February 2024

National Audit Office

2022/23 Audit Quality Inspection

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Purpose of the report

This report sets out the principal findings arising from the 2022/23 inspection of the National Audit Office's (the "NAO") audits of 2021/22 financial statements carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). We conducted our detailed inspection work in the period from October 2022 to November 2023 ("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. Historically, the C&AG has sought and obtained the FRC's consent to publish the report on the NAO's website, and we are supportive of this public transparency and will continue with this approach.

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 terms of reference agreed in 2022; it also included reviewing the performance of the NAO's:

- Companies Act audit work on behalf of the Independent Supervisor (a statutory responsibility);
- Audit work supporting opinions on the financial statements of non-Companies Act audits (which the FRC carries out on a contractual basis). The number of non-Companies Act audits we review is agreed with the NAO; and
- Firm-wide procedures, based on those areas set out in International Standard on Quality Control (UK) 1 ("ISQC 1").

The NAO asks us not to review the quality of audit work of 'contracted out' audits (where the audit work is undertaken by an external audit firm but audit report signed by the C&AG) and also the NAO's audit work supporting its regularity opinion is not within the scope of our review. No Companies Act audits are contracted out by the NAO.

The population from which the risk-based sample of audits was chosen varied in complexity, size and risk, with 133 of the 292 audited entities having revenues of between £10 million and £500 million and 53 having revenues in excess of £1 billion. For the sample of audits inspected, revenue ranged from £43 million to £1.8 billion. For one audit the entity did not have any revenue, by the nature of its operating framework, but had net expenditure of almost £2.4 billion. A further entity, again reflecting the nature of its operating framework, reported a trading loss of £249 million, rather than revenue.

AQR does not select audits for inspection on a statistical basis, so changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of NAO's performance and are not necessarily indicative of any overall change in audit quality.

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 inspection of both individual audits and a review of 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 action should be taken under the Auditor General Disciplinary Rules 2012.

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. However, we would write to the C&AG if we identify deficiencies in audit quality which would have led to disciplinary action if similar deficiencies had been identified in an audit undertaken by an audit firm regulated by the FRC.

1. Overview

Summary of inspection findings

We inspected nine individual audits this year (five Companies Act and four non-Companies Act audits), the same as in the prior year.

As reflected in the AQR inspections performed, audit quality at the NAO has fallen for a second year. We have not yet seen the consistent improvements in audit quality that were anticipated under the NAO's Quality Plan which was launched in January 2021. The NAO must prioritise a detailed root cause analysis for these audit quality inspection results to aid the development and implementation of a robust and comprehensive action plan and to inform the Audit Transformation Programme, the first phase of which the NAO implemented from the 2022/23 audit cycle.

We assessed three of the nine audits inspected (33%) as requiring no more than limited improvements, a very significant decline from 56% in the previous year and 71% in 2020/21. The issues contributing to the poor 2022/23 inspection cycle results were varied. Details of key findings driving this assessment are outlined on page 12.

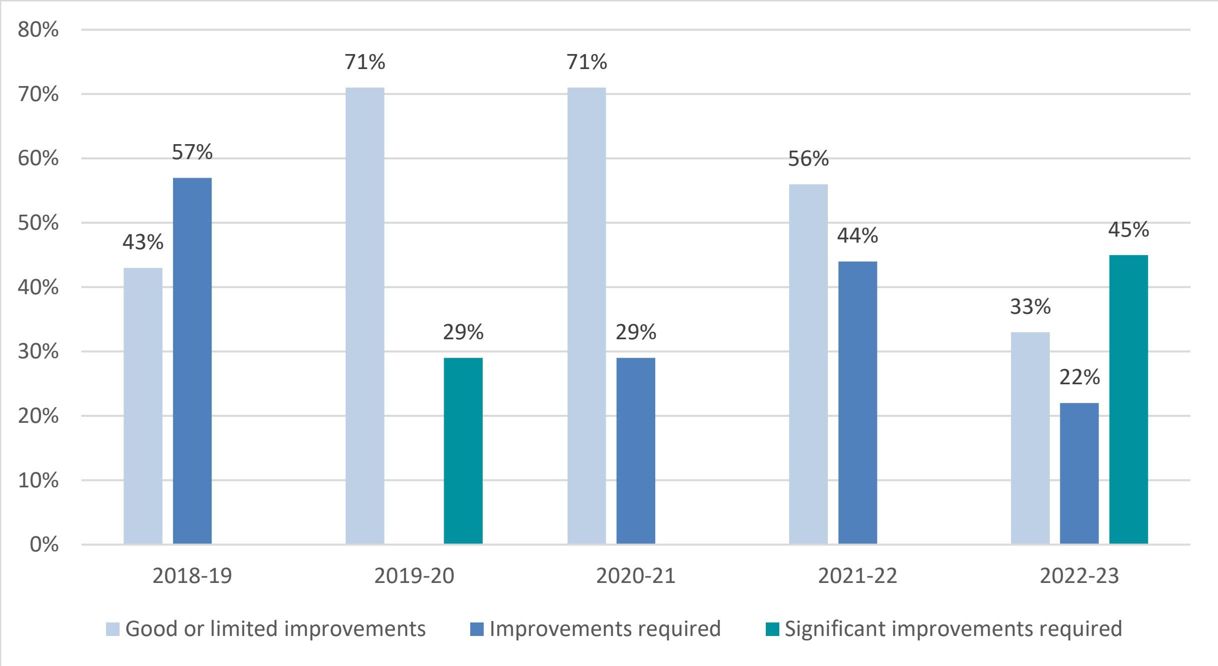
For the most part, in our view the issues arising were not unique to the facts and circumstances of the individual audit being inspected. Rather, they highlight possible weaknesses in the overall system of quality control at the NAO which require prompt identification and rectification. For the next round of inspections at the NAO, and in common with our approach across the major audit firms, we will inspect how the NAO has implemented the new International Standard on Quality Monitoring (ISQM1).

