4 November 2022

National Audit Office

2021/22 Audit Quality Inspection

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Purpose of the report

This report sets out the principal findings arising from the 2021/22 inspection of the National Audit Office's (the "NAO") audits of 2020/21 financial statements 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 2021 to July 2022 ("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 and also to the Independent Supervisor in its monitoring role in respect of Companies Act audits.

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 also 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 17 February 2022. It included reviewing the performance of the NAO's:

- Companies Act audit work on behalf of the Independent Supervisor (a statutory responsibility); and

- Audit work supporting opinions 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.

As part of our usual process, we consider whether action under the FRC's enforcement procedures is appropriate for inspections, as follows:

Companies Act audits

- 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 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 considered by the Director AQR for further action.

Non-Companies Act audits

- The FRC monitors the audit quality of non-Companies Act 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. Overview

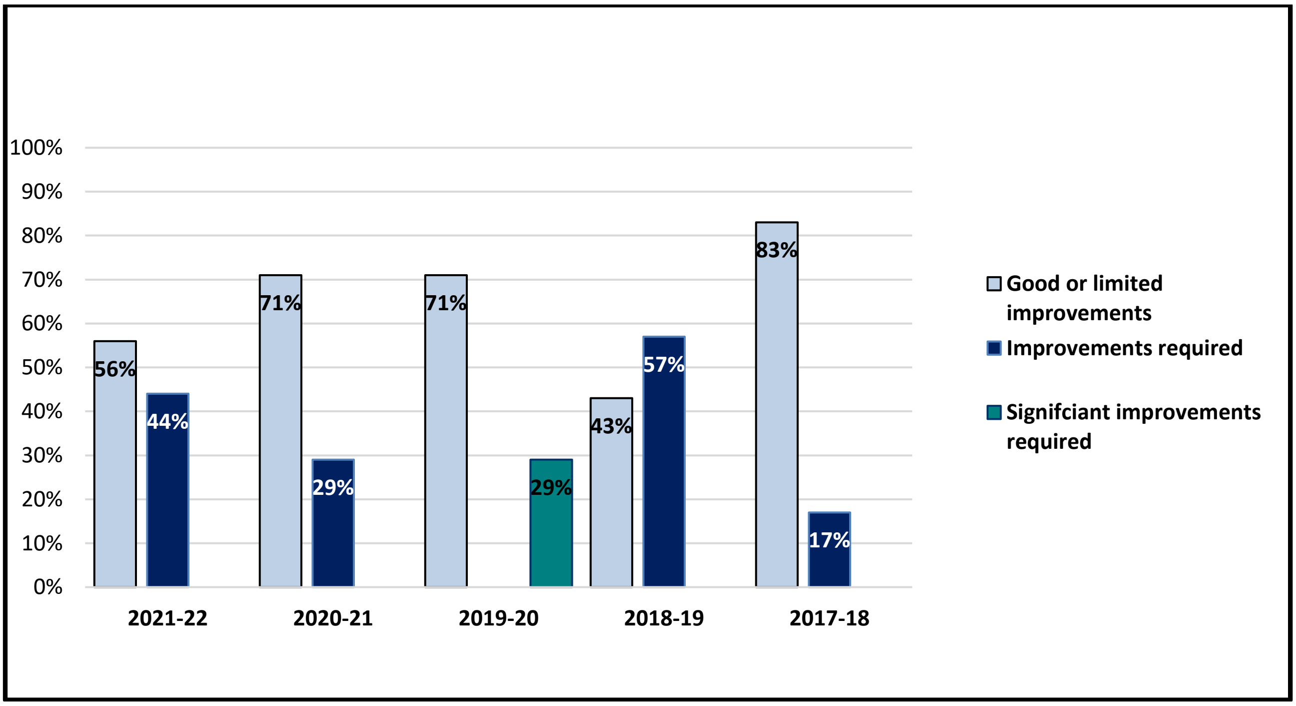
Summary of findings

We inspected nine individual audits this year (five Companies Act and four non-Companies Act audits). This was an increase from seven audits in the previous year, with one additional audit selected for review for each of Companies Act and non-Companies Act audits.

