number of targeted reviews of audits with complex financial instrument balances. Also, throughout the first half of 2021, we communicated the emerging findings from our external reviews so that all staff were able to consider whether these were relevant to their audits and to take appropriate action. We published a guide to audit teams covering seven areas of focus when completing their 2020-21 audits.

We also assign the most appropriate people, who have the required skills and experience, to specific audits as part of our staff rotation policy, including ensuring the Responsible Individual assigned to each engagement is, and remains, the best qualified to act in this role. We rotate people from this particular type of work where quality reviews indicate this is the best course of action. For example, for the 2021-22 cycle of audit work, we have already re-assessed and taken action so that we have the most appropriate people assigned to take forward these audits and will continue to keep the position under review as we move forward. We also have a pipeline of new Responsible Individuals in place so that we maintain our capacity in this area.

We are undertaking a thorough root cause analysis across relevant audits to establish where further action is needed to improve the quality of our audits. We will also reflect carefully on the need for further training and guidance in these areas and will refresh our quality plan as appropriate.

Some of these actions were taken during the 2020-21 cycle of audits and will therefore also be reflected as we audit 2021-22 financial statements. We will continue to take steps to improve our work in these areas and develop our approach in line with emerging best practice.

Justification and explanation of key judgments around materiality

Materiality has a pervasive impact on the audit process, including the auditor's assessment of the risks of material misstatement and the extent of audit evidence required in respect of those risks. Auditors should ensure that materiality levels are set to identify misstatements which could reasonably be expected to influence the economic decisions of all users of the financial statements.

Key findings

- On one audit, the audit team did not adequately evidence its consideration of the range of users and the information they would use for short-term and long-term decision-making; and the purpose and information presented in the primary financial statements, when determining that a materiality based on a disclosure was more appropriate than the primary financial statements metric. In addition, the audit report narrative for materiality in this instance did not adequately present why materiality judgments were appropriate and clear to users.

- On two additional audits, Expenditure was significantly larger than the balance sheet and overall materiality was set in excess of the balance sheet financial statement line items. The audit teams did not consider setting lower specific materiality amounts for certain balances and disclosures or assess how the balance sheet financial statement line items might have influenced the decision making of stakeholders and users of the financial statements.

NAO's actions

We highlighted this finding to audit teams in our recently issued Review Guide. In this, we asked teams in their 2020-21 audits to explicitly consider the range of users of the financial statements and whether we needed to apply a lower materiality threshold to some areas dependent on their interest.

We will build on and incorporate this guidance into our methodology for 2021-22, with requirements to firstly identify all of the relevant users of the financial statements when considering materiality and more explicitly consider the metrics which the users may be focussed upon as part of this consideration. Our guidance will make clear that this should include a consideration of any metrics disclosed in the annual report when selecting the materiality base.

In addition to this, we will emphasise in our guidance, the need for the auditor to consider setting lower specific materiality amounts for key balances or disclosures in circumstances where a small number of key items significantly dominate the financial statements to ensure that the focus on lower value items is proportionate to the users of the financial statements.

We will also add guidance into our Extended Auditor Report templates to prompt auditors to ensure that their description of materiality judgments reflect the documentation on the audit file and is focussed on the perspective of the users of the financial statements. For the 2020-21 audit cycle, all Extended Auditor Reports have been subject to review by FAPQ. A key focus of this review has been in ensuring that materiality judgments are appropriately described and have a focus on the requirements of the users of the financial statements.

We are currently reviewing our full suite of audit tooling as part of our Audit Transformation Programme and intend to embed the above guidance within this tooling as part of our revised methodology.

Audit sampling procedures

Sampling procedures allow auditors to obtain sufficient and appropriate audit evidence efficiently over large populations without testing the entire population. Auditors should ensure that there is sufficient justification for the sample sizes used in their testing so that the sample provides a reasonable basis upon which to draw conclusions for the entire population.

Key findings

- On three audits, the audit team did not adequately evidence the judgments made by the NAO's Analytical Methodology Team ("AMT") in determining sample sizes. In particular, there was a lack of evidence to show that the audit team had demonstrated that the judgments used by the AMT provided sufficient evidence.
- In addition, on one of those audits, the audit team did not hold a revised consultation with the AMT when the final population value increased from the initial population value, to ensure that the initial sample size remained appropriate.
- On one other audit, the sample testing performed was not sufficiently evidenced, with the audit team not appropriately recording sufficient details of the evidence sighted to ensure this could be reperformed and that appropriate evidence had been obtained to support the conclusions that the samples being verified were appropriate.