Of the audits inspected in the current year which required more than limited improvements:

- Four audits (three Companies Act and one non-Companies Act) were assessed as requiring significant improvements. This is extremely concerning as there have been no such inspection results since the 2019/20 inspection cycle. A quality assessment of significant improvements indicates that there are significant concerns regarding the sufficiency or quality of audit evidence, that there is a greater than acceptable risk of an unidentified material misstatement, or that there are significant concerns regarding the appropriateness of significant audit judgments in the areas reviewed; and

- Two (one Companies Act audit and one non-Companies Act audits) were assessed as requiring improvement (prior year: four audits).

*Our assessment of the quality of audits inspected**



Our key findings related principally to the need to:

- Improve the internal quality review process;
- Improve the understanding and application of aspects of the Revised Ethical Standard 2019;
- Take further steps to ensure consistency in quality of more complex financial services audits;
- Improve the audit procedures over the valuation of harder-to-value assets and liabilities;
- Improve the evaluation and challenge of management over key judgments and estimates;
- Improve the consideration and testing of journal entries to respond to the risk of fraud and management override of controls; and
- Improve the audit of revenue.

* 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 breaches of the Revised Ethical Standard 2019, 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 2022/23 column refers to the NAO's audits of 2021/22 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 an urgent evaluation as to what changes are needed to its Audit Transformation Programme to ensure it will deliver the improvements required within an 18 month timeframe.

We have not identified any particular themes that have contributed to the 2022/23 inspection results. Whilst, as in previous years, we continue to have findings relating to valuations, judgments and estimates, and journals, there are also significant findings this year relating to breaches of the Ethical Standard, errors in audit reports, necessary skills and experience of the audit team for more specialised audits, supervision, review and direction of staff, material undetected errors in the cash flow statement and in the audit of revenue.

We have seen positive actions where the NAO has taken steps to address the key findings in our 2021/22 report, including the roll out of new audit programmes and checklists to assist with the audit of harder to value assets and the audit of expected credit losses; enhanced procedures for the appointment of EQCRs and guidance on minimum time commitments; improved use of auditor experts on some audits; and root cause analyses to assess the reasons for all of the lower AQR inspection grades.

However, we continue to identify weaknesses in the NAO's audit of significant judgments and estimates, particularly in the areas of valuation of harder to value assets, and the testing of journals.

The NAO must consider the effectiveness and timeliness of its previous actions and developments in the Audit Transformation Programme. The results of the NAO's root cause analysis on the recurring findings, will be key in determining what further actions are required. We note that it takes the NAO considerable time to finalise root cause analyses and this is likely to delay the implementation of the necessary actions.

In the previous two inspection cycles, we identified an unacceptable trend of poorer audit quality relating to financial services and audits of financial services-related balances of 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 provisions and fair value estimates in these types of entities).

Notwithstanding the actions already taken by the NAO, including the improved use of auditor experts on some audits, we continue to identify significant failings in the audit of these areas.

In the current inspection cycle, we inspected five entities in the financial services sector or with financial services-related balances. We assessed the work on a medium sized entity and one large department as requiring significant improvements, and one medium sized entity as requiring improvement. The other two audits where significant improvements were required were not impacted by financial services-related balances or entities in that sector, but one did have harder to value assets.

We are encouraged to see the NAO's commitment to making the required improvements through the ongoing implementation of its Audit Transformation Programme (which is due to be fully rolled out for the NAO's 2023/24 audit cycle) and the investment in its centres of expertise and the establishment of framework agreements to provide access to external expertise.