This year, we assessed five of the nine audits inspected (56%) as requiring no more than limited improvements, a decline from 71% in the previous year. The proportion of audits assessed as requiring at least improvement has moved towards the levels last seen in 2018/19. The NAO must critically evaluate all its audit quality results in relation to its Audit Transformation Programme and related initiatives. The NAO should consider how the learning from this year's reviews can be implemented to support audit quality and prevent recurrence of findings. Details of key findings driving this assessment are outlined on page 8.

Of the nine audits selected for inspection, four audits (two Companies Act and two non-Companies Act) were assessed as requiring improvement. This was an increase from the two audits assessed as requiring improvement in the previous year, where seven audits were selected for inspection. No audits were assessed as requiring significant improvements, which is consistent with the 2020/21 inspection cycle.

*Our assessment of the quality of audits inspected**



* 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 2021/22 column refers to the NAO's audits of 2020/21 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 the NAO to take action to achieve the necessary improvements, including evaluation as to what changes are needed to its Audit Transformation Programme to ensure it will deliver the improvements required.

The finding that contributed most to the 2021/22 inspection results related to reliance placed by audit teams on (and the challenge of) the work performed by others. This included reliance placed on fund or investment management statements to confirm valuation of assets, without adequate procedures to confirm the reliability and appropriateness of these valuations.

We have seen that the NAO has taken steps to address the key findings in our 2020/21 report, including additional training and mandating consultations. However, given we continue to identify weaknesses in the NAO's audit of significant judgments and estimates, particularly in the area of valuation of harder to value assets, the NAO must consider the effectiveness and timeliness of its previous actions, and the results of its root cause analysis on the recurring findings, in determining what further actions are required.

In the previous inspection cycle, we also 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 asked the NAO to consider these issues urgently and identify steps to improve the quality of this work.

More specifically, we noted that the NAO needed to consider whether it had the necessary skills and expertise in this area given the complexities of auditing valuation models (such as those frequently used in the determination of loan loss provisions and fair value estimates in these types of entities).

We are encouraged to see the NAO's commitment to making the required improvements through the development of an Audit Transformation Programme which is due to be rolled out for the NAO's 2022-23 audit cycle and its investment in central technical teams to support the audit of financial instruments. In addition, we have already observed a number of positive changes to the NAO's IFRS 9 methodology in response to issues raised as part of our firm-wide work last year.

In the current inspection cycle we again inspected a sample of entities in the financial services sector or with financial services-related balances. We noted the work on a medium sized entity and one large department to be of a good standard but continue to highlight concerns over the audit work of more complex financial services balances, such as expected credit loss calculations as well as the audit work over level 3 financial assets. Two of the audits where improvements were required were impacted by financial services-related balances or entities in that sector.

As the NAO finalises its Audit Transformation Programme, it must re-assess whether the planned changes are sufficient to remediate the audit shortcomings in this area. The NAO must demonstrate that further improvements have been made in its 2022 year-end audits of financial services entities, which we will inspect in 2023.

In respect of the four 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, effectiveness and appropriateness of the NAO's actions to address the findings raised.

NAO's overall response

We are grateful to the AQR for its recent inspection of our 2020-21 financial audit work. While highlighting that none of our audits reviewed required significant improvement, its reviews show that we have addressed some, but not all, of the areas for improvement previously identified.

We are investing heavily in audit quality. Our Financial Audit Quality Plan recognises that quality comes from clear leadership, a culture of learning and the pursuit of excellence, effective training and development, strong technical resources, effective systems, and the retention and recruitment of high-quality professionals.

The Quality Plan responds to the findings of internal and external reviews. In 2021-22, this has included strengthening our Centre of Expertise on Financial Instruments, rolling out mandatory training on key areas of improvement, and sharing the results of root cause analysis so that the learning is applied consistently across our audits.