NAO’s actions

We are introducing a revised approach to audit sampling for the 2021-22 audit cycle. This revised approach has been piloted in the 2020-21 cycle where teams have consulted with AMT where appropriate. For certain expected common issues (e.g. batching, multi-location sampling), where engagement teams depart from our standardised methodology, AMT will provide them with a clear output for the audit file detailing the proposed alternative sampling approach. This output will include the rationale for the approach adopted and will note materiality and how this has impacted upon the approach. In addition to this, the output will contain standard wording to prompt the team to stand back and consider the sufficiency of audit evidence and re-consult with AMT to confirm that the approach remains valid in circumstances where the population value changes. The relevant procedures in our audit software will prompt engagement teams to consider the appropriateness of this output in the context of their audit prior to concluding for the 2021-22 audit cycle onwards.

Our standard testing templates provide sufficient scope and guidance for audit teams to document and record evidence which has been audited in order to enable re-performance where this is necessary. We will re-emphasise the need to do this with auditors and will also ensure that this is fully embedded within our Audit Pathways graduate training, reflecting that much of this detailed testing is undertaken at trainee level.

Consideration and testing over journal entries to respond to the risk of fraud and management override of controls

The audit response to the fraud risk of management override of controls requires journal entry testing. A lack of appropriate audit procedures and testing of higher risk factors increases the risk that a material misstatement within the financial statements would not be identified by the audit team.

Key findings

- On two audits, the audit team did not perform appropriate procedures over aspects of journal entry testing, including not sufficiently testing the completeness of manual journal entries, justifying through quantitative and qualitative analysis why business process testing supported the non-testing of particular journals and assessing the qualitative factors of fraud when selecting journals for further testing.

NAO’s actions

We have already introduced a significant update to our standard journals analytic for our 2020-21 audit cycle. This, by default, requires audit teams to derive the complete population of journals from the entire general ledger obtained from audited entities. Users are required to clearly justify any judgments made when filtering this information to arrive at the final journals population to be reviewed for fraud risk. As part of our update to the associated materials with the journals analytic, we will add a requirement for the audit team to stand back and consider the output of their derivation of the journals population prior to concluding on the sufficiency of audit evidence within the relevant test requirement.

We have also reviewed relevant training and guidance materials in relation to the audit of journals in view of these findings. On the basis of this work, we intend to include more in-depth training on identifying a journals population for new audit leads within our Audit Pathways graduate training for 2021. At the same time, we have identified the potential for improvements to our existing guidance to set clearer expectations as to the documentation and explanations required, which we intend to make ahead of the 2021-22 audit cycle.

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:

- Review of methodology changes, with focus on IFRS 9 methodology;
- Root cause analysis processes; and
- Other firm-wide procedures.

Review of IFRS 9 methodology & changes to ISA 540 (revised) methodology as applicable to financial services audits

Background

Application of IFRS 9 has been mandatory for IFRS reporters for periods beginning on or after 1 January 2018. The standard increased the level of judgment and estimation uncertainty involved and often requires the use of complex models. To minimise the risk of misapplication, audit teams need methodology and guidance.

We have reviewed the NAO's IFRS 9 methodology, including any changes to methodology for ISA 540 (revised), as applicable to the audits of financial services entities, both for estimates within the scope of IFRS 9 and any other key changes applicable to other estimates.

