National Audit Office

National Highways

Audit planning report on the 2021-22 financial statements audit

Report to those charged with governance
8 December 2021

This report presents details of our proposed approach for the audit of 2021-22 financial statements

We plan our audit of the financial statements to respond to the risks of material misstatement and material irregularity. This report sets out how we have built our assessment of risk, what we base materiality on, those risks we expect to be significant and how we will respond to those risks. We also set out in this report details of the team carrying out the audit, the expected timing of the audit and our fees.

Actions for the Audit and Risk Assurance Committee

Members of the Audit Committee (ARAC) are invited to discuss:

- Whether our assessment of the risks of material misstatement to the financial statements is complete (including any matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken);
- Whether management's response to these risks are adequate;
- Our proposed audit plan to address these risks;
- Whether the financial statements could be materially misstated due to fraud, and communicate any areas of concern to management and the audit team

We would also like to take this opportunity to enquire of those charged with governance about the following areas:

- Other matters those charged with governance consider may influence the audit of the financial statements
- The entity's objectives and strategies, and the related business risks that may result in material misstatements
- Possibility, knowledge of and process for identifying and responding to the risks of fraud
- Oversight of the effectiveness of internal control
- Whether any non-compliance with any laws or regulations (including regularity) have been reported to those charged with governance (e.g. from staff, service organisations or other sources)
- Policies, procedures and systems for recording non-compliance with laws, regulations and internal policies.

Matt Kay, Engagement Director

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Overview

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Audit Risks (pages 9 to 12)

We plan our audit of the financial statements to respond to the risks of material misstatement to transactions and balances and irregular transactions.

We have identified the following risks which have the most significant impact on our audit:

- Presumed risk of management override of controls
- Valuation of the Strategic Road Network (SRN)
- Provisions for Land and Property purchases

We have identified the following areas of audit focus:

- Accruals valuation
- PFI contracts
- VAT discussions with HMRC
- IFRS 16 – Embedded Leases
- Spending Review and cuts to RIS 2
- Smart Motorways

Materiality (page 15)

- When setting materiality, we consider both qualitative and quantitative aspects that would reasonably influence the decisions of users of the financial statements.
- We plan to apply an overall materiality for Strategic Road Network related assets of £1,300m but apply a lower materiality of £64m to all other transactions and balances, including capital additions.

Overall account materiality (1%)	£1,300m	
Additional materiality (1.5%)	£64m	
Error reporting threshold	£300k	Applies to all errors

Audit team, fee and timetable

- Matt Kay will be responsible for the overall audit. The full engagement team is presented on pages 16 and 22.
- Our audit fee for this year is £315k. The fee is the same as in 2020-2021.
- We are planning to complete the audit in advance of the summer 2021 Parliamentary Recess. We will be working towards a slightly earlier certification than in 2020-21 given that the Department for Transport is aiming to have its accounts certified in the pre-recess period this year.

Changes to our assessment of risk since 2020-21

FinancialAuditPlanning

The NAO have updated our risk assessment on the basis of known industry developments and internal organisational development since the prior year audit, as follows:

Risks and areas of focus diminishing or superseded since 2020-21	Risks and areas of audit focus identified in 2020-21 that remain relevant for 2021-2022		New risks and areas of focus for 2021-22
	Risks that are broadly consistent with last year	**Risks that have evolved and developed since last year**	
Significant Risks	Significant Risks	Significant Risks	Significant Risks
	Valuation of the Strategic Road Network (SRN) Presumed risk of management override of controls Provisions for Land and Property purchases		
Areas of Audit Focus	Areas of Audit Focus	Areas of Audit Focus	Areas of Audit Focus
Transfer of staff into HE EU exit and pandemic impacts	VAT discussions with HMRC PFI Contracts Accruals valuation IFRS 16 – Embedded Leases		Spending Review and Cuts to RIS 2 Smart Motorways

Building our assessment of risk

We are well placed to develop an understanding of the risks to National Highways drawing on your own assessment, the historic assessment of risk and the broader context.

National Highway's assessment of risk

National Highways' strategic risk register sets out a number of risks. We have engaged with management to understand the background to these risks, movement in impact and likelihood and have considered how these inform our assessment of audit risks.

- **Reputation**
  - Pace of technological change
  - Ineffective securing of information
- **Delivery**
  - Complex operational environment and supply chains
- Environment
  - Air quality, carbon reduction, noise, biodiversity loss
- Safety
  - Ineffective controls, asset failure
- People
  - Recruitment and remuneration

Past assessment of audit risk

The 2020-21 audit highlighted a number of areas of audit risk and focus, we have built on this historical assessment to consider whether these remain risks for the year.

- **Management override of controls**
- **Provisions for Land and Property purchases**
- **Valuation of the Strategic Road Network (SRN)**

Our wider work

We have drawn upon our wider assurance work to inform our risk assessment.

- **Delivering the Second Road Investment Strategy VFM Study**

Broader context

Our risk assessment draws on the understanding of the broader environment in which National Highways operates.

- **EU Exit**
- **Covid-19**
- **Climate change**
- **Smart motorways**

Significant risks and areas of audit focus

National Highways' assessment of risk / Our assessment of audit risk and areas of focus		Reputation		Delivery		Safety	Environment	People
		Pace of technological change	Ineffective securing of information	Complex operating environment	Supply chain disruption	Ineffective controls, asset failure	Air quality, carbon reduction, noise, biodiversity loss	Recruitment and remuneration
Significant risks	Presumed risk of management override of controls		●	●				●
Significant risks	**Valuation of the Strategic Road Network (SRN)**	●	●	●		●	●	
Significant risks	Provisions for Land and Property purchases	●	●	●				
Other areas of focus	**Accruals**		●					
Other areas of focus	**IFRS 16 – Embedded Leases**		●					
Other areas of focus	**PFI Contracts**			●				
Other areas of focus	**VAT Discussions with HMRC**			●				
Other areas of focus	**Spending Review and cuts to RIS 2**			●	●	●	●	
Other areas of focus	**Smart Motorways**	●		●		●		

The table shows how the key business and operational risks identified by National Highways may impact on the Annual Report and Accounts and give rise to significant risks and areas of audit focus for our audit.

These are areas where we will perform additional audit work as outlined in the following pages and report our findings to you.

Our initial assessment of the risk of fraud

We shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in our auditor's judgment, relevant to their responsibilities. It is our responsibility as auditors to report to those charged with governance:

- Any risks of material misstatement identified due to fraud
- Any matters we think are relevant to those charged with governance regarding management's process for identifying and responding to the risks of fraud in the entity

Below, we have included details of our initial assessment of the risk of fraud relevant to National Highways, and how this may impact on the financial statements.

Risk of material misstatement due to fraud

National Highways operates 2% of the UK's road network and has a significant impact on the UK market for network services. However, all transactions are undertaken with established, large-scale providers, and it is highly unlikely that any transactions would not be conducted at arms-length.

The Strategic Road Network (SRN) valuation is based on subjective accounting judgements, given that there is no active market for such assets. There is a low risk of fraudulent activity in relation to this as no individual or party is liable to gain from incorrectly valuing the SRN.

There may be a risk around period end accruals which may be generated artificially to ensure actuals align with budgets. We will assess the internal controls around the journals process and take assurance over this risk through our substantive testing. Accounting for accruals is included as a risk factor for this year audit.

We therefore conclude that the risk of material misstatement due to fraud is low, and we also rebut the presumed risk of fraud within revenue recognition due to the relative size of National Highway's income (£58m in 2020-21), and a general lack of complexity in those income streams.

The presumed risk regarding management override of controls remains as management are in a unique position to manipulate accounting records and override key controls. Although we assess this risk as low, we will address this risk through the significant risk 'presumed risk of management override'.

Matters regarding management processes for identifying and responding to the risks of fraud

Through our audit work to date, including work on significant risks in the prior year, we have not identified any significant concerns about the nature, extent or frequency of management's assessment of fraud risk.

We have not identified any significant failings by management regarding their monitoring or addressing deficiencies in internal controls or communication with us as auditors. NH uses IT controls to create segregation of duties and have appropriate access controls, and Internal Audit perform a series of reviews annually to ensure that adequate segregation of duties exist.

Our response to the significant risks*

Presumed risk of management override of controls

Why we have identified this as a risk

Under International Standards on Auditing (ISA (UK) 240) there is a presumed risk of management override for all audited bodies. Management is in a unique position to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively.

It should be noted that this is a standard, presumed risk on all financial audits (ISA (UK) 240). We have identified no particular risk factors in relation to NH management.

Work we plan to undertake in response

Controls

Given the risk relates to the override of internal controls by management, we do not seek to place significant reliance on controls. However, we will document and assess the design and implementation of controls, e.g. segregation of duties, journals approvals which could prevent management's manipulation of the accounting records and financial statements.

Substantive

We will:

- **review the accounts preparation process –** this review will include an assessment of the mapping of transactions to their appropriate account codes, and specific checks of year end journals;
- **test a risk based sample of journals –** our testing will look at the key risks, which will include journals with a significant budgetary impact, rarely used account codes, potential duplicate journals, journals posted by those who do not regularly process journals, alongside other risk factors;
- **review of material accounting estimates –** we will look for any indication of bias, alongside our standard testing, which will likely include significant accruals, provision balances, staff cost capitalisation, and transfers and impairments from Assets Under Construction; and
- **test all significant or unusual transactions –** through our analysis of financial data and other evidence sources, we will look to identify other transactions for testing.

*The auditor shall identify and assess the risks of material misstatement at:
(a) the financial statement level;
(a) the assertion level for classes of transactions, account balances, and disclosures
to provide a basis for designing and performing further audit procedures.

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Our response to the significant risks*

Valuation of the Strategic Road Network (SRN)

Why we have identified this as a risk

The SRN and related Assets Under Construction (AUC) balances are dominant components for the financial statements, with a 2020-21 balance of £132bn. The value is derived from the depreciated replacement cost of the SRN, which is calculated using the best available information to establish an accounting estimate, alongside the actual cost of recent schemes, and the asset records. A number of accounting assumptions are implicit in determining the valuation, which requires continual review, as does the application of indices used to revalue costing rates between 5-yearly assessments, and how asset information has applied to calculate a discount from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures).

This remains a complex and highly material estimate for 2021-22 and so is recognised as a significant risk of material misstatement. There are no planned revaluations or other one off events this financial year, so work will focus on the other movements such as indexation, depreciation and additions.

Work we plan to undertake in response

- (*Controls*) Confirm the design and implementation **of controls** operated by NH and Atkins in respect of the assets, NH's overall governance processes over the SRN valuation and reflecting conditions data in the valuation of the SRN;

- (*Substantive*) Thoroughly evaluate in accordance with ISA 540 the revaluation models for all asset types with the extent of work proportionate to per-category financial statements risk, and an emphasis on the overall **reasonableness of assumptions and methodology,** and the **accuracy of source data**. Specific work will include the following.
  - Obtaining assurance over the **completeness of changes to asset quantities**, using audited data on projects completed in year, substantive testing of dimensional variances and independent calculations including refreshing the detailed model previously produced by the NAO's modelling team of the network length
  - Confirming the **reasonableness of the indices** applied to inflate costs to current measures and ensuring these have been correctly applied, and that the QQR cost rates have been correctly brought forward
  - Reviewing the reasonableness of the **conditions data applied for depreciation** of roads and structures, including the methodology used, and the reliability and recency of data, as well as searching for any specific **impairment indicators**
  - We will review the work of Transport Research laboratory (TRL) in certifying the road survey vehicles used for obtaining the road conditions data in the annual road surveys, and perform ISA 500 procedures to confirm their expertise and independence.
  - Commissioning advice from (as in 2020-21) a structural engineering expert in respect of Highways' **transformation of physical data into a depreciation % estimate for roads and structures. This will include consideration of any changes to the applied methodology, and testing of a sample of asset depreciation calculations.**

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Our response to the significant risks*

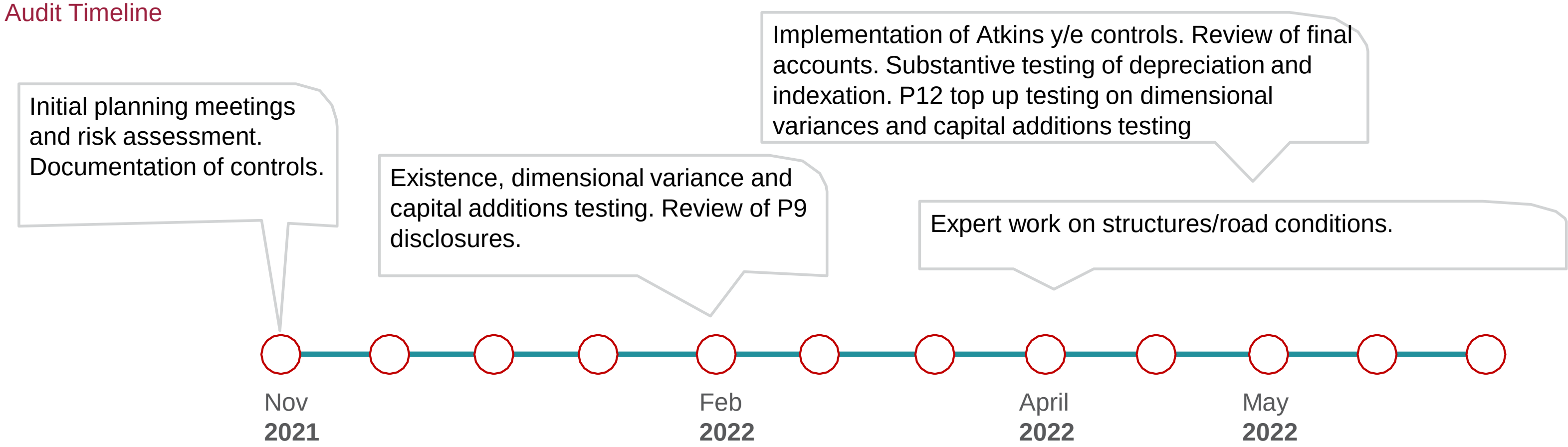
Valuation of the Strategic Road Network (SRN) *continued*

This estimates work is supported by our standard sample testing of capital additions and renewals (SRN and AUC) to ensure that additions meet the recognition criteria, existence testing of assets to confirm the asset register items are valid, a substantive analytical procedure to ensure depreciation and revaluation entries have been correctly performed based on the data. We perform this work to our standard level of precision since the areas targeted are not in themselves drivers of the significant risk, but they form part of our assurance build-up for the valuation. We also do not include the technology category in the scope of our significant risk due to its lower value (20-21 NBV £1.52bn), but cover this through standard sample testing. Finally, we audit the SRN accounts disclosures to ensure they are sufficient, consistent, understandable and disclose appropriate information on the estimation and judgements used to support the users.

Road Investment Strategy 2 2020 – 2025 (RIS2) Changes:

There are no one off quinquennial valuations expected for this year, however NH have identified to us that £0.5bn of RIS 2 funding had, in agreement with DfT, been reprofiled into future years of the RIS period. Additionally in the recent spending review there were indications of cost saving measures by Treasury which may reduce overall RIS funding. This could have implications for built up AUC balances in the SRN for schemes paused or curtailed (20-21 SRN AUC was £2.2bn). We will at year end review static AUC balances that may be affected, considering whether they remain valid in respect of the above funding changes, and if impairment or write offs are necessary.

SRN Audit Timeline



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Our response to the significant risks*

Provisions for Land and Property purchases

Why we have identified this as a risk

Land and property is acquired as part of improving the network, the overall balance at 31 March 2021 was £381m, made up as follows: £170m of blight; £217m of CPO; £62m for the Lower Thames Crossing; £57m for the A27 Arundel Bypass; and £29m for Part 1 claims. The provisions are supported by large and complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high.

Valuation (inherent uncertainty) – NH relies on estimates provided by the VOA that often lack a robust evidence base. In 2020-21 our expert valuer was able to conclude that the estimates were not materially incorrect, but we have recommended that NH work with VOA to secure better quality evidence for estimates provided.

We further note that management rely on a legacy system (HAL) in recording these provisions, which is used primarily by the property team for asset management purposes. The prior year sample testing noted a number of errors, namely in data entry and manual calculations in the system.

Work we plan to undertake in response

We will:

- assess the design and implementation of controls for recognising provisions for land and property purchases in the financial statements.
- substantively test a sample of provisions to gain assurance over the balances within the financial statements. Testing will involve tracing the values in the provisions system to either a valuation report or other third-party confirmation outlining the basis of the valuation, re-performing manual calculations, and selecting a sub sample of payments and aggregations against the chosen provisions.
- challenge and review NH's application of the IAS 37 recognition criteria.
- engage an expert valuer to assist with our work on provisions. They will review a subset of land and property valuations that underly the provisions within our sample, specifically reviewing the assumptions made in VOA's assessment of the most likely value.

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(a) the assertion level for classes of transactions, account balances, and disclosures
to provide a basis for designing and performing further audit procedures.

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Areas of audit focus

The following are matters which we consider have a direct impact on the financial statements but do not represent significant risks of material misstatement as defined by ISA (UK) 315.

If during the audit these areas of focus have a significant effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, we may include these in our extended auditor report as key audit matters, as defined by ISA (UK) 701.

Title	Audit Area Affected	Audit Response
Accruals valuation	Accruals, non-capital expenditure, capital expenditure, i.e. SRN & AUC additions	Testing in the prior year identified a high number of sample errors (although their aggregate value was not material), and we encountered difficulties in obtaining sufficient evidence for these accruals. The workshops we provided in 2020-21 were successful in helping to improve the accuracy of larger accruals. A number of errors were identified, but this time in lower value accruals. We have offered to hold these workshops again. We will also review a small number of accruals at interim to ensure we can give specific feedback to the business on the quality of evidence prior to the year-end audit. As in 2020-21, we will stratify our sample population in order to focus our sample on higher value accruals where the risk of material misstatement is greater.
IFRS 16 – Embedded leases	Non-SRN PPE	2019-20 saw a successful transition to IFRS 16, the new leasing standard. However, risk remains especially with embedded leases which may be a feature of construction contracts to which NH is a party. In 2019-20, while our additional procedures did not identify any leases omitted from the population provided, we recommended that retain evidence of IFRS 16 contract review to support continuing implementation. NH have set up a new process which will see the FBPs submitting confirmation of lease reviews on a monthly basis. In addition to this, they have added a spot check review centrally to ensure that no embedded leases are missed; we will review the results of this exercise again in the 2021-22 audit.

Areas of audit focus

The following are matters which we consider have a direct impact on the financial statements but do not represent significant risks of material misstatement as defined by ISA (UK) 315.

If during the audit these areas of focus have a significant effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, we may include these in our extended auditor report as key audit matters, as defined by ISA (UK) 701.

Title	Audit Area Affected	Audit Response
PFI Contracts	Expenditure, PFI assets	As in previous years, the NH Balance Sheet includes PFI liabilities built on analysis of financial models agreed between NH and the SPVs with design/build/finance/operate responsibilities. The derivation of these models – whose accounting consequences are set at inception – are inherently complex which the audit committee should note hence our raising a risk factor. However, given the 100% audit work carried out between 2018 and 2020 to reverify the evidence and accounting for these contracts, we do not anticipate any additional work being needed in 2021-22 beyond checking the proper accounting of actual PFI invoices received in-year, and keeping in view any refinancing events (none currently expected).
VAT discussions with HMRC	Provisions, liabilities, expenditure	While we are not expecting the effect of current discussions to be highly material, we know NH are engaging with HMRC on recoverability of VAT on pre-construction costs and expect this to be finalised at the end of January. The prior audit identified amounts recorded as receivables when recoverability was contentious. We will review correspondence between NH, HMRC and NH experts and assess this throughout the audit, including any disputes or uncertainty at year end.

Areas of audit focus

The following are matters which we consider have a direct impact on the financial statements but do not represent significant risks of material misstatement as defined by ISA (UK) 315.

If during the audit these areas of focus have a significant effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, we may include these in our extended auditor report as key audit matters, as defined by ISA (UK) 701.

Title	Audit Area Affected	Audit Response
Spending Review and cuts to RIS2	Capital expenditure, i.e. SRN and AUC additions	As a result of the Spending Review, the second Road Investment Strategy budget has been cut by £3.4bn, and management have so far re-profiled £500m of capital spend in agreement with DfT. Major planned projects including the £1.7bn Stonehenge Tunnel scheme, and the Lower Thames Crossing, are included in this re-profiling following some delays in planning. In our audit work we will consider the impact of the reprofiling of RIS2 and any other ongoing portfolio management changes that may have an impact on carrying values, disclosure requirements or land and property valuations.
Smart Motorways	SRN and AUC additions capital expenditure, impairment, accruals	The safety features of Smart Motorways has been an object of significant public interest for some time and was subject to a significant evidence stocktake in 2020, alongside commitments to specific improvements, and a one year on review in 2021. On 2 November, the Transport Select Committee recommended a full pause in the rollout, and some pauses have been announced by NH representatives on specific projects pending an NH-DfT of the select committee evidence. Whilst primarily an operational and safety – rather than financial – issue, we note the significant activity in this area and the need for finance and the audit team to keep in view the impact of any changes on the value of existing Smart Motorway assets, and any impairment or write-offs that might be required to assets under construction. While no wide-scale halt in construction has been announced, we note the pause for reflection on specific projects, and around the year end, with the benefit of more information, we will consider the impact of any project decisions to estimates made within related capital accruals on the cost of work done by 31 March.

Materiality

Basis for overall materiality calculation	£132,497m	2020-21 total property, plant and equipment balance
Overall account materiality (~1%)	£1,300m	£1,300m applies in respect of SRN related PPE asset balances (excluding capital additions)
Basis for additional materiality calculation	£4,271m	P7 management accounts adjusted gross expenditure
Additional materiality (1.5%)	£64m	£64m applies in respect of all other assets, liabilities, revenue and expenditure, reflecting taxpayer perspective.
Error reporting threshold	£300k	We report to you all misstatements, whether adjusted or unadjusted, above £300k in respect of items audited under both materiality levels.

We have set our overall account materiality, currently £1,300 million, as approximately 1% of the prior year value of the infrastructure assets, reflecting the significant interest among SRN users in the extent and condition of the network.

We set a lower additional materiality in relation to all financial statement elements driven by taxpayer spending, recognising the interest from Parliament and the public in National Highways' total expenditure of public funds. In practice, as a result:

- overall materiality applies to the SRN valuation, the associated non-cash entries (e.g. depreciation), and non-cash elements of closely SRN related PPE held for operational purposes; and
- our additional threshold applies to all other transactions and balances, including SRN/AUC capital additions. This has been calculated at 1.5% of adjusted forecast gross expenditure, giving £64m.

We have retained overall materiality at 1% based on (prudently) the SRN and AUC net book values reflecting user interest in the network.

These levels remain comparable to those used in the prior year.

A matter is material if its omission or misstatement would reasonably influence the decisions of users of the financial statements. The assessment of what is material is a matter of the auditor's professional judgement and includes consideration of both the amount and the nature of the misstatement.

The concept of materiality recognises that absolute accuracy in financial statements is rarely possible. An audit is therefore designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. We apply this concept in planning and performing our audit, and in evaluating the effect of identified misstatements on our audit and of uncorrected misstatements, if any, on the financial statements and in forming the audit opinion. This includes the statistical evaluation of errors found in samples which are individually below the materiality threshold but, when extrapolated, suggest material error in an overall population. As the audit progresses our assessment of both quantitative and qualitative materiality may change.

We also consider materiality qualitatively. In areas where users are particularly sensitive to inaccuracy or omission, we may treat misstatements as material even below the principal threshold(s).

These areas include:

- the remuneration report;
- disclosures about losses and special payments;
- our audit fee; and
- irregular income and expenditure.

Timing of the audit and audit fee

The timetable comprises an interim visit commencing 3 February 2022 for 4 weeks and a final visit commencing 3 May with certification planned for July 2022.

Fees

The fee for the audit is £315k.

The principle agreed with Parliament is that our fee is set to recover the full costs of the audit, rather than make a profit from or subsidise an audit. The NAO determines its fees with reference to standard hourly rates for our staff, which are reviewed annually, and updated when costs change.

Completion of our audit in line with the timetable and fee is dependent upon National Highways:

- delivering a complete Annual Report and Accounts of sufficient quality, subject to appropriate internal review, on the date agreed;
- delivering good quality supporting evidence and explanations within the agreed timetable;
- and making staff available during the audit.

If significant issues arise and we are required to perform additional work this may result in a change in our fee. We will discuss this with you before carrying out additional work.

In consultation with:

- Management;
- Audit Committee;
- Internal Audit;
- Key stakeholders

review National Highways' operations, assess risk for our audit and evaluate the control framework.
Determine audit strategy.

December 2021: Audit Planning Report presented to the Audit Committee

February: Test expenditure and income

March 2022: Present any significant findings from interim work

May 2022: Receipt of 1st draft accounts

May to June 2022: test expenditure and income and significant balances and disclosures.

August 2022: Lessons learned meeting.

Autumn 2022: Management Letter: provide final recommendations on control matters identified.

June 2022: Audit Completion Report: present our audit findings and recommendations.
July 2022: Seek representations and C&AG issues opinion.

National Audit Office

Our audit approach – Other Matters

Other Matters

Audit scope and strategy

This audit plan covers the work we plan to perform to express an opinion on whether the financial statements are free from material misstatement and are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The plan is also designed to ensure the audit is performed in an effective and efficient manner. The NAO financial audit team will work alongside the NAO VFM team to identify any areas of potential focus for upcoming studies. Our audit approach is a risk based approach, ensuring that audit work is focussed on significant risks of material misstatement and irregularity. Additionally by working with auditor's experts, the NAO financial audit team will contribute external sense checking of the reliability of the financial statements.

Our audit approach is a risk based approach, ensuring that audit work is focussed on significant risks of material misstatement and irregularity.

In areas where users are particularly sensitive to inaccuracy or omission, a lower level of materiality is applied, e.g. for the audit of senior management remuneration disclosures and related party transactions.

When undertaking our risk assessment we take into account several factors including:

- Inquiries of management
- Analytical procedures
- Observation and inspection of control systems and operations
- Examining business plans and strategies

Our risk assessment will be continually updated throughout the audit.

Independence

We are independent of National Highways in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed entities/public interest entities. We have fulfilled our ethical responsibilities in accordance with these requirements and have developed important safeguards and procedures in order to ensure our independence and objectivity.

Information on NAO quality standards and independence can be found on the NAO website: https://www.nao.org.uk/about-us/our-work/governance-of-the-nao/transparency/.

We will reconfirm our independence and objectivity to the Audit Committee following the completion of the audit.

Our audit approach – Other Matters

Other Matters

Management of personal data

During the course of our audit we have access to personal data to support our audit testing.

We have established processes to hold this data securely within encrypted files and to destroy it where relevant at the conclusion of our audit. We confirm that we have discharged those responsibilities communicated to you in the NAO's Statement on Management of Personal Data at the NAO.

The statement on the Management of Personal Data is available on the NAO website:

http://www.nao.org.uk/freedom-of-information/publication-scheme/how-we-make-decisions/our-policies-and-procedures/policies-and-procedures-for-conducting-our-business/

Using the work of internal audit

We liaise closely with internal audit through the audit process and seek to take assurance from their work where their objectives cover areas of joint interest.

Communication with the NAO

Organisations we audit tell us they find it helpful to know about our new publications, cross-government insight and good practice.

Our website holds a wealth of information from latest publications which can be searched, to pages sharing our insights on important cross-cutting issues. We also publish blogs and send email notifications to subscribers about our work on particular sectors or topics. If you would like to receive these alerts, please sign up at: http://bit.ly/NAOoptin. You will always have the option to amend your preferences or unsubscribe from these emails at any time.

IT Audit

IT Audit

Background

National Highways (NH) implemented the Cloud based Oracle Fusion system during the 2018/2019 financial reporting year. With the implementation of Oracle Fusion we made plans to move to a controls based approach in relation to our audit of purchases, when the controls environment made this possible.

There have been some barriers to us moving to a controls based approach. We summarise the issues that has been a barrier to adopting a controls approach:

- When Oracle Fusion was first implemented in 2018/2019 NH sought to adopt the same business processes for the cloud based Oracle system as they had operated with the on premise based Oracle system. The business processes that operated over the on premise system did not align well with the business processes needed for the new cloud based systems. As such, a high level of manual intervention and auxiliary processes were needed to operate the cloud Oracle system to ensure the accuracy of the financial data recorded on the system. These manual processes would have made a controls based approach to the audit inefficient due to the number of controls we would have needed to test.
- During 2019/2020 NH engaged KPMG to assist in enhancing its P2P processes. Although this resulted in enhancement to the P2P processes so they were better aligned with how the cloud based system operated, we once again did not seek to rely on the P2P controls operated as they had not operated throughout the year and, once again, we did not see this to be an efficient and effective way to deliver our audit as we would have had to test both the new controls and those operated prior to the new controls being implemented
- Our experience with other controls audits we do is that it can take several years for controls to embed such that we can obtain the evidence we need to support a controls based audit approach. Given this experience, last year (2020/21 audit) we did not plan to adopt a controls approach but we did undertake detailed fact finding to gather information on the controls processes implemented over NH's Purchase to Pay (P2P) cycle. Our work in 2020/2021 not only looked at the controls operated over purchases processed via the Oracle Fusion system, but we also extended our fact gathering to other systems that supported NH's purchasing activities. These "other" systems we did fact gathering on were:
  - HAL – This system is used to process land invoices. This system is an in house maintained system
  - Apps and Certs – This system is used for payments to large providers maintaining the road network under National Highways' oversight. This is a third party application run on the Oracle PaaS (Platform as a Service) IT infrastructure;
  - Confirm – Confirm is used for the delivery of road operations that are insourced. Insourced means that National Highways staff manage these parts of the network with the actual on-site work being purchased from, and done by, third party providers. This system, like Oracle Fusion, is a Cloud based SaaS (Software as a Service) solution. This means the software is third party solution running on a third parties IT infrastructure.

As noted above our experience is that it typically takes two audit cycles to move from a non controls approach to an approach based on reliance on controls. As such, whilst we plan to undertake work in 2021/2022 with the expectation to place reliance on P2P controls, we recognise that there may be more issues we need to address before we can achieve such controls reliance. We plan to undertake our controls testing prior to the financial year end so that if a full controls approach is not possible then we can adjust our audit approach accordingly.

IT Audit

IT Audit

Work we plan to undertake

Our work will focus in purchasing done using Oracle Fusion, Apps and Certs and Confirm but ***not*** HAL, given relative volume of spend and because the system is planned to be replaced in 2022/23..

All NH's purchasing processes are heavily automated or IT dependent, Given that we need to test the IT General Controls that support these automated controls. This will involve testing controls over any changes made to the system (change control). We will also test access controls, both the controls over user access to the system (end users) but also the access rights that technical IT staff may have (privileged access). As many of the processes rely on Cloud systems we will also need to obtain controls report from third party providers to obtain assurance over controls operated by these third parties

The programme of work we plan to undertake over P2P processes during 2021/2022 is as follows:

	TESTING AREA	Information gathering	Walkthrough of end to end process	Controls design effectiveness assessment	Implementation of controls assessment	Operational Effectiveness testing
1.	Supplier Master data maintenance					
a.	New supplier	✓	✓	✓	✓	Limited testing
b.	Supplier amendments	✓	✓	✓	✓	Limited testing
2.	Raising requisition / purchase order creation	✓	✓	✓	✓	Limited testing
3.	Receipting of goods and services	✓	✓	✓	✓	Limited testing
4.	Receipting and recording supplier invoices	✓	✓	✓	✓	Limited testing
5.	Payments to suppliers					
a.	BACS Payment Run Creation	✓	✓	✓	✓	Limited testing
b.	BACS Payment Run Release	✓	✓	✓	✓	Limited testing
c.	CHAPS payments	✓	✓	✓	✓	Limited testing

NAO National Audit Office

IT Audit

IT Audit

Work we plan to undertake

Apps and Certs - End to End Purchasing Process

	TESTING AREA	Information gathering	Walkthrough of end to end process	Controls design effectiveness assessment	Implementation of controls assessment	Operational Effectiveness testing
1.	Purchase agreement set up	✓	✓	✓	✓	✓
2.	Certificate set up and approval	✓	✓	✓	✓	✓

Confirm - End to End Purchasing Process

	TESTING AREA	Information gathering	Walkthrough of end to end process	Controls design effectiveness assessment	Implementation of controls assessment	Operational Effectiveness testing
1.	Set up of items of work for delivery by supplier	✓	✓	✓	✓	✓
2.	Evidencing completion of work by supplier	✓	✓	✓	✓	✓
3.	Approval of work for payment	✓	✓	✓	✓	✓

Any issues that we identify, that may hinder reliance on controls, we will report to management prior to the current year end in the hope, and expectation, that any issues arising can be addressed before the year end, so allowing reliance on controls.