We will reflect further on the AQR's findings as we develop and embed our plans. We continue to focus our efforts on the remaining areas for improvement, in particular our work on complex financial instruments and our reliance on experts when gaining assurance on estimates requiring specialist professional knowledge.

Alongside this improvement activity, we have developed a new audit methodology designed to be compliant with the requirements of the new ISA 315, which sets new standards for risk assessment and planning the audit procedures necessary to address the risks identified. Having piloted the methodology on a sample of our 2021-22 audits, we are rolling it out to all our 2022-23 audits, supported by a major programme of training for our audit teams.

The next stage in our audit transformation programme is to pilot and then implement a replacement for our audit software platform. The new software is designed to guide auditors to deliver consistently high quality in line with the new methodology and support them in making greater use of data analytics.

The quality of our work gives us our licence to operate in undertaking our work on behalf of Parliament. We take all these findings seriously and our transformation programme currently underway is providing us with a key opportunity to reconsider our methodologies, audit approach, and training to transform our audit service, improve quality, insight and efficiency. We shall see benefits from these changes from our 2022-23 audits but acknowledge that the full impact will take several years. In the meantime, we have taken additional measures to address the quality inspection findings highlighted in this report. We have set these out in more detail under the relevant sections of this report.

Scope of our 2021/22 inspection

We examined aspects of nine individual audit engagements, all of which had year-ends dated 31 March 2021. We inspected five Companies Act audits out of 68 audits performed (prior year: four out of 71 audits) and four non-Companies Act audits out of 336 audits performed (prior year: three out of 331 audits)[1]. The NAO audits three public interest entities and one of these was inspected in the year.

In the year to 31 March 2021, 111 contracted-out non-Companies Act audits were excluded from selection, as agreed with the NAO. This is where the NAO retains overall responsibility and issues the audit opinion, but contracts with an 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 one large company, two medium-sized companies and two smaller ones.

The non-Companies Act audits selected comprised two large Departments, an Executive Agency and an Arm's Length Body.

We also undertook part of our cyclical review of the NAO's processes, policies and procedures supporting audit quality ("firm-wide procedures"), including a focused review of engagement quality control reviews, consultations and internal quality monitoring. We will continue to consider and evaluate the adequacy of the number of non-Companies Act audits inspected on a voluntary basis and discuss issues arising with the C&AG and the Independent Supervisor.

We currently report privately to the NAO on each audit inspected 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.

We are pleased that the NAO is developing its response to further enhance its engagement with Audit Committees, recognising the C&AG's statutory independence from the bodies they audit on behalf of Parliament. This will include making more transparent reporting to members of Audit Committees of the results of quality inspections and wider lessons that the NAO is taking forward to facilitate discussions between Audit Committees and audit teams. As an interim step, some audit teams have already shared their AQR inspection findings with the relevant Audit Committee where this was felt to be the most effective way to engage in a discussion on audit quality.

The NAO continues to take forward its on-going commitment to improve its transparency and accountability. A key development during 2021-22 was to work with the Public Accounts Commission ("the Commission"), on behalf of Parliament, so that the Commission would be able to scrutinise

[1]The NAO performed:
- 404 audits as of 8 November 2021, comprising 336 non-Companies Act audits and 68 Companies Act audits; and
- 406 audits as of 13 November 2020, comprising 331 non-Companies Act audits and 71 Companies Act audits.

effectively the quality of the NAO's financial audit work. In November 2021, and for the first time, the C&AG and colleagues attended a hearing of the Commission in which they were challenged to respond to matters concerning the NAO's quality arrangements, the C&AG's response to the most recent AQR inspection findings, and the NAO's plans to improve further the quality of its work. The NAO expects these arrangements to be an annual event and a key part of its wider response to the Government's recent White Paper, Restoring Trust in Audit and Corporate Governance.