These findings highlight that, as the NAO implements its Audit Transformation Programme, it must re-assess whether its planned changes are sufficient to remediate the audit shortcomings identified from the inspections in the current and prior year. The NAO must demonstrate that further improvements have been made in its audits of financial services entities, and those with harder to value assets, which we will continue to inspect. In respect of the two audits assessed as requiring significant improvements and the two audits assessed as requiring improvements, the NAO has completed a thorough Root Cause Analysis ("RCA") on the issues that led to quality standards not being met. On the final two audits, which were assessed as requiring significant improvements, the inspection reports were finalised in January 2024 and the RCA analysis will be completed in February. This work allows findings to be fed into the 31 March 2024 year-end audits. We will closely monitor and assess the effectiveness and appropriateness of the NAO's actions to address the findings raised.

Good practice

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

Good practice observations
Execution On one Companies Act audit the team thoroughly assessed the work undertaken by the predecessor auditor and management's previous methodology for calculating a provision. As a result of this, and the audit team's subsequent challenge of management, a material prior period adjustment was recorded. On this same audit, the use of an auditor's expert and the scoping of the expert's report provided the audit team with significant assurance over management's revised methodology for calculating the provision. Another example of good practice was the quality of reporting to the Audit Committee. On another audit, the auditor had clearly set out the complexities associated with a provision, how these had been addressed and the basis for the conclusions reached. 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.

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

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

- Engagement director and staff matters;
- Acceptance and continuance;
- Ethics and Independence; and
- Tone at the Top.

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

- Improving the application of aspects of the Revised Ethical Standard 2019, particularly the requirements relating to the independence threats arising from long association.

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

In the light of this year's findings and also given the introduction of the International Standard on Quality Management, the FRC plans to discuss the further support it might provide to the NAO in its role as an improvement regulator.

NAO's overall response

We are disappointed that the outcomes from the AQR's inspection of our 2021/22 audits show we have yet to see the full benefit of many of the measures we have put in place since we launched our first Quality Plan in 2021 and their impact on the grading of our audits. We take the AQR's findings seriously and, as we outline throughout this document, we continue to take action to address all these issues.

We have concluded that these recent findings show that we are capable of delivering high quality audits and do not point to a fundamental flaw in our audit methodology. However, the AQR's inspection results show that we need to do more to ensure all audit teams apply our methodology properly and consistently across our portfolio of individual audits. We recognise we need to do even more in areas of complexity to address the AQR's findings and to reflect increasing professional expectations.

To address the AQR's inspection results, we are currently completing a comprehensive, holistic "Quality First" plan encompassing all aspects of our audit work, rigorously aligned with ISQM1 and our System of Quality Management. At a strategic level, this will focus on our people and our quality culture. Our plan will introduce targeted interventions to support improvements in our audit work for application from our 2023/24 audit cycle. This will address the AQR's detailed findings, and those from our internal quality monitoring programme. Our interventions will build on improvements we have already made in the areas of auditing estimates, harder to value assets, financial service transactions and journals, taking forward our detailed responses in section 2 of this report. We will enhance our own root cause analysis programmes to provide further insights into our firm-wide procedures and as a measure of our success in implementing our quality culture. We have also recently announced changes in our financial audit governance structures to strengthen our governance and oversight over our audit work, including investing in the capacity of our central support and compliance teams, and in our digital and IT audit capability.

As we implement the actions set out in our Quality First plan, we will use the functionality which is now presented to us following the implementation of our Audit Transformation Programme so that all audit teams know what is expected of them and apply requirements in a consistent way. Our Audit Transformation Programme represents a very significant financial investment over several years. Its first phase was in place from our 2022/23 cycle of audits which implemented our new risk assessment methodology, following the requirements of updated ISA 315. Our risk assessment methodology involves a much more structured, granular process to identify and assess each risk of material misstatement. To complement this, we have also implemented substantially enhanced and tailored audit responses. From 2023/24, audit teams will start using our new audit software platform ("Apex") which systematises our new methodology. Apex uses workflow and automation which makes it much easier for our teams to achieve consistent application of auditing standards. We continue to review and improve our work programmes and templates so that all audit teams are clear on what is required of them to meet professional standards and are able to apply these standards consistently across all our audit work. Future phases of our Audit Transformation Programme, which we will roll out during 2024 and 2025, will introduce greater use of data analytics as well as applying IT controls-led approaches where relevant.

While we refreshed our System of Quality Management in 2022 as part of our implementation of ISQM1, we are not complacent about the challenges we face. We are taking stock of the AQR's inspections and findings from our own internal quality monitoring programme to ensure that we have fully understood the implications for our System of Quality Management, making improvements where needed.