Appendix 1: The NAO audit team

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Executive Leader

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Appendix 2: Scope and responsibilities

In line with ISAs (UK) we are required to agree the respective responsibilities of the C&AG/NAO and the Accounting Officer/Client, making clear that the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
These responsibilities are set out in the Letter of Engagement of 22 November 2021 and are summarised here.

Area	Accounting Officer/management responsibilities	Our responsibilities as auditor
Scope of the audit	• Prepare financial statements in accordance with Companies Act 2006 and that give a true and fair view. • Process all relevant general ledger transactions and make these, and the trial balance, available for audit. • Support any amendments made to the trial balance after the close of books (discussing with us). • Agree adjustments required as a result of our audit. • Provide access to documentation supporting the figures and disclosures within the financial statements. • Subject the draft account to appropriate management review prior to presentation for audit	• Conduct our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)). • Report if the financial statements do not, in any material respect, give a true and fair view. • Review the information published with the financial statements (e.g. annual report) to confirm it is consistent with the accounts and information obtained during the course of our audit.
Fraud	• Primary responsibility for the prevention and detection of fraud. • Establish a sound system of internal control designed to manage the risks facing the organisation; including the risk of fraud.	• Provide reasonable assurance that the financial statements (as a whole) are free from material misstatement, whether caused by fraud or error. • Make inquiries of those charged with governance in respect of your oversight responsibility.

Appendix 2: Scope and responsibilities (cont'd)

Area	Accounting Officer/management responsibilities	Our responsibilities as auditor
Regularity	• Ensure the regularity of financial transactions. • Obtain assurance that transactions are in accordance with appropriate authorities, including the organisation's statutory framework and other requirements of Parliament and HM Treasury.	• Conduct our audit of regularity in accordance with Practice Note 10, 'Audit of financial statements of public sector bodies in the United Kingdom (2020)', issued by the Financial Reporting Council. • Confirm the assurances obtained by the National Highways that transactions are in accordance with authorities. • Have regard to the concept of propriety, i.e. Parliament's intentions as to how public business should be conducted.
Propriety	• Ensure the propriety of financial transactions • Ensure that patterns of resource consumption should meet high expectations of public conduct, and robust governance and respect Parliament's intentions, conventions and control procedures, including any laid down by the Public Accounts Committee.	• Propriety is not readily susceptible to objective verification and, as such, is not expressly covered in the opinion on financial statements. When issues of propriety come to light in the course of the audit of financial statements, the auditor considers whether and, if so, how they may be reported.
Governance statement	• Review the approach to the organisation's governance reporting. • Assemble the governance statement from assurances about the organisation's performance and risk profile, its responses to risks and its success in tackling them. • Board members, with the support of the Audit Committee, evaluate the quality of internal control and governance, and advise on any significant omissions from the statement.	• Confirm whether the governance statement is consistent with our knowledge of the organisation, including its internal control. • Consider whether the statement has been prepared in accordance with HM Treasury guidance, including Managing Public Money.
Accounting estimates and related parties	• Identify when an accounting estimate, e.g. provisions, should be made. • Appropriately value and account for estimates using the best available information and without bias. • Identify related parties. • Appropriately account for and disclose related party transactions.	• Consider the risk of material misstatement in respect of accounting estimates made by management. • Perform audit procedures to identify, assess and respond to the material risks of not accounting for or disclosing related party relationships appropriately. • Significant risks are set out on pages 9-12.

Appendix 3: Follow up to recommendations we made in the previous year

In 2020-21 we made recommendations to National Highways, communicated in the form of a Management Letter.

This was presented to the ARAC on 22 September 2022.

Appendix 4: Future changes to auditing standards

ISA (UK) 315 (Revised) : Identifying and Assessing the Risks of Material Misstatement

Effective from 2022-23

ISA 315 is the critical standard which drives the auditor's approach to the following areas:

- Risk Assessment
- Understanding the entity's internal control
- Significant risk
- Approach to addressing significant risk (in combination with ISA 330)

The International Auditing & Assurance Standards Board (IAASB) concluded that whilst the existing version of the standard was fundamentally sound, feedback determined that it was not always clear, leading to a possibility that risk identification was not consistent.

The aims of the revised standard is to:

- Drive consistent and effective identification and assessment of risks of material misstatement
- Improve the standard's applicability to entities across a wide spectrum of circumstances and complexities ('scalability')
- Modernise ISA 315 to meet evolving business needs, including:
  - how auditors use automated tools and techniques, including data analytics to perform risk assessment audit procedures
  - how auditors understand the entity's use of information technology relevant to financial reporting
- Focus auditors on exercising professional scepticism throughout the risk identification and assessment process.

The key impacts are:

- Significant increase in work on entity's use of IT in business and system of internal control.
- Clearer workflow within the standard to highlight the importance of the auditor's understanding of the entity and environment, the applicable financial reporting framework, and system of internal control.
- New concepts: e.g. inherent risk factors, spectrum of inherent risk
- Changed definitions: notably, the definition of 'significant risk'
  - **Significant risk** – An identified risk of material misstatement:
    - For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
    - That is to be treated as a significant risk in accordance with the requirements of other ISAs (UK).

Appendix 4: Future changes to auditing standards

ISA (UK) 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Effective from 2022-23

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional and involves deception or is unintentional. ISA (UK) 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

The revision to the standard aims to clarify the obligations of auditors to identify and assess the risk of material misstatement due to fraud, as well as including supplemental requirements and guidance to enhance the auditors' procedures.

Key changes are:

- The objectives of the auditor have been revised to emphasise the requirement to obtain reasonable assurance about whether the financial statements are free from material misstatement due to fraud.
- There is a greater focus on professional scepticism including that audit approaches don't show bias to looking for corroborative evidence or excluding contradictory evidence.
- There are new requirements for the auditor to determine whether the engagement team requires specialised skills or knowledge to perform their work on fraud, including their assessment of fraud risk, associated procedures and evaluation of the evidence obtained.
- There is additional guidance regarding the discussion required by ISA (UK) 315 among the audit engagement team. This is to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud or error. The revised ISA (UK) 240 emphasises the need for an exchange of ideas among all engagement team members about fraud risk factors.
- The auditor shall make inquiries of management, or others within the entity who deal with fraud allegations, to determine whether they have knowledge of any actual, suspected or alleged fraud, including cases of fraud raised by employees or other parties.
- Auditors are to hold a discussion with those charged with governance regarding the risks of fraud in the entity and to consider the implications for the audit.
- The auditor must communicate with those charged with governance matters relating to fraud (unless prohibited by law or regulation) and the auditor's assessment of the risks of material misstatement due to fraud.
- Auditors must evaluate whether their assessment of the risk of material misstatement due to fraud remains appropriate at audit conclusion, that sufficient appropriate audit evidence has been obtained, and that the financial statements are not materially misstated as a result of fraud.
- The auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud.

Appendix 5: Fraud matters

FinancialAuditPlanning

ISA (UK) 240 'The auditor's responsibility to consider fraud in an audit of financial statements' requires us, as your auditors, to make inquiries and obtain an understanding of the oversight exercised by those charged with governance.

What can constitute fraud?

Fraudulent Financial Reporting: Intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.

Internal misappropriation of assets: Theft of an entity's assets perpetrated by management or other employees.

External misappropriation of assets: Theft of an entity's assets perpetrated by individuals or groups outside of the entity, for example grant or benefit recipients.

Fraud risk factors

Rationalisation/attitude: Culture of environment enables management to rationalise committing fraud – attitude or values of those involved, or pressure that enables them to rationalise committing a dishonest act.

Incentive/Pressure: Management or other employees have an incentive or are under pressure.

Opportunity: Circumstances exist – ineffective or absent control, or management ability to override controls – that provide opportunity

ISA inquiries

Our inquiries relate to your oversight responsibility for

- Management's assessment of the risk that the financial statements may be materially misstated owing to fraud, including the nature, extent and frequency of such assessments;
- Management's process for identifying and responding to the risks of fraud, including any specific risks of fraud that management has identified or that has been brought to its attention;
- Management's communication to the Audit Committee (and others charged with governance) on its processes for identifying and responding to the risks of fraud; and
- Management's communication, if any, to its employees on its views about business practices and ethical behavior.

We are also required to ask whether you have any knowledge of any actual, suspected or alleged fraud and discuss with you the risks of fraud in the entity.

Audit approach

We have planned our audit of the financial statements so that we have a reasonable expectation of identifying material misstatements and irregularity (including those resulting from fraud). Our audit, however, should not be relied upon to identify all misstatements or irregularities. The primary responsibility for preventing and detecting fraud rests with management.

We will incorporate an element of unpredictability as part of our approach to address fraud risk. This could include, for example, completing procedures at locations which have not previously been subject to audit or adjusting the timing of some procedures.

We will report to the Audit Committee where we have identified fraud, obtained any information that indicates a fraud may exist or where we consider there to be any other matters related to fraud that should be discussed with those charged with governance.

Appendix 6: Guidance for governance

Guidance for governance

Support to Audit Committees

We have developed a range of guidance and tools to help public sector Audit Committees achieve good corporate governance. This includes specific guidance on financial reporting and management during Covid-19

https://www.nao.org.uk/search/pi_area/support-for-audit-committees/

https://www.nao.org.uk/report/guidance-for-audit-and-risk-committees-on-financial-reporting-and-management-during-covid-19/

Climate Risk: A good practice guide for Audit and Risk Assurance Committees

Audit committees play a key role in scrutinising and advising the Board and Accounting Officer on risks arising from climate change. This guide will help ARACs recognise how climate change risks could manifest themselves and support them in challenging senior management on their approach to managing climate change risks

Climate change risk: A good practice guide for Audit and Risk Assurance Committees - National Audit Office (NAO) Report

Corporate Governance Code for central government departments

The document was released in April 2017 and lays out the model for departmental boards, chaired by Secretaries of State and involving ministers, civil servants and non-executive board members. The principles outlined in the code will also prove useful for other parts of central government and they are encouraged to apply arrangements suitably adapted for their organisation.

https://www.gov.uk/government/publications/corporate-governance-code-for-central-government-departments-2017

Sustainability reporting

This guidance is to assist with the completion of sustainability reports in the public sector. It sets out the minimum requirements, some best practice guidance and the underlying principles to be adopted in preparing the information.

https://www.gov.uk/government/publications/public-sector-annual-reports-sustainability-reporting-guidance-2020-to-2021

Good practice in annual reports

The Building Public Trust Awards recognise outstanding corporate reporting that builds trust and transparency. The interactive PDF below illustrates a range of good practice examples across annual reports in both the public and private sector.

https://www.nao.org.uk/report/good-practice-in-annual-reports-february-2021/

Disclosure Guides

Our disclosure guides for clients help audited bodies prepare an account in the appropriate form and that has complied with all relevant disclosure requirements.

http://www.nao.org.uk/report/nao-disclosure-guides-for- entities-who-prepare-financial-statements-in-accordance-with-the-government-financial-reporting-manual-frem/

Good Practice in Annual Reporting

The Audit Committee plays a key role in scrutinising the Annual Report and Accounts, ensuring the quality of disclosures and its understandability for users.

To support the Audit Committee in this role, we have published our **Good Practice in Annual Reporting** guide.

The Guide, issued in February 2021, provides specific examples of best practice we identified during our review of a sample of 2019-20 annual reports. The good practice principles are grouped under the following headings: supporting accountability, transparency, accessibility and understandability (on the right) and these should be evident across the common sections of an annual report (on the left).

We hope you find this Guide useful as you prepare your Annual Reports for 2020-21.

Strategy | **Risks** | **Operations** | **Governance** | **Measures of success** | **Financial performance** | **Understandable**

Could you be a winner in 2020-21?
If you would like to nominate your organisation for the Building Public Trust Awards for your 2020-21 Annual Report and Accounts, please speak to your NAO Team or contact us at Building.Public.Trust@nao.org.uk.

Good Practice in Annual Reporting

Essential features of a good annual report

Supporting Accountability

- telling the story of the organisation in a fair and balance way;
- compliance with the relevant reporting requirements; and
- clear action points to take forward.

Transparency

- frank and honest analysis;
- consideration of the challenges an organisation is facing;
- appropriate use of data; and
- quantification of risks and performance measures.

Accessibility

- highlights key trends in the financial statements;
- concise summaries of key points; and
- consideration of how the organisation engages with key stakeholders and meets their needs.

Understandable

Use of:
- plain English to explain difficult concepts;
- infographics and diagrams to communicate important messages; and
- clearly integrated structure to help users navigate it effectively.

National Audit Office

National Highways

Interim audit progress report on the 2021-22 FINANCIAL STATEMENT AUDIT

Report to those charged with governance
8th March 2022

Contents

Interim audit progress

Introduction

This report summarises the key matters from our interim audit of the 2020-21 financial statements of National Highways (NH). We would like to thank the finance team, HR and business areas for their support. We have been successful in completing most the expenditure, payroll, capital additions and existence samples. To support Highways in improving their processes we also carried out a dry run sample of accruals, attempting to identify key issues that can be resolved between now and year-end. Further details can be found on page 8. We have discussed these issues with the finance team and have engaged with finance business partners to explain evidence required for accruals with the goal of improving evidence quality at the final accounts period.

Our overarching approach to risk is unchanged from the approach set out in our Audit Planning Report previously presented to the December Audit and Risk Committee.

We will formally report progress on our prior year recommendations in our Audit Completion Report and Management Letter for 2021-22.

Testing performed between 7 February and 04 March

Financial statements

Interim audit work focused on in-year transactions recorded to period 9 (end of December 2021).

Completed

- Sample testing of employee starters, leavers and amendments;
- Existence testing of SRN assets;
- Sample testing of PFI service charges; and
- Completeness testing of SRN databases stored by NH to the Atkins RAAVs revaluation output. We identified one error from this where an asset had been constructed but not transferred to RAAVS, and are considering the wider impact.

In progress –we have staff booked in March to close-down remaining sample testing ahead of year-end. *Note the number in brackets is outstanding sample items.*

- Substantive analytical procedure over payroll figures; including salaries and employer contributions to NI and pensions;
- Sample test of manual journals (all remaining; n.b. sample was selected later in interim process);
- Samples of maintenance and other expenditure (2 remaining);
- Sample testing of AUC additions (2 remaining) and renewals (9 remaining). Sample of SRN Land classifications (2 remaining). One additions error has been identified where the costs related to a previous financial year, resulting in an understatement 2020-21 figures; and
- Sample test of accruals (2/5 remaining)

Interim audit progress *continued*

Testing performed between 7 February and 04 March

Other work to note	*We brought forward some of our year-end testing where possible to reduce the workload and minimise risk at final.*	**In progress** • A dry run sample of accruals in order to identify and eliminate possible issues at final (see page 8 for further details) • Set up of our SRN analytical procedures to ensure efficiency at year-end • Reviewed any changes to PFI contracts in year such as refinancing events • Updated our understanding of key financial controls over core audit areas

Changes to our assessment of risk since 2020-21

The NAO have updated our risk assessment on the basis of known industry developments and internal organisational development since the prior year audit, as follows:

Risks and areas of focus diminishing or superseded since 2020-21	Risks and areas of audit focus identified in 2020-21 that remain relevant for 2021-2022		New risks and areas of focus for 2021-22
	Risks that are broadly consistent with last year	Risks that have evolved and developed since last year	
Significant Risks	**Significant Risks**	**Significant Risks**	**Significant Risks**
	Valuation of the Strategic Road Network (SRN) Presumed risk of management override of controls Provisions for Land and Property purchases		
Areas of Audit Focus	**Areas of Audit Focus**	**Areas of Audit Focus**	**Areas of Audit Focus**
Transfer of staff into NH EU exit and pandemic impacts	VAT discussions with HMRC PFI Contracts Accruals valuation IFRS 16 – Embedded Leases		Spending Review and Cuts to RIS 2 Smart Motorways

Response to significant risks – Strategic Road Network

Update on our response to significant financial statement risks

Significant risk	Findings
Valuation of the Strategic Road Network (SRN) The SRN and related Assets Under Construction (AUC) balances are dominant components for the financial statements, with a 2020-21 balance of £132bn. The value is derived from the depreciated replacement cost of the SRN, which is calculated using the best available information to establish an accounting estimate, alongside the actual cost of recent schemes, and the asset records. A number of accounting assumptions are implicit in determining the valuation, which requires continual review, as does the application of indices used to revalue costing rates between 5-yearly assessments, and how asset information has applied to calculate a discount from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures). This remains a complex and highly material estimate for 2021-22 and so is recognised as a significant risk of material misstatement. There are no planned revaluations or other one-off events this financial year, so work will focus on the other movements such as indexation, depreciation and additions.	**Work at interim:** As the risk relates to year end valuation, much of the work over the SRN takes place at year end. Interim findings on work to date as follows: We have conducted work on the design and implementation of controls over the SRN, and our understanding of the RAAVS valuation model operated by management's expert. This has not identified any issues thus far. Testing of in year capital additions, renewals, existence and completeness is in progress. We have not identified any significant errors to date and expect to complete the majority of this work on time for the end of interim fieldwork. We are in discussions with management regarding the Smart Motorways pause, and possible valuation impacts on schemes under construction. A comprehensive paper has been provided and is under review, with questions raised such as around the impact of new emergency refuge area spacing on the Smart Motorway uplift. We do not expect there to be any material issues on valuation at this stage. As in prior years, we will be using an auditor's expert with civil engineering expertise to assist us in evaluating the appropriateness of the condition-based depreciation methodology for structures and road assets. The expert will comment on the reasonableness of the methodology, focusing on any changes from the prior year, and will test a sample of structures and roads on our behalf to ensure that the method has been consistently applied. We are currently in the latter stages of procuring an expert for this purpose and expect to conclude this well in advance of the final audit. In reviewing the Q3 valuation, a significant £1.4bn decrease in structures valuation was identified as being due to changes to depreciation methodology affecting retaining walls. This seemed disproportionate as retaining walls tend to be lower in value, so was challenged; subsequent investigation identified that the actual cause was due to tunnels being given a nil condition score which had understated their valuation by c£1.3bn. Highways are taking action to correct this for the final Q4 valuation, and it is not expected to be an issue for the year end accounts.

Response to significant risks – Provisions & Management Override of Controls

Update on our response to significant financial statement risks

Significant risk	Findings
Provisions Land and property is acquired as part of improving the network, the overall balance at 31 March 2021 was £381m, made up as follows: £170m of blight; £217m of CPO; £62m for the Lower Thames Crossing; £57m for the A27 Arundel Bypass; and £29m for Part 1 claims. The provisions are supported by large and complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high. Valuation (inherent uncertainty) – NH relies on estimates provided by the VOA that often lack a robust evidence base. In 2020-21 our expert valuer was able to conclude that the estimates were not materially incorrect, but we have recommended that NH work with VOA to secure better quality evidence for estimates provided. We further note that management rely on a legacy system (HAL) in recording these provisions, which is used primarily by the property team for asset management purposes. The prior year sample testing noted a number of errors, namely in data entry and manual calculations in the system.	**As the risk relates to year end valuation, much of the work over the provisions takes place at year end. Interim findings on work to date as follows:** • We have conducted work on the design and implementation of controls over the provisions, and our understanding of the VOA valuations. This has not identified any issues thus far. • We have re-engaged Knight Frank as our auditor's expert to assist with work at year end. Knight Frank will review a sample of underlying valuations and comment on their material reasonableness. We expect to select the samples for expert review at the end of April 2022. • We have liaised with the Highways legal team and management to identify any significant changes to provisions this year and will review board minutes and papers.
Management override of controls Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively. Under International Standards on Auditing (UK) 240 there is a presumed risk of management override for all audited bodies.	The NAO has produced a new data analytic to analyse journals to focus testing on the riskiest of journals, which we used to pick our interim journal sample for testing. Testing is currently ongoing, with no issues around management override identified so far. We will carry out further focused testing on journals, estimates and any significant or unusual transactions at final audit. In particular, we will consider the assumptions underpinning each of the key estimates in the accounts.

Other audit areas

We have provided an update on other key areas of the audit below.

Audit area	Interim Findings
Accruals valuation	To support Highways in improving their accruals processes following the difficulties faced last year, we agreed to select a sample of 5 complex accruals at P9 to review. This review is ongoing in discussion with Highways' management. • 2 of the 5 selected samples were corrections within the PRISM system for erroneous postings made by Oracle. This corresponds to an ongoing issue identified in the prior year, where erroneous postings are made to the GL when the value of a purchase order is increased or reduced from its original value (the ledger posts a transaction that recreates the posting of all invoiced / receipted transaction amounts against the original PO). This is the first time the issue has been noted specifically within our accruals testing; the PRISM system was implemented in 2020-21 but has been used much more widely by the business in 2021-22. Management have an established process for identifying and correcting these items as reviewed in 2020-21, but we will re-review the process and the completeness of the checking exercise at year-end to ensure that we are materially comfortable with both expenditure and accruals balances. • In 1 sample we identified the use of a debit entry to an accrual account code that was incorrectly decreasing the accruals balance. The item related to an overpayment of recoverable VAT and should have been recorded in receivables. There is no net impact on the balance sheet as a result of this transaction, and it is an issue we also identified in the prior year. • We have additionally held a meeting with Highways FBPs in February to explain the audit approach and what would be appropriate audit evidence, to support work at final audit.
PFI Contracts	We have discussed with management any expected changes to contracts which might have accounting implications. No issues have been identified at interim.

Executive Summary – IT Audit Work GITC & P2P

Background:

With the significant progress that National Highways has made in enhancing its controls around its purchasing processes we are seeking, over time, to move to a controls based approach over NH's purchasing processes. During this audit year (2021/2022) we are seeking to increase the extent of our testing of GITC and purchasing controls on work completed in the prior audit. If this testing shows that controls have operated effectively during the period we will seek to rely on purchasing controls for our final testing (but not our interim testing).

Current assessment of the control environment based on audit testing completed to date

Our work has provided initial overage of most of the areas which we need to test. However we have not yet achieved good coverage in terms of the detailed testing of controls.

Based on the work done to date we can conclude that ***we will not be able to place assurance on the controls operated over the Confirm system***. This conclusion is based on discussions with NH management and the findings from the NH internal audit report issued September 2021.

Oracle Fusion

In relation to the controls operated over Oracle Fusion we have been able to identify controls processes that operate related to both general IT controls (GITC) and purchase to pay controls (P2P). From our testing we have noted:

• Logical Access - some exceptions in testing. These matters are being followed up with management;

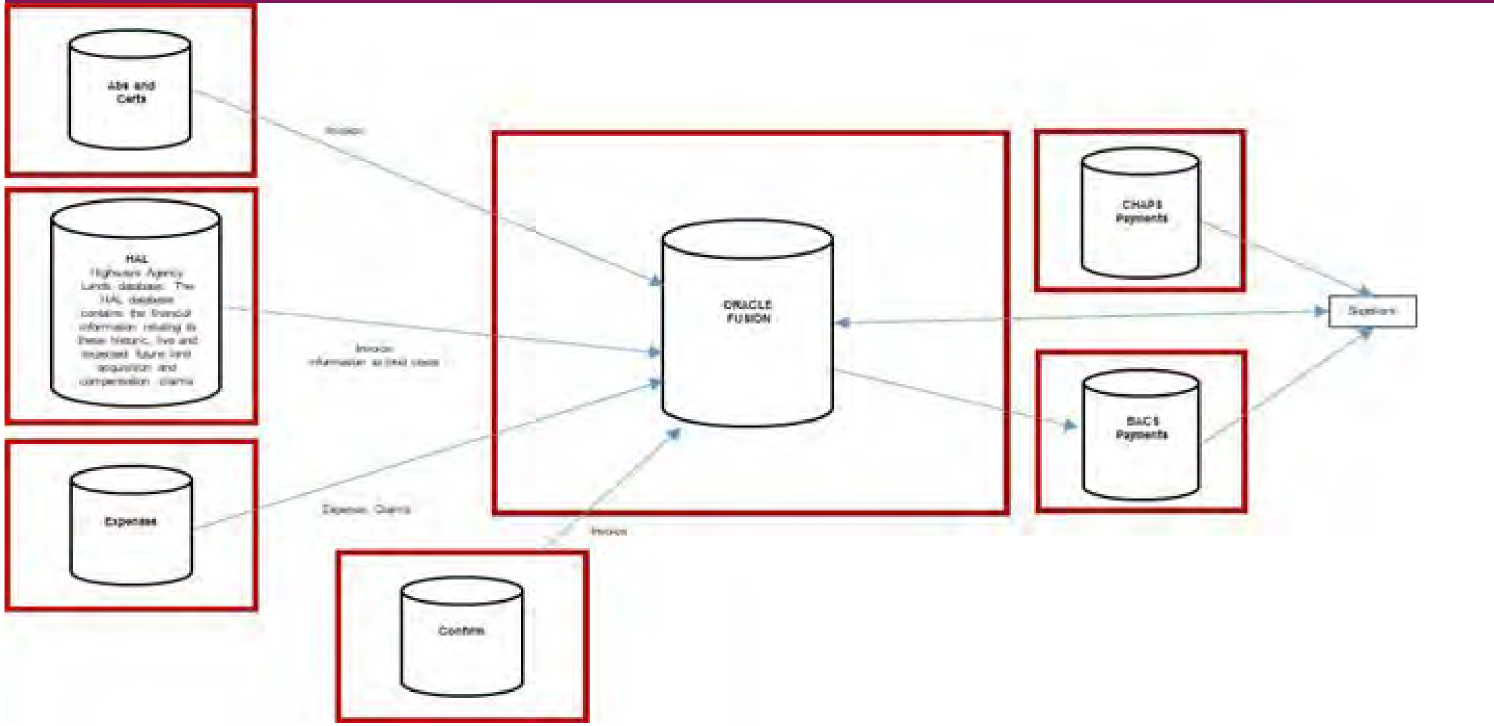
• Change Management - the lack of a formal tool for managing NH administered changes to its Oracle systems. We need to do more work to assess if the lack of such a formal change management tool impacts on the level of assurance we are able to gain; and

• The extent to which controls operated rely on manual checks and the extent to which they rely on automated controls.

Apps & Certs

In relation to controls over Apps and Certs, this application operates in the same GITC control environment as Oracle Fusion. In relation to the purchasing controls, Apps & Certs is used as a means of logging the extent of work done by suppliers with this information generating being interfaced to Oracle Fusion where invoices are raised and approved. We still need to gather some more information on the extent to where the controls processes operate (i.e. within Apps and Certs) or within Oracle Fusion.

ANNEX: A high level overview of the purchasing systems in place in NH



Preparations for final audit

Final audit arrangements

Final audit fieldwork

Our audit work is scheduled for four weeks commencing Monday 2 May 2022, with initial data and draft accounts to be provided by Highways before this (specific dates to be agreed with Highways finance).

Audit work to be performed at final audit

Our final audit visit will address the following audit areas:

Financial Statements

i. Substantive testing: we will perform substantive testing on income and expenditure for periods 10 to 12, all disclosures, and on all material balances in the Statement of Financial Position as at 31 March 2021.

ii. Significant risk work covering the SRN and Land and Property Provisions

iii. Review of Financial Statements: we will review the accuracy, completeness and quality of the disclosures in the accounts.

Annual Report

i. Remuneration Report: we will test the accuracy of disclosures in the Remuneration Report and confirm that they are complete.

ii. Review of Governance Statement: we will review the governance statement to ensure it is consistent with our understanding and complies with HM Treasury's guidance.

iii. Review of Strategic and Directors' Reports: we will ensure that the Reports are consistent with the financial statements and our understanding, specifically considering the 'fair, balanced and understandable' requirement on management, on which we must also provide an opinion.

Reporting our findings to the Audit and Risk Committee

The Audit and Risk Committee meeting to approve the year-end financial statements is scheduled for 22nd June 2022, we will provide a full Audit Completion Report summarising our findings.

National Audit Office

National Highways
Audit completion report on the 2021-22 financial statements audit

Report to those charged with governance
22 June 2022

This report presents our findings from the audit of 2021-22 financial statements

Dear Audit Committee Members:

We anticipate recommending to the Comptroller and Auditor General (C&AG) that he should certify the 2021-22 financial statements with an unqualified audit opinion, without modification in respect of both regularity and the true and fair view on the financial statements. The draft Enhanced Audit Report is presented as a separate agenda item to the Committee.

At the date of this report our audit of the financial statements is progressing well and will be concluded subject to completion of the areas detailed on pages 7 and 8. While there are a number of areas still to fully close down, progress overall is fair and some high risk areas including provisions and PPI are fully complete. The audit is due to be completed in advance of Parliamentary Recess and we will communicate any updates to the finalised audit completion report to those responsible for governance on completion, as well as giving a progress update verbally at committee.

The total audit fee charged for the year is £333.5k, an increase of £18.5k from the audit fee disclosed in our Audit Planning Report (£315k). The increase is primarily due to a higher-than-expected cost for external expert assurance work on the strategic road network following a procurement exercise to identify a new contractor and was discussed at the previous Audit and Risk Committee meeting.

There are no contingent fees in respect of the National Highways audit.

Actions for the Audit Committee

The Audit Committee is invited to:

- Review the findings set out in this report, including the enhanced audit report and draft letter of representation which are presented as separate items to the Committee;
- Consider whether the unadjusted misstatements, set out in the identified misstatements section (pages 26 to 28) should be corrected. The Audit and Risk Committee minutes should provide written endorsement of management's reasons for not adjusting misstatements; and
- Consider the adequacy of the going concern disclosures included in the draft financial statements and conclude on whether this is a fair assessment. We request that this consideration is included in the letter of representation to the Comptroller and Auditor General (C&AG).

We will issue a separate management report of our findings for 2021-22 and progress on prior year recommendations at the next Audit and Risk Committee meeting on 28 September 2022. We would like to thank [redacted] and his staff for their assistance during the audit process.

Yours Sincerely,

Matt Kay

Contents

Overview

Audit risks (pages 9 to 19)

Presumed risk of management override of controls

We have considered the presumed risk of management override of controls under International Standards on Auditing (ISA (UK) 240).

We have not noted any issues of management override of control in our audit work.

Provisions for Land and Property purchases

We have noted findings against the risk as a result of testing which include manual entry and VOA input errors to the provisions system. Our auditor's expert has reviewed a sample of underlying land cost estimate valuations and has set out some preliminary findings. We have not yet received a finalised version of the expert report but do not expect it to raise any material concerns.

Valuation of the Strategic Road Network (SRN)

We have responded to new risks in 2021-22, including the engagement of an Auditor's Expert to review the significant change to the HECI index which has caused a c£9.7bn increase to the valuation of the strategic road network.

Our expert has also reviewed the condition-based depreciation methodology supporting structures and road assets, including confirmation as to the application of the method against a sample of both structures and roads. This was judged overall reasonable; see pages 10 - 16 for a summary of the findings.

Whilst our wider work on the SRN is close to completion, including the more routine sample testing, we have not yet received a finalised version of the expert reports. Testing of some adjustments and disclosures is also ongoing.

Overall Materiality (SRN) ~1% of SRN Balance

£1.3bn

Materiality has remained the same level as that reported in the Audit Planning Report. Our overall account materiality is set at approximately 1% of the prior year value of infrastructure assets (SRN and related AUC), reflecting the significant interest among SRN users in the extent and condition of the network.

We did not adjust materiality upwards for the final SRN balances so that we could prudently maintain a lower materiality figure, and because the large increase was primarily driven by indexation over which we have performed specific audit procedures for assurance.

We have reported all misstatements above £300k.

Secondary Materiality ~1.5% of total adjusted expenditure

£64.0m

Secondary materiality has remained the same level as that reported in the Audit Planning Report. We set secondary materiality as approximately 1.5 % of total prior year adjusted expenditure and applied to all transactions and balances that reflect cash spending, including SRN capital additions. In practice, this applies to all areas other than the SRN and associated non-cash revaluation and depreciation entries.

We did not adjust materiality upwards for the final outturn expenditure position (which would have yielded a corresponding materiality of £64.6m), so that we could prudently maintain a lower materiality figure.

We have reported all misstatements above £300k.

Overview – Adjusted and unadjusted misstatements

Adjusted misstatements (Page 25)

£NIL

The current impact of adjusted misstatements is a nil net impact on the statement of financial position and the statement of comprehensive net expenditure.

One gross adjustment within the provisions note was identified, which has a gross impact of £160m but nets to nil in the closing balance. See page 25 for detail.

Un-adjusted misstatements (Pages 27 - 28)

Overall Materiality (based on infrastructure assets)

£1.0m

The impact of unadjusted misstatements would increase net expenditure by £1.0m and decrease net assets by the same amount.

We have yet to finalise a couple of areas of estimation uncertainty, including our review of the completeness of the above adjustment, and review of the DRC impact driven by new Emergency Refuge Areas in the Transport Select Committee report. We have presented the maximum potential variance in each case on page 27 – with the 'worst-case' scenarios individually and collectively immaterial. These are also not included in the above total.

Note that management identified a £452m error in the prior year valuation of smart motorway assets which we have reviewed and has been corrected in the 2021-22 financial year. This is not included in the above total given the correction.