Developments in audit regulation

On 12 July 2022, the FRC published a Position Paper setting out the next steps to reform the UK's audit and corporate governance framework. The paper follows the Government Response to the consultation on strengthening the UK's Corporate Governance, Corporate Reporting and Audit systems, including the creation of the Audit, Reporting and Governance Authority (ARGA), to replace the FRC. The document builds on the areas of the Government Response that fall within the FRC's remit, providing advanced clarity for stakeholders on how the work of reform will be delivered ahead of government legislation. The outcome may affect the scope and reporting of our future inspections.

Reviews of NAO individual audits

Our key findings related principally to the need to:

- Improve the audit procedures over the valuation of harder-to-value assets and investments;
- Improve the evaluation and challenge of management over key judgments and estimates, including the use of experts;
- Take further steps to ensure consistency in the quality of more complex financial services audits;
- Strengthen the framework of group auditor oversight of component auditor work; and
- Improve the consideration and testing of journal entries to respond to the risk of fraud and management override of controls.

Good practice observations

We identified one example of good practice in relation to the audit team's challenge of assumptions and consideration of external evidence to support a key judgment. Whilst we identified this example of good practice, we also continued to identify findings in this area.

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 several 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 the NAO's quality control procedures ("firm-wide")

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

- Engagement Quality Control Reviews (EQCR);
- Internal Quality Monitoring;
- Consultations; and
- Audit file archiving.

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

- Improving the timeliness of the internal quality monitoring process; and
- Enhancements to certain aspects of its processes and procedures around EQCR's, including formalising the allocation process to ensure that EQCRs have the required level of qualifications in auditing financial services balances.

Good practice observations
No specific good practice examples were raised in our review of firm-wide areas.

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

As at the date of reporting, the NAO's internal quality monitoring cycle had not concluded and therefore we have not been able to compare the results of the NAO's internal monitoring to AQR's results. Completion of this is later than in prior years, when we have been able to report on the results of the internal quality monitoring, and we therefore expect increased timeliness in the process for the coming year.

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. As well as findings on audits assessed as requiring improvements, the key findings can include those on individual audits assessed as requiring limited improvements if they are considered key due to the extent of occurrence across the audits we inspected.

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 audit procedures over the valuation of harder-to-value assets and investments

The valuation of assets can involve significant judgment. Auditors should focus sufficiently on testing the valuation of these investments to be able to identify any material misstatement of the entity's assets. For example, defined benefit pension scheme assets are included on the balance sheet of entities at fair value and can include investments which are hard to value.

Key findings

There were findings on three audits in relation to the NAO's audit approach of the valuation of harder-to-value assets, including two audits where this finding was assessed as requiring improvement. In these cases, the audit team:

- Did not undertake an adequate assessment of the nature of the assets, including the extent of complexity and judgment required to value the assets.
- Relied on fund or investment manager statements to confirm valuation of material assets without adequate further procedures to confirm the reliability and appropriateness of these valuations.
- On one audit, the audit team placed reliance on a pension fund auditor to perform further procedures. The pension fund auditor performed this work to a materiality significantly greater than the NAO-determined materiality, resulting in inadequate sample sizes and thresholds for testing the reliability and appropriateness of these valuations.
- Did not appropriately review reports over investment manager controls when placing reliance on the related controls for valuations of assets. In one instance where the control report was obtained, the audit team did not make it clear as to the extent of the assurance obtained as a result of these valuation controls and therefore whether any further substantive audit procedures were required.

NAO's actions

We have established a Centre of Expertise on Financial Instruments to support audit teams in the audit of harder-to-value assets and investments. The Centre of Expertise provides advice and guidance to teams, as well as access to external specialist expertise where required. It is implementing an action plan to ensure consistency in the quality of our audit of complex financial instruments.

In response to the AQR's findings, we are updating our 2022-23 work programmes on harder-to-value assets and investments to ensure that audit teams are clear what is expected of them. To support audits that were already underway when the AQR reviews took place, we highlighted the AQR's findings to our teams through emerging finding bulletins and masterclasses. We also provided training to all audit teams on the importance of evidencing their consideration of the quality of evidence supporting key balances, including evidence obtained from third parties.