Scope of our 2022/23 inspection

We examined aspects of nine individual audit engagements, all of which had year-ends dated 31 March 2022. We inspected five Companies Act audits out of 70 audits performed (prior year: five out of 68 audits) and four non-Companies Act audits out of 336 audits performed (prior year: four out of 336 audits)[1]. The NAO audits four public interest entities; none of these were inspected in the year.

In the year to 31 March 2022, there were 114 contracted-out non-Companies Act audits which were excluded from selection by 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 one large department, two Funds managed by government departments, and an Executive Agency.

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 partner and staff matters, acceptance and continuance, ethics and independence, and tone at the top. We also held discussions to understand the NAO's implementation of ISQM1.

We will continue to consider and evaluate the adequacy of the number of non-Companies Act audits inspected on a voluntary basis and discuss scoping and sample sizes of both Companies Act and contracted-out audits 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. Historically, the C&AG has sought and obtained the FRC's permission to publish the report on the NAO's website, and we are amenable to continuing with this approach. 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.

Given the quality results in the last two years and the part that Audit Committees can usefully play in assessing and monitoring audit quality, we would strongly encourage the NAO to increase the transparency around our inspection reports, by improving both the communication of our inspection results and related engagement with Audit Committees. For all Companies Act audits inspected, we would recommend that our engagement with, and reporting to Audit Committee Chairs is consistent with our inspections of major audit firms.

In response to this, the NAO in June 2023 launched an initiative with audit chairs of the bodies it audits to prompt discussions with each committee on the quality of its audit work. These discussions will promote the detail in the NAO's annual transparency report and its quality findings more generally. Where specific audits are inspected by the AQR, and building on some existing practice,

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[1]The NAO performed:
- 406 audits as of 31 March 2022, comprising 336 non-Companies Act audits and 70 Companies Act audits; and
- 404 audits as of 31 March 2021, comprising 336 non-Companies Act audits and 68 Companies Act audits.

the NAO will discuss detailed findings with the relevant audit committees so areas of concerns can be shared and actioned.

The NAO continues to take forward its on-going commitment to improve its transparency and accountability. A key development in recent years has been to work with the Public Accounts Commission ("the Commission"), on behalf of Parliament, so that the Commission is able to scrutinise effectively the quality of the NAO's financial audit work. The C&AG and colleagues now attend annual hearings of the Commission at which they can 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.

Controls based audits

We note that, currently, the NAO adopts only limited controls (including IT controls) testing where they rely upon the design, implementation and operating effectiveness of management internal controls. In the current year, only 13 audits (approximately 4% of all audits conducted) tested the operating effectiveness of internal controls, and there are plans to adopt controls-based audits for two large Government departments in 2023/24. We note that this proportion of controls based audits is lower than that found at major audit firms, reflecting the age of the systems in place within the NAO's audited bodies. We would encourage the NAO to continue to seek opportunities with its audited bodies to increase the number of controls based audits, particularly on the largest entities subject to audit.

Developments in audit regulation

Since our previous report, there have been no significant developments in audit regulation applicable to the NAO.

NAO's internal quality monitoring results

We have previously raised concerns over delays in the NAO's Internal Quality Monitoring (IQM) process. The IQM process consists of a sample of completed audit files being selected each year by the NAO for a retrospective internal audit quality inspection. We have seen insufficient improvement made to reduce these delays. IQM in respect of year ended 31 March 2022 audits had still not been completed by 31 March 2023. Our observation is that there is insufficient priority given to quality inspections, with limited resource available in the central team to perform these reviews, and the approach of using auditors who themselves have audit delivery commitments to assist in performing the reviews is not working.

Overall, the NAO's monitoring found that of the 24 audits assessed, 8 (33%) were found to require improvements/significant approvements, while 16 (67%) were judged to be good or requiring only limited improvements.

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 significant improvements' and '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 quality control review process

Auditing Standards require the auditor to record the nature, timing, extent and results of audit procedures undertaken, evidence obtained, and significant professional judgments made. This facilitates appropriate direction, supervision and review. Quality control procedures should detect and remedy shortcomings in audit evidence before the audit report is signed. An engagement quality control reviewer (EQCR), someone with sufficient and appropriate experience and authority to evaluate and challenge significant audit judgments and conclusions, can be an important part of the quality control review process.

Key findings

We found evidence that the quality control review processes undertaken were not as thorough as they should have been, resulting in errors in audit reports and primary statements not being identified. In three audits, two of which were assessed as requiring significant improvements, and one assessed as requiring improvements, we identified errors in the audit reports issued. These related to the omission of one balance sheet date from the audit qualification and factually inaccurate statements regarding the application of the listed entity rules of the Revised Ethical Standard.

In two further audits, both assessed as requiring significant improvements, we identified highly material errors in the cash flow statement and related disclosure notes in one and in the other, the audit team did not identify or evaluate the performance obligations within a material amount of deferred revenue which was brought forward at the start of the financial year, and remained carried forward at the year-end, despite this being evident in a key disclosure in the financial statements.