Key findings

- The NAO should enhance its risk assessment guidance with respect to IFRS 9, including the potential introduction of a rebuttable presumption for ECL as a significant risk for audits of financial sector entities, whilst still permitting a flexible approach driven by an appropriate risk assessment.
- The NAO does not have a Business Model ("BM") or Solely Payments of Principal and Interest ("SPPI") checklist or specific audit programmes for this element of IFRS 9. The NAO should consider providing guidance for teams in this area.
- IFRS 9 requires consideration of forward-looking economic assumptions that are appropriate to capture the risk of the entity and have appropriate probability weightings attached. The NAO should consider developing a rebuttable presumption requirement for the use of economic specialists.
- Models are typically fundamental to the production of the ECL estimate. These models can be highly complex, requiring audit teams to seek the assistance of credit modelling specialists. Audit teams need to ensure that the overall procedures are appropriate and commensurate with the risk of each individual modelling situation, including sufficient assessment and follow-up of experts' work. The NAO provides general guidance and procedures on the audit of complex models, although this is not specific to ECL models. Model code review is not mandated but is employed in practice as a further technique where internal modelling experts are engaged to assist in the audit of models. The NAO should enhance its guidance on ECL modelling considerations, specifically regarding the use of model code reviews, model re-builds, and the extent of reliance on monitoring controls.

- The NAO should refine its effective interest rate ("EIR") guidance for revenue recognition purposes, including additional EIR checklists, as well as considering the use of challenger models.

As noted above we have found a history of issues with regards to the audit of more complex financial services related balances, including observations with regard to work performed within the scope of IFRS 9. It is important that the NAO's methodology provides appropriate and clear guidance to support individual audit teams in this area.

Other 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 has completed a similar exercise in respect of the new ISAs which are effective in December 2020 and January 2021 and has accordingly updated its Financial Audit Manual ("FAM").

The key change affecting the NAO is the implementation of ISA 540 (Revised) – *Auditing Accounting Estimates and Related Disclosures*. The implementation of this Standard was led by the NAO's Technical centre. The revised methodology has been written into the 2020 Financial Audit Manual, and the NAO has created a new Estimates Planning Tool which is the key document to embed the revised ISA (UK) 540 into its audit methodology.

We also looked at the guidance and methodology updates issued to audit teams in responding to the auditing and accounting challenges posed by Covid-19, which included focus in relation to going concern.

Key findings

We had no key findings to report.

NAO's response and actions

On IFRS 9 methodology

We continue to develop our approaches to the audit of areas involving significant accounting estimates. In recent years, we have introduced specific risk assessment tools for pensions, property and investments and increased the wider use of experts (whether commissioned externally or using our dedicated modelling team and in-house economists). For 2019-20 audits, we provided additional guidance to teams on the audit of expected credit losses and the potential impact of Covid-19 on our risk assessment for financial instruments more widely. Our recent review of in-progress 2020-21 audits in response to the AQR's recommendations has confirmed that economic expertise is being employed on audits where entities use multiple economic scenarios as part of their expected credit loss modelling.

The FRC findings show that our existing audit methodology should be strengthened to improve the quality and consistency of audit work in relation to the audit of financial instruments and complex models. Our newly developed methodology, which we will implement fully for 2022-23 audits, aims to address this via building up our risk assessment based on the specific requirements of each accounting standard. This, in turn, will then inform more specific and tailored audit responses.

In the meantime, we are taking forward additional measures to support our 2020-21 and 2021-22 audit work. As observed by the FRC, we do not currently include a formal presumption of significant risk relating to expected credit losses within our methodology. However, our new Estimates Planning Tool (effective from our 2020-21 audits) uses weighted inherent risk factors to direct teams to explicitly consider this where relevant risk factors such as the use of complex models or a material degree of estimation uncertainty are present. For 2020-21, we also reinforced in our Review Guide to teams our expectations regarding the classification of ECLs as an area of significant risk and the use of economic expertise. We are building on this approach in our new methodology, using a centrally determined weighting of inherent risk factors (calibrated using known high-risk areas such as expected credit losses) to help teams consistently assess risk.

We acknowledge the FRC's observation that more detailed guidance and support for the audit of expected credit losses would help support teams to apply the existing methodology to a high standard in this area. We will therefore issue further guidance and materials for 2021-22 audits as recommended and have separately responded to the FRC with our detailed proposed actions. These include the development of a risk assessment tool for amortised cost and ECL measurements, checklists to help teams document their assessment of SPPI and business model assessments and further guidance regarding model and code review.

Root Cause Analysis

Background

Thorough and robust 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 uses the "five whys" approach, a widely used technique designed to identify root causes, when performing RCA. The NAO seeks to identify the key root causes of audit quality findings, with themes being identified annually through an informal discussion process by the central team. As part of our work, we reviewed three RCA reports for audits inspected by AQR in the prior inspection cycle.