Improve the evaluation and challenge of management over key judgments and estimates, including the use of experts

Financial statements often include balances subject to estimation and judgment, including valuation of assets and expected losses, which involve estimation uncertainty and management judgment. Audit teams are expected to assess these judgments adequately and perform appropriate challenge procedures.

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.

Audit teams consider the need to use internal specialists (working as part of the audit team) or experts (reporting to the audit team) in challenging management in areas of estimation and judgment. Audit teams should assess and evaluate the objectivity and capability of the specialist/expert and evaluate their work and conclusions to assess whether they address the risks identified and provide sufficient audit evidence which can be relied upon.

Key findings

Whilst we identified one example of good practice in relation to the NAO's audit of a significant judgment, we continued to identify weaknesses and inconsistency in this area, particularly in the audit of valuations. Two audits were identified as requiring improvement as a result of findings in this area.

- On one audit, we identified that:
  - The audit team did not adequately challenge or corroborate the assumptions used in management's valuation model for an investment, specifically the forecasted revenue growth, margin improvements and discount rate.
  - Reliance was placed on an auditor expert to assess these key assumptions without appropriate evaluation of the work performed. The audit team did not sufficiently evidence its assessment of the relevance and reliability of assumptions used by the expert.
- On another audit, the audit team did not adequately assess and challenge the management's approach to value a significantly material asset balance, particularly due to potential changes as a result of Covid-19.

As the audit of significant estimates and assumptions has been an area of recurring finding, the NAO must urgently update its Audit Transformation Programme to address our concerns in this area.

NAO's actions

In autumn 2021, in response to previous AQR findings we provided mandatory training to audit teams on the requirements of ISA (UK) 500 on audit evidence, covering the need to consider sources of audit evidence and the differential requirements for management experts or external information sources. Practical examples included scenarios on evidence required to support management's estimates and valuations. The benefits of this training is expected to be seen in our 2021-22 audits.

As part of our implementation of ISA (UK) 540 standard on Auditing Estimates, we revised our standard audit work programmes for estimates, providing supporting guidance and mandatory training, which included specific elements on exercising professional scepticism when auditing estimates. For our 2022-23 audits, we are reviewing these work programmes and guidance to ensure they are sufficiently clear on the requirements in the areas for improvement noted by the AQR, including evidencing challenge of management judgments and auditor's experts.

Take further steps to ensure consistency in quality of more complex financial services 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 expected credit losses (ECL)). Financial services audits represent a specialised area of auditing and require specialised audit approaches to ensure methodologies are developed in line with best professional practice and financial reporting standards.

Key findings

In the previous year, we highlighted key findings in relation to the audit of more complex financial services audits and more complex financial services- related balances on other audits in the previous six inspection cycles.

In the current inspection cycle we have inspected two financial service companies, as well as considered the work performed on financial services related balances on other audits. Whilst we acknowledge that the NAO is committed to improve in this area of auditing and note that a medium sized financial services audit achieved a good grading, it is still not consistently achieving the necessary level of audit quality, specifically for large or complex financial services-related balances, such as expected credit loss provisions.

In two audits, we identified recurring findings identified from the prior year where the audit team had failed to obtain sufficient evidence to support the key assumptions and accounting treatment of the ECL provision calculation, including insufficient testing over probability of default assumptions as well as the SICR (significant increase in credit risk) process. We also identified insufficient procedures performed over the reliability and integrity of data used within the calculation of the expected credit loss. One of these audits was identified as requiring more than limited improvements due to this issue.

NAO's actions

We have established a Centre of Expertise on Financial Instruments to support audit teams in the audit of complex financial instruments. The Centre of Expertise provides advice and guidance to teams, as well as access to external specialist expertise where required. It is implementing an action plan to ensure consistency in the quality of our audit of complex financial instruments. A number of these actions, including new guidance and improved access to external specialist expertise, were in place to support our 2021-22 audits.