NAO Actions

We recognise the deficiencies raised by the AQR and took prompt action to mitigate the risk of these issues arising again.

On the issue of errors in the issued audit reports, and during the 2022/23 cycle of audits, we introduced a checklist which we required every audit team to complete making it clear the checks they needed to undertake before the audit report could be signed. In the case of the omitted balance sheet date from an audit qualification, the checklist covers this specific situation which related to a third, and more historic, balance sheet which was the subject of a restatement due to material errors identified by the audit team. As part of our subsequent root cause analysis, we identified that this omission was largely down to human oversight as more care was needed at the final stages of the audit as work was being drawn together to form an audit conclusion. We consider that this omission would not lead to a reader of our audit report to being misled. Indeed, our audit report pointed to a number of significant failings by the audited body which led to the qualification of our audit opinion.

On the material errors in the cash flow statement, this arose as there was insufficient focus by the audit team on this primary statement which might have alerted them to a transaction which should not have been included in the statement. As soon as this issue was identified, we notified audit teams of this issue through our findings bulletins and issued further guidance for teams to follow on cash-flow statements, focusing on higher-risk areas where more attention is likely to be required. We are currently considering what further improvements and clarifications can be made to the audit response requirements and material to support teams as they audit the cash flow statement from the 2023/24 audit cycle.

We cover our response to the issues that arose in interpreting the ethical standard in the next section.

We are currently reviewing the AQR's findings in the area of deferred income and will update our audit responses to address any further potential gaps as part of our 2023/24 cycle of audits.

Improve the compliance and application of aspects of the Revised Ethical Standard 2019

The Revised Ethical Standard 2019 provides a framework to ensure that users of financial statements can have confidence that an audit opinion is independent and objective. The audit reports issued by the NAO stated that the Ethical Standard's rules for listed entities had been applied (on a voluntary basis). The rules for listed entities differ from those for unlisted entities. One area of difference is that the listed entity rules require safeguards to be put in place if a Responsible Individual has been involved in an audit for more than five years.

Key findings

In the current inspection cycle, we identified two audits where there had been a reportable breach of the Revised Ethical Standard 2019. In both instances the audit report stated that the ethical standards relating to listed entities had been applied, but, despite the fact that the audit engagement directors for both audits had been in post for more than five years, no appropriate safeguards were applied to mitigate the threat arising from their long association with the audit.

NAO Actions

We accept the findings raised by the AQR and acted promptly to remedy these.

In the case of our audit reports stating that we applied the Ethical Standard's rules for listed entities, our root cause analysis highlighted that where we had sought to apply a higher ethical standard than required to non-listed entities, we had not properly translated the wording in the Standard to that in our Financial Audit Manual. The wording of our template reports was therefore incorrect where four engagement directors had been in post for more than five years. We acted swiftly by updating our Manual to bring it in line with the requirements of the Ethical Standards for listed entities were they to apply and changed our audit certificate template for non-listed entities to remove reference to ethical requirements for listed entities so that audit teams applied the correct wording in their audit reports. We are clear that we applied ethical standards appropriate to the nature of the entities and that the work undertaken on each audit and its conclusions was suitably independent, albeit this wasn't properly reported in the auditor's report.

The extensions related to two engagement directors working on the audits of non-listed entities and who were asked to extend their time on their audits so as to further enhance the quality of the audit work for which they were responsible.

For 2023/24, we have retained our policy requiring central approval for an Engagement Director's association on an audit engagement beyond five years for all entities, including non-listed entities, and have bought forward the timing of consideration and approval of any extensions. We have also ensured that, where safeguards are needed, these are applied consistently.

Take further steps to ensure improvement in the 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 two years, we have 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 departmental entities, one executive agency and two 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 one of the departmental audits and one company audits achieved good gradings, on the three other audits referred to, two were assessed as requiring significant improvements, and the other required improvements.

In the departmental audit requiring significant improvements, we identified similar findings from previous years where the audit team had failed to obtain sufficient evidence to support the key assumptions and accounting treatment of complex financial assets and liabilities. On this audit, we also had significant concerns about the relevant skills and experience of audit team members, the EQCR and the external specialist used, given the specialised nature of the audited entity.

In the company audit requiring significant improvements our key findings related to material errors in the cash flow statement, lack of challenge over management's presentation of the income statement, and testing of journals.

NAO's actions

We continue to recognise the importance of findings in this area and are reflecting on where we need to strengthen our approach further, building on the considerable investment we have already made.

We continue to invest in our Financial Instruments Centre of Expertise in enhancing its capacity and developing the expertise it has so as to advise audit teams on best practice to apply to their audits. The Centre has developed detailed annual plans of work setting out its ambitions to address the issues raised previously by the AQR. It is held accountable for the delivery of its plan by our executive directors.