Secondary Materiality

£13.3m

The current impact of unadjusted misstatements under the secondary materiality would decrease net spend by £13.3m and increase net assets by the same amount.

Key audit findings

Changes of our assessment of risk since planning

Since the audit planning period, the SRN valuation significant risk and smart motorways risk factor have both been developed. On the SRN, a sharp uplift driven by indexation was seen at the year-end which required a specific audit response. On Smart Motorways, we have audited management's assessment as to the impact of the smart motorways pause on the financial statements. No new significant risks or risk factors have been identified.

Risks and areas of focus diminishing or superseded since planning	Risks and areas of audit focus identified at planning that remain relevant.		New risks and areas of focus
	Risks that are broadly consistent with planning	Risks that have evolved and developed since planning	
Significant Risks	Significant Risks	Significant Risks	Significant Risks
	Presumed risk of management override of controls; Provisions for Land and Property purchases	Valuation of the Strategic Road Network (SRN)	
Areas of Audit Focus	Areas of Audit Focus	Areas of Audit Focus	Areas of Audit Focus
	VAT discussions with HMRC; PFI Contracts; IFRS 16 – Embedded Leases; Accruals valuation; Spending Review and Cuts to RIS 2	Smart Motorways	

Key audit findings

FinancialAuditCompletion

Status of our audit

At the date of this report our audit of the financial statements is is progressing well and will be concluded subject to completion of the areas listed below. The audit is due to be completed in advance of Parliamentary recess and we will communicate any updates to the finalised audit completion report to those responsible for governance.

Name	Actions to resolve	Owner of action	Status
SRN work	Several testing areas are in progress on the SRN particularly: - SRN Renewals – sufficient, appropriate audit evidence for x3 samples outstanding since interim fieldwork; - Work on valuation adjustments, including the smart motorways lane adjustment, staff cost capitalisation, AUC pipeline adjustment, and AUC write downs; - Work on depreciation SAPs and review of management experts upon receipt of report - Review of specific disclosures and accounting policies	NH NAO NAO NAO	
SRN and Provisions Expert Findings	The final expert findings and report on structures and roads depreciation, and on the application of HECI indexation, is outstanding, but is expected to be received in week commencing 20th June. The provisions review is also on track. Discussions with the experts, and their draft findings reports, are positive, and are not expected to pose material challenge.	NAO	
AUC Impairment	Review of impairment to non-SRN AUC for which further details were requested in relation to L&SP MPM considerations. Details were provided recently and are under review.	NAO	
Journals work	Work on ETB journals and P10-12 journals is ongoing.	NH / NAO	
Smart motorway pause	• Inclusion of disclosures on the smart motorway pause were discussed in fieldwork but have not yet been added into the accounts. • NAO quantification of potential Emergency Refuge Area modern equivalent variance.	NH NAO	
Losses and Special Payments	There are two queries outstanding in relation to losses and special payments, where some of the expenditure samples were identified as potential losses over £300k and queried with Highways. If they are new losses, these will need to be disclosed and HMT approval obtained.	NH	

Key audit findings

Status of our audit... continued

Name	Actions to resolve	Owner of action	Status
Other outstanding sample items	The following samples are outstanding, as at the date of writing: • 1x payables • 1x receivables • 2x provisions • 4x SRN renewals • 2x maintenance expenditure We have reviewed all provided evidence and are in active discussion with National Highways to close-down the remaining queries on approximately half of our **accruals** samples.	NH	Green
Capital commitments	Review of the commitments disclosures is still to be completed by NAO	NAO	Green
Internal Reviews	Final internal reviews of the audit file, and resolution of any queries arising.	NAO	Green
Review of the final version of the annual report, financial statements and annual governance statement	We will need to review the final version of the annual report, financial statements and annual governance statement.	NAO	Green

Status

- Red: Likely to result in material adjustment or significant change to disclosures within the financial statements
- Amber: Potential to result in material adjustment or significant change to disclosures within the financial statements
- Green: Not considered likely to result in material adjustment or change to disclosures within the financial statement

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

1. Presumed risk of management override of controls

Details and Audit Response

Under International Standards on Auditing (ISA (UK) 240) there is a presumed risk of management override for all audited bodies. Management is in a unique position to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively.

It should be noted that this is a standard, presumed risk on all financial audits (ISA (UK) 240). We have identified no particular risk factors in relation to National Highways.

Audit Findings and Conclusion

We have reviewed the accounts preparation process, as well as adjustments made to the accounts in the year-end Extended Trial Balance. We have found no indication of management override of controls in testing to-date.

We performed a risk-based analysis of manual journals and selected those which we considered to be high risk (due to size or nature) for testing. We agreed all journals to appropriate evidence and confirmed that they had been appropriately reviewed. Testing is nearing completion. We found no indication of management override of controls.

We have tested the significant estimates made by management, including the valuation of the Strategic Road Network, and valuation of accruals and provisions.

We also performed a retrospective review of estimates made in the prior year and found no indication that these were not appropriate. We have found no indication of management override of controls.

We reviewed the general ledger for significant and unusual transactions. We did not identify any transactions which we considered to fall into this category.

We have not identified any evidence of management override of controls in our work to date.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network

Details and Audit Response

The SRN and related Assets Under Construction (AUC) balances are dominant components for the financial statements, with a 2020-21 balance of £132bn (the 2021-22 balance is.£141bn). The value is derived from the depreciated replacement cost of the SRN, which is calculated using the best available information to establish an accounting estimate, alongside the actual cost of recent schemes, and the asset records. A number of accounting assumptions are implicit in determining the valuation, which requires continual review, as does the application of indices used to revalue costing rates between 5-yearly assessments, and how asset information has applied to calculate a discount from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures).

This remains a complex and highly material estimate for 2021-22 and so is recognised as a significant risk of material misstatement. There are no planned revaluations or other one off events this financial year, so work will focus on the other movements such as indexation, depreciation and additions.

Audit Findings and Conclusion

(*Controls*):

- We have reviewed the design and implementation of controls operated by National Highways and Atkins over the asset valuations for the SRN. This confirmed the controls were adequately designed and implemented at year end. The key controls supporting the SRN valuation include quarterly exception reporting and corrections carried out by Atkins on roads and structure valuation runs, as well as review, investigation and sign-off for changes carried out by National Highways in response to issues identified by Atkins

(*Substantive*)

- We reviewed the revaluation model (RAAVS) this year and confirmed it was operating in line with our expectations and was applying the valuation methodology and assumptions of Highways appropriately. This included reviewing Atkins work as operator of the RAAVS process as management expert against ISA 500 for competence and independence, this did not identify any concerns.
- We obtained assurance over **asset quantities** and their completeness through our standard work on the asset databases and RAAVS, checking figures between sources to confirm consistency without omissions.
- We corroborated this by updating NAO modelling work on the road network length using *Openstreetmap* as independent data source. We have reviewed in year additions, road openings and de-trunkings to confirm the closing length for the roads had not significantly changed from the modelling figure (6,905km 21-22 compared to 6,840.7km which is an insignificant change over 2 years). This is consistent with our assumption that the network is slow moving in terms of area quantity.

2. Valuation of the Strategic Road Network continued

Audit Findings and Conclusion continued

- As part of existence sample work we have also reviewed the **classification of land as rural vs urban** (as this significantly affects value) and checked the land take buffer zone against the model data to confirm reasonable. No issues identified from this work.
- We have confirmed the reasonableness of the **indices applied for revaluing professionally determined costing rates to current prices** and ensuring these have been applied through our indexation SAP and benchmarking exercises, including confirming the correct carry forward of QQR Rates. Note that due to the increased inflation and higher than anticipated indexation uplift of c£10bn we also engaged our expert to review the bespoke HECI indices which is detailed in the later expert findings slides.
- **Land indexation** saw a £1bn rise in asset value. We applied challenge here by reviewing alternative land indices held by the NAO (urban HPI and rural Knight Frank), and reviewed the difference in impact. This work supported that the indices used were reasonable.
- The review of the reasonableness of **conditions data for the roads and structures** is ongoing with work on the substantive analytical procedures in progress, however work to date, including discussions with our expert as to quality of underlying data and the related depreciation methodology, has not identified any material concerns. We have considered the road surveys conducted this financial year and confirmed they have surveyed the full network (20-21 due to COVID disruption part of the network had not been fully surveyed, with 14% not covered).
- We have reviewed the work of Transport Research Laboratory (TRL) in certifying the **road survey vehicles used for obtaining the road conditions data**, and performed ISA 500 procedures to confirm their expertise and independence. No issues identified.
- We have challenged brought-forward management judgements in relation to the **land compensation percentage uplift**, and the **right of use to crown lands** this year to refresh our work on high-level assumptions. This has confirmed the judgements remain valid.

In-year events

Smart motorways pause

This year there was a pause announced to the construction of new smart motorways. As part of our audit we considered whether this would mean an impact for existing smart motorway balances (built and AUC costs for in progress). Highways provided papers with their consideration on this. We agreed with management's view that there was not an impairment impact to existing smart motorways or assets under construction, a pause would not undo construction to date and the announced changes of additional emergency refuge areas would not negatively impact existing work. In relation to DRC modern equivalent we have made enquiries regarding if quantity of Emergency Refuge Areas changing would impact the uplift rates and require an obsolescence adjustment – Highways provided a response which is under review with us. Any potential impact will be immaterial to the accounts given the overall size of the smart motorways uplift.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network continued

Smart motorway valuation adjustment update

At final audit Highways made an adjustment to correct an error identified on the smart motorways lanes, identified as a result of the review in year prompted by the smart motorway pause enquiries. Smart motorways ALRs are built by converting a 3-lane road's hard shoulder to create an additional lane, the valuation adjustment is applied in RAAVS by Atkins. Highways identified that for some smart motorway sections in the asset database (HAPMS) an extra lane had been added there prior to RAAVS, the result of this is similar to duplicating the uplift which overstated the road valuation by £452m. This has been adjusted downwards in 2021-22 and treated prospectively under IAS 8 as the difference is immaterial.

We have note that Highways did not review all smart motorway sections in this exercise due to the high number of sections involved (they have used a batch sample), so there is a possibility of erroneous sections not having been corrected. We are yet to formally conclude our review of this exercise, although we have estimated the maximum possible error through an analysis assuming that every smart motorway section had an extra lane erroneously added in HAPMS. From this we are confident that any missed misstatement would be immaterial, at a maximum of c.£100m.

Road Investment Strategy 2 (RIS 2) changes

We identified at planning that c£0.5bn of capital spend from RIS2 being re-profiled into future years, and the spending review had indications of cost saving measures by Treasury which may also affect. We have considered the possibility that this could impact built up AUC balances in the SRN for schemes paused or curtailed, and with review of the nature of the AUC and discussion with Highways concluded that this is not the case. The construction work is not considered time sensitive, and while this may affect the timing of future asset recognition, our assessment is that the pause does not diminish the value to the business of the costs expended, so does not affect the current Balance Sheet.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network continued

Standard SRN Audit Work (outside the scope of the significant risk)

- Work on SRN renewals is ongoing. We have faced significant difficulty obtaining evidence of sufficient quality to support 3x renewal sample items which were have been outstanding since interim fieldwork. These samples were all managed through the Bravo sub-system, where 3rd party evidence had not been retained, and where the available records supporting the amount internally generated and of insufficient standard to pass audit review. Management were later able to provide contracts to support wider agreements with the suppliers, but we remain unable to vouch the specific work done or the associated cost our sampled items. We will be raising a recommendation on this issue and regarding the appropriate retention of sufficient and appropriate audit evidence to support the ledger. We are in active discussion with National Highways as to a way to resolve these queries, which may involve direct confirmation from the suppliers as to the spend in question.

- Work on capital additions to AUC has been completed. This work identified 3 prior period errors, 2 of which had been identified and corrected by Highways in year as part of their review processes. Following review of these items, we are content these were not indicative of more widespread error.

- Testing of asset existence and completeness has been completed and has not identified any concerns

- Work on SRN disclosures and accounting policies is ongoing, we do not note any significant concerns from work to date.

- SRN transfers and SRN disposals have not been sample tested this year, as the values of both were immaterial to the accounts. We reviewed the movements to confirm they aligned with our expectations and found they did, there were no major transfers or disposals planned that had not been included. Board and other review did not identify any omissions.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network – Expert Findings

Expert review of Roads and Structures

In our planning report we said we would commission advice from a structural engineering expert in respect of Highways' transformation of physical data into depreciation % estimate for roads and structures. We have received draft findings from the expert, and all requested evidence and clarifications from Highways. Initial findings are noted as follows.

Roads Depreciation

- The four condition factors used for the weighting were considered appropriate, and there were no in year changes to methodology.
- The sample review of road outputs has been completed and has confirmed the method was correctly implemented.
- Broadly the assumptions underpinning the valuation depreciation such as depreciable percentage (17.55%) are reasonable.
- Recommendations from the expert will include commentary on consistent application of the depreciable percentage, the application of zero condition scores for survey machine unreliable, and quality and completeness of the methodology documentation (lack of single detailed document, capture of key assumptions). Observations on the use of fretting have been noted for further consideration as well. We will report in detail on these recommendations in the management letter, following agreement with management. The recommendations are not material to the audit.

Structures Depreciation

- The valuation methodology and key assumptions are reasonable in their application. There have been no changes to the methodology applied by Highways this year for consideration.
- The sample review of structures outputs has been completed and has confirmed that the methodology has been correctly implemented and that the information contained within the IAMIS system is present and satisfactory.
- The use of the "moderate" deterioration curve was noted to result in overly pessimistic assessments of an elements' service life, which was also identified to be the case in previous year's audit reports. A refinement of the deterioration curves would be an improvement for the process, although we note that it is materially correct for audit.
- Conversion of Severity and Extent Values into Percentage Through Life continues to generate unexpected results. The worse defect on any single component is assumed to represent that condition of the entire element - leading to a pessimistic representation of the current defects.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network – Expert Findings continued

Structures Depreciation (continued)

Our expert noted that the approach of using a single depreciable percentage (69.89%) for all structures may not reflect the differing construction types of structures. The engineering assumptions underpinning 69% of a bridge being depreciable based on substructure of bridges and culverts will not be the same as for retaining walls and gantries. A range of percentages by type may be more accurate data. In the Highways RAAVS Manual Volume 1a prior to 2018/19 the non-depreciable element is only used for bridges/culverts with gantries and retaining walls being fully depreciated, indicating the depreciable percentage approach may be less suitable for them and result in potential under-depreciation. We have considered the values of these elements and note this below.

Structures Type Details			
TYPE	**Sum of Gross (£) Inclusive**	**Sum of Nett (£) Inclusive**	**Comment**
BRIDGE	34,578,623,745	26,192,048,749	69.89% ok
CULVERT	2,001,352,801	1,768,689,253	69.89% ok
GANTRY	1,319,936,197	1,146,477,326	Potentially under-depreciated
SPECIAL	7,414,726,184	5,601,383,297	69.89% ok
WALL	2,753,224,582	2,105,710,823	Potentially under-depreciated
Impact on Gantries and Walls			
TYPE	**Sum of Nett (£) Inclusive**	**Revised Net without undepreciable %**	**Sum of Depreciation impact**
GANTRY	1,146,477,326	1,071,747,803	74,729,523
WALL	2,105,710,823	1,826,749,035	278,961,787
Total	3,252,188,149	2,898,496,838	353,691,311

From this review we have confirmed any potential impact of this issue would not be material to the accounts, with impact being a maximum of £354m under-depreciation under the assumption gantries and walls are fully depreciable.

We are clarifying this with the expert, but remain content the issue is immaterial - and not one that represents a misstatement given potential averaging of depreciation outcomes over the smaller structure types.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below

2. Valuation of the Strategic Road Network – Expert Findings

Expert review of Bespoke indices (HECI)

We have expanded the scope of our expert's work to include review of the SRN indexation in-light of the increasing inflationary affects around year end which were expected to cause significant valuation changes - and the use by Highways of a bespoke index (HECI) for revaluing network roads, structures and comms assets. The expert scope includes a review the reasonableness of the index and weightings, a consideration of whether the movement has aligned with expectations, and a comparison against alternatives. While we are yet to receive a final report our expert has **deemed the index appropriate**, making the following points.

- HECI index is based on a model produced by BCIS, based on National Highways workload by percentages which then applies indexation uplifts based on indices identified by BCIS as appropriate for application to that work area.
- The series of indices making up the HECI are considered to be appropriate for purpose, using the industry-accepted national standard for inflation adjustment exercises, and related ONS series.
- Projected index movements appear reasonable, the most significant uplifts relate to energy inputs and carbon based products such as steel which are more affected.
- The weightings used could be reviewed in detail, as they are potentially the source of a large amount of outturn variability.
- Alternative indices would not provide significant improvement to valuation beyond HECI.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below.

3. Provisions for Land and Property Purchases

Details and Audit Response

Land and property is acquired as part of improving the network, the overall balance at 31 March 2021 was £381m, made up as follows: £170m of blight; £217m of CPO; £62m for the Lower Thames Crossing; £57m for the A27 Arundel Bypass; and £29m for Part 1 claims. The provisions are supported by large and complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high.

Valuation (inherent uncertainty) – National Highways relies on estimates provided by the VOA that often lack a robust evidence base. In 2020-21 our expert valuer was able to conclude that the estimates were not materially incorrect, but we have recommended that National Highways work with VOA to secure better quality evidence for estimates provided.

We further note that management rely on a legacy system (HAL) in recording these provisions, which is used primarily by the property team for asset management purposes. The prior year sample testing noted a number of errors, namely in data entry and manual calculations in the system.

Audit Findings and Conclusion

Review of controls:
We have carried out testing on the design and implementation of controls, noting that the implementation/operation of controls has improved from the prior year – largely driven by central finance's response to include monthly checks on valuations to ensure they are updated every 6 months. However, there were still a few instances where the valuations had not been updated in over 6 months. We did not seek to rely on controls, and instead performed fully substantive testing over the provisions and aggregation process.

Substantive testing:
We selected a sample of 11 scheme level ('888') cases and 23 cases relating to individual land parcels for substantive testing. We split the population in this way again this year due to the scheme level cases being larger and more complicated than individual cases.

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below.

3. Provisions for Land and Property Purchases

Substantive testing (continued)

The provisions sample value could be supported by a valuation provided by the VOA, adjusted for manual entries and payments made against the provision. Payments consist of genuine payments where part of a provision is settled or a capital addition is made against the scheme, but can also be due to aggregation where individual cases are set up for each claimant and a deduction is made against the scheme level provision to avoid double counting.

We tested the VOA valuation by tracing the values in HAL to either a valuation report or a confirmation email outlining the basis of the valuation from the VOA. We re-performed manual calculations and selected a sub-sample of payments and aggregation against the sampled provisions. For individual cases, we were able to agree the payments to our wider testing of capital expenditure.

IAS 37 Recognition criteria

We reviewed National Highway's application of the IAS 37 recognition criteria in detail in the prior year and in 2019-20. In the current year, we confirmed the appropriate application of National Highways' recognition policy against each sample item in the provisions sample, no issues were noted.

We challenged management as to whether any cases had been quashed within the 6-week challenge period after a DCO is granted given that there has been an increase in interest in schemes especially given growing interest from environmental campaigners. On this basis we have requested that management review the recognition points going forward to ensure the basis of recognising CPO remains valid based on past precedent.

Engagement of an expert valuer

We have engaged an expert (Knight Frank) to review a subset of land and property valuations in detail for 5 of our samples. Based on our discussions with the expert and review of their interim findings, their expected conclusion is that the valuations have been carried out appropriately, with the report not expected to raise material concerns. Their initial review has identified similar findings to those in the prior year, that despite the overall positive conclusion, the valuation reports could provide greater justification and detail for how assumptions have been made and how estimates have been reached, as well as a general lack of standardisation.

Knight Frank intend to hold discussions with National Highways and VOA to clarify queries relating to the valuations and valuation methodology. Following this, they will provide a final report to us which will set their findings and will include some recommendations which we will report separately in more detail in our management letter (to the next Audit and Risk Committee meeting).

Key audit findings

Findings from our work on significant risks

The risks previously communicated in our planning report are presented below.

3. Provisions for Land and Property Purchases

Audit Findings and Conclusion (continued)

In our sample testing, we noted the following findings:

- Sample errors arising due to outdated valuations not being removed from HAL, manual entries being incorrectly calculated by National Highways, or where details had been entered incorrectly by the VOA.
- Valuations are required to be updated every 6 months, but we have identified some instances where they had not been updated, although this has improved from the prior year
- We note a general reliance on the VOA - although there has also been an improvement in this from the prior year. The error rate could be reduced with more detailed review.
- We note that whilst several individuals are involved in the Lands Cost Estimate and valuations process, the process for extracting information from HAL and the monitoring and preparation of the provisions balance is performed by a single individual. If the individual were to be absent, the process would become disrupted. We encourage a sharing of knowledge to avoid disruption to the process and to ensure appropriate review of the provisions balances and disclosures.

Based on our sampling of single schemes and aggregate schemes, we extrapolate a finalised net overstatement in the provisions balance of £3.6m (see page 27).

Key audit findings

Other areas of audit focus

The following are matters which we considered had a direct impact on the financial statements but did not represent significant risks of material misstatement as defined by ISA (UK) 315.

Title	Audit response	Audit findings and conclusion
Accruals valuation	Testing in the prior year identified a high number of sample errors (although their aggregate value was not material), and we encountered difficulties in obtaining sufficient evidence for these accruals. The workshops we provided in 2020-21 were successful in helping to improve the accuracy of larger accruals. A number of errors were identified, but this time in lower value accruals. We have offered to hold these workshops again. We will also review a small number of accruals at interim to ensure we can give specific feedback to the business on the quality of evidence prior to the year-end audit. As in 2020-21, we will stratify our sample population in order to focus our sample on higher value accruals where the risk of material misstatement is greater.	From our testing of accruals, we sampled and reviewed 92 items across the capital (57) and resource (35) accruals population. The capital accruals sample is well progressed. We have noted some errors in testing, with most items sitting below the £500k balance sheet review threshold adopted by finance. Some errors relate to a classification issues whereby the accrual should have been recorded as a payable (though this is not a valuation issue), with others including instances where accruals had been raised despite the liability having been settled before year-end. Further, there were also some more minor estimation differences to actuals regarding proportion of works complete. The resource accruals sample is also nearing completion. As in capital accruals, we have noted some errors where local teams have accrued for works that were already complete (leading to some 100% errors), failing to correct system errors, lack of evidence held (and sometimes retained) to support the estimates, and failing to adjust forecasts in traffic model estimates which had been skewed in 20-21 by the Covid-19 pandemic. Based on our sampling of capital accruals and resource accruals completed to-date, we extrapolate an overstatement in the accruals balance of £4.1m. See page 27 for a summary of the extrapolated errors.

Key audit findings

Other areas of audit focus

Title	Audit response	Audit findings and conclusion
IFRS 16 – Embedded leases	2019-20 saw a successful transition to IFRS 16, the new leasing standard. However, risk remains especially with embedded leases which may be a feature of construction contracts to which National Highways is a party. In 2019-20, while our additional procedures did not identify any leases omitted from the population provided, we recommended that retain evidence of IFRS 16 contract review to support continuing implementation. National Highways have set up a new process which will see the FBPs submitting confirmation of lease reviews on a monthly basis. In addition to this, they have added a spot check review centrally to ensure that no embedded leases are missed; we will review the results of this exercise again in the 2021-22 audit.	The risk factor is focused on the completeness of identified leases given the nature of construction contracts. In response, we have therefore obtained a copy of the central finance embedded leases log again this year and are content that National Highways are still performing the process that was implemented in the prior year. However, we note that the check appears to have only be performed once in the year compared with 3 times in the prior year. The central review log takes a report of all new contracts in the period and then requests are sent to the relevant FBP to confirm if any embedded leases/indicators are present. We note that central finance have chased FBPs who have not responded to requests. None of the reviews have identified any embedded leases. We are content that the review has given us adequate assurance over the completeness of leases and the continued implementation of IFRS 16.
Spending Review and cuts to RIS2	As a result of the Spending Review, the second Road Investment Strategy budget has been cut by £3.4bn, and management have so far re-profiled £500m of capital spend in agreement with DfT. Major planned projects including the £1.7bn Stonehenge Tunnel scheme, and the Lower Thames Crossing, are included in this re-profiling following some delays in planning. In our audit work we will consider the impact of the reprofiling of RIS2 and any other ongoing portfolio management changes that may have an impact on carrying values, disclosure requirements or land and property valuations.	We have kept the spending review in view throughout our testing, including in our review of the main estimates that have been impacted by the re-profiling - including land and property provision valuations and capital accruals. We have not noted any material concerns relating to the reprofiling of spend in calculation of these estimates. We conclude that the implications as to the Spending Review are disclosed fairly in the Annual Report.

Key audit findings
Other areas of audit focus

Title	Audit response	Audit findings and conclusion
PFI Contracts	As in previous years, the National Highways Balance Sheet includes PFI liabilities built on analysis of financial models agreed between National Highways and the SPVs with design/build/finance/operate responsibilities. The derivation of these models – whose accounting consequences are set at inception – are inherently complex which the audit committee should note hence our raising a risk factor. However, given the 100% audit work carried out between 2018 and 2020 to reverify the evidence and accounting for these contracts, we do not anticipate any additional work being needed in 2021-22 beyond checking the proper accounting of actual PFI invoices received in-year, and keeping in view any refinancing events (none currently expected).	We have confirmed that there have been no changes to the key underlying assumptions, or any changes to the terms of the PFI contracts. We have not identified any indication of changes to these contracts in our review of board minutes or through our wider audit work. We have substantively tested PFI service charges back to supporting invoices, noting no discrepancies. We performed 100% testing in 2019-20 and so have rolled forward our model and testing from that year and agreed that the 2021-22 models are consistent. We have reconciled these to the financial statements and noted no issues. We also commented on Note 7.5.3 in the accounts, noting that service charge expenditure (£315m) was lower than the minimum ‘no later than one year’ amount at the last balance sheet date (£355m). We noted that there are variable elements within the service charge that determine the minimum and have asked National Highways to state this in the note. We also confirmed that National Highways has a process in place for reviewing the condition of assets ahead of the transfer of assets back to National Highways at the end of the PFI contract and seen evidence of the early stages of this process.
VAT discussions with HMRC	While we are not expecting the effect of current discussions to be highly material, we know National Highways are engaging with HMRC on recoverability of VAT on pre-construction costs and expect this to be finalised at the end of January. The prior audit identified amounts recorded as receivables when recoverability was contentious. We will review correspondence between National Highways, HMRC and National Highways experts and assess this throughout the audit, including any disputes or uncertainty at year end.	In our expenditure testing we have tested the treatment of VAT for every item selected, including the application of hybrid VAT rates. We have also reviewed the net position of the VAT receivable balance in the SoFP, including viewing correspondence with HMRC, evaluating management’s position of it being recoverable as reasonable. As part of this we have confirmed that the dispute surrounding pre-construction costs have been concluded with HMRC in year, as has as a separate dispute relating to advance works. The financial statements correctly reflect the settlement, including a write-off of the engineering and construction provision for VAT and transfer of the liability to accruals.

Key audit findings
Other areas of audit focus

The following are matters which we considered had a direct impact on the financial statements but did not represent significant risks of material misstatement as defined by ISA (UK) 315.

Title	Audit response	Audit findings and conclusion
Smart motorways	The safety features of smart motorways has been an object of significant public interest for some time and was subject to a significant evidence stocktake in 2020, alongside commitments to specific improvements, and a one year on review in 2021. On 2 November, the Transport Select Committee recommended a full pause in the rollout, and some pauses have been announced by National Highways representatives on specific projects pending a National Highways-DfT review of the select committee evidence. Whilst primarily an operational and safety – rather than financial – issue, we note the significant activity in this area and the need for finance and the audit team to keep in view the impact of any changes on the value of existing smart motorway assets, and any impairment or write-offs that might be required to assets under construction. While no wide-scale halt in construction has been announced, we note the pause for reflection on specific projects, and around the year end, with the benefit of more information, we will consider the impact of any project decisions to estimates made within related capital accruals on the cost of work done by 31 March.	Highways prepared a paper assessing the impact of the pause on the accounts which we have reviewed. We agreed with Highways that the pause did not constitute an impairment event for existing built motorways or AUC, as whilst the pause stops future work on new builds, the in-progress 6x ALRs will continue to completion and the already built ones will not be de-constructed. The government’s commitment to increasing safety emergency refuge areas has been noted as a potential change to the modern equivalent asset under DRC (from 2.5km to 1.1km), with an adjustment similar to that made for the steel vs concrete road barriers made in a prior audit considered. However, Highways noted that the total value of the smart motorway cost uplift to date was c£630m (below materiality), so the cost of additional refuge areas would not be significant enough to justify adjustment. Additionally, they noted difficulty identifying this cost as the uplift does not specify to that level. There are a couple of outstanding points on this area: • Inclusion of disclosures on the smart motorway pause were discussed in fieldwork but have not yet been added into the accounts; and • NAO review of Highways responses, and quantification of the Emergency Refuge Area modern equivalent difference (immaterial).

Key audit findings

FinancialAuditCompletion

Areas of management judgement

The following are the matters which we are required to report to the Audit and Risk Committee for bodies who follow the UK Corporate Governance Code.

Description	Management's judgment	Our view
Director's assessment of principle risks facing National Highways	Principal risks are owned by the Executive team and monitored by the Board. Collectively, the Board and the Executive team maintain visibility of all risks sitting at principal and secondary levels, including status and mitigation plans, through periodic risk reporting and review process. The principal risks are disclosed in the annual report and are assessed against strategic outcomes including improving safety for all, delivering better environmental outcomes and meeting the needs of all road users.	The disclosures within the annual report as to the Company's risk assessment and management processes are adequate. The Company's risk management process is considered robust. The listed Principal risks it faces that are disclosed are in line with our knowledge of the Company.
Director's assessment of National Highways' future prospects and going concern	The directors have a reasonable expectation that the company has adequate resources to operate for the foreseeable future. The financial statements are therefore prepared on a going concern basis. In forming this view the directors/management have: • Reviewed the company's future funding commitments received from government through the publication of the second Road Investment Strategy (RIS2), which sets out the £24 billion resource and capital funding that the company will receive during the five years from 2020–21 to 2025-26; • Kept DfT fully aware of commitments made which stretch beyond the period covered by the RIS2 period; • Reviewed internal budgets, plans and cash flow forecasts; and • Reviewed DfT's Main Estimate for 2021–22.	We have reviewed Management's assessment and agree that the financial statements should be prepared on a Going Concern basis. We have no concerns with management's assessment or disclosure.
Internal controls	The Company establishes internal controls to mitigate risks related to fraud, error or non-compliance with laws and regulations. The Corporate Assurance function provides an objective and independent opinion on the effectiveness of internal control, and the Company participates in DfT's management assurance process.	Following our review of the Company's internal control environment and our work on the design and implementation of controls relating to significant audit risks, we conclude that the entity's system of internal controls affect financial reporting is effective.

Key audit findings
List of adjusted misstatements

Adjusted misstatements (both materiality levels)

Misstatements that we have identified, have been adjusted and are above our clearly trivial threshold of £300k. We have identified one significant adjustment – although it has a nil net impact on the statement of comprehensive net expenditure or the statement of financial position. There were no other adjustments above trivial.

Adjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE DR £000	SOCNE CR £000	SOFP DR £000	SOFP CR £000
Adjustment to gross movements within land and property provisions	Known	We noted that additions and write-backs to Land and Property provisions looked unusually high in the accounts. On enquiry, it transpired that movements in the valuation on the Lower Thames Crossing scheme had inadvertently been accounted for twice given an in-year adjustment moving the respective costs to a new project pin. This is essentially an 'in and out' on the face of the provisions note.	L&P provisions (additions)	£'k			163,073	
			L&P provisions (write-backs)	£'k				163,073
		Cumulative misstatements:	Debits and credits				163,073	163,073
			Net impact on financial statements					0

Uncorrected misstatements are set out on the following pages.

Key audit findings

List of unadjusted misstatements

Unadjusted misstatements – Overall Materiality

As at the date of reporting, uncorrected misstatements would increase net spend by £1.0m and decrease net assets by the same amount under our overall materiality level. The table below lists **unadjusted misstatements** which exceed our clearly trivial threshold of £300k.

We request that these uncorrected misstatements be corrected or a rationale as to why they are not corrected be considered and approved by the Audit and Risk Committee, and provided within the Letter of Representation.

Unadjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE DR £000	SOCNE CR £000	SOFP DR £000	SOFP CR £000
SRN Reconciliation difference	Known	Reconciliation of the SRN roads identified an error on depreciation of £1.0m understating the expense.	Depreciation	£'k	1,086			
			SRN Road acc depr	£'k				1,086
		Cumulative misstatements:	**Sum of debits and credits**		1,086			1,086
			Net impact on financial statements		1,086			1,086

<u>Estimation uncertainty issues not included in the table above</u>

I. We have made enquiries regarding whether the Emergency Refuge Area requirements from the TSC report would impact the uplift rates and require an obsolescence adjustment to the modern equivalent asset. Any potential impact will be immaterial to the accounts given the size of the total motorways uplift (c.£600m) - with any uncertainty much smaller than this. See page 11 for details.