Other actions, including an update of our work programmes to ensure teams are clear what is expected of them, will be implemented for our 2022-23 audits. In particular, we will update our work programmes and supporting guidance on the calculation of Expected Credit Losses, the area where the AQR has continued to identify findings.

Strengthen the framework of group auditor oversight of component auditor work

The group audit team is responsible for the oversight of the group audit, including work at component level and therefore needs to demonstrate sufficient involvement throughout the audit process.

Key findings

For all group audits inspected, we inspected the level of involvement of the group audit partner and other group audit team members in the direction, supervision and review of the component audit teams. For three audits, we identified findings in respect of aspects of the group audit team's oversight, including one assessed as requiring improvements.

In particular, there were areas of the audit where there was insufficient evidence that the group audit team had adequately assessed the work of the component auditors, including the approach adopted and whether additional procedures were required to obtain sufficient assurance. For all three audits, this included areas of significant risk.

NAO's actions

As part of our Audit Transformation Programme, we have revisited our audit approach to group audits and related tools and templates to support those audit teams who are responsible for the audit of group entities. This will take effect from our 2022-23 audits. To support audits that were already underway when the AQR reviews took place, we highlighted the AQR's findings to our teams through emerging finding bulletins and masterclasses.

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

Auditors are expected to perform appropriate testing of journals as one of the key audit procedures in response to the risk of management override. 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

In the prior year, we reported that the NAO needed to improve the quality of evidence on aspects of journal entry testing. This year, we inspected the testing of journal entries on all audits inspected. We continue to identify weaknesses of a limited improvement nature in this area:

- On seven audits, the audit team did not sufficiently justify why certain journals were excluded from further testing, including journals which met the high-risk criteria determined by the audit team.

- For two of the above audits, the audit team did not adequately evidence how the risk criteria used to select journals for testing were responsive to the fraud risks identified within the company.

NAO's actions

We note the AQR's findings in this area identified issues where only limited improvements were assessed as being required. This reflects the actions we have previously taken, such as the promulgation of emerging findings from previous inspection reviews, so that our auditors focus on areas of risk and evidence their judgments and associated testing accordingly.

During 2021-22, we provided mandatory in-depth training to all audit colleagues on identifying a journals population. This sets out clearer expectations as to the documentation and explanations required for testing. This training goes through the steps we expect teams to follow to derive the complete population of journals from the entire general ledger obtained from audited entities. Our auditors are required to justify clearly their judgments when deciding on the journals population to be tested for the risk of fraud. We believe this training will address the AQR's findings, but we will continue to reinforce the learning from the training through guidance and desk-training.

3. Review of the NAO's quality control procedures ("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:

- Engagement quality control review;
- Consultations;
- Audit file archiving; and
- Internal Quality Monitoring.

We performed the majority of our review based on the policies and procedures the NAO had in place on 31 March 2022. We also set out our approach to reviewing the NAO's quality control procedures and a summary of our prior year findings (in the two previous years) at the end of this section.

Engagement quality control review (EQCR)

Background

An EQCR is required to be an objective evaluation, by a suitably qualified audit practitioner, of the significant judgments made by the audit team. The reviews are completed on public interest and other heightened risk audits before the audit report is signed. Our inspection evaluated the NAO's policies and procedures in relation to the appointment of EQCR reviewers. Key factors included the individuals' audit experience and level of seniority, availability and capacity, internal and external quality results and industry knowledge. We also considered how the challenges raised by the EQCR were made and resolved, as well as the training provided to reviewers.

Key findings

- The NAO portfolio includes entities which have significant financial services balances. The NAO should formalise the allocation process such that only reviewers with the required level of specialism and qualifications in auditing financial services balances are allocated to these reviews.
- The NAO should issue guidance on the minimum level of time reviewers are expected to spend on reviews and monitor where reviewers have charged significantly fewer hours than expected.
- In developing its guidance for the use of EQCR assistants to support EQCRs, the NAO should ensure that this includes a formal policy on the allocation and appointment of such resource, with consideration of their experience, knowledge, and independence. This guidance should also include the scope for use of an EQCR assistant.