For our 2022-23 audits, the Centre:

- introduced new tools with guided workflow for the audit of investments in funds;
- issued an expected credit loss standback quality checklist; and
- put in place a Financial Instrument Framework Contract for the commissioning of Financial Instrument external expertise.

From 2022/23, we strengthened our EQR appointment process to emphasise further consideration of the skills necessary to undertake this role, including financial instrument expertise, and our Centre advises reviewers where necessary.

We are reflecting further on these ambitions, together with the AQR's findings, as the Centre develops its plans for 2024. Specific actions we are currently considering include:

- Refresher training for the Service Line, with focus on most regularly encountered quality issues.
- Promoting and better understand the quality and consistency of our work on Expected Credit Losses through a programme of Centre led cold reviews responding to areas of identified weakness.
- Further developing our Investments in Funds Guided Workflow and promoting correct usage through training and our programme of targeted outreach.
- Improving support to teams auditing the fair value measurement of unlisted equity investments.
- Improving support to teams auditing IFRS 7 disclosures (e.g. by making guidance on specific topics more readily available and accessible).

We will also:

- Continue to promote audit quality through the Centre's consultation service (which includes facilitating access to external specialists and market data).
- Continuing to develop the knowledge, experience and resilience of the Centre itself.
- Support the transition of our market data solution to a newer web-based platform.

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

The valuation of assets and liabilities can involve significant judgment. Auditors should ensure that audit procedures are adequate to be able to identify any material misstatement, particularly where assets and liabilities are hard to value.

Key findings

There were findings on three audits in relation to the NAO's audit work over the valuation of harder-to-value assets and liabilities, with two audits assessed as requiring significant improvement in this area, and the other as requiring improvement. In these cases, the audit teams:

- Did not undertake an adequate assessment of the nature of the assets and liabilities, including the extent of complexity and judgment required to value these;
- Did not undertake sufficient and adequate procedures to conclude that the information in a specialist's memorandum constituted sufficient, appropriate audit evidence in an area of significant risk;
- Failed to summarise the outputs of its procedures and the audit challenges made to provide a clear overall summary that its conclusions on the valuation of assets and liabilities was based on the audit work undertaken; and
- Did not obtain and evaluate management's own assessment of assumptions which had material impacts on management's valuation of a hard to value asset.

As the audit of harder to value assets and liabilities has been an area of recurring findings, the NAO must urgently update its training and guidance to address our concerns in this area.

NAO's actions

We continue to recognise the importance of findings in this area and are reflecting on where we need to strengthen our approach further, building on the considerable amount of work we have already taken forward - some of which we have fully embedded during our 2022/23 audit cycle.

We also highlight that, for two of the three audits mentioned above, the AQR has acknowledged that we had responded effectively to previous significant findings on these audits in relation to our procedures on harder to value assets and liabilities.

Since our 2021/22 audit cycle, we have implemented significant changes to our audit methodology, including for harder to value assets and liabilities. This has included introducing a structured risk assessment for each risk of material misstatement, considering the relevant inherent risk factors for harder to value assets and liabilities, and adopting tailored responses. We have also secured further external expertise where necessary to support our audit approach and scepticism of the evidence presented to us by management.

For 2022/23, and as mentioned in the previous section, our Financial Instruments Centre of Expertise rolled out new tools to support the audits of harder to value financial assets (investment funds) and liabilities (ECLs).

From our 2022/23 audits, and with the introduction of our new risk assessment tool, we used audit risk assessment data arising from this to centrally identify those audits with harder to value financial assets and liabilities. This has given us a better understanding of risk in our portfolio of audits and where to target support. From our 2023/24 audits, we will extend this to property assets requiring engagement with our Property Centre of Expertise.

From our 2023-24 audit cycle, the implementation of our new audit software has allowed us to review our guidance and templates so that audit teams can apply requirements to each of their audits in a consistent way. We will reinforce this with additional training to set out our requirements in the areas raised by the AQR, including reinforcing the need to adopt a sceptical mindset in these complex areas, taking into account the further findings raised by the AQR.

Improve the evaluation and challenge of management over key judgments and estimates

Financial statements often include balances subject to estimation and judgment, including valuation of assets and expected losses, which involve estimation uncertainty and management 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.

Audit teams consider the need to use 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 two examples of good practice in relation to the NAO's use of auditor experts in the audit of significant judgments, we continued to identify weaknesses and inconsistency in this area, particularly in the audit of valuations. Two audits were assessed as requiring significant improvements and another assessed as requiring improvements as a result of findings in this area.

- For the two audits requiring significant improvements we found that there was insufficient evaluation and challenge of management's assessments in areas identified as significant risks; and
- On the audit requiring improvements, the audit team did not adequately assess and challenge management's revised methodology used to value a significantly material financial asset balance.