II. Completeness of the prior year smart motorway adjustment; there is a possibility of erroneous lane inclusions not having been corrected in Highways exercise, but we have estimated the maximum potential error relating to this to be c.£100m. See page 12 for details.

<u>Prior year issues</u>

As explained in our SRN risk, Highways made an adjustment to correct a £452m error identified in the prior year smart motorways valuation uplift. This was corrected in 2021-22. Given that the error has been corrected in the current financial year, it has not been included in our summary of misstatements above. We further note that our un-adjusted misstatements relating to overall materiality in the prior year were £352m, so we are content that there is not a material issue in the prior year accounts with regards to the above (materiality is £1.3bn).

Key audit findings

List of unadjusted misstatements

Unadjusted misstatements – Secondary Materiality

At the date of reporting, uncorrected misstatements decrease net spend and increase net assets by £13.3m

The table below lists **unadjusted misstatements** which exceed our clearly trivial threshold of £300k.

We request that these uncorrected misstatements be corrected or a rationale as to why they are not corrected be considered and approved by the Audit and Risk Committee, and provided within the Letter of Representation

Unadjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE DR £000	SOCNE CR £000	SOFP DR £000	SOFP CR £000
Provisions - Scheme level differences	Extrapolated	Differences as a result of valuations not being updated or manual calculations being miscalculated. Net understatement.	Provisions	£'k				1,067
			Expenditure (provisions)	£'k	1,067			
Provisions - individual cases	Extrapolated	Differences as a result of valuations not input correctly by VOA or manual calculations being miscalculated. Net overstatement.	Provisions	£'k			4,670	
			Expenditure (provisions)	£'k		4,670		
Accruals - capital	Extrapolated	The current extrapolated results from our sample testing suggest that capital accruals are overstated.	Accruals	£'k			1,392	
			Capital Expenditure	£'k				1,392
Accruals - resource	Extrapolated	The current extrapolated results from our sample testing suggest that resource accruals are overstated.	Accruals	£'k			2,797	
			Expenditure	£'k		2,797		
		Cumulative misstatements (*c.f.*):	**Sum of debits and credits**	**£'k**	1,067	7,467	8,859	2,459
			Net impact on financial statements			6,400	6,400	

Key audit findings

List of unadjusted misstatements… continued

Unadjusted misstatements – Secondary Materiality

Unadjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE DR £000	SOCNE CR £000	SOFP DR £000	SOFP CR £000
		Cumulative misstatements b.f. from previous page			1,067	7,467	8,859	2,459
Cut-off error within expenditure	Known	In our expenditure cut-off testing we noted that management had not accrued for Company credit card charges. Given the nature of spend, we have been able to ringfence this error (known error).	Accruals	£'k				155
			Other expenditure	£'k	155			
Maintenance expenditure	Extrapolated	We identified 3 small errors in our sample testing of maintenance expenditure, which, when extrapolated, lead to a most likely error of £3,922k in the population.	SOFP	£'k		3,922		
			Maintenance expenditure	£'k			3,922	
Other expenditure	Extrapolated	We identified errors in our sample testing of other expenditure, which, when extrapolated, lead to a most likely error of £313k in the residual population and a known error of £1,083k in a higher value item.	SOFP	£'k		1,396		
			Other expenditure	£'k			1,396	
Other expenditure sample	Known	A stock write off of £1.8m was identified in the sample however, the stock was previously impaired in a 20-21 adjustment, so the in-year entry duplicates the expense to the SOCNE, understating inventory. The error has been ring-fenced.	Inventories	£'k			1,750	
			Other expenditure	£'k		1,750		
		Cumulative misstatements:	**Sum of debits and credits**		1,222	14,535	15,927	2,614
			Net impact on financial statements			13,313	13,313	

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Other audit findings

Financial statement disclosures	We have challenged management over the adequacy of disclosures in the financial statements, including in the following areas: • Enhancement of the disclosure explaining the significant change in the HECI index, which has driven a significant increase in the valuation of road assets; and • Enhancement of the provisions disclosure to explain significant, in-year write-backs. We have made a number of other suggestions to improve narrative disclosures and to ensure completeness of the disclosures required under the Companies Act (2006), FReM and other relevant guidance. We will review subsequent versions of the financial statements in order to conclude that the required changes have been made.
Accounting policies and financial reporting	We have performed the following procedures with regards to the appropriateness of the judgements made by the entity on accounting policies, particularly new or changed policies: • Ensured that all accounting policies are in line with IFRS. We are content that the accounting policies are complete, accurate and compliant with the relevant standards and have been appropriately applied. We have performed procedures on the appropriateness of the judgements made by the entity on the required accounting estimates, such as those detailed against our SRN valuation and provisions significant risks, and those specified against our accruals risk factor in this report. There are no material inconsistencies in the annual report that have not been corrected. We are content that the accounting policies are complete, accurate and compliant with the relevant standards and have been appropriately applied.
Regularity, propriety and losses	We found no issues of irregularity or impropriety during our audit. In our wider expenditure testing, we have noted losses that potentially fall within the scope of Managing Public Money that would require HMT approval and disclosure in the accounts. We are currently in discussion with management regarding these.

Other audit findings

Risk of Fraud	We shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in our auditor's judgment, relevant to their responsibilities. It is our responsibility as auditors to report to those charged with governance: • Any risks of material misstatement identified due to fraud • Any matters we think are relevant to those charged with governance regarding management's process for identifying and responding to the risks of fraud in the entity The risks of material misstatement due to fraud identified and reported at planning included the presumed risk of management override of controls. We rebutted the presumed risk of fraud in revenue recognition. Since we last reported to you we have not identified any further risks of material misstatement due to fraud. We have nothing to report in respect of management's processes for identifying and responding to the risks of fraud.
Duplicate ledger postings	We reported in the prior year audit that we had identified erroneous system generated transactions in expenditure sample testing. Further instances of such transactions have also been identified in our testing in 2021-22, and we have, in each instance, confirmed that Highways reversed the transactions via correcting entries. Erroneous postings are made to the GL when the value of a purchase order is increased or reduced from its original value - the ledger posts a transaction that recreates the posting of all invoiced / receipted transaction amounts against the original PO. We have revisited the process that Highways has in place for identifying and correcting these items. We tested a sample of items flagged by the process and confirmed they had been corrected. Furthermore, our IT audit team identified a specific account code as being the default entry for these generated transactions, so we have reviewed the postings for the affected months to check for possible completeness issues. This review did not identify any material concerns, and we remain satisfied with the process in place.
Cash and bank reconciliation	In our testing of cash and bank, we noted that £1.9m in items had been identified as received in the bank, but the breakdown of items had not been allocated in the bank reconciliation. Some of these items were several months old and had not yet been investigated. The unreconciled amount is clearly immaterial. We will be raising a recommendation to management in our Management Letter regarding the issue.

Other audit findings

Principal risks facing National Highways	As National Highways is complying with the UK Corporate Governance Code, we are required to communicate to you our views on the robustness of the directors' assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity and its outcome, including the related disclosures in the annual report. Whilst we have not performed additional procedures to inform our view, we consider that the assessment was robust and related disclosures are appropriate.
Prospects of National Highways	In addition to the above, we are required to report to you our views about the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate. We also are required to communicate our views on the directors' statements: • in the financial statements, as to whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, including any related disclosures; and • in the annual report as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures. Whilst we have not performed additional procedures to inform our view, we consider that the directors' explanation is robust and related disclosures are appropriate.
The effectiveness of National Highways' system of internal control	Our responsibilities as auditors do not extend to providing an opinion on the overall effectiveness of the system of internal control. However, in our view, based solely upon the audit procedures performed, we consider that the system of internal control is effective.

Appendices

Appendix 1 - Audit Scope

We are nearing completion of our audit of the 2021-22 financial statements in accordance with International Standards on Auditing (UK) issued by the Financial Reporting Council and with the audit planning report presented to the Audit and Risk Committee in December 2021.

We have also read the content of the draft annual report and the governance statement to confirm that:

- In my opinion the parts of the Remuneration Committee Report to be audited have been properly prepared in accordance with the Companies Act 2006;
- In the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have not identified material misstatements in the Strategic Report or the Directors' Report;
- The information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- that the corporate governance statement has been prepared in accordance with the Companies Act 2006.

As part of our audit, we assessed:

- whether the accounting policies are appropriate to the Company's circumstances and have been adequately disclosed;
- the reasonableness of significant accounting estimates made by the Accounting Officer; and
- the overall presentation of the financial statements.

We are also required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Appendix 2 - Other matters for consideration

Independence	We are independent of National Highways in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed entities. We have fulfilled our ethical responsibilities in accordance with these requirements and have developed important safeguards and procedures in order to ensure our independence and objectivity. Information on NAO quality standards and independence can be found on the NAO website: https://www.nao.org.uk/about-us/our-work/governance-of-the-nao/transparency/.
International standards on Auditing (UK)	We consider that there are no additional matters in respect of items requiring communication to you, per International Standards on Auditing (UK), that have not been raised elsewhere in this report or our audit planning report. Items requiring communication cover: • Fraud • Going concern • National Highways' compliance with laws and regulations • Significant difficulties completing the audit • Disagreements or other significant matters discussed with management • Other matters which may be relevant to the board or the audit committee in the context of fulfilling their responsibilities under the UK Corporate Governance Code.
Cooperation with other auditors	**Internal Audit** Our risk assessment, and the development of our audit plan, was informed by the work of internal audit. We met with Internal Audit as part of our audit planning process to inform our risk assessment have reviewed Internal Audit reports issued during the year identify areas of operating and financial statement risk.
Communication with the NAO	Organisations we audit tell us they find it helpful to know about our new publications, cross-government insight and good practice. Our website holds a wealth of information from latest publications which can be searched, to pages sharing our insights on important cross-cutting issues. We also publish blogs and send email notifications to subscribers about our work on particular sectors or topics. If you would like to receive these alerts, please sign up at: http://bit.ly/NAOoptin. You will always have the option to amend your preferences or unsubscribe from these emails at any time.

Appendix 2 - Other matters for consideration Cont'd

Management of personal data

During the course of our audit we have had access to personal data to support our audit testing.

The General Data Protection Regulations (GDPR) came into force in May 2018. These regulations make no difference to the C&G's access rights.

The Data Protection Act provides the C&AG with an exemption from the individual rights provisions where to apply the provisions would be likely to prejudice the proper discharge of the C&AG functions. For example this would mean that we would not need to inform an individual about processing nor could an individual object to processing of their information for audit purposes where that would disrupt an efficient audit.

We take our obligations under GDPR seriously. We have appointed a Data Protection Officer and all our staff are required to comply with formal data protection policies, guidelines and procedures designed to keep third party data secure and support privacy by design. We will destroy, return, or store personal data as necessary on completion of our work.

We confirm that we have discharged those responsibilities communicated to you in the NAO's Statement on Management of Personal Data.

The statement on the Management of Personal Data is available on the NAO website: http://www.nao.org.uk/freedom-of-information/publication-scheme/how-we-make-decisions/our-policies-and-procedures/policies-and-procedures-for-conducting-our-business

Appendix 3 - Updating our audits for ISA315 and ISA240 revisions

In light of regulatory and technological changes across the audit profession, and to ensure that we consistently deliver high quality, efficient and insightful audits, the NAO has launched a programme to develop and modernise how we conduct our financial audits.

Our aim is to ensure that we consistently deliver high quality, efficient and insightful audits, responding to changes in the audit profession and taking opportunities such as utilising new technologies.

We will be reviewing our whole approach with a focus on 3 key pillars:

Revising our audit methodology

We are updating our methodology – how we identify, assess and respond to audit risk, and our sampling approach - to reflect new and emerging auditing standards, regulatory requirements and enhanced expectations for audit quality. A key driver for change is the updated standard ISA315: *Identifying and Assessing the Risk of Material Misstatement.*

Enhancing insight by further embedding digital audit approaches

We will expand controls-based audit through closer integration of IT audit and data analytics. We will work with the organisations we audit to identify business processes and controls that can support IT audit and analytics. Over time, we expect to enhance the value and insight we bring through our audits.

Introduce new audit software

Our updated audit platform will ensure our auditors are well placed to deliver high quality work consistently and efficiently, in line with standards and best practice. Our new software will support better integration with IT audit and data analytics tools, as well as guided workflow and more efficient and clearer documentation.

Initially the most noticeable change for those we audit will be the application of our new methodology which will apply from the audits of 2022-23 accounts, reflecting the effective date of ISA 315. We have set out the key changes that will be coming this autumn and what these mean for National Highways.

Appendix 3 - Updating our audits for ISA315 and ISA240 revisions Cont'd

The changes to the NAO's methodology – and the changes to the nature and amount of audit work we need to do - are primarily driven by the revisions to *ISA 315 - Identifying and Assessing the Risk of Material Misstatement,* with further changes arising from *ISA (UK) 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.*

ISA 315- Identifying and Assessing the Risk of Material Misstatement

ISA 315 drives the auditor's approach to; risk assessment; understanding the entity and its environment (including the entity's system of internal control); and addressing significant risk.

The International Auditing & Assurance Standards Board (IAASB) concluded that whilst the existing version of the standard was fundamentally sound, feedback determined that it was not always clear, leading to a possibility of inconsistent risk identification.

The aims of the revised standard are to:

- Drive consistent and effective identification and assessment of risks of material misstatement
- Improve the standard's applicability to entities across a wide spectrum of circumstances and complexities ('scalability')
- Modernise ISA 315 to meet evolving business needs, including:
  - how auditors use automated tools and techniques, including data analytics to perform risk assessment audit procedures
  - how auditors understand the entity's use of information technology relevant to financial reporting
- Focus auditors on exercising professional scepticism throughout the risk identification and assessment process.

ISA 240-The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

ISA (UK) 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

The revision to the standard aims to clarify the obligations of auditors to identify and assess the risk of material misstatement due to fraud, as well as including supplemental requirements and guidance to enhance the auditors' procedures.

Both of these revisions apply to all audit firms, not just the NAO. They are effective for audits of financial statements for periods beginning on or after 15th December 2021, which equates to the 2022-23 financial year for UK public sector entities.

While changing our methodology to be compliant with these revised standards we are also taking the opportunity to implement changes that provide a platform for wider developments in auditing, such as the increased use of controls assurance and digital audit approaches.

Appendix 3: Updating our audits for ISA315 and ISA240 revisions - ISA 315 Cont'd

Where our current methodology focuses on account balances and financial statement lines, our new methodology under ISA315 focuses much more on the business processes of an audited entities and the risks to the financial statements these may give rise to.

Once we have identified risks relevant to our client, the new methodology places each risk on a 'Spectrum of Inherent Risk' as either a significant, medium, or low risk. Based on this placement, different combinations of assurance (inherent, controls, and substantive) are used to address the risk.

Review business processes undertaken by our clients → Identify risks of material misstatement → Place risks on the 'Spectrum of Inherent Risk' → Design assurance procedures to address the risk

The spectrum of inherent risk is a new concept and means that we need to consider risk across an audit engagement in a more nuanced, granular way and our corresponding response may be more focused. The key impacts are:

- Significant increase in work required on entity's use of IT in business and system of internal control.
- Clearer workflow within the standard to highlight the importance of the auditor's understanding of the entity and environment, the applicable financial reporting framework, and system of internal control.

A 'significant risk' is now defined in the context of the spectrum of inherent risk:

"an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs (UK)".

Whereas the previous definition focussed on a need for special audit consideration:

"an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."

Appendix 3: Updating our audits for ISA315 and ISA240 revisions - ISA 315 Cont'd

The FRC sees changes in methodology arising from ISA315 as giving rise to several benefits, including:

- An approach which better meets evolving business needs, including the use of automated audit tools and techniques and the use of IT in financial reporting.
- Obtaining a better understanding of our clients and their business, allowing us to add more value through our findings and recommendations.
- Allowing audit responses to be more fully driven by risk, focusing on the more relevant audit assertions.
- Driving consistent and effective identification and assessment of risk, ensuring a complete and high-quality risk assessment.
- Providing more opportunity to take controls assurance, moving the balance of audit work away from year end substantive (sample) testing.

Appendix 3: Updating our audits for ISA315 and ISA240 revisions - ISA 240 Cont'd

The changes to ISA 240 do not alter the scope of our audit when it comes to fraud:

Management responsibilities	Our responsibilities as auditor
• Primary responsibility for the prevention and detection of fraud. • Establish a sound system of internal control designed to manage the risks facing the organisation; including the risk of fraud.	• Provide reasonable assurance that the financial statements (as a whole) are free from material misstatement, whether caused by fraud or error. • Make inquiries of those charged with governance in respect of your oversight responsibility.

The key changes seek to clarify the auditor's role and objectives in identifying fraud :

- Emphasis on the requirement to obtain reasonable assurance about whether the financial statements are free from material misstatement due to fraud.
- Greater focus on professional scepticism.
- New requirements for the auditor to determine whether the engagement team requires specialised skills or knowledge to perform their work on fraud.
- Additional guidance regarding the audit engagement team's discussion on how and where the entity's financial statements may be susceptible to material misstatement due to fraud or error. The revised ISA 240 emphasises the need for an exchange of ideas among all engagement team members about fraud risk factors.
- The auditor shall make inquiries of management, or others within the entity who deal with fraud allegations, to determine whether they have knowledge of any actual, suspected or alleged fraud, including cases of fraud raised by employees or other parties.
- Auditors are to hold a discussion with those charged with governance regarding the risks of fraud in the entity and to consider the implications for the audit.

We will also communicate to those charged with governance our assessment of the risks of material misstatement due to fraud in addition to matters relating to fraud (unless prohibited by law or regulation) that we would have communicated under the previous version of ISA 240 with additional emphasis in the updated ISA for us to report any matters we think relevant regarding management's process for identifying and responding to the risks of fraud.

Appendix 3: Updating our audits for ISA315 and ISA240 revisions – what audited entities will see

We have piloted the use of our new methodology for a number of audits in 2021-22 to allow us to trial the changes and understand the key impacts on our clients.

Audit Planning

Finance teams may be required to support additional engagement during audit planning to facilitate our detailed documentation of controls and processes, in order to correctly identify risks and to enhance our understanding of the business in order to assess the significance of the risk.

This will be an upfront investment, and we anticipate that this part of the audit should be quicker after the initial year.

Many of the significant risks previously reported are likely to remain under our new approach to risk assessment, however, the IAASB has predicted that more risks will be identified. In practice this may include previously reported significant risks being broken down into several components with targeted responses.

For Audit and Risk Committees this will provide a greater insight into how the risks we identify could affect the financial statements.

For audited entities we expect to have a better conversation on controls and processes, earlier in the audit.

Audit Fieldwork

Depending on the outcome of our risk assessment, the audit fieldwork we perform may be broadly consistent with the approach we have taken in prior years.

In order to smooth the transition, we have already adopted a revised sampling approach (used in 2021-22 audits) that focuses on the areas of most risk and complements the new methodology.

Our audit responses to significant risks will be proportionate to the level of risk identified, so while there may be additional risks identified this does not necessarily equate to a significant increase in audit work as our responses to risk will be more targeted.

The new approach will refocus our resources on the key risks and judgements, provide more opportunities to take controls assurance, as well as focusing on the more relevant audit assertions, as opposed to all audit assertions. In the future, we will be moving towards more automated, data-led techniques, including IT audit.

Appendix 4: Future accounting standards

Accounting standard	Detail	Future direction for <client name>
IFRS 17: Insurance Contracts Effective from periods starting on or after 1 January 2023 IFRS 17 implementation has been deferred from its original implementation date of 1 January 2022 by the IASB. HM Treasury are consulting on the public sector interpretation of this Standard for FReM bodies. It expects implementation in 2025-26, and public sector guidance is expected before December 2022.	IFRS 17: Insurance Contracts replaces IFRS 4 of the same name. The new standard will apply more standardised and rigorous requirements on accounting for insurance contracts. The new standard sets clearer expectations on the recognition, classification and measurement of assets and liabilities in relation to insurance contracts. The scope of the standard covers insurance contracts issued and re-insurance contracts issued or held. An insurance contract is defined as: "*A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.*" HMT are considering the application of IFRS 17 to the public sector. The standard reflects appropriate practice for the commercial insurance industry and implementation without adaptation may not be suitable for the public sector. HMT have already identified the practice of self-insurance across the public sector as an area that may adapted for government bodies. They are seeking feedback on where such self-insurance arrangements might exist, so the extent of this undertaking can be considered when the standard is adapted for the FReM.	Entities should consider if in their normal course of business they provide any insurance contracts and consider what systems and reporting may be required to manage the change in accounting policy. Audit committees are asked to consider whether, through contractual arrangements or custom and practice, their enterprises insure other bodies against specific risks. Where arrangements are identified, entities should engage with HMT on the application of the standard within the public sector. Audit committees are requested to continue to monitor new transaction streams or arrangements against the criteria of IFRS 17 to ensure all liabilities are appropriately recognised across the government estate. Although the implementation of IFRS 17 is not planned until 2025-26, the standard should not be underestimated and preparations will be required where appropriate. Accounting for insurance contracts requires information and understanding of actuarial adjusted outcomes, risk and discounting. Clients will need to prepare different data, system and processes to implement the standard.

Appendix 5 - Good Practice in Annual Reporting

The Audit Committee plays a key role in scrutinising the Annual Report and Accounts, ensuring the quality of disclosures and its understandability for users.

To support the Audit Committee in this role, we have published our **Good Practice in Annual Reporting** guide.

The Guide, issued in January 2022, provides specific examples of best practice we identified during our review of a sample of 2020-21 annual reports. The good practice principles are grouped under the following headings: supporting accountability, transparency, accessibility and understandability and these should be evident across the common sections of an annual report (below).

Could you be a winner in 2021-22?
If you would like to nominate your organisation for the Building Public Trust Awards for your 2021-22 Annual Report and Accounts, please speak to your NAO Team or contact us at **Building.Public.Trust@nao.org.uk**.

Appendix 5 - Good Practice in Annual Reporting

Essential features of a good annual report

Supporting accountability

- telling the story of the organisation in a fair and balanced way;
- compliance with the relevant reporting requirements; and
- clear action points to take forward.

Transparency

- frank and honest analysis;
- consideration of the challenges an organisation is facing;
- appropriate use of data; and
- quantification of risks and performance measures.

Accessibility

- highlights key trends in the financial statements;
- concise summaries of key points; and
- consideration of how the organisation engages with key stakeholders and meets their needs.

Understandable

Use of:

- plain English to explain difficult concepts;
- infographics and diagrams to communicate important messages; and
- clearly integrated structure to help users navigate it effectively.

Appendix 6: Review of Purchase to Pay Business Process and General IT Controls (GITC) work

Summary of testing

NAO's IT audit team assessed ability to achieve controls assurance over purchasing in relation to the following systems:

- Oracle Fusion
- Apps and Certs
- Confirm

This included testing of Purchase to Pay (P2P) controls, general IT controls, and Service organisations.

Finding area	Issues identified	Conclusion
Confirm	There was a lack of: • any controls (SOC1) reports for Confirm • an effective control environment operating around Confirm	We are unable to take controls assurance over Confirm
Oracle Fusion and Apps and Certs	There was a lack of: • controls reports covering the whole audit period for Oracle Fusion • formal evidence to demonstrate National Highways' management's regular review and oversight of the service provided	We are unable to take controls assurance over Oracle Fusion and Apps and Certs

[National Highways letterhead]

The Comptroller and Auditor General
National Audit Office
157-197 Buckingham Palace Road
Victoria
LONDON
SW1W 9SP

LETTER OF REPRESENTATION: NATIONAL HIGHWAYS LIMITED

I acknowledge as Accounting Officer of National Highways Limited ('the Company') my responsibility for preparing accounts that give a true and fair view of the state of affairs, net expenditure, changes in tax-payers equity and cash flows of National Highways for the year ended 31 March 2022.

In preparing the accounts, I was required to:

- apply appropriate accounting policies on a consistent basis in accordance with International Financial Reporting Standards;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards have been followed and disclosed and explain any material departures in the accounts; and
- make an assessment that the Company is a going concern and will continue to be in operation throughout the next year; and ensure that this has been appropriately disclosed in the financial statements.

I confirm that for the financial year ended 31 March 2022:

- neither I nor my staff authorised a course of action, the financial impact of which is that transactions infringe the requirements of regularity as set out in Managing Public Money;
- having considered and enquired as to the Company's compliance with law and regulations, I have disclosed to you any actual or potential non-compliance that could have a material effect on the ability of the Company to conduct its business or whose effects should be considered when preparing financial statements;
- all accounting records have been provided to you for the purpose of your audit. All other records and related information, including minutes of all management meetings which you have requested have been supplied to you;
- all transactions undertaken by the Company have been recorded in the accounting records and are properly reflected in the financial statements; and
- the information provided regarding the identification of related parties is complete; and the related party disclosures in the financial statements are adequate.

All material accounting policies as adopted are detailed in the relevant notes to the accounts.

INTERNAL CONTROL

I acknowledge as Accounting Officer my responsibility for the design and implementation of internal controls to prevent and detect error and I have disclosed to you the results of my assessment of the risk that the financial statements could be materially misstated.

I confirm that I have reviewed the effectiveness of the system of internal control and that the disclosures I have made are in accordance with HM Treasury guidance on the Governance Statement.

FRAUD

I acknowledge as Accounting Officer my responsibility for the design and implementation of internal controls to prevent and detect fraud and I have disclosed to you the results of my assessment of the risk that the financial statements could be materially misstated as a result of fraud.

I have disclosed to you any knowledge of fraud or suspected fraud affecting ther Company involving management, employees who have significant roles in internal control, or others where the fraud could have a material effect on the financial statements.

I have disclosed to you any knowledge of any allegations of fraud or suspected fraud, affecting the Company's financial statements communicated by employees, former employees, analysts, regulators or others.

ACCOUNTING ESTIMATES

I acknowledge as Accounting Officer my responsibility to make judgments and estimates on a reasonable basis.

I confirm that the methods, the data, and the significant assumptions used by the Company in making accounting estimates and related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of International Financial Reporting Standards.

GOING CONCERN

I have assessed whether the going concern basis of accounting is appropriate for the Company. The plans for future actions upon which this assessment – taking into account the Company's future funding commitments from the Government for RIS2 through to 2026, as well as a review of commitments beyond the RIS2 period, internal budgets, plans and cashflow forecasts - are feasible. The assumptions made in my assessment are reasonable and appropriate in the context of International Financial Reporting Standards.

ASSETS

General

All assets included in the statement of financial position were in existence at the reporting date and owned by the Company and free from any lien, encumbrance or charge, except as disclosed in the financial statements. The statement of financial position includes all tangible assets owned by the Company.

Non-Current Assets

All assets are capitalised in line with the capitalisation criteria and thresholds specified in Note 6 to the accounts.

Strategic Road Network related assets

The Company's surveyors undertake a full revaluation of the SRN at intervals not exceeding five years. Indices are applied in the years between full valuations on the SRN to reflect depreciated replacement cost.

In revaluing the overall SRN components in interim valuation years, including the 2021-22 financial year, I am content that the HECI index, as adopted for roads, structures and technology assets, remains the most appropriate index for use, provides the best estimate in uplifting the asset values and has been fairly applied. The change in this index has increased the valuation of the Strategic Road Network by c£9.7 billion.

I am content that the valuation adjustment for smart motorways is materially accurate and complete. In forming this view I have considered the completeness of the exercise carried out to identify the £452m adjustment that has corrected the erroneous inclusion of an additional lane within sections of smart motorway when calculating the valuation uplift in the prior year.

The Company's cost estimate of the SRN reflects the most recent information of quantities and condition, using neutral and appropriate professional judgement where necessary. I am content that the rates provide the best estimate supporting the valuation basis described in note 6. I am content that these have been fairly applied.

I remain content that our judgement that the sub-structure of the road has an unlimited useful life, in light of the continued renewal of top layers, is appropriately based on the Company's engineering expertise, and that the extent of condition change over the winter measurement break does not materially impact the financial statements.

In all material respects, the Company is not aware of any SRN components which should be impaired or derecognised – including structures and technology assets – beyond those already included in the accounts.

Other Current Assets

On realisation in the ordinary course of the Company's operations the other current assets in the statement of financial position are expected to produce at least the amounts at which they are stated. Adequate provision has been made against all amounts owing to the Company which are known, or may be expected, to be irrecoverable.

VAT receivable

I am content that the VAT receivable reported by the Company at £106.6m represents the best estimate of the value recoverable following review of the year-end transactions in 2021-22. The Company expects to recover the full amount recognised based on correspondence with HMRC.

LIABILITIES

General

All liabilities have been recorded in the statement of financial position in accordance with International Financial Reporting Standards.

Accruals

I consider the accruals balance to be materially fairly stated in the accounts. I am satisfied that the judgements made to estimate the value of work completed in the year are reasonable.

Provisions and Contingent Liabilities

Provision is made in the financial statements for:

- Land and property acquisition;
- Engineering and construction;
- Leased asset refurbishment;
- Early retirements; and
- Other provisions, including injury and damage claims.

I consider the land and property acquisition provision balance – including the additions and write-backs relating to those provisions - to be materially fairly stated in the accounts. I am satisfied that the judgements made in the underlying valuations are reasonable.

I have disclosed to you all actual or possible litigation and claims whose effects should be considered when preparing the financial statements. All such matters have been accounted for and disclosed in accordance with International Financial Reporting Standards.

I am not aware of any action which is or may be brought against the Company under the Insolvency Act 1986.

Other Liabilities

PFI Liabilities

National Highways holds longstanding service concession arrangements under Private Finance Initiative contracts. These contracts have not been re-financed in the 2021-22 financial year, nor have there been other contractual changes made that have driven changes to the underlying assumptions or logic in the accounting models.

OTHER DISCLOSURES

Results

Except as disclosed in the financial statements, the results for the year were not materially affected by transactions of a sort not usually undertaken by the Company, or circumstances of an exceptional or non-recurring nature.

Losses and special payments

All losses and special payments requiring disclosure under the requirements of Managing Public Money have been included in the Annual Report, following inclusion of the items identified in the audit.

Unadjusted Errors

The following unadjusted errors have been brought to my attention:

FINAL TABLE TO BE INCLUDED AT THE CONCLUSION OF THE AUDIT – SEE CURRENT POSITION IN AUDIT COMPLETION REPORT

I consider the effect of these unadjusted errors to be immaterial, both individually and in aggregate, to the financial statements taken as a whole.

Events after the Reporting Period

All matters regarding events occurring subsequent to the date of the financial statements, and for which International Financial Reporting Standards require adjustment or disclosure, have been adjusted or disclosed.

Nick Harris
Chief Executive

[Date]

INDEPENDENT AUDITOR'S REPORT TO THE SOLE SHAREHOLDER OF NATIONAL HIGHWAYS LIMITED

Opinion on financial statements

I have audited the financial statements of National Highways Limited (the Company) for the year ended 31 March 2022 which comprise the Company's:

- Statement of Financial Position as at 31 March 2022;
- Statement of Comprehensive Net Expenditure, Statement of Cash Flows and Statement of Changes in Taxpayers' Equity for the year ended 31 March 2022; and
- the related notes including the significant accounting policies.

The financial reporting framework that has been applied in the preparation of the financial statements is applicable law and UK adopted International Accounting Standards in conformity with the requirements of the Companies Act 2006.

In my opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 March 2022 and of the net expenditure for the year then ended;
- have been properly prepared in accordance with UK adopted International Accounting Standards; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on regularity

In my opinion, in all material respects the income and expenditure recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Basis for opinion

I conducted my audit in accordance with International Standards on Auditing (ISAs) (UK), applicable law and Practice Note 10 '*Audit of Financial Statements of Public Sector Entities in the United Kingdom'*. My responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of my report.

Those standards require me and my staff to comply with the Financial Reporting Council's Revised Ethical Standard 2019. I have also elected to apply the ethical standards relevant to listed entities. I am independent of the Company in accordance with the ethical requirements that are relevant to my audit of the financial statements in the UK. My staff and I have fulfilled our other ethical responsibilities in accordance with these requirements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

The framework of authorities described in the table below has been considered in the context of my opinion on regularity.

Framework of Authorities	
Authorising legislation	• Infrastructure Act 2015 • The Delegation of Functions (Strategic Highways Companies) (England) Regulations 2015 • The Licence issued by the Secretary of State for Transport providing statutory directions to the Company
HM Treasury and related authorities	• The Framework Document between the Department for Transport and the Company • HM Treasury guidance, including Managing Public Money, and Cabinet Office Spending Controls, to the extent they are made applicable to the Company by the Framework

Conclusions relating to going concern

In auditing the financial statements, I have concluded that the Company's use of the going concern basis of accounting in the preparation of the financial statements is appropriate.

My evaluation of the director's assessment of the entity's ability to continue to adopt the going concern basis of accounting included a review of the Company's future funding commitments from the Government for RIS2 through to 2026, as well as a review of commitments beyond the RIS2 period, internal budgets, plans and cashflow forecasts.