Key findings

- We identified instances where the RCA did not clearly identify why issues, such as failures to update a risk assessment or retain appropriately detailed documentation, had occurred. The NAO should ensure that its RCA process goes far enough to ensure that the key root causes for audit findings are consistently identified.

- There is no formal process for identifying themes to ensure that the key root causes from all RCA reviews are appropriately weighted and considered. The NAO should formalise the process for identifying themes and ensure that there is a clear record of how the individual RCA reviews are incorporated into the themes identified.

- Our recurring inspection findings over areas of audit judgment and challenge of management indicate that the NAO has not yet sufficiently 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 areas of good practice:

- The coverage of RCA reviews was broad. The reviews looked into a number of elements that could have caused the issues and why those elements existed and covered good practice areas and the specific team actions to result in good practice.

- The use of a small, consistent team of facilitators to conduct RCA reviews allowed for common themes to be identified across different audit teams.

- There was extensive sharing of RCA findings within the audit practice in an open and transparent manner.

- It was also encouraging to see that the RCA linked through to the quality plan and that tangible and specific responses were being identified for all RCA findings.

NAO's response and actions

We have undertaken a programme of Root Cause Analysis in recent years and significantly expanded our programme last year. We therefore welcome the areas of good practice identified by the AQR.

We are taking steps to further enhance our RCA work. These include ensuring our programme consistently identifies the key root causes in all reviews. We are working to ensure there is a detailed review and challenge of individual RCA reports to ensure they consistently draw out the key root causes. We are also making changes to the process adopted for RCA sessions to ensure they better support the consistent identification of the key root causes.

Although we were confident we had a robust process for identifying themes, we will formalise the creation of a mapping document that contains causes from each RCA review and how these relate to the overall themes. This should provide a clear record of how the results of individual RCA reviews map into the themes identified.

We recognise the importance of instilling a culture of challenge. In January 2021, our first Quality Plan set out the whole system approach we are taking to secure consistently high-quality in all our audit work. The Plan focuses on consistency because, although our internal and external inspections tell us that the bulk of our audits meet high professional standards, there are exceptions to this. We will refresh this Plan annually so that we continue to stress the importance of the challenge of management.

Other firm-wide procedures - Staff Matters

Background

The NAO has recently refreshed its core values which continue to prioritise audit quality. We understand this emphasis is communicated to the practice with the expectation that it will be reflected in the appraisal process. From 2020, the NAO updated its appraisal system so that all staff received one of two performance ratings, instead of three as previously. Staff receiving the lower rating are identified as requiring additional support. From 2021, the NAO appointed performance coaches to support each individual in their performance and development. We have been informed that discussions and appraisals are expected to acknowledge where staff are performing well based on feedback received and the quality of their work, including the results from internal and external programmes of quality reviews.

Separate to this formal process, the NAO supports a staff awards scheme, whereby annual awards are given in categories including the NAO values. For each category, an individual or team will be selected as the winner and three highly commended awards. Staff can nominate teams or other colleagues for these awards and receive an email to notify them they have been nominated. Also, on an informal basis, staff on audits that receive good internal or external quality results may receive emails to acknowledge and congratulate them on their work.

Key findings

- The NAO should continue to strengthen its formalised mechanisms to incentivise staff to prioritise audit quality and to recognise staff who deliver high quality audit work; and

- The NAO should monitor whether the 2-rating system is sufficiently flexible to distinguish between varying performance levels and to acknowledge staff who deliver high quality audit work.

NAO's response and actions

We will continue to keep our appraisal system, and its effectiveness, under review. The NAO is committed to ensuring all colleagues have the support and opportunities to deliver excellent work which meets required quality standards and in meeting our Values.

However, we do not consider that the best way to distinguish performance, and motivate people, is through the addition of additional rating tiers. We moved to a two-tier rating scale from 2020 and introduced other mechanisms so that managers and employees are better able to focus their discussions on good quality feedback, rather than on a particular rating. These mechanisms highlight individual achievements and discuss stretching developmental opportunities which, in themselves, can provide recognition and motivate staff. In addition to the feedback provided in appraisals and snapshots, we use personal development plans which give colleagues further opportunities to discuss their career goals and how the office can support them to achieve these.