As the audit of significant estimates and assumptions has been an area of recurring findings, the NAO must urgently update its training and guidance to address our concerns in this area.

NAO's actions

As highlighted in the previous sections, we continue to recognise the importance of findings in this area and are reflecting on where we need to strengthen our approach further, building on the considerable amount of work we have already taken forward - some of which we will have fully embedded during our 2022/23 audit cycle.

From our 2022/23 audit cycle, we have implemented significant changes to our audit methodology. This has included introducing a structured risk assessment for each risk of material misstatement, considering the relevant inherent risk factors for areas of key judgment and estimates, and adopting tailored responses.

From our 2023/24 audit cycle, the implementation of our new audit software has allowed us to review our guidance and templates so that audit teams can apply requirements to each of their audits in a consistent way. We will reinforce this with additional training to set out our requirements in the areas raised by the AQR, including reinforcing the need to adopt a sceptical mindset in these complex areas, taking into account the further findings raised by the AQR.

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 significant risks of management override and fraud. 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 previous two years, we have 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 in this area:

- On one audit, the audit team identified 430 journals which met its risk criteria, but tested only 10 journals without sufficiently justifying why the criteria used did not correctly identify journals at risk of management override of controls.

- On another audit, the exclusion of journals from testing and the risk criteria applied resulted in no journals being tested.

- On a further three audits, the audit team did not sufficiently justify why certain journals were excluded from further testing.

As the consideration and testing of journals has been an area of recurring findings, the NAO must urgently update its training and guidance to address our concerns in this area.

NAO's actions

We note that our AQR and internal inspection programmes for 2021/22 continued to identify inconsistent application of our journals testing methodology at an audit engagement level.

To support our work for the 2021/22 audit cycle, we rolled out mandatory training for all staff alongside updates to our journals tools and templates. Following findings from our inspection programmes, we issued refresher training in March 2022 to apply to our 2022/23 audits and this was supported by presentations to our grade groups on examples of best practice.

For 2023/24, and following additional discussions with the AQR, we will issue further guidance on procedures teams need to perform when justifying the exclusion of journals from testing.

We are also developing new tools on anomaly detection, including reviewing the applicability of tools available from third party suppliers, which we will implement into our journals app from 2024/25.

Improve the audit of revenue

Accounting for revenue can be complex, particularly where entities deliver multiple services and where contracts cover more than one financial accounting period. Auditors should undertake sufficient procedures and obtain sufficient evidence to confirm that revenue is accounted for appropriately.

Key findings

In one audit, which was assessed as requiring significant improvements, we found that the audit team:

- Did not undertake its own assessments of complex multi-year contracts to assess whether revenue was being recognised in accordance with accounting standards; and

- Did not identify that a material amount of items within deferred revenue had been recognised for over a year, and therefore did not assess whether this was appropriate and consistent with the underlying contracts and accounting standards.

NAO's actions

We have implemented a new contract-based approach to revenue testing in our 2022/23 cycle of audits as part of our adoption of the revised ISA 315: Risk Assessment. Under this revised approach, audit teams review all new material contracts and contract modifications, evidencing our review of management's assessment of revenue recognition against the relevant standard. Previously, we had approached revenue testing through sampling in-year revenue transactions.

We are currently reviewing the AQR's findings in this area and will update our audit responses to address any further potential gaps as part of our 2023/24 cycle of audits.

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 focused on the following areas:

- Engagement Director and staff matters;
- Acceptance and Continuance;
- Ethics and Independence; and
- Tone at the Top.

We performed the majority of our review based on the policies and procedures the NAO had in place on 31 March 2023. 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 Director and Staff matters

Background

In accordance with the requirements of ISQC1, the NAO has detailed policies and procedures to provide it with reasonable assurance that it has sufficient personnel with the appropriate knowledge and experience to undertake audit work. We have reviewed these processes and their application within our firm-wide inspection activity this year.

Key findings

We have no key findings to report regarding engagement director and staff matters. We were pleased to note that the appraisal documentation we reviewed, for both engagement directors and other audit staff, evidenced strong awareness of the importance of audit quality.

Acceptance and Continuance

Background

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

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

Key findings

We have no key findings to report regarding the NAO's acceptance and continuance process.

Ethics and independence

Background

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

Key findings

Our key findings in relation to ethics and independence are set out in section 2 above, where we reported on two ethical standards breaches for the long association risk.

Tone at the Top

Background

ISQC1 requires an organisation to establish policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements. We have reviewed these policies and procedures and discussed them with those responsible for implementing them.

Key findings

We have no key findings to report with regards to the policies and procedures establishing a culture of quality.