Based on the work I have performed, I have not identified any material uncertainties relating to events or conditions that, individually or collectively, may cast significant doubt on the Company's ability to continue as a going concern for a period of at least twelve months from when the financial statements are authorised for issue.

In relation to the entities reporting on how they have applied the UK Corporate Governance Code, I have nothing material to add or draw attention to in relation to the directors' statement in the financial statements about whether the director's considered it appropriate to adopt the going concern basis of accounting.

My responsibilities and the responsibilities of the directors with respect to going concern are described in the relevant sections of this report.

Overview of my audit approach

Key audit matters

Key audit matters are those matters that, in my professional judgment, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditor, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of the audit of the financial statements as a whole, and in forming my opinion thereon. I do not provide a separate opinion on these matters.

I have determined that there are no other key audit matters to communicate in my report.

This is not a complete list of all risks identified though the course of my audit but only those areas that had the greatest effect on my overall audit strategy, allocation of resources and direction of effort. I have not, for example, included information relating to the work I have performed in relation to the presumed risk of management override of controls under International Standard on Auditing (UK) 240, an area where my work has not identified any matters to report. In addition, I have not reported on the work I have performed in relation to the impact of the Smart Motorways pause driven by the recent Transport Select Committee recommendations – given that financial statement is not material.

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The areas of focus were discussed with the Audit and Risk Committee; their report on matters that they considered to be significant to the financial statements is set out on pages XX-XX.

The key audit matters I report on are consistent with those I identified in the prior year.

Valuation of the Strategic Road Network (SRN)

Description of risk

The SRN is the dominant component of the accounts (£141.4 billion) as at 31 March 2022. The valuation comprises an estimate of the depreciated replacement cost of the SRN, as a proxy for its fair value in the absence of income or market-based sources. The estimate uses the best information available on the actual cost of recent schemes, together with records about the number, type and condition of physical assets.

Several assumptions are implicit in determining the SRN valuation, the validity of which needs keeping under review; for example, whether costing rates for material SRN elements remain a reasonable basis for valuing a modern equivalent asset.

There was not a quinquennial (QQR) valuation or other significant one-off valuation event in the financial year, but there has been a significant change to the SRN valuation given changes to the National Highways Capital Enhancement Cost Index (HECI), which is applied to the costing rates for roads and structures assets. This resulted in an £8.1 billion upwards impact on valuation, forming the largest component of the aggregate £7.9 billion upwards movement for 2021-22. The index has moved significantly given inflation and the wider economic climate.

The SRN valuation therefore contains multiple areas of judgement and estimation uncertainty. I treat this area as a significant matter for audit because of the inherent complexity and estimation uncertainty. The Company details the critical judgements and estimates they have made in relation to the SRN at note 6.2 and note 9 in the financial statements.

How the scope of my audit responded to the risk	My procedures on the SRN valuation are geared towards evaluating the reasonableness of management's estimate of its value, to assess: • the quality of source data in the underlying databases; • the reasonableness of costing rates and cost indexation factors applied in-year; and • the adjustments made in respect of the network's condition based on the available evidence from asset management activities, amongst other key assumptions.

I have engaged an expert to review the condition-based depreciation methodology supporting structures and road assets, which included review of a sample of assets to confirm that the methodology had been consistently and correctly applied. I also engaged my expert to review the significant increase to the HECI index which has caused the most significant uplift in valuation.

Key observations (NB. red = placeholder text)

My expert's review has confirmed that the condition-based depreciation methodology applied to structures and roads remains reasonable and has been correctly applied to the relevant assets.

My expert also confirmed that the underlying increase within the HECI index is reasonable, through benchmarking of the largest, constituent elements of the index, and consideration of alternatives.

In auditing the valuation applied to Smart Motorways, I noted that management had incorrectly included an additional lane within sections of Smart Motorway when calculating the valuation uplift for Smart Motorways in the prior year. Management assessed the impact of the adjustment to immaterial, at £452m, and have corrected the error in-year. I have performed procedures to gain assurance over the material completeness of the adjustment.

In concluding my wider audit work on the SRN, I did not identify any material misstatements in the valuation of the road network recognised and disclosed in the financial statements

Provisions for Land and Property purchases

Description of risk

The Company recognised provisions for land and property acquisition of £296.1m as at 31 March 2022. These relate to the estimated cost of planning blight, discretionary and compulsory acquisition of property and compensation for property owners arising from physical construction of road schemes.

The balance has significantly decreased from the prior year (£381.0m as at 31 March 2021), primarily a result of significant write-backs of £252.8m but also due to a reduction in the number of new schemes requiring provision.

As the underlying land cost estimate valuations present an element of significant inherent judgement and estimation uncertainty, this area is treated as a significant matter for the audit. Further information on the accounting for land and property purchases is included in notes 7.4 and 9.4 of the financial statements.

How the scope of my audit responded to the risk

I performed the following procedures over the provisions for land and property purchases balance:

- reviewed the accounting treatment of provisions and contingent liabilities against IAS 37;
- challenged the reasonableness of significant write-backs;
- engaged an auditor's expert to review a sample of underlying land and property valuations; and

- tested a sample of provisions at year end to agree the valuation and existence of the provision to supporting documentation.

Key observations (placeholder text in red)

In our sample testing, I noted that manual entry errors had been made on the provisions system where calculations had been carried out incorrectly by management, or where details had been entered incorrectly by management's expert. I also noted some instances where valuations had not been updated within 6 months, which is outside of the official policy. I extrapolated the errors found within my testing over the provisions balance and found the extrapolated error to be less than materiality.

My auditor's expert was of the view that valuation reports and other evidence provided by the management's expert could be more consistent and could provide greater justification and detail as to how assumptions have been made and how estimates have been reached, particularly for Single Scheme valuations. Overall, my expert was satisfied that the valuations were reasonable following further challenge to management's expert.

Following the results of testing and review of my expert's findings, I note an improvement on the prior year process. I did not identify any material misstatements in the provisions balance recognised and disclosed in the financial statements.

Valuation of accruals

Description of risk

Where work has been performed by the Company or its contractors by the year end, but an invoice has not been raised, the company raises an accrual for the expected costs. The largest balances relating to accruals relate to capital investment in the road network, for example on renewals and enhancement projects.

The company expects to be well informed about these costs, but there remains a level of estimation at the year-end about the amount of work delivered. This may differ from plan, for example as a result of unexpected under or over-delivery by the Company's contractors. Both controllable factors (such as contractor project management) and uncontrollable factors (such as ground conditions and weather) provide a level of estimation uncertainty which the company addresses through a post Balance Sheet review exercise.

These factors are part of the estimation uncertainty outlined by the company under the comments concerning cost of work done in the 'Critical accounting judgements and key sources of uncertainty' section in note 9.2.

How the scope of my audit responded to the risk

I substantively tested the accruals balance using a stratified sample testing approach. This allowed me to focus testing on higher value accruals and split resource and capital accruals.

Key observations (placeholder text in red)

This testing identified valuation differences between the evidence available and book value in the draft accounts, which derives from estimates made around the year end by relevant project teams, subject to checking on larger balances by the central finance team. Multiple root causes were involved, including where accruals had been recognised despite payment having been made before year-end, or where teams had accrued for more work than had in fact taken place.

By extrapolating the results of my stratified testing over the relevant populations, and considering the results in aggregate, I was able to gain sufficient assurance the accruals balance is not materially misstated.

Application of materiality

Materiality

I applied the concept of materiality in both planning and performing my audit, and in evaluating the effect of misstatements on my audit and on the financial statements. This approach recognises that financial statements are rarely absolutely correct, and that an audit is designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. A matter is material if its omission or misstatement would, in the judgement of the auditor, reasonably influence the decisions of users of the financial statements.

Based on my professional judgement, I determined overall materiality for the Company's financial statements at £1.3 billion, which is approximately 0.92% of the SRN balance. I chose this benchmark given users' interest in the Company's performance in managing and enhancing the network and providing service potential for road users. We have deemed non-SRN property, plant and equipment to be subject to this materiality given that the key assets in those classes, such as motorway service locations, have a function closely linked with the SRN.

Given that such a large element of the infrastructure asset is brought forward and reflects non-cash entries, and given additional user interest in the publicly funded cost of the Company's activities, we have deemed that misstatements of a lesser amount than overall materiality could influence the decisions of users of the accounts. I have therefore applied a secondary threshold for materiality applied to all transactions and balances that reflect cash spending, including SRN capital additions. I have determined that the level to be applied to these components is £64.0 million, being approximately 1.50% of the Company's total adjusted expenditure, calculated by adjusting net expenditure to exclude non-cash costs such as depreciation and impairment, and to include capital additions.

Performance Materiality

I set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole. For the overall materiality level, performance materiality was set at 85% (2020-21: 85%) of the materiality figure adjusted for uncorrected misstatements identified in the previous period. For the secondary materiality threshold, I have set performance materiality at 85% (2020-21: 85%) of the materiality figure adjusted for an anticipated most likely error of 15%.

Other Materiality Considerations

As well as quantitative materiality there are certain matters that, by their very nature, would if not corrected influence the decisions of users, for example, any errors reported in the Remuneration Committee Report. Assessment of such matters would need to have regard to the nature of the misstatement and the applicable legal and reporting framework, as well as the size of the misstatement.

I applied the same concept of materiality to my audit of regularity. In planning and performing audit work in support of my opinion on regularity and evaluating the impact of any irregular transactions, I took into account both quantitative and qualitative aspects that I consider would reasonably influence the decisions of users of the financial statements.

Error Reporting Threshold

I agreed with the Audit and Risk Committee that I would report to it all uncorrected misstatements identified through my audit in excess of £300k, as well as differences below this threshold that in my view warranted reporting on qualitative grounds. I also report to the Audit and Risk Committee on disclosure matters that I identified when assessing the overall presentation of the financial statements.

Total unadjusted audit differences reported to the Audit and Risk Committee have decreased/increased net expenditure/assets by £x.

Audit scope

The scope of my audit was determined by obtaining an understanding of the Company and its environment, including the entity wide controls, and assessing the risks of material misstatement.

Other Information

The other information comprises information included in the Annual Report, but does not include the financial statements and my auditor's report thereon. The directors are responsible for the other information.

My opinion on the financial statements does not cover the other information and except to the extent otherwise explicitly stated in my report, I do not express any form of assurance conclusion thereon.

In connection with my audit of the financial statements, my responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or my knowledge obtained in the audit or otherwise appears to be materially misstated.

If I identify such material inconsistencies or apparent material misstatements, I am required to determine whether this gives rise to a material misstatement in the financial statements themselves. If, based on the work I have performed, I conclude that there is a material misstatement of this other information, I am required to report that fact.

I have nothing to report in this regard.

Opinion on other matters prescribed by the Companies Act 2006

In my opinion the parts of the Remuneration Committee Report to be audited have been properly prepared in accordance with the Companies Act 2006.

In my opinion, based on the work undertaken in the course of the audit:

- the Strategic Report and the Directors' Report been prepared in accordance with applicable legal requirements; and
- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements;
- the information about internal control and risk management systems in relation to financial reporting processes, and about share capital structures, in compliance with rules 7.2.5 and 7.2.6 in the Disclosure Rules and Transparency Rules sourcebook made by Financial Conduct Authority (the FCA Rules), is consistent with the financial statements and has been prepared in accordance with applicable legal requirements; and

- Information about the Company corporate governance code and practices and about its administrative, management and supervisory bodies and their committees complies with rules 7.2.2, 7.2.3 and 7.2.7 of the FCA Rules

Matters on which I report by exception

In the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, I have not identified material misstatements in

- the Strategic Report or the Directors' Report.
- the information about internal control and risk management systems in relation to financial reporting processes and about share capital structures, given in compliance with rules 7.2.5 and 7.2.6 of the FCA Rules.

I have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires me to report to you if, in my opinion:

- adequate accounting records have not been kept or returns adequate for my audit have not been received from branches not visited by my staff; or
- the financial statements and the parts of the Remuneration Committee Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of director's remuneration specified by law are not made; or
- a corporate governance statement has not been prepared by the company; or
- I have not received all of the information and explanations I require for my audit;

Corporate governance statement

The Listing Rules require me to review the Directors' statement in relation to going concern, longer-term viability and that part of the Corporate Governance Statement relating to the Company's compliance with the provisions of the UK Corporate Governance Statement specified for my review.

Based on the work undertaken as part of my audit, I have concluded that each of the following elements of the Corporate Governance Statement is materially consistent with the financial statements or my knowledge obtained during the audit:

- Directors' statement with regards the appropriateness of adopting the going concern basis of accounting and any material uncertainties identified [set out on pages XX];
- Directors' explanation as to its assessment of the entity's prospects, the period this assessment covers and why they period is appropriate [set out on pages XX];
- Directors' statement on fair, balanced and understandable [set out on pages XX];
- Board's confirmation that it has carried out a robust assessment of the emerging and principal risks [set out on pages XX];
- The section of the annual report that describes the review of effectiveness of risk management and internal control systems [set out on pages XX]; and
- The section describing the work of the Audit and Risk committee [set out on pages XX].

Responsibilities of the Directors for the financial statements

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for:

- the preparation of the financial statements in accordance with the applicable financial reporting framework and for being satisfied that they give a true and fair view;
- internal controls as directors determine is necessary to enable the preparation of financial statement to be free from material misstatement, whether due to fraud or error.
- assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

My objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue a report that includes my opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Extent to which the audit was considered capable of detecting non-compliance with laws and regulations including fraud

I design procedures in line with my responsibilities, outlined above, to detect material misstatements in respect of non-compliance with laws and regulations, including fraud. The extent to which my procedures are capable of detecting non-compliance with laws and regulations, including fraud is detailed below.

Identifying and assessing potential risks related to non-compliance with laws and regulations, including fraud

In identifying and assessing risks of material misstatement in respect of non-compliance with laws and regulations, including fraud, we considered the following:

- the nature of the sector, control environment and operational performance including the design of the Company's accounting policies, key performance indicators and performance incentives.
- Inquiring of management, the Company's head of internal audit and those charged with governance, including obtaining and reviewing supporting documentation relating to the Company's policies and procedures relating to:
  - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
  - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud; and
  - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations including the Company's controls relating to the Company's compliance with the Companies Act 2006 and Managing Public Money.
- discussing among the engagement team and involving relevant internal and external specialists, including in asset valuation, regarding how and where fraud might occur in the financial statements and any potential indicators of fraud.

As a result of these procedures, I considered the opportunities and incentives that may exist within the Company for fraud and identified the greatest potential for fraud in the following areas: revenue recognition, posting of unusual journals, and bias in management estimates including year-end accruals. In common with all audits under ISAs (UK), I am also required to perform specific procedures to respond to the risk of management override of controls.

I also obtained an understanding of the Company's framework of authority as well as other legal and regulatory frameworks in which the Company operates, focusing on those laws and regulations that had a direct effect on material amounts and disclosures in the financial statements or that had a fundamental effect on the operations of the Company. The key laws and regulations I considered in this context included the Companies Act 2006, Managing Public Money, Tax Legislation and Cabinet Office Spending Controls to the extent they are made applicable to the Company by The Framework Document between the Department for Transport and the Company.

Audit response to identified risk

As a result of performing the above, the procedures I implemented to respond to identified risks included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with provisions of relevant laws and regulations described above as having direct effect on the financial statements;
- enquiring of management, the Audit and Risk Committee and in-house legal counsel concerning actual and potential litigation and claims;
- reading and reviewing minutes of meetings of those charged with governance and the Board and internal audit reports; and
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

I also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

A further description of my responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of my report.

Other auditor's responsibilities

I am required to obtain evidence sufficient to give reasonable assurance that the income and expenditure reported in the financial statements have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that I identify during my audit.

Matthew Kay (Senior Statutory Auditor)

XX July 2022

For and on behalf of the

Comptroller and Auditor General (Statutory Auditor)

National Audit Office

157-197 Buckingham Palace Road

Victoria

London

SW1W 9SP

From:	KAY, Matt
To:	[redacted]@nationalhighways.co.uk; [redacted]@nationalhighways.co.uk
Cc:	[redacted] (Company Secretary); [redacted]
Subject:	Pre-signoff notifications
Date:	12 July 2022 19:25:14
Attachments:	image006.png

Dear [redacted],

I am on the point of signing the NH accounts subject to the last couple of work programmes. Before I do I want to just wrap up notifiable changes between the NAO report which came to ARAC and now. I don't think this is anything critical except an item you have already knowingly adjusted for, so this is just for the record.

Adjusted audit differences

The major change is the £1.6bn uplift in SRN valuation. This change was processed prior to [redacted] signature and I had already discussed it with [redacted] in brief as the issue developed.

The adjustment has been processed to reflect forecast specific inflationary pressures in February and March 2022 that aren't built into the NHCECI (HECI) index for 31 March. In the draft accounts, this was based on a forecast position from February to the end of the year, and this excluded inflationary changes driven by the Ukraine war. The uplift calculation was based on weighted and representative ONS indices, which are readily updated for actuals, as opposed to BCIS indices given that there is a time-lag effect. We deemed this a necessary adjustment to achieve a materially reasonable update of inflation cost based on known pressures at the year end (though none beyond – clearly inflation continued to rise in the months since, and this is next year's problem.)

The adjustment increases the value of the SRN by £1,646m; it is taken against the revaluation reserve and does not affect net expenditure. We are satisfied it has been properly processed in the final accounts, including in the associated disclosures and the financial analysis.

Unadjusted audit differences

There is no change since ARAC in the position for misstatements identified against our overall (SRN-dominant) materiality.

We previously notified that the correction of misstatements we identified against our secondary threshold (total expenditure driven) of £64m would decrease net expenditure and increase net assets by £13.3m. As we have closed down the audit this has changed very slightly to £15.3m. The increment (£2m) arises from the finalisation of our work on accruals (#6 and #7 in the table below) and an emergence of a small unreconciled difference on VAT receivables (#9). The full, final, table is below – other than those numbered items noted, this remains as per ARAC position.

Matt

--
Matt Kay | Director
[redacted] | Assistant: [redacted], [redacted]

National Audit Office

National Highways

Audit planning report on the 2022-23 financial statements audit

Report to those charged with governance
16 January 2023

This report presents details of our proposed approach for the audit of the 2022-23 financial statements

We plan our audit of the financial statements to respond to the risks of material misstatement and material irregularity. This report sets out how we have built our assessment of risk, what we base materiality on, those risks we expect to be significant and how we will respond to those risks. We also set out in this report details of the team carrying out the audit, the expected timing of the audit and our fees.

Actions for the Audit and Risk Assurance Committee

We would like to alert members of the Audit Committee (ARAC) to changes in our risk assessment procedures (in line with revised ISA 315 – further details on page 6), and invite the Committee to discuss:

- Whether our assessment of the risks of material misstatement to the financial statements is complete (including any matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken);
- Whether management's response to these risks is adequate;
- Our proposed audit plan to address these risks;
- Whether the financial statements could be materially misstated due to fraud, and communicate any areas of concern to management and the audit team;

We would also like to invite the committee to consider our fraud risk assessment on slide 13.

We would like to take this opportunity to enquire of those charged with governance about the following areas:

- Other matters those charged with governance consider may influence the audit of the financial statements
- The entity's objectives and strategies, and the related business risks that may result in material misstatements
- Possibility, knowledge of and process for identifying and responding to the risks of fraud
- Oversight of the effectiveness of internal control
- Whether any non-compliance with any laws or regulations (including regularity) have been reported to those charged with governance (e.g. from staff, service organisations or other sources)
- Policies, procedures and systems for recording non-compliance with laws, regulations and internal policies.
- Whether members have knowledge of any actual, suspected or alleged fraud affecting the entity.

Sarah Che

Engagement Director

Contents

Overview

Audit Risks (pages 9 to 12)

We plan our audit of the financial statements to respond to the risks of material misstatement to transactions and balances and irregular transactions.

We have identified the following risks of material misstatement:

- Presumed risk of management override of controls
- Accounting for the Strategic Road Network
- Recognition and measurement of Land and Property provisions

We have broken the risks down into a more granular level of detail on the following page.

Page 14 also sets out other matters relevant to the audit, related to Accruals and Turnover in the Finance Team. We do not consider these areas to constitute significant risk.

Materiality (page 15)

- When setting materiality, we consider both qualitative and quantitative aspects that would reasonably influence the decisions of users of the financial statements.
- Materiality is calculated as a percentage of a chosen materiality base. Our main materiality is £1,400m and is based on infrastructure assets (£143bn in 2021-22), as they are the predominant driver of the balance sheet and of significant interest to those networks' users. This will apply to all Strategic Road Network related assets.
- Due to additional interest in taxpayer funded expenditure, we apply an additional threshold to all transactions and balances related to in year taxpayer expenditure (including capital additions). This results in a materiality of £69m
- The percentage applied to calculate additional materiality has been maintained at 1.5% and for the overall materiality this has been maintained at 1%.

Audit team, fee and timetable

- Sarah Che will be responsible for the overall audit. The full engagement team is presented on page 20.
- Our audit fee for this year is £347,000. The fee has increased by 4% (2021-22 - £333,500) due to increases in our cost base and increasing audit quality standards. Further detail is provided on page 17.
- We are planning to complete the audit in advance of the summer 2023 Parliamentary recess.

Audit risks - detailed breakdown

Accounting for the SRN

Our significant risk relating to the SRN can be broken down to a more granular level, and covers the following risks:

- Disclosures and the SRN balance are incomplete.
- Entries within the SRN database do not exist in real life.
- Impairment of assets has not been considered on a sufficiently frequent basis.
- Depreciation methodology has not been calculated or applied appropriately - including errors in the calculation or incorrect Useful Economic Lives (UELs).
- Disclosures - revaluation and depreciation estimation uncertainty disclosures are not sufficient or accurate.
- Revaluation – the assumptions, data and method used in the revaluation are not appropriate. There are errors in the revaluation calculation.
- Indexation - assets have not been indexed appropriately. The method of indexation used is not appropriate

Recognition and valuation of land and property provisions

Our significant risk relating to the recognition and valuation of lands provisions can be broken down to a more granular level, and covers the following risks:

- The method used for calculating the land estimate/provision is not appropriate.
- The assumptions used in the calculation of the land estimate are not appropriate.
- The estimation uncertainty and other provision related disclosures are not sufficient or accurate.

Presumed risk of management override of controls

Our presumed significant risk relating to management override of controls can be broken down to a more granular level, and covers the following risks:

- Estimates - management bias impacts judgements and decisions made in arriving at both significant and non significant estimates.
- Management overrides controls to manipulate the financial statements using manual journals.
- Management enters into significant or unusual transactions to engage in fraudulent reporting or to conceal misappropriation of assets or irregular transactions.

Changes to how we assess risk

ISA (UK) 315 (Revised) is effective for audits of financial statements for periods beginning on or after 15 December 2021 – for most audited entities this will be the financial statements for 2022-23.

The new approach places risks of material misstatement on the 'Spectrum of Risk' as either a significant, medium, low or no risk. Based on this placement, different combinations of assurance (inherent, controls, and substantive) are used to address the risk.

The definition of 'significant risk' has changed. A 'significant risk' is now defined as:
"*an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or that is to be treated as a significant risk in accordance with the requirements of other ISAs (UK)*".
Many of the significant risks previously reported are likely to continue to remain under this new definition.
The spectrum of risk means that we consider risk across an audit engagement in a more nuanced way and our corresponding response may be more focused.

Key changes to ISA (UK) 315 (Revised) are:

- It has been modernised to meet evolving business needs, including the use of automated audit tools and techniques and the use of IT in financial reporting
- There is a greater focus on entity business processes, generating more valuable insights for audited entities.
- It allows for audit response to be driven by risk, leading to a more targeted audit and providing more opportunities to take controls assurance, as well as focusing on the more relevant audit assertions.
- It drives consistent and effective identification and assessment of risk of material misstatement, ensuring a complete and high quality risk assessment

Spectrum of Risk

Financial Statement Impact \ Likelihood	Low	Medium	High
High	Significant or Medium Risk	Significant Risk	Significant Risk
Medium	Low Risk	Medium Risk	Significant Risk
Low	No Risk	Low Risk	Significant or Medium Risk

Building our assessment of risk

We are well placed to develop an understanding of the risks to National Highways drawing on your own assessment, the historic assessment of risk and the broader context

National Highways' assessment of risk

National Highways' strategic risk register sets out a number of risks. We have engaged with management to understand the background to these risks, movement in impact and likelihood and have considered how these inform our assessment of audit risks.

- **Reputation**
- Pace of technological change
- Ineffective securing of information
- **Delivery**
- Complex operational environment and supply chains
- Environment
- Air quality, carbon reduction, noise, biodiversity loss
- Safety
- Ineffective controls, asset failure
- People
- Recruitment and remuneration

Our audit Risk Assessment

The 2021-22 audit highlighted a number of areas of audit risk and focus, we have built on this historical assessment to consider whether these remain risks for the year. We have made inquiries of management (and other appropriate individuals within the entity), performed analytical procedures, and carried out observations and inspections to inform our assessment of risk.

- **Management override of controls**
- **Valuation of the Strategic Road Network (SRN)**
- **Provisions for Land and Property Purchases**

Wider Factors

We have drawn upon our wider assurance work and our understanding of the broader environment in which National Highways operates to inform our risk assessment.

- **Delivering the Second Road Investment Strategy VFM study**
- **Climate Change**
- **Smart Motorways**

Significant risks and areas of focus

The table shows how the key business process and operational risks identified by National Highways may impact on the Annual Report and Accounts and give rise to significant risks and areas of focus for our audit.

These are areas where we will perform additional audit work as outlined in the following pages and report our findings to you.

National Highways' assessment of risk		Reputation		Delivery		Safety	Environment	People
Our assessment of audit risk and areas of focus		Pace of technological change	Ineffective securing of information	Complex operating environment	Supply chain disruption	Ineffective controls, asset failure	Air quality, carbon reduction, noise, biodiversity loss	Recruitment and remuneration
Significant risks	Presumed risk of management override of controls		●	●				●
Significant risks	Accounting for the Strategic Road Network	●	●	●	●	●	●	
Significant risks	Recognition and measurement of land and property provisions	●	●	●				

Our response to the significant risks*

Presumed risk of management override of controls

Why we have identified this as a risk

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively.

This is a presumed risk for all audited bodies under International Standards on Auditing (ISA 240).

This significant risk is in line with previous years. Further detail on our assessment of the risk of fraud within National Highways is set out on page 13.

Work we plan to undertake in response

Controls:
Review of controls relevant to the audit including those over:

- Manual accounting journals;
- Segregation of duties;
- Year-end controls such as preparation of financial statements which includes review by senior management and the Audit and Risk Assurance Committee.
- Monthly management accounts;
- Changes in accounting policies, in particular those around significant estimates.

Given that the risk relates to the override of controls by management, we do not seek to place reliance on controls.

Substantive:

- We will make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
- Using data analytic tools, we will risk appraise and visualise the impact of manual journals on the financial statements to identify higher risk journal transactions for detailed audit examination.
- We will examine significant or unusual transactions and review errors collectively for patterns in adjustments.
- We will apply professional scepticism to the audit of key estimates and judgements and perform a retrospective review of significant estimates used in the prior year.
- We will consider the need to test other adjustments throughout the period.

*The auditor shall identify and assess the risks of material misstatement at:
(a) the financial statement level;
(a) the assertion level for classes of transactions, account balances, and disclosures
to provide a basis for designing and performing further audit procedures.

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Our response to the significant risks

Accounting for the Strategic Road Network (1/2)

Why we have identified this as a risk

The Strategic Road Network (SRN) and related Assets Under Construction (AUC) balances are significant balances within the financial statements, with a value of £143bn at 31st March 2022. In accordance with the Government's Financial Reporting Manual (FReM), the value of the SRN is derived using the Depreciated Replacement Cost, which uses the best available information to establish an estimate of replacing the asset with a modern equivalent, less deductions for physical deterioration and relevant obsolescence and optimisation. NH perform revaluation of the SRN on a continuous rolling basis, with each asset type undergoing full revaluation 5-yearly.

There is significant judgement involved in determining the valuation, in particular:

- A number of accounting assumptions implicit in determining the gross valuation.
- Selection of the appropriate indices to apply to reflect changes in costing rates between 5-yearly assessments.
- The appropriate application of asset information to calculate the deduction from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures).

This year there are also additional risks of material misstatement relating to the valuation of structures assets, as 2022-23 is a full revaluation year. A full revaluation involves recalculating the unit rates for different structures based on recently completed schemes, as well as ensuring the valuation method and assumptions used remain appropriate. This introduces an additional level of judgement and potential source of calculation error compared to indexed elements.

The valuation of the SRN is a judgemental, complex and highly material estimate for 2022-23, which is subject to significant assumptions, using complex base data and methodologies. Therefore, as in previous years, we have recognised a significant risk.

Capital additions, Depreciation and testing of technology assets are outside of the scope of this risk and are subject to our standard audit testing

Our planned response to this risk is set out on the following slide.

Our response to the significant risks

Accounting for the SRN (2/2)

Work we plan to undertake in response

In respect of the <u>ongoing risks</u>, we will:

Controls

- Confirm the design and implementation of controls operated by NH and Atkins in respect of the assets, NH's overall governance processes over the SRN valuation and reflecting conditions data in the valuation of the SRN.

Substantive

In accordance with ISA 540, evaluate the revaluation models for all asset types with the extent of work proportionate to the risk for each asset category, and an emphasis on the overall reasonableness of assumptions and methodology, and the accuracy of source data. This includes:

- Obtaining assurance over the completeness of changes to asset quantities, using audited data on projects completed in year, substantive testing of dimensional variances and/or independent calculations including refreshing the detailed model previously produced by the NAO's modelling team of the network length;
- Confirming the reasonableness of the indices applied to inflate costs to current measures and ensuring these have been correctly applied;
- Reviewing the reasonableness of the conditions data applied for depreciation of roads and structures, including the methodology used, and the reliability and recency of data, as well as searching for any specific impairment indicators; and
- Commissioning advice from a structural engineering expert in respect of Highways' transformation of physical data into a depreciation % estimate for roads and structures.

In respect of the <u>structures revaluation</u> we will:

Controls

- Review governance and control processes around the revaluation for structures.

Substantive

We will engage an auditor's expert to:

- Assess the appropriateness of the assumptions applied in the valuation model;
- Review the base data used in the valuation model;
- Review and evaluate the grouping of structures; and
- Review the rates calculated for each group of structures.

We will also review the adequacy of the disclosures in relation to the accounting estimates and their sensitivity to a range of assumptions.

Our response to the significant risks

Recognition and valuation of Land and Property Provisions

Why we have identified this as a risk

Land and property is acquired as part of improving the road network. National Highways recognises a provision in its accounts relating to these acquisitions, which at 31st March 2022 was valued at £296m. This provision is derived using complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high.

In valuing the provision, NH relies on estimates provided by the Valuation Office Agency (VOA) that often lack a robust evidence base. In 2021-22, we noted an improvement in the data quality, but we have recommended that NH work with VOA to secure better quality evidence for estimates provided, and to increase the level of knowledge sharing within the NH team in relation to the provisions accounting process. Our expert valuer was able to conclude that the estimates were not materially incorrect.

NH recognises provisions based on the stage that a scheme is at. This includes Blight being recognised at Preferred Route Announcement stage, Compulsory Purchase being recognised when a Development Consent Order (DCO)/CPO is granted, and Part 1 at the start of construction. Given the increase in challenges to DCO approvals within the 6 week challenge period after a DCO is granted (in particular for the A303 which resulted in the DCO being overturned), we are aware that NH are reviewing the recognition point of the Compulsory Purchase provision stage. We will review our position on this recognition point as part of our audit work.

Work we plan to undertake in response

Controls:

We will:

- Assess the design and implementation of controls for recognising provisions for land and property purchases in the financial statements.

Substantive:

We will:

- Substantively test a sample of provisions to gain assurance over the balances within the financial statements. Testing will involve tracing the values in the provisions system to either a valuation report or other third-party confirmation outlining the basis of the valuation, re-performing manual calculations, and selecting a sub sample of payments and aggregations against the chosen provisions;
- Review and challenge NH's application of the IAS 37 recognition criteria; and
- Engage an expert valuer to assist with our work on provisions. They will review a subset of land and property valuations that underly the provisions within our sample, specifically reviewing the assumptions made and methodology used in the VOA's assessment of the most likely value.

Our initial assessment of the risk of fraud (ISA 240)

We shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in our auditor's judgment, relevant to their responsibilities. Under ISA (UK) 240, it is our responsibility as auditors to report to those charged with governance:

- Any risks of material misstatement identified due to fraud
- Any matters we think are relevant to those charged with governance regarding management's process for identifying and responding to the risks of fraud a National Highways

Below, we have summarised our initial assessment of the risk of fraud relevant to National Highways, and how this may impact on the financial statements.