As part of their own appraisal discussions, managers reflect on how well they have supported their teams to deliver high quality work and achieve their development priorities and Group Directors will hold meetings during the year to discuss the performance and talent of their people. Senior colleagues already share particular successes in emails and our internal social media channels and we will continue to ensure our Executive Team continue to be informed of good quality internal and external inspections so they, in turn, can congratulate teams to help incentivise good quality work and act as an incentive to other colleagues. Also, a colleague's track record in delivering work which meets our quality standards is considered as part of the evidence to support an application for promotion.

Furthermore, we have a comprehensive review of our remuneration policy planned for year three of our Organisational Development Plan, with any changes implemented from April 2023. This will consider our whole reward package, including our approach to recognition.

With this context in mind, we will continue to re-emphasise that the recognition of achievement is a key component of appraisal discussions between performance coaches and their cadre of appraisees and we will ensure that this is properly highlighted within guidance supporting our 2021 appraisal discussions.

Also, as we consider our future approach to our pay and performance framework, we will ensure that that this continues to recognise the need to incentivise our people to deliver high quality work and to support them to do this.

Other firm-wide procedures – Training

Background

The NAO provides several training sessions to experienced staff which are highly recommended, but not mandatory. These sessions are primarily delivered via live online training or through discussion groups and cover topics including:

- RCA and quality monitoring findings; and
- Use of new analytics tools.

Post-course assessments are not routinely used. We also understand that the NAO intends to include training on climate change this year.

Key findings

- The NAO should consider mandating more key training sessions and centrally monitoring attendance of these. It should also consider consistently using post-course assessments for technical training to evaluate knowledge retention of individuals attending the training and to validate that the learning objectives have been met.
- The NAO has started to provide training around the impact of climate change on audit. It should ensure that the climate change training provides adequate guidance to consider how climate change may affect financial statement balances, disclosures and front half reporting, including an overview of the physical and transition risks. The training should also provide guidance on when specialist help needs to be sought. Given the evolving nature of this area, the NAO should also consider how it stays abreast of key developments. The NAO should monitor engagement with this training and guidance to ensure that the audit practice is responding appropriately to this topic as it increases in significance.

NAO's response and actions

On training: We note the AQR's observations and will continue to take these points into account as we design our next programme of learning and development activity.

We already mandate key training sessions and monitor attendance and completion of all our mandatory training courses. Where colleagues do not complete courses or attend seminars as and when expected, this is escalated within the relevant Group management for action to be taken so that all colleagues who have an audit role know what is required of them during an audit. We have also recently augmented these arrangements so that persistent non-compliance with our expectations, where appropriate, becomes part of an individual's performance assessment discussions.

On what we designate as a mandatory training course, the decision as to our classification of mandatory is made carefully, taking into account our total learning and development offering and the most effective means through which we give training to colleagues. So, for example, quality monitoring findings were included within the mandatory elements of our training, such as on audit scepticism and use of experts. The subsequent RCA sessions served to reinforce the messages given in our formal training while also allowing colleagues to discuss issues on a wider basis.

The action we are taking forward as we develop our 2021-22 L&D offering is to continue to consider the best approach to supporting our people through the most appropriate package to suit their needs. We will place a premium on mandatory training (and will continue to monitor compliance) as we develop our plans, which will be even more important as we begin to take forward our audit transformation programme.

We already use some testing as part of materials for technical training to support learning and evidence of completion, but we will look to expand this further. Our Learning and Development team have been developing our approach to post course evaluation and have designed evaluation programmes for our trainee learning programme – Audit Pathways.

We are actively reviewing the extent we use post course assessments for our broader technical training programme. As part of that review, we will consider issuing assessments with a gap post-completion of a module will focus on longer term retention of learning rather than acting as a short-term memory test. We envisage leaving a gap before testing which should encourage greater note taking and engagement with materials for longer term use. In designing post course assessments, we will consider the use of question banks, caps on attempts and analysis of question responses.

On climate change: We launched a specific training module for all financial audit colleagues to complete. This module takes into account the factors highlighted by the AQR and our expectations that all audit teams will need to evidence their consideration of potential issues and their impact on the financial statements in their audit files.