NAO’s response and actions

In Spring 2022, we held a Director Masterclass to support those who were appointed EQCR reviewers of our 2021-22 audits. This included highlighting experiences from one of our framework partners over the approach they were taking and covered expectations around the depth of a review, time spent on a review, and the requirement to evidence their challenge and conclusions.

We will take into account the AQR’s findings as we appoint reviewers for our 2022-23 cycle of audits. We will set out expectations of a minimum time expected and will put in place more formal monitoring of time devoted to such reviews as audits evolve.

We will revise our EQCR policy to formalise our appointment and allocation of reviewers, matching experiences to relevant audits where we can. We will also develop guidance on the use of EQCR assistants as we expand use of this practice which we have previously trialled on a limited basis.

Consultations

Background

Consultation with the NAO’s central functions, on difficult or contentious matters, enables auditors to be guided by collective experience and technical expertise. We have reviewed the NAO’s policies, procedures and guidance covering consultations with its central technical teams, including any circumstances in which it is mandatory. We have also considered the process of resolution of differences of opinion arising from consultation.

Key findings

We have no key findings to report regarding the NAO’s consultations process.

Audit documentation

Background

Audit documentation comprises the evidence obtained and conclusions drawn during an audit. Archiving ensures that the documentation is maintained, should it be needed in the future. We reviewed the NAO’s arrangements relating to the assembly and timely archiving of final audit files, and the monitoring and approval of changes made to audit files after the signing of the audit report.

Key findings

We have no key findings to report with regards to our review of the audit documentation processes.

Internal Quality Monitoring (IQM) Process

Background

It is a requirement for the NAO to monitor their own quality control procedures to evaluate whether they are adequate and operating effectively. This allows action to be taken should deficiencies be identified.

We performed a review of the NAO’s internal quality monitoring and evaluation arrangements, including the review scope and inspection cycle policies for individual engagements. Our review included checking the grading or other criteria used to distinguish between higher and lower quality audits, central moderation processes and reporting arrangements. We also considered the composition of the IQM team, including the extent of sector specialism as well as the budgeted hours for the IQM process.

Further, we selected a sample of completed IQM reviews and considered the scope, findings and overall assessment. Due to delays in the completion of the NAO's IQM reviews for the current cycle, our sample selection was limited to two engagements.

Key findings

- The NAO should, as a matter of priority, perform a root cause analysis to identify the key drivers for the untimeliness of the IQM review process, and develop potential solutions to ensure that these reviews are performed on a more timely basis, allowing for findings to be considered in the following year's audit.

- Teams can currently appeal grades received from moderated internal quality reviews through an informal process. The NAO should formalise the appeals process and ensure that all grade reconsiderations flow through this process.

NAO's response and actions

We recognise that the timetable for these reviews needs to be bought forward. For the 2021-22 cycle of reviews, we have included the first phase of reviews as one of our autumn 2022 planning priorities. We will undertake a root cause analysis so that we can consider other lessons, such as how we might monitor the progress of reviews more effectively and the resourcing of our programme of reviews.

The 2020-21 cold review timetable reflected the delivery of the completion of our 2020-21 audits which, due to the pandemic, was more spread-out than in previous years, and our need to prioritise the earlier completion of our 2021-22 audits. To mitigate this elongated timescale, we ensured that emerging findings from reviews were promulgated to colleagues so they could take immediate action where necessary.

On our moderation process, our reviews are completed collaboratively with teams. As such, discussions and appeals from teams, based on evidence, over the grading of their review are included within the review which, in turn, is discussed as part of the moderation stage. Once the moderation process has been completed and a grade decided, there is an opportunity for the reviewed Director to ask the Director responsible for our cold review programme to take further evidence into account. We will update our guidance to reiterate to teams the opportunity to contest the grade and also consider other alternative appeals processes. We will continue to encourage a culture where teams focus on learning from the process and promoting further improvements to our audit quality rather than a focus on the final grade.