Risk of material misstatement due to fraud

National Highways operates 2% (by length) of the UK's road network and has a significant impact on the UK market for network services. However, all transactions are undertaken with established, large-scale providers, and it is highly unlikely that any transactions would not be conducted at arms-length.

The Strategic Road Network (SRN) valuation is based on subjective accounting judgements, given that there is no active market for such assets. There is a low risk of fraudulent activity in relation to this as no individual or party is liable to gain from incorrectly valuing the SRN.

There may be a risk around period-end accruals which may be manipulated to ensure actuals align with budgets. We will assess the internal controls around the journals process and take assurance over this risk through our substantive testing.

We therefore conclude that the risk of material misstatement due to fraud is low. We also rebut the presumed risk of fraud within revenue recognition due to the relative size of National Highways' income (£109m in 2021-22), the lack of complexity in those income streams and the lack of incentive to manipulate revenue.

The presumed risk regarding management override of controls remains as management are in a unique position to manipulate accounting records and override key controls. Although we assess this risk as low, we will address this risk through the significant risk 'presumed risk of management override'.

Matters regarding management processes for identifying and responding to the risks of fraud

Through our audit work to date, including work on significant risks in the prior year, we have not identified any significant concerns about the nature, extent or frequency of management's assessment of fraud risk.

We have not identified any significant failings by management regarding their monitoring or addressing deficiencies in internal controls or communication with us as auditors. NH uses IT controls to create segregation of duties and have appropriate access controls, and Internal Audit perform a series of reviews annually to ensure that adequate segregation of duties exist. Although we do not consider NH's controls to be sufficient for the purposes of obtaining controls assurance, we do not consider there to be significant deficiencies which would leave NH particularly vulnerable to fraud.

Fraud risk factors relevant to National Highways

Whilst performance related pay is driven by KPIs, these primarily focus on safety and performance on the road network, rather than financial performance. As a result, the incentives for management to commit fraud are reduced.

However, given the wider economic environment and the impact of inflation on capital budgets, there is a risk that the Department for Transport (DfT) may be close to its approved control totals.

There is an increase risk that management at National Highways could come under pressure to commit fraud in relation to significant inflationary pressure on control totals at the Department level.

Other matters

The following are other matters which we wish to bring to the attention of those charged with governance in relation to the audit of the financial statements.

If during the audit these matters have a significant effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, we may include these in our extended auditor report as key audit matters, as defined by ISA (UK) 701.

Title	Area Affected	Response
Accruals	Accruals, non-capital expenditure, capital expenditure, i.e. SRN & AUC additions	Testing in recent years has identified a high number of sample errors (although their aggregate value was not material), and we encountered difficulties in obtaining sufficient/appropriate evidence for these accruals. The workshops we provided in recent years were successful in helping to improve the accuracy of larger accruals. The cover sheet supplied for use with each sample has also improved the focus on appropriate evidence, however, issues remain. We intend to review a small number of accruals at interim to ensure we can give specific feedback to the business on the quality of evidence prior to the year-end audit. As in 2021-22, we will stratify our sample population in order to focus our sample on higher value accruals where the risk of material misstatement is greater.
Finance team turnover	Accounts production, with a particular focus on land and property provisions	We are aware of a number changes within the National Highways finance team, including those who have been heavily involved in previous audits. In particular, we note that a key contact involved in the land and property provisions process has left NH. Whilst management have highlighted that knowledge sharing and handovers are underway, we are aware that there could be delays to audit delivery and in particular efficiently obtaining appropriate evidence. We will provide additional clarity to our audit deliverables request log (Client Liaison Schedule) and work with management to use the interim audit period as a dry run in some areas to reduce the risks at final audit. We encourage management to ensure that appropriate knowledge sharing is taking place well in advance of the audit period.

Materiality

Basis for overall materiality calculation	**£143,053m**	2021-22 total property, plant and equipment balance
Overall account materiality (1%)	**£1,400m**	£1,400m applies in respect of SRN related PPE asset balances (excluding capital additions)
Basis for additional materiality calculation	**£4,620m**	P7 management account adjusted gross expenditure
Additional materiality (1.5%)	**£69,304k**	£69m applies in respect of all other assets, liabilities, revenue and expenditure, reflecting taxpayer perspective.
Error reporting threshold	**£300k**	We report to you all misstatements, whether adjusted or unadjusted, above £300k in respect of items audited under both materiality levels.

We have set our overall account materiality, currently £1,400m, as approximately 1% of the prior year value of the infrastructure assets, reflecting the significant interest among SRN users in the extent and condition of the network.

We set a lower additional materiality in relation to all financial statement elements driven by taxpayer spending, recognising the interest from Parliament and the public in National Highways' total expenditure of public funds. In practice, as a result:

- overall materiality applies to the SRN valuation, the associated non-cash entries (e.g. depreciation), and non-cash elements of closely SRN related PPE held for operational purposes; and
- our additional threshold applies to all other transactions and balances, including SRN/AUC capital additions. This has been calculated at 1.5% of adjusted forecast gross expenditure, giving £69m.

We have retained overall materiality at 1% based on (prudently) the SRN and AUC net book values reflecting user interest in the network.

These levels remain comparable to those used in the prior year.

A matter is material if its omission or misstatement would reasonably influence the decisions of users of the financial statements. The assessment of what is material is a matter of the auditor's professional judgement and includes consideration of both the amount and the nature of the misstatement.

The concept of materiality recognises that absolute accuracy in financial statements is rarely possible. An audit is therefore designed to provide reasonable, rather than absolute, assurance that the financial statements are free from material misstatement or irregularity. We apply this concept in planning and performing our audit, and in evaluating the effect of identified misstatements on our audit and of uncorrected misstatements, if any, on the financial statements and in forming the audit opinion. This includes the statistical evaluation of errors found in samples which are individually below the materiality threshold but, when extrapolated, suggest material error in an overall population. As the audit progresses our assessment of both quantitative and qualitative materiality may change.

We also consider materiality qualitatively. In areas where users are particularly sensitive to inaccuracy or omission, we may treat misstatements as material even below the principal threshold(s).

These areas include:

- the remuneration report;
- disclosures about losses and special payments;
- our audit fee; and
- irregular income and expenditure.

Timing of the audit

The timetable comprises an interim visit commencing 6 February 2023 for 4 weeks and a final visit commencing 1 May 2023 with certification planned for July 2023

Planning

In consultation with Management, Audit Committee, Internal Audit and other Key stakeholders, review National Highways' operations, assess risk for our audit and evaluate the control framework.

Determine audit strategy.

Interim fieldwork

Test expenditure and income.

Final fieldwork

Test expenditure and income and significant balances and disclosures

Completion

June 2023- ACR: present our findings and recommendations.

July 2023- Seek management representations.

C&AG issues opinion. Management Letter: provide final recommendations on control matters identified.

Debrief

August 2023- Meeting to discuss lessons learned and improvements for the following year.

Our audit fee

The NAO audit fee quote is based on the anticipated cost of delivering our audit work. The level of audit work is dependent upon a number of factors, including the nature and extent of significant risks of material misstatement within the financial statements and ensuring quality audit procedures are undertaken to meet the requirements of International Standards on Auditing (ISAs).

Drivers behind changes in audit fees over the last few years include:

- **The Financial Reporting Council (FRC) has increased its expectations around the quality of audit work in light of a number of high-profile corporate failings.** This has resulted in the level of audit work increasing, particularly into the application of judgement and scepticism in relation to complex accounting estimates, revenue recognition, going concern, and the audit of groups.
- **Financial reporting changes.** In the past few years, new accounting standards IFRS 9: *Financial Instruments,* IFRS 15: *Revenue*, and IFRS 16: *Leases*, have resulted in significantly more complex financial reporting requirements.
- **Auditing standard changes.** Recent and upcoming changes to auditing standards have increased the complexity and volume of audit work required to carry out audits in line with these standards, partly as a response to questions over the sufficiency of audit in light corporate failings. In 2022-23, new auditing standards (ISA 240 and ISA 315) relating to risk assessment come into effect which will substantially change the approach auditors take to risk assessment and the resultant audit procedures.
- **Investment in technology.** We are investing in our technology to enhance auditing techniques, such as data analytics and testing of controls, to improve both the quality of the audit we provide and the insight we can offer into common financial reporting and management challenges.
- **Increase in underlying costs.** The underlying costs of the NAO have increased since last year. Therefore, in line with the scheme of fees agreed with Parliament, we have adjusted the costs of our audit through our hourly rates to ensure these costs are correctly recovered through audit fees.

Fees

The fee for the audit is £347,000.

The principle agreed with Parliament is that our fee is set to recover the full costs of the audit, rather than make a profit from or subsidise an audit. The NAO determines its fees with reference to standard hourly rates for our staff, which are reviewed annually, and updated when costs change.

Completion of our audit in line with the timetable and fee is dependent upon National Highways:
- delivering a complete Annual Report and Accounts of sufficient quality, subject to appropriate internal review, on the date agreed;
- delivering good quality supporting evidence and explanations within the agreed timetable;
- and making staff available during the audit.

If significant issues arise and we are required to perform additional work this may result in a change in our fee. We will discuss this with you before carrying out additional work.

The NAO is committed to delivering high-quality audit work and to meeting the expectations of our audited bodies, Parliament, the public, and other stakeholders. As a result of this commitment and the drivers outlined above, we have set our audit fee quote accordingly.

Other Matters

Audit scope and strategy

This audit plan covers the work we plan to perform to express an opinion on whether the financial statements are free from material misstatement and are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The plan is also designed to ensure the audit is performed in an effective and efficient manner. The NAO financial audit team will work alongside the NAO VFM team to identify any areas of potential focus for upcoming studies. Our audit approach is a risk based approach, ensuring that audit work is focussed on significant risks of material misstatement and irregularity. Additionally by working with auditor's experts, the NAO financial audit team will contribute external sense checking of the reliability of the financial statements.

Our audit approach is a risk based approach, ensuring that audit work is focused on significant risks of material misstatement and irregularity.

In areas where users are particularly sensitive to inaccuracy or omission, a lower level of materiality is applied, e.g. for the audit of senior management remuneration disclosures and related party transactions.

When undertaking our risk assessment we take into account several factors including:

- Inquiries of management
- Analytical procedures
- Observation and inspection of control systems and operations
- Examining business plans and strategies

Our risk assessment will be continually updated throughout the audit.

Independence

We are independent of National Highways in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to listed entities/public interest entities. We have fulfilled our ethical responsibilities in accordance with these requirements and have developed important safeguards and procedures in order to ensure our independence and objectivity.

Information on NAO quality standards and independence can be found on the NAO website: https://www.nao.org.uk/about-us/our-work/governance-of-the-nao/transparency/.

We will reconfirm our independence and objectivity to the Audit Committee following the completion of the audit.

Other Matters

Management of personal data	During the course of our audit we have access to personal data to support our audit testing. We have established processes to hold this data securely within encrypted files and to destroy it where relevant at the conclusion of our audit. We confirm that we have discharged those responsibilities communicated to you in the NAO's Statement on Management of Personal Data at the NAO. The statement on the Management of Personal Data is available on the NAO website: http://www.nao.org.uk/freedom-of-information/publication-scheme/how-we-make-decisions/our-policies-and-procedures/policies-and-procedures-for-conducting-our-business/
Using the work of internal audit	We liaise closely with internal audit through the audit process and seek to take assurance from their work where their objectives cover areas of joint interest.
Communication with the NAO	Organisations we audit tell us they find it helpful to know about our new publications, cross-government insight and good practice. Our website holds a wealth of information from latest publications which can be searched, to pages sharing our insights on important cross-cutting issues. We also publish blogs and send email notifications to subscribers about our work on particular sectors or topics. If you would like to receive these alerts, please sign up at: http://bit.ly/NAOoptin. You will always have the option to amend your preferences or unsubscribe from these emails at any time.
NAO's Transparency Report	The NAO's annually published Transparency Report documents how we support Parliament in holding government to account through our statutory public audits. The report includes details of our quality plan and the whole system approach we are taking to ensure consistently high-quality audit work including our adoption of the *International Standard on Quality Management (UK) 1 – Quality Management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements.*

Appendix 1: The NAO audit team

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Executive Leader

Sarah Che
Engagement Director

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Appendix 2: Scope and responsibilities

In line with ISAs (UK) we are required to agree the respective responsibilities of the C&AG/NAO and the Accounting Officer/audited entity, making clear that the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
These responsibilities are set out in the Letter of Engagement of 22 November 2021 and are summarised here.

Area	Accounting Officer/management responsibilities	Our responsibilities as auditor
Scope of the audit	• Prepare financial statements in accordance with Companies Act 2006 and that give a true and fair view. • Process all relevant general ledger transactions and make these, and the trial balance, available for audit. • Support any amendments made to the trial balance after the close of books (discussing with us). • Agree adjustments required as a result of our audit. • Provide access to documentation supporting the figures and disclosures within the financial statements. • Subject the draft account to appropriate management review prior to presentation for audit	• Conduct our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)). • Report if the financial statements do not, in any material respect, give a true and fair view. • Review the information published with the financial statements (e.g. annual report) to confirm it is consistent with the accounts and information obtained during the course of our audit.
Fraud	• Primary responsibility for the prevention and detection of fraud. • Establish a sound system of internal control designed to manage the risks facing the organisation; including the risk of fraud.	• Obtain reasonable assurance that the financial statements (as a whole) are free from material misstatement, whether caused by fraud or error. • Make inquiries of those charged with governance in respect of your oversight responsibility. • Discuss fraud risks associated with the entity with those charged with governance.

Appendix 2: Scope and responsibilities (cont'd)

Area	Accounting Officer/management responsibilities	Our responsibilities as auditor
Regularity	• Ensure the regularity of financial transactions. • Obtain assurance that transactions are in accordance with appropriate authorities, including the organisation's statutory framework and other requirements of Parliament and HM Treasury.	• Conduct our audit of regularity in accordance with Practice Note 10, 'Audit of financial statements and regularity of public sector bodies in the United Kingdom (revised 2022)', issued by the Financial Reporting Council. • Confirm the assurances obtained by the National Highways that transactions are in accordance with authorities. • Have regard to the concept of propriety, i.e. Parliament's intentions as to how public business should be conducted.
Propriety	• Ensure the propriety of financial transactions • Ensure that patterns of resource consumption should meet high expectations of public conduct, and robust governance and respect Parliament's intentions, conventions and control procedures, including any laid down by the Public Accounts Committee.	• Propriety is not readily susceptible to objective verification and, as such, is not expressly covered in the opinion on financial statements. When issues of propriety come to light in the course of the audit of financial statements, the auditor considers whether and, if so, how they may be reported.
Governance statement	• Review the approach to the organisation's governance reporting. • Assemble the governance statement from assurances about the organisation's performance and risk profile, its responses to risks and its success in tackling them. • Board members, with the support of the Audit Committee, evaluate the quality of internal control and governance, and advise on any significant omissions from the statement.	• Confirm whether the governance statement is consistent with our knowledge of the organisation, including its internal control. • Consider whether the statement has been prepared in accordance with HM Treasury guidance, including Managing Public Money.
Accounting estimates and related parties	• Identify when an accounting estimate, e.g. provisions, should be made. • Appropriately value and account for estimates using the best available information and without bias. • Identify related parties. • Appropriately account for and disclose related party transactions.	• Consider the risk of material misstatement in respect of accounting estimates made by management. • Perform audit procedures to identify, assess and respond to the material risks of not accounting for or disclosing related party relationships appropriately. • Significant risks are set out on pages 9-12.

Appendix 3: Follow up to recommendations we made in the previous year

In 2021-22 we made recommendations to National Highways, communicated in the form of a Management Letter.

Recommendation	Risk rating	Status	Update
IT - to work through the recommendations set out by our IT audit team	High risk*	*Ongoing*	*NAO have shared the findings from the IT audit team with NH. NH are working through the recommendations and the NAO IT audit team will follow up on progress separately in early 2023*
SRN - to work through the recommendations set out by our engineering expert	Medium risk	*Ongoing*	*NAO have shared the findings with NH, NH are working through the recommendations and are working on an action plan by 31 March 2023.*
SRN indexation - a material adjustment was required in the prior year as the HECI index was received in February based on actual data from January with a forecast for Feb/March- NH need to mitigate the risk of unexpected events around year end	Medium risk	*Ongoing*	*NH will continue to use the HECI index (due February 23) to index their assets. Last years issue was due to the associated impact of the Russian invasion of Ukraine on the world economy. NH consider this an anomaly and do not foresee an inflationary event of that scale taking place in the equivalent 2023 period, however, they commit to monitoring other construction indices during April such as Baxter's and Roco's along with those provided by ONS to gauge the movement, if deemed material NH will be prepared to make the appropriate adjustment to the accounts.*
Retention of sufficient, appropriate audit evidence on project subsystems - in particular due to the issues identified in the BRAVO system in the prior year where appropriate audit evidence was difficult to obtain	Medium risk	*Ongoing*	*Work will be done by NH with colleagues from the commercial team and finance business partners to review the contract management systems and amend them to ensure that auditable evidence is available. A specific contact has been identified for BRAVO/CEMAR queries for the current year.*
Land and Property Provisions – there should be enhanced checks over valuation dates and manual calculations, as well as knowledge sharing due to reliance on an individual team member	Low risk	*Ongoing*	*Improvements were seen in the provision data in 2021-22 but NH are ensuring that policies are reviewed and communicated widely, including highlighting issues that have been identified through the audit process. Continuity plans have been put in place, however, a key individual in the process in previous periods has left National Highways, so the risk here has increased.*
Land and Property Provisions recognition point - management should review and prepare a paper on the suitability of recognition point for DCO/CPO provisions for the next financial year.	Medium risk	*Ongoing*	*The recognition policy is based on National Highways having a constructive obligation. NH will review whether a constructive obligation is still relevant after the DCO challenges seen in recent periods.*

* The IT recommendation here is a consolidation of several IT recommendations in the IT management letter. The risk rating for each varies, however, we have reported them here with the highest risk rating seen across the recommendations.

Appendix 3: Follow up to recommendations we made in the previous year (continued)

Recommendation	Risk rating	Status	Update
Accruals – The post year end review exercise and the £500k reviewing threshold works well to reduce the risk of material misstatement, however, a higher rate of error was seen in resource accruals in 2021-22 - NH should have this as a specific area of focus for 2022-23.	Low risk	*Ongoing*	*Training will be updated to ensure accuracy on specific issues identified as part of the 2021-22 audit.* *The NAO will work with NH to deliver an updated training session for FBPs in early 2023 to help focus efforts for the year end.* *A review of after date invoices will be done and classification amended to align to best practice*
Cash and bank reconciliations – Reconciling items should be reviewed in a timely manner to ensure that they are accounted for properly. We would recommend explicitly including a reconciling item check - above a suitable threshold - into the monthly review process that must be actioned before sign-off of the bank reconciliation, a clear policy on the age limit for unmatched receipts management is aiming for and measurement in the monthly reconciliation process against that target (we note an understanding that there may always be the odd exception).	Low risk	*Ongoing*	*NH noted that identifying some items can be challenging but detailed work will be done on any outstanding items and these will be cleared every quarter.*
Inventory management - Where a vested stock arrangement is in place, management should review existing contractual arrangements and hold the third party to account by securing meaningful assurance – at proportionate intervals – on the existence or use of items held on the Company's behalf. Inventory management teams should regularly update finance on required write-off exercises, and retain documentation supporting these exercises, as there appears to have been miscommunication on write-offs with the double posting this year	Low risk	*Ongoing*	*The stock system is reviewed monthly against the general ledger and updates are provided back to the inventory team. NH note that this will ensure that write offs are correctly recorded.* *NH note that new reporting has been designed around the vested stock and quarterly reviews are being introduced to confirm existence.*
Payroll Listings – Remuneration Report (fair pay disclosure) - Ideally the average change in workforce pay and bonuses should be calculated on the same data source and payroll listing as used for the remainder of the fair pay disclosure, to ensure consistency of reporting.	Low risk	*Ongoing*	*NH note that the process around the remuneration report was updated in year. Improvements will be built on to incorporate the updated disclosure requirements and to ensure consistency.*

Appendix 4: Changes to auditing standards

ISA (UK) 315 (Revised) : Identifying and Assessing the Risks of Material Misstatement

Effective from 2022-23

ISA 315 is the critical standard which drives the auditor's approach to the following areas:

- Risk Assessment
- Understanding the entity's internal control
- Significant risk
- Approach to addressing significant risk (in combination with ISA 330)

The International Auditing & Assurance Standards Board (IAASB) concluded that whilst the existing version of the standard was fundamentally sound, feedback determined that it was not always clear, leading to a possibility that risk identification was not consistent.

The aims of the revised standard is to:

- Drive consistent and effective identification and assessment of risks of material misstatement
- Improve the standard's applicability to entities across a wide spectrum of circumstances and complexities ('scalability')
- Modernise ISA 315 to meet evolving business needs, including:
  - how auditors use automated tools and techniques, including data analytics to perform risk assessment audit procedures
  - how auditors understand the entity's use of information technology relevant to financial reporting
- Focus auditors on exercising professional scepticism throughout the risk identification and assessment process.

The key impacts are:

- Significant increase in work on entity’s use of IT in business and system of internal control.
- Clearer workflow within the standard to highlight the importance of the auditor’s understanding of the entity and environment, the applicable financial reporting framework, and system of internal control.
- New concepts: e.g. inherent risk factors, spectrum of inherent risk
- Changed definitions: notably, the definition of ‘significant risk’
  - **Significant risk** – An identified risk of material misstatement:
    - For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or
    - That is to be treated as a significant risk in accordance with the requirements of other ISAs (UK).

Appendix 4: Changes to auditing standards (cont'd)

ISA (UK) 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Effective from 2022-23

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional and involves deception or is unintentional. ISA (UK) 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements.

The revision to the standard aims to clarify the obligations of auditors to identify and assess the risk of material misstatement due to fraud, as well as including supplemental requirements and guidance to enhance the auditors' procedures.

Key changes are:

- The objectives of the auditor have been revised to emphasise the requirement to obtain reasonable assurance about whether the financial statements are free from material misstatement due to fraud.
- There is a greater focus on professional scepticism including that audit approaches don't show bias to looking for corroborative evidence or excluding contradictory evidence.
- There are new requirements for the auditor to determine whether the engagement team requires specialised skills or knowledge to perform their work on fraud, including their assessment of fraud risk, associated procedures and evaluation of the evidence obtained.
- There is additional guidance regarding the discussion required by ISA (UK) 315 among the audit engagement team. This is to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud or error. The revised ISA (UK) 240 emphasises the need for an exchange of ideas among all engagement team members about fraud risk factors.
- The auditor shall make inquiries of management, or others within the entity who deal with fraud allegations, to determine whether they have knowledge of any actual, suspected or alleged fraud, including cases of fraud raised by employees or other parties.
- Auditors are to hold a discussion with those charged with governance regarding the risks of fraud in the entity and to consider the implications for the audit.
- The auditor must communicate with those charged with governance matters relating to fraud (unless prohibited by law or regulation) and the auditor's assessment of the risks of material misstatement due to fraud.
- Auditors must evaluate whether their assessment of the risk of material misstatement due to fraud remains appropriate at audit conclusion, that sufficient appropriate audit evidence has been obtained, and that the financial statements are not materially misstated as a result of fraud.
- The auditor's report shall explain to what extent the audit was considered capable of detecting irregularities, including fraud.

Appendix 4: Changes to auditing standards

International Standard on Quality Management 1 (ISQM 1) (UK): *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*

And

International Standard on Quality Management (UK) 2: *Engagement quality reviews*

And

ISA (UK) 220 (Revised July 2021): *Quality Controls for an Audit of Financial statements.*

effective from 15 December 2022 for ISQM 1 and for the 2023-24 audit cycle for ISQM 2 and ISA 220

ISQM 1 is the auding standard which sets out the auditor's responsibilities to design, implement and operate a system of quality management. ISQM 1 will be released alongside a series of standards on quality including ISQM 2 *Engagement Quality Reviews* and ISA 220 (revised) *Quality Management for an Audit of Financial statements.* This series replaces the existing standard on quality*:* ISQC 1 *The International Standard on Quality Control* and the extant ISA 220.

ISQM 1

- ISQM 1 directs auditors to implement a system of quality management which is the mechanism that creates an environment that enables and supports auditors in performing quality audits and is intended to facilitate auditors in achieving consistent engagement quality.
- ISQM 1 requires that auditors transition from implementing quality policies and procedures which address the compliance requirements of ISQC 1, to an integrated and proactive approach to managing quality risks and responses. Key changes include:

i. A more proactive and tailored approach to managing quality, focused on achieving quality objectives through identifying risks to those objectives, and responding to the risks

ii. Expanded requirements to insert quality measures in respect of audit technology and the use of external service providers.

iii. New requirements addressing information and communication, including communication with external parties such as audit committees.

iv. Enhanced requirements for monitoring and remediation to promote more proactive monitoring of the system of quality management as a whole, and effective and timely remediation of deficiencies.

ISQM 2

- ISQM 1 establishes the NAO's responsibilities for our system of quality management and requires us to design and implement responses to address the quality risks. ISQM 2 is a standard wholly related to one of those quality responses: the engagement quality review.
- An engagement quality review is an objective evaluation of the significant judgments made by the engagement team on our highest risks audits and the conclusions reached thereon.

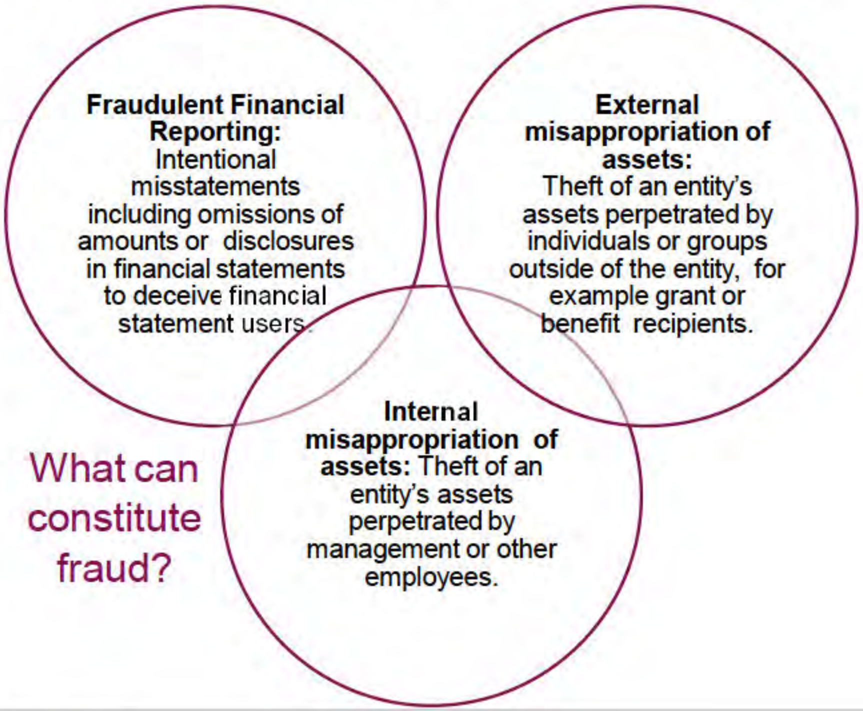
ISA 220

ISA 220 deals with the specific responsibilities of the auditor regarding quality management at the engagement level and the related responsibilities of the engagement partner.

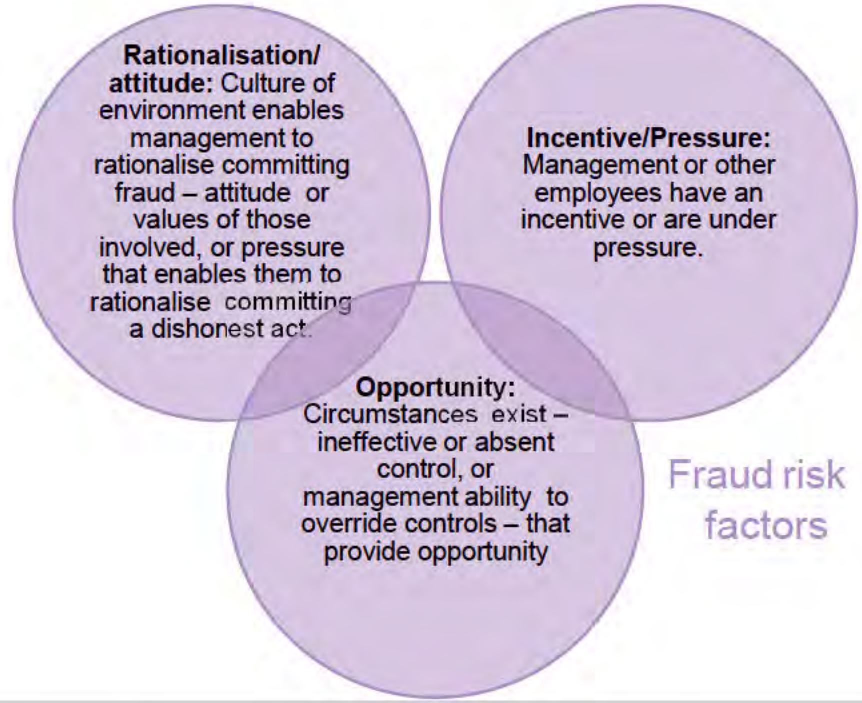
Appendix 5: Fraud matters

ISA (UK) 240 'The auditor's responsibility to consider fraud in an audit of financial statements' requires us, as your auditors, to make inquiries and obtain an understanding of the oversight exercised by those charged with governance.

What can constitute fraud?



Fraud risk factors



ISA inquiries

Our inquiries relate to your oversight responsibility for

- Management's assessment of the risk that the financial statements may be materially misstated owing to fraud, including the nature, extent and frequency of such assessments;
- Management's process for identifying and responding to the risks of fraud, including any specific risks of fraud that management has identified or that has been brought to its attention;
- Management's communication to the Audit Committee (and others charged with governance) on its processes for identifying and responding to the risks of fraud; and
- Management's communication, if any, to its employees on its views about business practices and ethical behavior.

We are also required to ask whether you have any knowledge of any actual, suspected or alleged fraud and discuss with you the risks of fraud in the entity.

Audit approach

We have planned our audit of the financial statements so that we have a reasonable expectation of identifying material misstatements and irregularity (including those resulting from fraud). Our audit, however, should not be relied upon to identify all misstatements or irregularities. The primary responsibility for preventing and detecting fraud rests with management.

We will incorporate an element of unpredictability as part of our approach to address fraud risk. This could include, for example, completing procedures at locations which have not previously been subject to audit or adjusting the timing of some procedures.

We will report to the Audit Committee where we have identified fraud, obtained any information that indicates a fraud may exist or where we consider there to be any other matters related to fraud that should be discussed with those charged with governance.

Appendix 6: Guidance for governance

Guidance for governance

Support to Audit Committees

We have developed a range of guidance and tools to help public sector Audit Committees achieve good corporate governance. This includes specific guidance on financial reporting and management during Covid-19

Insights - National Audit Office (NAO)

https://www.nao.org.uk/report/guidance-for-audit-and-risk-committees-on-financial-reporting-and-management-during-covid-19/

Climate Risk: A good practice guide for Audit and Risk Assurance Committees

Audit committees play a key role in scrutinising and advising the Board and Accounting Officer on risks arising from climate change. This guide will help ARACs recognise how climate change risks could manifest themselves and support them in challenging senior management on their approach to managing climate change risks

Climate change risk: A good practice guide for Audit and Risk Assurance Committees - National Audit Office (NAO) Report

Corporate Governance Code for central government departments

The document was released in April 2017 and lays out the model for departmental boards, chaired by Secretaries of State and involving ministers, civil servants and non-executive board members. The principles outlined in the code will also prove useful for other parts of central government and they are encouraged to apply arrangements suitably adapted for their organisation.

https://www.gov.uk/government/publications/corporate-governance-code-for-central-government-departments-2017

Sustainability reporting

This guidance is to assist with the completion of sustainability reports in the public sector. It sets out the minimum requirements, some best practice guidance and the underlying principles to be adopted in preparing the information.

https://www.gov.uk/government/publications/public-sector-annual-reports-sustainability-reporting-guidance-2020-to-2021

Good practice in annual reports

The Building Public Trust Awards recognise outstanding corporate reporting that builds trust and transparency. The interactive PDF below illustrates a range of good practice examples across annual reports in both the public and private sector.

https://www.nao.org.uk/report/good-practice-in-annual-reports-february-2021/

Disclosure Guides

Our disclosure guides for audited entities help audited bodies prepare an account in the appropriate form and that has complied with all relevant disclosure requirements.

Disclosure guide for entities who prepare financial statements in accordance with the Government Financial Reporting Manual (FReM) - National Audit Office (NAO) insight

Appendix 7: Good Practice in Annual Reporting

The Audit Committee plays a key role in scrutinising the Annual Report and Accounts, ensuring the quality of disclosures and its understandability for users.

To support the Audit Committee in this role, we have published our [Good Practice in Annual Reporting](#) guide.