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 (2022/23)	Prior year (2021/22)	Two years ago (2020/21)
• Engagement director and staff matters • Acceptance and Continuance • Ethics and Independence • Tone at the Top	• 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

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:

- Formalising the process for appointing Engagement Quality Control Reviewers (EQCR), and providing guidance on a) the minimum level of time reviewers are expected to spend on engagements; and b) the use of EQCR assistants.

- The need to improve the timeliness of root cause analyses, to allow for findings to be considered in the following year's audit, and the need to formalise the internal appeals process for internal quality review findings.

We provided an update on the firm’s actions in our 2021/22 report. In the current year, we identified recurring findings on the untimeliness of root cause analyses and completion of internal quality reviews.

Appendix 1: NAO's internal quality monitoring results

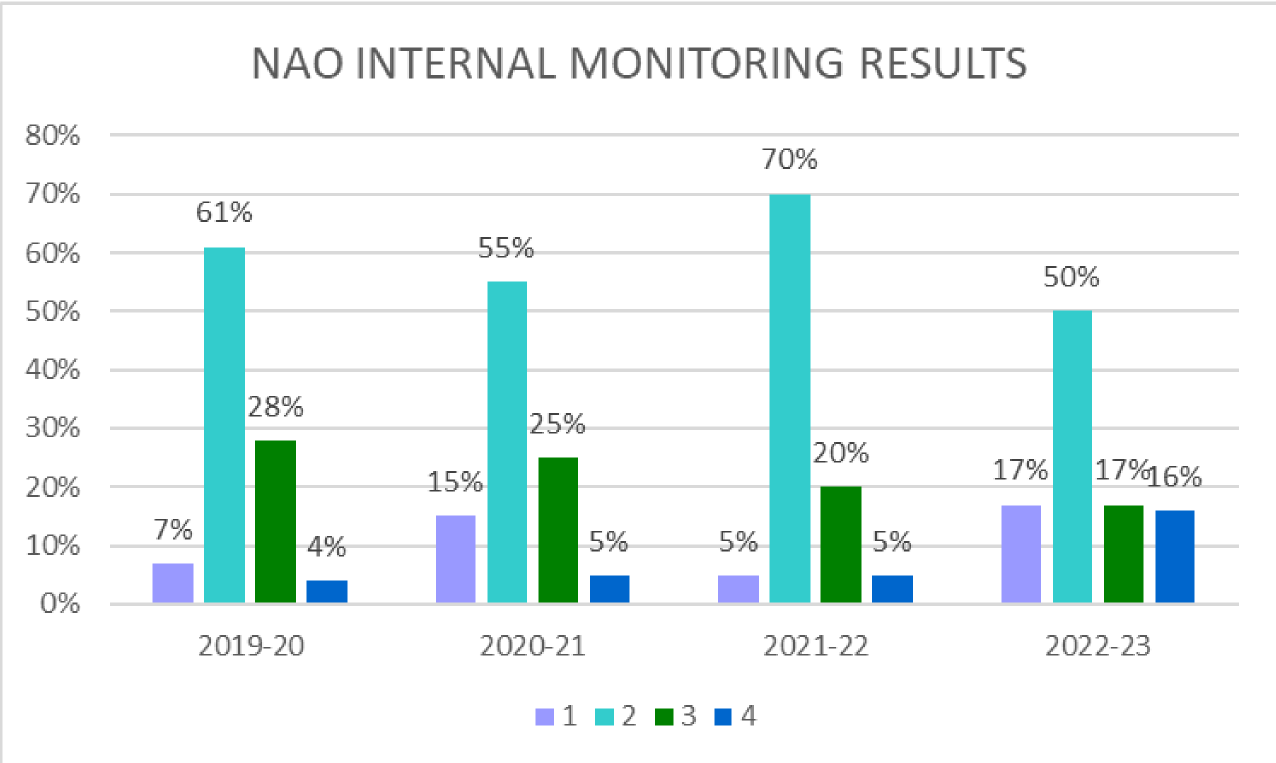
This appendix sets out information relating to the NAO's internal quality monitoring for individual audit engagements. It should be read in conjunction with the NAO's Transparency Report, published in November 2023, which provides further detail of the NAO's internal quality monitoring approach and results 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. In 2022/23, the NAO inspected 24 audits, which represented 7% of all audits undertaken. The number of inspections carried out in the previous three years ranged between 20 and 26, representing a similar proportion of all audits undertaken in each year.

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 NAO's internal quality monitoring cycle had concluded in September 2023. The results of this programme and comparisons to previous years, are set out below, where there has also been a deterioration in observed audit quality in 2022/23 compared to the previous years.

We urge the NAO to continue to perform a full RCA on these audit inspections to identify audit quality themes and resolve to establish a plan to address these matters for 2024 audits and also to embed change in their Audit Transformation Programme.



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 Engagement 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 Senior Audit Manager every three years and Senior 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.