As the completion of this module is part of our mandatory training programme, we are monitoring engagement with the module to gain assurance that all colleagues have completed the course. In addition, our programme of peer reviews will challenge teams as they progress their audits and our internal post certification inspection programme will consider teams’ compliance with this requirement.

Finally, we are currently considering our L&D offering to support the 2021-21 audit cycle and are planning a further mandatory session on this topic to update our training in this area to take into account developments as they occur.

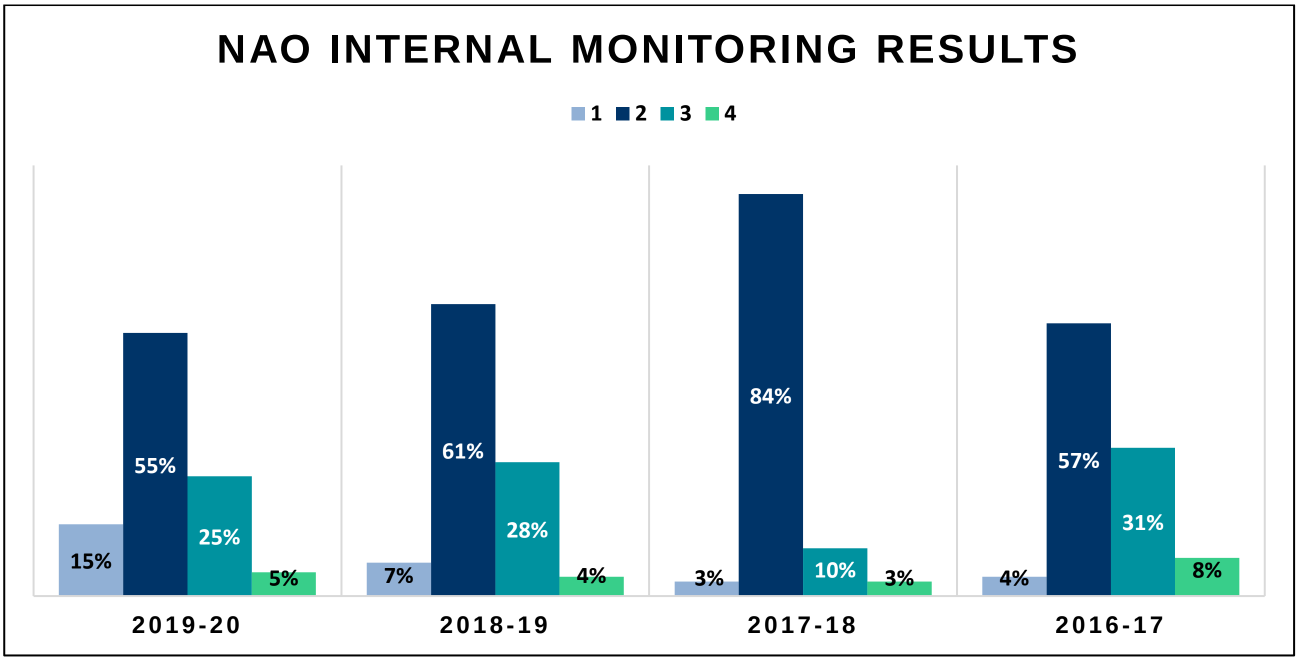
Appendix 1: NAO's internal quality monitoring results

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 2021, which provides 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 20 (28 in the previous year) individual audits with periods ending between 31 March 2019 and 31 March 2020, are set out below along with the results for the previous three years.



Given the sample size, changes from one year to the next in the proportion of audits moving 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").
2 - Limited improvements required	The review identified only limited improvements were needed to the audit approach.
3 - Areas for improvement	The review identified that more substantive improvements were needed to the audit approach in one or more areas.
4 - Significant areas for improvement	The review identified significant concerns in relation to the sufficiency or quality of audit evidence, the appropriateness of key judgments 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 is selected from the NAO's audit population considering 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 and its internal quality monitoring 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

We welcome the AQR's observations in our approach in planning and taking forward our internal programme of quality reviews.
We will continue to refine our programme, and associated Root Cause Analysis, so that any lessons learnt from these programmes will be fed back promptly to colleagues and so that our wider portfolio of audits can address any common findings. Wider learning will also be taken on board as part of our next Financial Audit Quality Plan.