The Guide, issued in January 2022, provides specific examples of best practice we identified during our review of a sample of 2020-21 annual reports. The good practice principles are grouped under the following headings: supporting accountability, transparency, accessibility and understandability and these should be evident across the common sections of an annual report (below).

Could you be a winner in 2022-23?
If you would like to nominate your organisation for the Building Public Trust Awards for your 2022-23 Annual Report and Accounts, please speak to your NAO Team or contact us at **Building.Public.Trust@nao.org.uk**.

Appendix 7: Good Practice in Annual Reporting

Essential features of a good annual report

Supporting accountability

- telling the story of the organisation in a fair and balanced way;
- compliance with the relevant reporting requirements; and
- clear action points to take forward.

Transparency

- frank and honest analysis;
- consideration of the challenges an organisation is facing;
- appropriate use of data; and
- quantification of risks and performance measures.

Accessibility

- highlights key trends in the financial statements;
- concise summaries of key points; and
- consideration of how the organisation engages with key stakeholders and meets their needs.

Understandable

Use of:

- plain English to explain difficult concepts;
- infographics and diagrams to communicate important messages; and
- clearly integrated structure to help users navigate it effectively.

Appendix 8: Audit and Risk Assurance Committee Effectiveness Tool

Audit and Risk Assurance Committees (ARACs) play a crucial role in supporting the effective governance of central government departments, their agencies and arm's-length bodies.

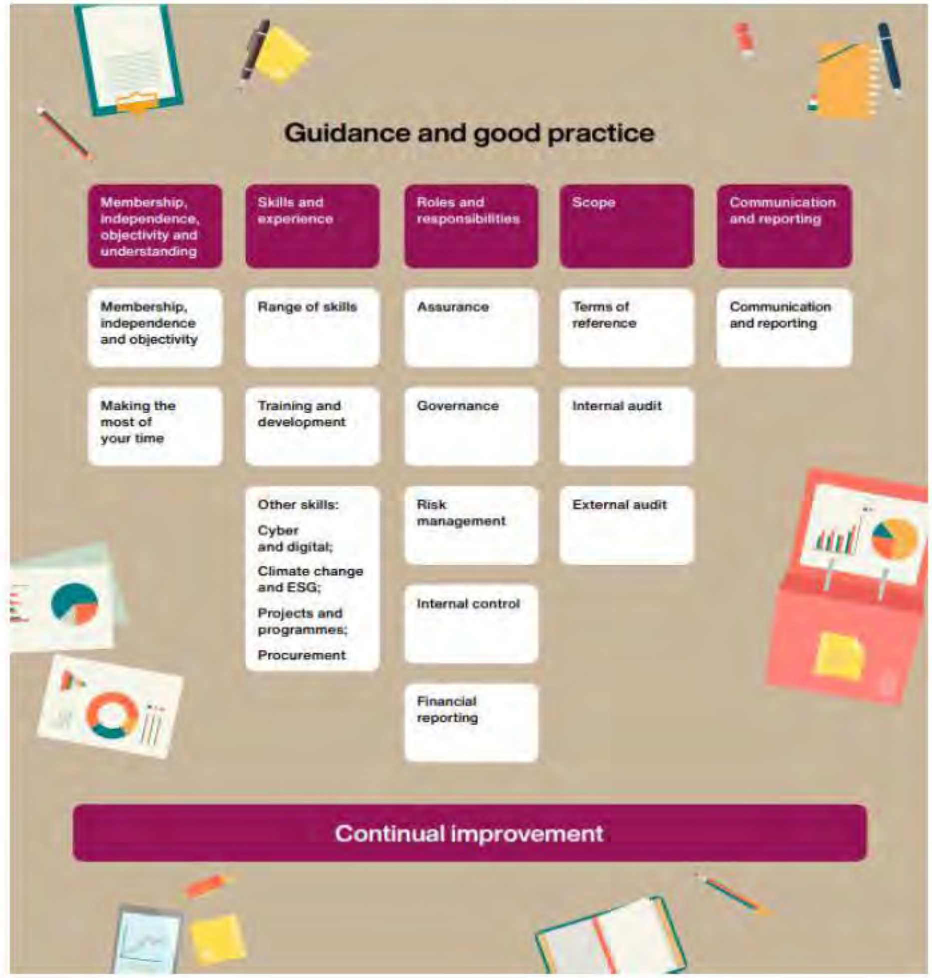
ARACs are operating in a highly challenging context. Government organisations are managing many risks and are required to be resilient to a number of new and increasingly complex pressures. This has created an environment where audit committees need to be dynamic and responsive to the changing risk profiles and demands of their organisations.

Our new and enhanced [effectiveness tool](#) is a comprehensive way for ARACs in central government to assess their effectiveness on a regular basis.

The tool provides a way for ARACs to assess their effectiveness against more than just the basic requirements. It provides aspects of good practice to allow ARACs to develop beyond the basic requirements of their role.

Our effectiveness tool outlines six areas for self-assessment:

- **membership, independence, objectivity and understanding**
- **skills and experience**
- **roles and responsibilities**
- **scope**
- **communication and reporting**
- **continual improvement**



Outcome Analyser

To gain an overall view of ARAC effectiveness, it is important that the individual views of all members are considered as a whole. Therefore we have created an accompanying [outcome analyser](#) which allows you to:

- generate an overall view of ARAC effectiveness; and
- drill down and analyse specific areas of strength or improvement on a section, sub-section and individual question level.

National Audit Office

National Highways

Interim audit progress report on the 2022-23 financial statements audit

Report to those charged with governance
28 March 2023

Contents

Interim audit progress

Introduction

This report summarises the key matters from our interim audit of the 2022-23 financial statements of National Highways (NH). We would like to thank the finance team, HR and business areas for their support. We have been successful in completing most of the expenditure, payroll, capital additions and existence samples. To support NH in improving their processes we also carried out a dry run sample of accruals and lands provisions, attempting to identify key issues that can be resolved between now and year-end. Further details can be found on page 9. We have discussed these issues with the finance team and have engaged with finance business partners to explain evidence required for accruals and provisions with the goal of improving evidence quality at the final accounts period.

Our overarching approach to risk is unchanged from the approach set out in our Audit Planning Report previously presented to the January Audit and Risk Committee, other than the minor changes highlighted on page 5.

We will formally report progress on our prior year recommendations in our Audit Completion Report and Management Letter for 2022-23

Interim audit progress

Testing performed during interim		
Financial Statements	*Interim audit work focused on in-year transactions recorded to period 9 (end of December 2022)*	**Completed** • Existence testing of SRN assets; • Dry run of lands provisions and accruals; • Sample testing of Maintenance and similar activities expenditure; and • Completeness testing of SRN databases stored by NH to the Atkins RAAVs revaluation output. **In progress – we will provide a verbal update on progress to the committee** • Sample testing of employees (including starters and leavers)- responses to queries to review • Samples of other expenditure (1 remaining)- inventory was written off after having been written off previously as part of a £18m write off. We are assessing the overall impact. (a similar issue occurred last year); • Sample testing of AUC additions (1 remaining) and renewals (2 remaining);
Other work to note	*We brought forward some of our year-end testing where possible to reduce the workload and minimise risk at final*	**In Progress** • A dry run sample of accruals in order to identify and eliminate possible issues at final (see page 9 for further details) • A dry run sample of provisions in order to identify and eliminate possible issues at final • A retrospective review of key estimates (SRN valuation and lands provisions) • Reviewed any changes to PFI contracts in year such as refinancing events • Updated our understanding of key financial controls over core audit areas, including a review of the complexity of underlying IT systems

Reminder of our audit risks - detailed breakdown

As noted in our Audit Planning Report, these are the areas we consider to be of highest risk in our audit work. Our detailed planning work has identified some additional risks, as well as some areas where our risk assessment has reduced. These are highlighted in red below.

Accounting for the SRN

Our significant risk relating to the SRN can be broken down to a more granular level, and covers the following risks:

- Disclosures and the SRN balance are incomplete.
- ~~Entries within the SRN database do not exist in real life.~~
- Impairment of assets has not been considered on a sufficiently frequent basis.
- Depreciation methodology has not been calculated or applied appropriately ~~- including errors in the calculation or incorrect Useful Economic Lives (UELs).~~
- Disclosures - revaluation and depreciation estimation uncertainty disclosures are not sufficient or accurate.
- Revaluation – the assumptions, data and method used in the revaluation are not appropriate. There are errors in the revaluation calculation.
- Indexation - assets have not been indexed appropriately. The method of indexation used is not appropriate

Recognition and valuation of land and property provisions

Our significant risk relating to the recognition and valuation of lands provisions can be broken down to a more granular level, and covers the following risks:

- The method used for calculating the land estimate/provision is not appropriate.
- The assumptions used in the calculation of the land estimate are not appropriate.
- The estimation uncertainty and other provision related disclosures are not sufficient or accurate.
- The data used in the calculation of the provision is inappropriate

Presumed risk of management override of controls

Our presumed significant risk relating to management override of controls can be broken down to a more granular level, and covers the following risks:

- Estimates - management bias impacts judgements and decisions made in arriving at both significant and non significant estimates.
- Management overrides controls to manipulate the financial statements using manual journals.
- Management enters into significant or unusual transactions to engage in fraudulent reporting or to conceal misappropriation of assets or irregular transactions.

Response to significant risks – Strategic Road Network

Update on our response to significant financial statement risks

Significant risk	Findings
Valuation of the Strategic Road Network (SRN) The SRN and related Assets Under Construction (AUC) balances are dominant components for the financial statements, with a 2021-22 balance of £143bn. The value is derived from the depreciated replacement cost of the SRN, which is calculated using the best available information to establish an accounting estimate, alongside the actual cost of recent schemes, and the asset records. A number of accounting assumptions are implicit in determining the valuation, which requires continual review, as does the application of indices used to revalue costing rates between 5-yearly assessments, and how asset information has applied to calculate a discount from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures). This remains a complex and highly material estimate for 2022-23 and so is recognised as a significant risk of material misstatement. This year is also a revaluation year for structures. Our work will focus on the revaluation methodology and assumptions, as well as other movements such as indexation, depreciation and additions.	**As the risk relates to year end valuation, much of the work over the SRN takes place at year end. Interim findings on work to date as follows:** We have conducted work on the design and implementation of controls over the SRN, and our understanding of the RAAVS valuation model operated by management's expert. This has not identified any issues thus far. Testing of in year capital additions, renewals, existence and completeness is in progress. We have not identified any significant errors to date and expect to complete the majority of this work on time for the end of interim fieldwork. We are in discussions with management regarding the valuation methodology for the revaluation of structures as part of the quinquennial review (QQR) in 2022-23. Management have not yet received a valuation methodology paper from Atkins which is of sufficient quality for our review, which may have a knock-on impact on our audit timetable. We would encourage management to ensure that Atkins are able to deliver the full valuation to the required timetable to avoid any delays to the audit. As in prior years, we will be using an auditor's expert with civil engineering expertise to assist us in evaluating the appropriateness of the condition-based depreciation methodology for structures and road assets. The expert will comment on the reasonableness of the methodology, focusing on any changes from the prior year, and will test a sample of structures and roads on our behalf to ensure that the method has been consistently applied. The expert will also review the methodology and assumptions used in the revaluation of structures. We are also aware that management plan to change the indices used to revalue parts of the SRN. We will evaluate the judgements made by management in selecting new indices, and the appropriateness of the indices chosen.

Response to significant risks – Provisions & Management Override of Controls

Update on our response to significant financial statement risks

Significant risk	Findings
Provisions Land and property is acquired as part of improving the network, and NH recognises a provision for the costs of these acquisitions. The overall balance at 31 March 2022 was £296m, made up as follows: £103m of blight; £161m of CPO; and £32m for Part 1 claims. The provisions are supported by large and complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high. In 2021-22, we noted an improvement in the data quality, but we have recommended that NH work with the VOA to secure better quality evidence for estimates provided, and to increase the level of knowledge sharing within the NH team in relation to the provisions accounting process. Our expert valuer was able to conclude that the estimates were not materially incorrect. We further note that management rely on a legacy system (HAL) in recording these provisions, which is used primarily by the property team for asset management purposes. Whilst the prior year sample testing saw improvements on the year before, we still noted a number of errors, namely in data entry and manual calculations in the system.	**As the risk relates to year end valuation, much of the work over the provisions takes place at year end. Interim findings on work to date as follows:** • We have conducted work on the design and implementation of controls over the provisions, and our understanding of the VOA valuations. This has included a review of the complexity of the underlying IT systems (HAL and Oracle). • We performed a dry run of a sample of 5 provisions (at scheme and individual case level). We identified similar issues to previous years, in particular that the quality of supporting justifications for valuations on individual cases was varied. • We have re-engaged Knight Frank as our auditor's expert to assist with work at year end. Knight Frank will review a sample of underlying valuations and comment on their material reasonableness. We expect to select the samples for expert review at the end of April 2023. • We have liaised with the Highways legal team and management to identify any significant changes to provisions this year and will review board minutes and papers. • We have retrospectively reviewed a sample of 5 provisions which have been closed during the 9 months to December 2022. We noted several large movements within the land cost estimates. There was no clear evidence of management's challenge of these movements or a an evidence trail demonstrating when decisions taken by management around requirements for land were made. We would expect a greater level of challenge around significant movement in provision values around year-end.

Response to significant risks – Provisions & Management Override of Controls

Update on our response to significant financial statement risks

Significant risk	Findings
Management override of controls	
Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively. Under International Standards on Auditing (UK) 240 there is a presumed risk of management override for all audited bodies.	We have performed a retrospective review over estimates in relation to the SRN valuation and the lands provisions in order to identify any evidence of management bias in accounting estimates. We have not identified any indications of management override of controls. During our final audit fieldwork, we will risk assess and substantively test a sample of journals.

NAO National Audit Office

Other matters

The following are other matters which we wish to bring to the attention of those charged with governance in relation to the audit of the financial statements.

Audit Area	Interim Findings
Accruals	To support NH in improving their accruals processes following the difficulties faced in previous years, we have performed a dry run of accruals testing. • We selected a random sample of 5 accruals to test as at 31 December 2022. We noted that there has been an improvement in the quality of evidence received compared to recent years. This was most notable when FBPs completed the NAO's accruals cover sheet and submitted this alongside the evidence. • We identified several discrepancies during our testing, however, these will not be carried forward as errors as this is a dry run. 2 samples had to be reselected because the original sample items related to 2016/17, they were journaled as non reversing ADIs and relate to VAT adjustments, but should have been reversed. No evidence was available to support these. The finance team provided support to outline why they are content this is a one off issue. 1 sample related to an £18m accrual that had been reversed and re-entered as £24m, however, the original accrual appeared in the accruals listing and could not be evidenced. • We have additionally held a meeting with National Highways FBPs in February to explain the audit approach and what would be appropriate audit evidence, to support work at final audit. This meeting was well attended and we feel that it showed a really good level of engagement by FBPs.
Inventory	Inventory is not a material area of the accounts; however, we are required to document the controls and processes in place relating to inventory as part of our interim audit. Whilst attendance and testing at a stock take is not currently required by our audit procedures this year, we are required to understand, review and document management's instructions and processes for stock takes and stock management. At interim, we held discussions with key members of the inventory team for both technology and salt inventory. We also plan to visit the NTLC to gain a greater understanding of the processes relating to inventory.

Preparations for final audit

Final audit arrangements

Final audit fieldwork

The bulk of audit work is scheduled for four weeks commencing Tuesday 2 May 2023, with initial data and draft accounts to be provided by National Highways before this (specific dates to be agreed with Highways finance). Work over the SRN, accruals and provisions will continue into early to mid-June due to the complexity of this balance.

Audit work to be performed at final audit

Our final audit visit will address the following audit areas:

Financial Statements

i. Substantive testing: we will perform substantive testing on income and expenditure for periods 10 to 12, all disclosures, and on all other areas of the accounts deemed to be at risk of material misstatement.

ii. Significant risk work covering management override of controls, the SRN and Land and Property Provisions

iii. Review of Financial Statements: we will review the accuracy, completeness and quality of the disclosures in the accounts.

Annual Report

i. Remuneration Report: we will test the accuracy of disclosures in the Remuneration Report and confirm that they are complete.

ii. Review of Governance Statement: we will review the governance statement to ensure it is consistent with our understanding and complies with HM Treasury's guidance.

iii. Review of Strategic and Directors' Reports: we will ensure that the Reports are consistent with the financial statements and our understanding, specifically considering the 'fair, balanced and understandable' requirement on management, on which we must also provide an opinion.

Reporting our findings to the Audit and Risk Committee

The Audit and Risk Committee meeting to approve the year-end financial statements is scheduled for 20th June 2023, we will provide a full Audit Completion Report summarising our findings.

National Audit Office

National Highways

Audit completion report on the 2022-23 financial statements audit

Report to those charged with governance

20 June 2023

This report presents our findings from the audit of 2022-23 financial statements

Dear Audit Committee Members:

We anticipate recommending to the Comptroller and Auditor General (C&AG) that he should certify the 2022-23 financial statements with an unqualified audit opinion, without modification in respect of both regularity and the true and fair view on the financial statements. The draft Enhanced Audit Report will be shared with the committee in advance of certification.

At the date of this report our audit of the financial statements is progressing well and will be concluded in line with our planned timetable, subject to completion of the areas detailed on page 7. While there are a number of areas still to fully close down, progress overall is good. The audit is due to be completed in advance of the Parliamentary Recess and we will communicate any updates in the finalised audit completion report to those responsible for governance on completion, as well as giving a progress update verbally at the committee.

The total audit fee in the Audit Planning Report was £347,000, however, work is still ongoing, in particular for the SRN Quinquennial Revaluation, Whilst changes to the fee are not planned at this point, we are unable to confirm this as the final fee given the outstanding work. There are no contingent fees in respect of the National Highways audit.

Actions for the Audit Committee

The Audit Committee is invited to:

- Review the findings set out in this report, including the audit enhanced audit report and draft letter of representation which are presented as separate items to the committee;
- Consider whether the unadjusted misstatements, set out in the identified misstatements section (page 18), should be corrected. The Audit Committee minutes should provide written endorsement of management's reasons for not adjusting misstatements; and
- Consider the adequacy of the going concern disclosures included in the draft financial statements and conclude on whether this is a fair assessment. We request that this consideration is included in the letter of representation to the Comptroller and Auditor General (C&AG).

We will issue a separate management report of our findings for 2022-23 and progress on prior year recommendations at the next Audit Committee meeting on 5th October. We would like to thank [redacted] and his team for their assistance during the audit process.

Yours Sincerely,

Sarah Che

Contents

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Overview

Audit risks (pages 8 to 16)

Presumed risk of management override of controls

We have considered the presumed risk of management override of controls under International Standards on Auditing (ISA (UK) 240).

We have not noted any issues of management override of control in our audit work.

Recognition and measurement of Land and Property Provisions

Our testing of provisions is ongoing, but we are not expecting any material issues. So far, we have noted findings against the risk as a result of testing which include manual entry and VOA input errors to the provisions system. Our auditor's expert has reviewed a sample of underlying land cost estimate valuations and will set out some preliminary findings.

Accounting for the Strategic Road Network (SRN)

We have responded to a more granular breakdown of the risks relating to the SRN this year, which are outlined in more detail on slide 7

Our expert is also reviewing the condition-based depreciation methodology supporting structures and road assets, including confirmation as to the application of the method against a sample of both structures and roads. They are also reviewing the quinquennial valuation of structures and the methodology behind this, and we are expecting further questions to be raised with National Highways now that all the data has been received.

Whilst our wider work on the SRN is close to completion, including the more routine sample testing, we have not yet received a finalised version of the expert reports, which is due by the end of June. Testing of some adjustments and disclosures is also ongoing.

Overall Materiality (SRN) ~1% of SRN Balance

£1.4bn

Materiality has remained the same level as that reported in the Audit Planning Report. Our overall account materiality is set at approximately 1% of the prior year value of infrastructure assets (SRN and related AUC), reflecting the significant interest among SRN users in the extent and condition of the network.

We did not adjust materiality upwards for the final SRN balances (which would have resulted in a materiality of £1.5bn) so that we could prudently maintain a lower materiality figure, and because the large increase was primarily driven by indexation over which we have performed specific audit procedures for assurance.

We have reported all misstatements above £300k.

Secondary Materiality ~1.5% of total adjusted expenditure

£69.3m

Secondary materiality has remained the same level as that reported in the Audit Planning Report. We set secondary materiality as approximately 1.5 % of total prior year adjusted expenditure and applied to all transactions and balances that reflect cash spending, including SRN capital additions. In practice, this applies to all areas other than the SRN and associated non-cash revaluation and depreciation entries.

We did not adjust materiality upwards for the final outturn expenditure position (which would have yielded a corresponding materiality of £69.6m), so that we could prudently maintain a lower materiality figure.

We have reported all misstatements above £300k.

Overview – Adjusted and unadjusted misstatements

Adjusted misstatements (Page 17)

£3.336m

The current impact of adjusted misstatements is a £3.336m increase to inventory assets on the statement of financial position and a decrease in expenditure on the statement of comprehensive net expenditure.

One gross adjustment within the SRN note was identified, which resulted in an increase of £1.77bn to net assets and reserves, but net nil impact on the SoFP. See page 18 for detail.

This figure is subject to change as we finalise our audit as set out on page 7.

Unadjusted and extrapolated misstatements (Page 18)

£nil

We have identified errors in our sample test of expenditure, accruals and provisions which are individually below our reporting threshold. When we have finalised our testing, we will extrapolate these errors. Any extrapolated errors above our reporting threshold will be reported to you in our final audit completion report.

This figure is subject to change as we finalise our audit as set out above and on page 7.

When we have finalised our testing and our quantification of known misstatements, we will report to you any over the reporting threshold which management have chosen not to adjust. Currently there are no unadjusted misstatements to report.

Audit risks- detailed breakdown

Accounting for the SRN

Our significant risk relating to the SRN can be broken down to a more granular level, and covers the following risks:

- Disclosures and the SRN balance are incomplete.
- Entries within the SRN database do not exist in real life.
- Impairment of assets has not been considered on a sufficiently frequent basis.
- Depreciation methodology has not been calculated or applied appropriately - including the data used being inappropriate
- Disclosures - revaluation and depreciation estimation uncertainty disclosures are not sufficient or accurate.
- Revaluation – the assumptions, data and method used in the revaluation are not appropriate. There are errors in the revaluation calculation.
- Indexation - assets have not been indexed appropriately. The method of indexation used is not appropriate

Recognition and valuation of land and property provisions

Our significant risk relating to the recognition and valuation of lands provisions can be broken down to a more granular level, and covers the following risks:

- The method used for calculating the land estimate/provision is not appropriate.
- The assumptions used in the calculation of the land estimate are not appropriate.
- The estimation uncertainty and other provision related disclosures are not sufficient or accurate.

Presumed risk of management override of controls

Our presumed significant risk relating to management override of controls can be broken down to a more granular level, and covers the following risks:

- Estimates - management bias impacts judgements and decisions made in arriving at both significant and non significant estimates.
- Management overrides controls to manipulate the financial statements using manual journals.
- Management enters into significant or unusual transactions to engage in fraudulent reporting or to conceal misappropriation of assets or irregular transactions.

Key audit findings

Status of our audit

At the date of this report our audit of the financial statements is progressing well and will be concluded subject to completion of the areas detailed below. The audit is due to be completed in advance of Parliamentary recess and we will communicate any updates to the finalised audit completion report to those responsible for governance.

Name	Actions to resolve	Owner of action	Status
SRN work	Several testing areas are in progress on the SRN particularly: - Work on valuation adjustments, including the staff cost capitalisation, AUC pipeline adjustment, and AUC write downs; - Work on depreciation SAPs and review of management experts upon receipt of report - Review of specific disclosures and accounting policies - Review and benchmarking of indexation	NH/NAO	🟡
SRN expert findings	Our expert is continuing their work on the SRN, with work relating to the conditions review for Structures and Roads nearing completion. However, work on the review of the methodology behind the QQR, including the impact of a lack of data for the tunnels QQR, is ongoing. Further questions are expected as our expert reviews the methodology and rates calculated and a final report is expected by the end of June.	NAO	🟡
Provisions expert findings	Our expert is close to completing their review of samples and methodology for provisions, with an interim report due imminently and final report due soon after. Based on discussions so far, no major concerns have been raised.	NAO	🟢
Provisions sample testing	The sample test of provisions is nearing completion, however, the outstanding areas include our review of evidence supporting payments against provision valuations and supporting evidence from the VOA for individual case level provisions.	NAO/NH	🟢
Journals	Work on ETB journals and P1-12 journals is ongoing	NH/NAO	🟢
Internal Reviews	Internal reviews are underway, but the final internal reviews of the audit file and subsequent resolution of any queries arising are still ongoing	NAO	🟢
Review of V2 and final version of draft accounts and annual report	We will need to review the second draft set of annual accounts, as well as the final version of the annual report, financial statements and annual governance statement.	NAO	🟢

Status

🔴 Likely to result in material adjustment or significant change to disclosures within the financial statements

🟡 Potential to result in material adjustment or significant change to disclosures within the financial statements

🟢 Not considered likely to result in material adjustment or change to disclosures within the financial statement

Key audit findings

Findings from our work on significant risks

Presumed risk of management override of controls

Details

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively.

This is a presumed risk for all audited bodies under International Standards on Auditing (ISA 240). We have identified no particular risk factors in relation to National Highways.

This significant risk is in line with previous years.

Audit Response, Findings and Conclusion

We have reviewed the accounts preparation process, as well as adjustments made to the accounts in the year-end Extended Trial Balance (ETB). **We have tested ETB adjustments made so far, but our testing is ongoing as we review any further adjustments before the accounts are signed.**

We performed a risk-based analysis of manual journals and selected those which we considered to be high risk (due to size or nature) for testing. We agreed all journals to appropriate evidence and confirmed that they had been appropriately reviewed. **Testing is nearing completion.**

We have tested the significant estimates made by management, including the valuation of the Strategic Road Network, and valuation of accruals and provisions. **Our testing of these estimates is nearing completion.**

We also performed a retrospective review of estimates made in the prior year and found no indication that these were inappropriate.

We reviewed the general ledger for significant and unusual transactions. We did not identify any transactions which we considered to fall into this category.

We have not identified any evidence of management override of controls in our work to date..

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Details

The Strategic Road Network (SRN) and related Assets Under Construction (AUC) balances are significant balances within the financial statements, with a value of £156bn in the draft accounts (2021-22: £143bn).

In accordance with the Government's Financial Reporting Manual (FReM), the value of the SRN is derived using the Depreciated Replacement Cost, which uses the best available information to establish an estimate of replacing the asset with a modern equivalent, less deductions for physical deterioration and relevant obsolescence and optimisation. NH perform revaluation of the SRN on a continuous rolling basis, with each asset type undergoing full revaluation 5-yearly.

There is significant judgement involved in determining the valuation, in particular:
- A number of accounting assumptions implicit in determining the gross valuation.
- Selection of the appropriate indices to apply to reflect changes in costing rates between 5-yearly assessments.
- The appropriate application of asset information to calculate the deduction from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures).

This year there are also additional risks of material misstatement relating to the valuation of structures assets, as 2022-23 is a full revaluation year. A full revaluation involves recalculating the unit rates for different structures based on recently completed schemes, as well as ensuring the valuation method and assumptions used remain appropriate. This introduces an additional level of judgement and potential source of calculation error compared to indexed elements.

The valuation of the SRN is a judgemental, complex and highly material estimate for 2022-23, which is subject to significant assumptions, using complex base data and methodologies. Therefore, as in previous years, we have recognised a significant risk.

Capital additions, depreciation and testing of technology assets are outside of the scope of this risk and are subject to our standard audit testing.

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Audit Response, Findings and Conclusion

Controls

- We have reviewed the design and implementation of controls operated by National Highways and Atkins over the asset valuations for the SRN. This confirmed the controls were adequately designed and implemented at year end. The key controls supporting the SRN valuation include quarterly exception reporting and corrections carried out by Atkins on roads and structure valuation runs, as well as review, investigation and sign-off for changes carried out by National Highways in response to issues identified by Atkins.

Substantive

- We reviewed the **revaluation model** (RAAVS) this year and confirmed it was operating in line with our expectations and was applying the valuation methodology and assumptions of Highways appropriately. This included reviewing Atkins work as operator of the RAAVS process as management expert for competence and independence, as required by auditing standards. This did not identify any concerns.
- We obtained assurance over **asset quantities** and their completeness through our testing of the asset databases and RAAVS, checking figures between sources to confirm consistency without omissions.
- We corroborated this by updating NAO modelling work on the road network length using *Openstreetmap* as independent data source. We have reviewed in year additions, road openings and de-trunkings to confirm the closing length for the roads had not significantly changed from the modelling figure (6,906km as at 31 March 2023 compared to 6,841km as at 31 March 2020 which is an insignificant change over 3 years). We also note that the year-on-year movement in road length is a highly insignificant 1km movement. This is consistent with our assumption that the network is slow moving in terms of area quantity.
- As part of existence sample work we reviewed the **classification of land as rural vs urban** (as this significantly affects value) and checked the land take buffer zone against the model data to confirm it is reasonable. No issues were identified from this work.
- The review of the reasonableness of **conditions data for the roads and structures** is ongoing with work on the substantive analytical procedures in progress, however work to date, including discussions with our expert as to quality of underlying data and the related depreciation methodology, has not identified any material concerns.
- We have reviewed the work of Transport Research Laboratory (TRL) in certifying the **road survey vehicles used for obtaining the road conditions data**, and performed ISA 500 procedures to confirm their expertise and independence. No issues identified.
- We have challenged brought-forward management judgements in relation to the **AUC Write-down percentages** and **Greenfield Assumptions** this year to refresh our work on high-level assumptions. Our work so far on this has confirmed the judgements remain valid.

Key audit findings

Findings from our work on significant risks.

Accounting for the Strategic Road Network

Audit, Response Findings and Conclusion

Areas of judgement – Indexation

- During 2022-23, **management chose to change the index** used from HECI (a bespoke to index) to the more readily available and public Implied Output Price Indicator (IOPI). We are reviewing the reliability and appropriateness of the index, along with the impact this change has on the financial statements and any indicators of management bias. This is a significant judgement area and our review is ongoing.
- We are in the process of confirming the reasonableness of the **indices used to revalue roads, special structures and technology assets** and ensuring that these have been applied through our indexation substantive analytical procedure and benchmarking exercises, including confirming the carry forward of previously audited QQR rates.
- Management originally used the Q3 index to revalue the SRN, however, the movement seen in Q4 when the data was published in early May, was material and resulted in a £1.77bn increase in the valuation of the SRN. This has been reported as a misstatement and management have adjusted for this.
- **Land indexation** saw a £1.3bn rise in asset value. We are in the process of applying challenge here by reviewing alternative land indices held by the NAO (urban HPI and rural Knight Frank), and reviewing any differences in impact. This work will also consider the reasonableness of indices used by National Highways to index land.

Areas of judgement – Quinquennial Revaluation of Structures

We have performed additional work to review the underlying costing data and assumptions associated with the quinquennial revaluation. This includes engaging a structural engineering expert to assess the methodology used by Highways to value structures as well as an assessment of the costing rates generated as part of this exercise.

Our work is ongoing, including discussions with Atkins to understand how the revaluation has been performed, and detailed review of the calculations supporting this. Our audit work so far has found that the revaluation exercise has been performed using a limited range of recent costing information, with this focusing solely on the recent A14 project.

Although they were due to be undergo quinquennial revaluation this year, Tunnels have been indexed as opposed to a full revaluation due to a lack of recent tunnel costing information within National Highways. Our work on this is ongoing, particularly focussing on:

- Challenging management on whether indexation is appropriate, particularly in the context of the QQR for other structures resulting in a downwards valuation of 12.6%, compared with a 12.6% upwards revaluation on Tunnels if indexation is applied (this is the same percentage by coincidence),
- Whether this approach constitutes a material departure from Highways' accounting policies, and
- The appropriate disclosure of this fact, taking into account the above two accounting policies.

Our work on this is ongoing, and has been impacted by delays in receiving information and the methodology papers from Atkins. We expect to finalise our work by the end of June.

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Audit, Response Findings and Conclusion

Areas of judgement – Expert review of Roads and Structures

As set out in our planning report, we have sought advice from a structural engineering expert in respect of Highways' transformation of physical data into depreciation % estimate for roads and structures. Our expert's work is nearing completion in this area, and no significant issues have been raised at this point.

Areas of judgement – Events after the reporting date

In April 2023, the government announced the cancellation of smart motorways. As part of our audit we considered whether this represented a post balance sheet event under *'IAS 10 – Events after the reporting date'* and whether an adjustment was required. Management's judgement is that the cancellation arose after year end and was not an impairment event that existed at the reporting date.

We have reviewed the work of management in reaching this conclusion, seeking evidence to support the judgement, and we are satisfied it is reasonable.

We note that management have begun the process of obtaining approval for the write off of £62m in the 2023-24 financial statements.