Approach to reviewing the firm's quality control procedures

We review firm-wide procedures based on those areas set out in ISQC 1 (some areas on an annual basis and others on a three-year rotational basis). The table below sets out the areas of focus for this year and the previous two years:

Current year (2021/22)	Prior year (2020/21)	Two years ago (2019/20)
• Engagement quality control review • Consultations • Audit documentation • Internal Quality Monitoring	• Audit methodology (recent changes to auditing and accounting standards), with a focus on IFRS 9 • Root cause analysis • Training for auditors	• Acceptance and continuance • Audit methodology (recent changes to auditing and accounting standards) • Training for auditors • Ethics and independence

Firm-wide key findings and good practice in prior inspections

In our prior year report we identified key findings in relation to the following areas we reviewed on a rotational basis:

- 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; and

- Ensuring that the appraisal system sufficiently incentivises audit staff to prioritise audit quality.

We provided an update on the firm's actions in our 2020/21 report. In the current year, we identified recurring findings in our inspection of individual audit files in relation to expected credit losses. The NAO must consider the effectiveness of its previous actions, and the results of its root cause analysis on the recurring findings, in determining what further actions are required.

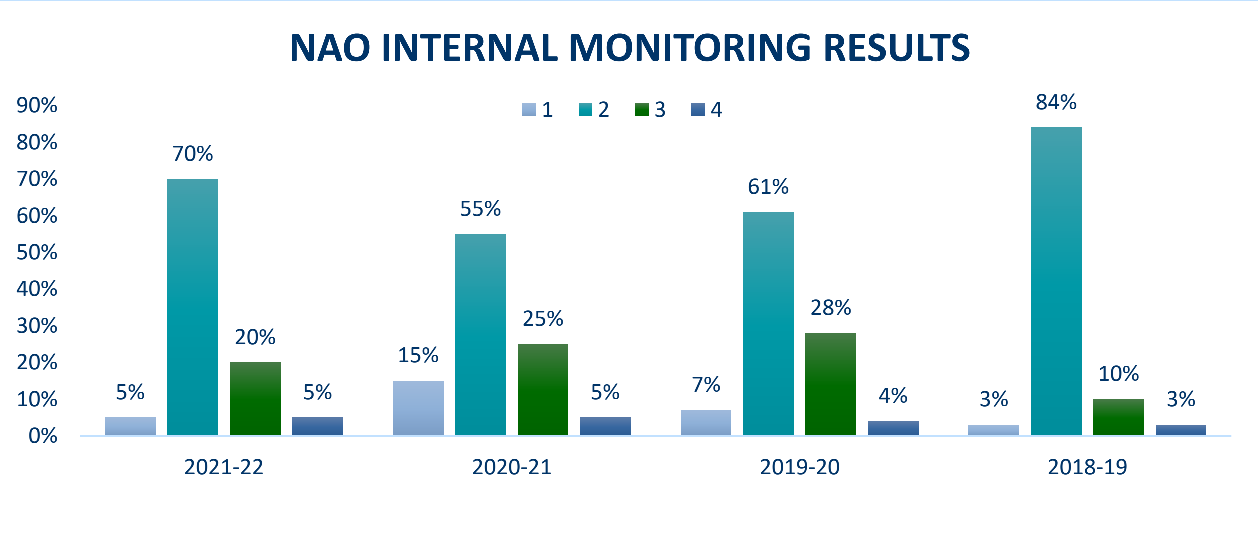
Appendix 1: NAO's internal quality monitoring results

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 2022, 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

As at the date of reporting, the NAO's internal quality monitoring cycle had not concluded. The current results, as of 14th July 2022, are set out below, including 20 reviews completed as at this date and excluding seven reviews still in progress.



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.