Key audit findings
Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Details

Land and property is acquired as part of improving the road network. National Highways recognises a provision in its accounts relating to these acquisitions, which was valued at £406m in the draft accounts (2021-22: £296m). This provision is derived using complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high.

In valuing the provision, NH relies on estimates provided by the Valuation Office Agency (VOA) that often lack a robust evidence base. In 2021-22, we noted an improvement in the data quality, but we have recommended that NH work with VOA to secure better quality evidence for estimates provided, and to increase the level of knowledge sharing within the NH team in relation to the provisions accounting process. Our expert valuer was able to conclude that the estimates were not materially incorrect.

NH recognises provisions based on the stage that a scheme is at. This includes Blight being recognised at Preferred Route Announcement stage, Compulsory Purchase being recognised when a Development Consent Order (DCO)/CPO is granted, and Part 1 at the start of construction. Given the increase in challenges to DCO approvals within the 6 week challenge period after a DCO is granted (in particular for the A303 which resulted in the DCO being overturned), we requested a paper from management on whether that recognition point remains appropriate.

Audit Response, Findings and Conclusion

Controls:

We have carried out an assessment of the design and implementation of controls.

The implementation of controls has improved from the prior year. Following our recommendations, management has:

- Included monthly checks on valuations to ensure they are updated every 6 months; and
- Engaged with the Valuations Office Agency (VOA) to enhance their comments on valuations entered into the National Highways' Lands database (HAL), which stores the valuations for land. Data extracted from HAL is used to calculate the provisions value in the financial statements.

However, there were still a few instances where the valuations had not been updated in over 6 months. We have not sought to rely on controls, and instead performed fully substantive testing over the provisions and aggregation process.

Key audit findings

Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Substantive:
We substantively tested a sample of provisions which included 11 scheme level ('8888') cases and 30 cases relating to individual land parcels.

Provisions are calculated based on a valuation provided by the VOA, adjusted for manual entries and payments made against the provision. Payments consist of genuine payments where part of a provision is settled or a capital addition is made against the scheme, but can also be due to aggregation where individual cases are set up for each claimant and a deduction is made against the scheme level provision to avoid double counting.

We tested the VOA valuation by tracing the values in HAL to either a VOA valuation report or a confirmation email from the VOA outlining the basis of the valuation. We re-performed manual calculations and selected a sub-sample of payments and aggregation against the sampled provisions. For individual cases, we were able to agree the payments to our wider testing of capital expenditure.

Our testing identified the following:

- Sample errors arising due to manual entries being incorrectly calculated by National Highways by using the old methodology rather than the new guidance, or where the totals had been entered incorrectly by the VOA. Most of the errors have been found in the lower value samples.
- Valuations are required to be updated every 6 months, but we have identified some instances where they had not been updated, with one relating to a scheme that is currently paused due to a re-tendering process for a new supplier. We have also noted one instance where the new estimate was submitted in March 2023 but was not approved by year-end.

We note a general reliance on the VOA - although there has also been an improvement in this from the prior year, with additional narrative being added to the files for individual cases. We have noted some instances where the figures have not been added up correctly in the VOA report. The error rate could be reduced with more detailed review.

Through our P13 adjustments review (ETB journals review), we note that an adjustment was posted for manual entry errors etc identified in the samples reviewed as part of the process in March. Whilst this highlights a strengthened review process by the finance team, it is clear that earlier review by the lands team may reduce the number of errors picked up in the finance team and later the audit teams' sample testing.

Following completion of our sampling, we will need to review and extrapolate the errors identified, and we will provide an update once this information is available.

Key audit findings

Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Areas of judgement – application of recognition criteria

We reviewed National Highway's application of the IAS 37 recognition criteria in detail in the prior year and in 2019-20. In the current year, we confirmed the appropriate application of National Highways' recognition policy against each sample item in the provisions sample, no issues were noted.

We challenged management on whether their recognition policy continues to be appropriate, in light of increased challenge to DCO approvals within the six-week challenge period. Management's judgement is that, although there has been an increase in challenge, this has not led to a increase in cases being quashed and therefore their policy remains appropriate. We have evaluated management's judgement, including seeking supporting evidence, and we are satisfied it is appropriate.

Engagement of an expert valuer

We have engaged an auditor's expert (Knight Frank) to review a subset of land and property valuations in detail for 5 of our samples, as well as re-review a sample they reviewed in a previous audit cycle in order to understand any progress made against our recommendations. Based on our discussions with the expert so far, they do not expect to raise any significant concerns. Their initial review has identified similar findings to those in the prior year: that despite the overall positive conclusion, the valuation reports could be more consistent and standardised, as well as provide greater justification and detail for how assumptions have been made and how estimates have been reached.

Knight Frank intend to hold discussions with National Highways and VOA to clarify queries relating to the valuations and valuation methodology. Following this, they will provide a report to us which will set their findings and will include some recommendations which we will report separately in more detail in our management letter (to the next Audit and Risk Committee meeting).

Key audit findings

Areas of management judgement

The following are the matters which we did not consider to represent significant risks to the financial statements but that the Audit Committee should be aware of, as they are areas of management judgement:

Description	Audit response	Audit findings and conclusion
Accruals	Testing in the prior year identified improvements in Highways process for recording and substantiating accrual values In 2021-22 we noted some errors in testing (extrapolating to a most likely error value of £9.3m), with most items sitting below the £500k balance sheet review threshold adopted by finance. As in 2021-22, this year we stratified our sample population in order to focus our sample on higher value accruals where the risk of material misstatement is greater. We continued to provide a presentation workshop to the business regarding sufficient evidence requirements in our accruals testing prior to the final audit. We also requested that finance business partners submitted evidence for their accruals using the NAO template form (new in 2021-22).	From our testing of accruals, we sampled and reviewed 74 items across the capital (57) and resource (17) accruals population. The capital accruals sample is well progressed (two thirds of samples closed). We have noted a small number of errors in testing so far, with most items sitting below the £500k balance sheet review threshold adopted by finance. The errors broadly relate to: Classification issues whereby the accrual should have been recorded as a payable (though this is not a valuation issue); and minor estimation differences to actuals regarding proportion of works complete or amounts paid. We are finalising details for a more significant error due to P13 adjustments which have been input inversely (i.e debit as a credit). This has been corrected by the finance team, however, the overall error value is just below materiality. The resource accruals sample is also nearing completion (two thirds of samples closed). We have noted a small number of errors due to the estimation methodology used.
Smart Motorways	Smart Motorways were paused in the previous financial year, however, in April 2023, the government announced that the Smart Motorways programme was being cancelled. As a result, we requested that management prepare a paper setting out their view on accounting for the Smart Motorways decision in line with IAS 10 (Events After the Reporting Period).	The paper prepared by management concluded that Smart Motorways were cancelled in April 2023 and were a non adjusting event on the basis that there were no indicators of the decision at the balance sheet date. We reviewed this position and performed some independent review of media articles, internal communications and government announcements, and concluded that the position reached by management was reasonable

Key audit findings

Areas of management judgement

The following are the matters which we are required to report to the Audit Committee for bodies who follow the UK Corporate Governance Code.

Description	Management's judgement	Our view
Director's assessment of principle risks facing National Highways	Principal risks are owned by the Executive team and monitored by the Board. Collectively, the Board and the Executive team maintain visibility of all risks sitting at principal and secondary levels, including status and mitigation plans, through periodic risk reporting and review process. The principal risks are disclosed in the annual report and are assessed against strategic outcomes including improving safety for all, delivering better environmental outcomes and meeting the needs of all road users.	The disclosures within the annual report as to the Company's risk assessment and management processes are adequate. The Company's risk management process is considered robust. The listed Principal risks it faces that are disclosed are in line with our knowledge of the Company.
Director's assessment of National Highways' future prospects and going concern	The directors have a reasonable expectation that the company has adequate resources to operate for the foreseeable future. The financial statements are therefore prepared on a going concern basis. In forming this view the directors/management have: • Reviewed the company's future funding commitments received from government through the publication of the second Road Investment Strategy (RIS2), which sets out the £24 billion resource and capital funding that the company will receive during the five years from 2020–21 to 2025-26; • Kept DfT fully aware of commitments made which stretch beyond the period covered by the RIS2 period; • Reviewed internal budgets, plans and cash flow forecasts; and • Reviewed DfT's Main Estimate for 2022-23	We have reviewed Management's assessment and agree that the financial statements should be prepared on a Going Concern basis. We have no concerns with management's assessment or disclosure.
Internal controls	The Company establishes internal controls to mitigate risks related to fraud, error or non-compliance with laws and regulations. The Corporate Assurance function provides an objective and independent opinion on the effectiveness of internal control, and the Company participates in DfT's management assurance process.	Following our review of the Company's internal control environment and our work on the design and implementation of controls relating to significant audit risks, we conclude that the entity's system of internal controls affect financial reporting is effective.

Key audit findings

List of adjusted misstatements

Adjusted misstatements

Misstatements that have been identified, adjusted and are above our clearly trivial threshold of £300k have been set out below.

An adjustment has been made by management for a balance sheet review exercise that saw debits and credits entered the wrong way. We are finalising the information relating to this error, however, the value of the adjustment is in the region of £66m.

Adjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE		SOFP	
					DR	CR	DR	CR
Inventory write off	Known	£18m of inventory was previously written off a couple of years ago, but not disposed of. In year some of this inventory was disposed of and written off for a second time. This has been corrected. The same issue occurred in the last financial year.	Inventory	£'k			3,336	
			Other expenditure	£'k		3,336		
Indexation uplift to SRN	Known	The indexation figure used in the revaluation was based on Q3, however, the movement between the Q3 and Q4 indices of 1.31% resulted in a material movement to the Net Book Value of the SRN	SRN	£'k			1,770,044	
			Revaluation Reserve	£'k				1,770,044
		Cumulative misstatements:	**Debits and credits**			3,336	2,018,377	2,015,041
			Net impact on financial statements			3,336	3,336	0

Key audit findings

List of unadjusted misstatements

Unadjusted misstatements

We have identified errors in our sample test of expenditure, accruals and provisions which are individually below our reporting threshold. When we have finalised our testing, we will extrapolate these errors. Any extrapolated errors above our reporting threshold will be reported to you in our final audit completion report.

We have also identified a misstatement in the holiday pay accrual, which we are currently working with Highways to quantify.

This figure is subject to change as we finalise our audit as set out above and on page 7.

When we have finalised our testing and our quantification of known misstatements, we will report to you any over the reporting threshold which management have chosen not to adjust. Currently there are no unadjusted misstatements to report.

Other audit findings

Financial statement disclosures	We have challenged management over the adequacy of disclosures in the financial statements in the following areas: • Enhancement of PFI service charge disclosure to explain the difference between the in year SoCNE figure and the prior year current service charge obligation • Enhancement of cash disclosures given the negative cash balance in year We have made a number of other suggestions to improve narrative disclosures and to ensure completeness of the disclosures required under the Companies Act (2006), FReM and other relevant guidance. We will review subsequent versions of the financial statements in order to conclude that the required changes have been made.
Accounting policies and financial reporting	We have performed the following procedures with regards to the appropriateness of the judgements made by the entity on accounting policies, particularly new or changed policies • Ensured that all accounting policies are in line with IFRS. We have performed the following procedures on the appropriateness of the judgements made by the entity on the required accounting estimates: We have performed procedures on the appropriateness of the judgements made by the entity on the required accounting estimates, such as those detailed against our SRN valuation and provisions significant risks, and those specified against our accruals risk factor in this report. There are no material inconsistencies in the annual report that have not been corrected. We are content that the accounting policies are complete, accurate and compliant with the relevant standards and have been appropriately applied.
Regularity, propriety and losses	We found no issues of irregularity or impropriety during our audit.

Other audit findings Cont'd

Risk of Fraud

We shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in our auditor's judgment, relevant to their responsibilities. It is our responsibility as auditors to report to those charged with governance:

- Any risks of material misstatement identified due to fraud
- Any matters we think are relevant to those charged with governance regarding management's process for identifying and responding to the risks of fraud in the entity

The risks of material misstatement due to fraud identified and reported at planning included the presumed risk of management override of controls. We rebutted the presumed risk of fraud in revenue recognition.

Since we last reported to you we have not identified any further risks of material misstatement due to fraud.

We have nothing to report in respect of management's processes for identifying and responding to the risks of fraud.

Other audit findings

Principal risks facing National Highways	As National Highways is complying with the UK Corporate Governance Code, we are required to communicate to you our views on the robustness of the directors' assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity and its outcome, including the related disclosures in the annual report. Whilst we have not performed additional procedures to inform our view, we consider that the assessment was robust and related disclosures are appropriate.
Prospects of National Highways	In addition to the above, we are required to report to you our views about the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate. We also are required to communicate our views on the directors' statements: • in the financial statements, as to whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, including any related disclosures; and • in the annual report as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures. Whilst we have not performed additional procedures to inform our view, we consider that the directors' explanation is robust and related disclosures are appropriate .
The effectiveness of National Highways' system of internal control	Our responsibilities as auditors do not extend to providing an opinion on the overall effectiveness of the system of internal control. However, in our view, based solely upon the audit procedures performed, we consider that the system of internal control is effective

Appendices

Appendix 1 - Audit Scope

We are nearing completion of our audit of the 2022-23 financial statements in accordance with International Standards on Auditing (UK) issued by the Financial Reporting Council and with the audit planning report presented to the Audit and Risk Committee in January 2023.

We have also read the content of the draft annual report and the governance statement to confirm that:

- the parts of the Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 2006;
- in the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have not identified any material misstatements in the Strategic Report or the Directors' Report;
- the information given in the Strategic and Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- that the corporate governance statement has been prepared in accordance with the Companies Act 2006.

As part of our audit, we assessed:

- whether the accounting policies are appropriate to the Company's circumstances and have been adequately disclosed;
- the reasonableness of significant accounting estimates made by the Directors; and
- the overall presentation of the financial statements.

We are also required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Further disclosures on responsibilities:

- ISAs (UK) do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When an extended auditor's report is issued, the auditor's responsibilities are to determine and communicate key audit matters in the auditor's report.
- The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

Appendix 2- Other matters for consideration

Independence	We are independent of National Highways in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, as applied to listed entities. We have fulfilled our ethical responsibilities in accordance with these requirements and have developed important safeguards and procedures in order to ensure our independence and objectivity We reported in our Audit Planning Report issued in January 2023 that we would apply the FRC Ethical Standard as applied to listed entities for this engagement. As National Highways is not a listed entity, we have elected not to formally apply these additional requirements to this engagement. We have not changed our underlying policies on auditor independence and continue to apply more stringent requirements, aligned to those for listed entities, interpreted for the public sector context. Information on NAO quality standards and independence can be found on the NAO website: https://www.nao.org.uk/about-us/our-work/governance-of-the-nao/transparency/.
International standards on Auditing (ISAs) (UK)	We consider that there are no additional matters in respect of items requiring communication to you, per International Standards on Auditing (ISAs) (UK), that have not been raised elsewhere in this report or our audit planning report. Items requiring communication cover: • Fraud • Going concern • National Highways' compliance with laws and regulations • Significant difficulties completing the audit • Disagreements or other significant matters discussed with management • Other matters which may be relevant to the board or the audit committee in the context of fulfilling their responsibilities under the UK Corporate Governance Code
Cooperation with other auditors	Internal Audit Our risk assessment, and the development of our audit plan, was informed by the work of internal audit. We met with Internal Audit as part of our audit planning process to inform our risk assessment have reviewed Internal Audit reports issued during the year identify areas of operating and financial statement risk.

Appendix 2 - Other matters for consideration Cont'd

Communication with the NAO	Organisations we audit tell us they find it helpful to know about our new publications, cross-government insight and good practice. Our website holds a wealth of information from latest publications which can be searched, to pages sharing our insights on important cross-cutting issues. We also publish blogs and send email notifications to subscribers about our work on particular sectors or topics. If you would like to receive these alerts, please sign up at: http://bit.ly/NAOoptin. You will always have the option to amend your preferences or unsubscribe from these emails at any time.
Management of personal data	During the course of our audit we have had access to personal data to support our audit testing. The General Data Protection Regulations (GDPR) came into force in May 2018. These regulations make no difference to the C&G's access rights. The Data Protection Act provides the C&AG with an exemption from the individual rights provisions where to apply the provisions would be likely to prejudice the proper discharge of the C&AG functions. For example this would mean that we would not need to inform an individual about processing nor could an individual object to processing of their information for audit purposes where that would disrupt an efficient audit. We take our obligations under GDPR seriously. We have appointed a Data Protection Officer and all our staff are required to comply with formal data protection policies, guidelines and procedures designed to keep third party data secure and support privacy by design. We will destroy, return, or store personal data as necessary on completion of our work. We confirm that we have discharged those responsibilities communicated to you in the NAO's Statement on Management of Personal Data. The statement on the Management of Personal Data is available on the NAO website: http://www.nao.org.uk/freedom-of-information/publication-scheme/how-we-make-decisions/our-policies-and-procedures/policies-and-procedures-for-conducting-our-business

Appendix 3: Changes to audit quality management standards

In line with the audit profession as a whole, the NAO is adopting a suite of new quality management standards which have been issued by our regulator, the Financial Reporting Council. International Standard on Quality Management (ISQM) (UK) 1 was adopted in the 2022-23 audit cycle and primarily impacted the NAO's central system of quality management. ISQM (UK) 2 and International Standard on Auditing (ISA) (UK) 220, which will take effect from the 2023-24 audit cycle, will have a more direct impact on individual audit engagements. These standards are summarised below.

ISQM (UK) 1
Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements

Effective from 2022-23

This standard required the NAO to design, implement and operate a system of quality management for audit engagements. This has included:

- establishing quality objectives;
- identifying and assessing the risks that could threaten the achievement of those objectives; and
- designing and implementing responses to mitigate those risks.

In implementing ISQM (UK) 1, we have reassessed, refreshed and updated our existing quality control procedures into a proactive, whole-system quality management approach, incorporating our annual Financial Audit Quality Plan. More information on our approach to quality management is provided through our annual Transparency Report.

ISQM (UK) 2
Engagement quality reviews

Effective from 2023-24

This standard sets out the process for appointing engagement quality reviewers, the eligibility criteria for appointment and the process of performing, documenting and concluding engagement quality reviews.

An engagement quality review is an evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, which is carried out during the audit by an independent Director.

Engagement quality reviews are performed on certain audits where required by standards or as a discretionary quality response.

ISA (UK) 220
Quality management for an audit of financial statements

Effective from 2023-24

This standard:

- embeds the concept of quality management at the engagement level;
- contains requirements relating to professional scepticism; and
- strengthens the role of the Engagement Director and their responsibilities for direction, supervision and review of the audit.

Appendix 3: Changes to audit quality management standards

What do the new quality management arrangements mean for audited entities?

From 2023-24 audits onwards, quality management standards will require engagement teams to consider explicitly what actions are required to be taken as part of the audit engagement in response to quality risks that are identified by the NAO's system of quality management and findings from the NAO's ongoing programme of quality monitoring. This may result in changes to audit procedures which have been carried out in previous years, reflecting the responses the engagement team considers necessary to address the quality risks.

The aim is that these changes will enable you to have greater confidence in the quality of our audit.

Feedback on the quality of audit work

Where relevant, our quality responses are informed by feedback received from audited entities. As set out in the terms of our engagement with you, it is our desire to provide you at all times with a high quality service to meet your needs. If at any time you would like to discuss with us how our service to you could be improved or if you are dissatisfied with any aspect of our services, please raise the matter immediately with the Engagement Director. If, for any reason, you would prefer to discuss these matters with someone outside the engagement team, please contact the NAO's Director, Financial Audit Practice and Quality [redacted]@nao.org.uk). We undertake to look into any complaint carefully and promptly and to do all we can to explain the position to you.

Good Practice in Annual Reporting

The Audit Committee plays a key role in scrutinising the Annual Report and Accounts, ensuring the quality of disclosures and its understandability for users.

To support the Audit Committee in this role, we have published our [Good Practice in Annual Reporting] guide.

The Guide, issued in January 2022, provides specific examples of best practice we identified during our review of a sample of 2020-21 annual reports. The good practice principles are grouped under the following headings: supporting accountability, transparency, accessibility and understandability and these should be evident across the common sections of an annual report (below).

Could you be a winner in 2021-22?
If you would like to nominate your organisation for the Building Public Trust Awards for your 2021-22 Annual Report and Accounts, please speak to your NAO Team or contact us at Building.Public.Trust@nao.org.uk.

Good Practice in Annual Reporting

Essential features of a good annual report

Supporting accountability

- telling the story of the organisation in a fair and balanced way;
- compliance with the relevant reporting requirements; and
- clear action points to take forward.

Transparency

- frank and honest analysis;
- consideration of the challenges an organisation is facing;
- appropriate use of data; and
- quantification of risks and performance measures.

Accessibility

- highlights key trends in the financial statements;
- concise summaries of key points; and
- consideration of how the organisation engages with key stakeholders and meets their needs.

Understandable

Use of:

- plain English to explain difficult concepts;
- infographics and diagrams to communicate important messages; and
- clearly integrated structure to help users navigate it effectively.

Audit and Risk Assurance Committee Effectiveness Tool

Audit and Risk Assurance Committees (ARACs) play a crucial role in supporting the effective governance of central government departments, their agencies and arm's-length bodies.

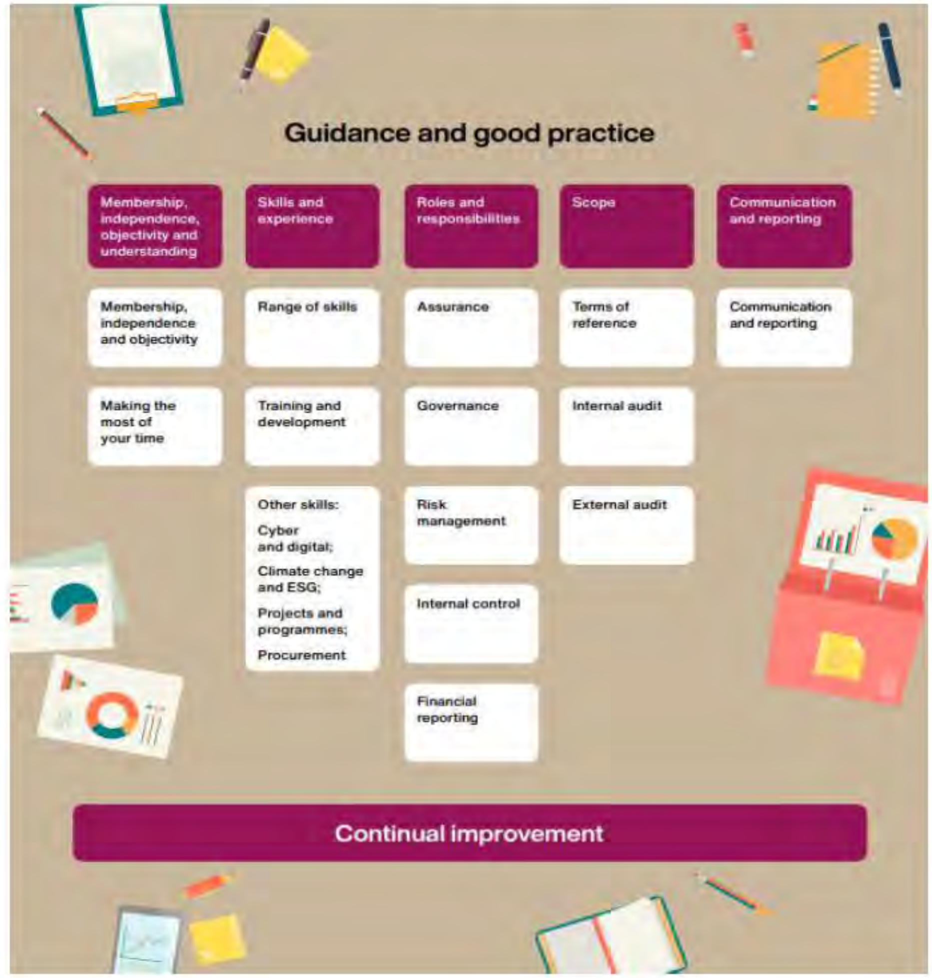
ARACs are operating in a highly challenging context. Government organisations are managing many risks and are required to be resilient to a number of new and increasingly complex pressures. This has created an environment where audit committees need to be dynamic and responsive to the changing risk profiles and demands of their organisations.

Our new and enhanced effectiveness tool is a comprehensive way for ARACs in central government to assess their effectiveness on a regular basis.

The tool provides a way for ARACs to assess their effectiveness against more than just the basic requirements. It provides aspects of good practice to allow ARACs to develop beyond the basic requirements of their role.

Our effectiveness tool outlines six areas for self-assessment:

- **membership, independence, objectivity and understanding**
- **skills and experience**
- **roles and responsibilities**
- **scope**
- **communication and reporting**
- **continual improvement**



Outcome Analyser

To gain an overall view of ARAC effectiveness, it is important that the individual views of all members are considered as a whole. Therefore we have created an accompanying outcome analyser which allows you to:

- generate an overall view of ARAC effectiveness; and
- drill down and analyse specific areas of strength or improvement on a section, sub-section and individual question level.

National Audit Office

National Highways

Audit completion report on the 2022-23 financial statements audit

Report to those charged with governance

20 June 2023 (updated 13 July 2023)

This report presents our findings from the audit of 2022-23 financial statements

Dear Audit Committee Members:

We anticipate recommending to the Comptroller and Auditor General (C&AG) that he should certify the 2022-23 financial statements with an unqualified audit opinion, without modification in respect of both regularity and the true and fair view on the financial statements. The draft Enhanced Audit Report has been shared with the committee in advance of certification.

This report has been reissued to confirm our final audit findings. Changes to the original version are highlighted in yellow.

At the date of this report our audit of the financial statements is complete subject to our final checks on the signed Annual Report and Accounts.

The total audit fee is £348,500. This has slightly increased from the fee set out in the Audit Planning Report (£347,000) due to delays providing evidence on the SRN valuation which meant the NAO incurred additional costs.

Actions for the Audit Committee

The Audit Committee is invited to:

- Review the findings set out in this report, including the audit enhanced audit report and draft letter of representation which are presented as separate items to the committee;
- Consider whether the unadjusted misstatements, set out in the identified misstatements section (page 18), should be corrected. The Audit Committee minutes should provide written endorsement of management's reasons for not adjusting misstatements; and
- Consider the adequacy of the going concern disclosures included in the draft financial statements and conclude on whether this is a fair assessment. We request that this consideration is included in the letter of representation to the Comptroller and Auditor General (C&AG).

We will issue a separate management report of our findings for 2022-23 and progress on prior year recommendations at the next Audit Committee meeting on 5th October. We would like to thank [redacted] and his team for their assistance during the audit process.

Yours Sincerely,

Sarah Che

Contents

Overview

Audit risks (pages 8 to 16)

Presumed risk of management override of controls

We have considered the presumed risk of management override of controls under International Standards on Auditing (ISA (UK) 240).

We have not noted any issues of management override of control in our audit work.

Recognition and measurement of Land and Property Provisions

Our testing of provisions is ongoing, but we are not expecting any material issues. So far, we have noted findings against the risk as a result of testing which include manual entry and VOA input errors to the provisions system. Our auditor's expert has reviewed a sample of underlying land cost estimate valuations and has assessed them as reasonable.

Accounting for the Strategic Road Network (SRN)

We have responded to a more granular breakdown of the risks relating to the SRN this year, which are outlined in more detail on slide 6.

Our expert has reviewed the condition-based depreciation methodology supporting structures and road assets, including confirmation as to the application of the method against a sample of both structures and roads. They have also reviewed the quinquennial valuation of structures and the methodology behind this and confirmed that it is reasonable.

Our work over the SRN is complete.

Overall Materiality (SRN) ~1% of SRN Balance

£1.4bn

Materiality has remained the same level as that reported in the Audit Planning Report. Our overall account materiality is set at approximately 1% of the prior year value of infrastructure assets (SRN and related AUC), reflecting the significant interest among SRN users in the extent and condition of the network.

We did not adjust materiality upwards for the final SRN balances (which would have resulted in a materiality of £1.5bn) so that we could prudently maintain a lower materiality figure, and because the large increase was primarily driven by indexation over which we have performed specific audit procedures for assurance.

We have reported all misstatements above £300k.

Secondary Materiality ~1.5% of total adjusted expenditure

£69.3m

Secondary materiality has remained the same level as that reported in the Audit Planning Report. We set secondary materiality as approximately 1.5 % of total prior year adjusted expenditure and applied to all transactions and balances that reflect cash spending, including SRN capital additions. In practice, this applies to all areas other than the SRN and associated non-cash revaluation and depreciation entries.

We did not adjust materiality upwards for the final outturn expenditure position (which would have yielded a corresponding materiality of £69.6m), so that we could prudently maintain a lower materiality figure.

We have reported all misstatements above £300k.

Overview – Adjusted and unadjusted misstatements

Adjusted misstatements (Page 17)

£3.336m

The current impact of adjusted misstatements is a £3.336m increase to net assets on the statement of financial position and a decrease in expenditure on the statement of comprehensive net expenditure.

One gross adjustment within the SRN note was identified, which resulted in an increase of £1.77bn to net assets and reserves, but net nil impact on the SoFP. See page 18 for detail.

Unadjusted and extrapolated misstatements (Page 18)

£661k

We have identified errors in our sample test of expenditure, accruals and provisions which we have extrapolated. Any extrapolated errors above our reporting threshold have been reported to you in this final audit completion report.

The extrapolated errors result in a £661k increase to net assets on the statement of financial position, with a £661k decrease to expenditure.

Audit risks- detailed breakdown

Accounting for the SRN

Our significant risk relating to the SRN can be broken down to a more granular level, and covers the following risks:

- Disclosures and the SRN balance are incomplete.
- Entries within the SRN database do not exist in real life.
- Impairment of assets has not been considered on a sufficiently frequent basis.
- Depreciation methodology has not been calculated or applied appropriately - including the data used being inappropriate
- Disclosures - revaluation and depreciation estimation uncertainty disclosures are not sufficient or accurate.
- Revaluation – the assumptions, data and method used in the revaluation are not appropriate. There are errors in the revaluation calculation.
- Indexation - assets have not been indexed appropriately. The method of indexation used is not appropriate

Recognition and valuation of land and property provisions

Our significant risk relating to the recognition and valuation of lands provisions can be broken down to a more granular level, and covers the following risks:

- The method used for calculating the land estimate/provision is not appropriate.
- The assumptions used in the calculation of the land estimate are not appropriate.
- The estimation uncertainty and other provision related disclosures are not sufficient or accurate.

Presumed risk of management override of controls

Our presumed significant risk relating to management override of controls can be broken down to a more granular level, and covers the following risks:

- Estimates - management bias impacts judgements and decisions made in arriving at both significant and non significant estimates.
- Management overrides controls to manipulate the financial statements using manual journals.
- Management enters into significant or unusual transactions to engage in fraudulent reporting or to conceal misappropriation of assets or irregular transactions.

Key audit findings

Findings from our work on significant risks

Presumed risk of management override of controls

Details

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by using its position to override controls that otherwise appear to be operating effectively.

This is a presumed risk for all audited bodies under International Standards on Auditing (ISA 240). We have identified no particular risk factors in relation to National Highways.

This significant risk is in line with previous years.

Audit Response, Findings and Conclusion

We have reviewed the accounts preparation process, as well as adjustments made to the accounts in the year-end Extended Trial Balance (ETB). **We have tested ETB adjustments made so far, but our testing is ongoing as we review any further adjustments before the accounts are signed.**

We performed a risk-based analysis of manual journals and selected those which we considered to be high risk (due to size or nature) for testing. We agreed all journals to appropriate evidence and confirmed that they had been appropriately reviewed. **Testing is nearing completion.**

We have tested the significant estimates made by management, including the valuation of the Strategic Road Network, and valuation of accruals and provisions. **Our testing of these estimates is nearing completion.**

We also performed a retrospective review of estimates made in the prior year and found no indication that these were inappropriate.

We reviewed the general ledger for significant and unusual transactions. We did not identify any transactions which we considered to fall into this category.

We have not identified any evidence of management override of controls in our work to date..

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Details

The Strategic Road Network (SRN) and related Assets Under Construction (AUC) balances are significant balances within the financial statements, with a value of £156bn in the draft accounts (2021-22: £143bn).

In accordance with the Government's Financial Reporting Manual (FReM), the value of the SRN is derived using the Depreciated Replacement Cost, which uses the best available information to establish an estimate of replacing the asset with a modern equivalent, less deductions for physical deterioration and relevant obsolescence and optimisation. NH perform revaluation of the SRN on a continuous rolling basis, with each asset type undergoing full revaluation 5-yearly.

There is significant judgement involved in determining the valuation, in particular:

- A number of accounting assumptions implicit in determining the gross valuation.
- Selection of the appropriate indices to apply to reflect changes in costing rates between 5-yearly assessments.
- The appropriate application of asset information to calculate the deduction from gross replacement cost to reflect actual condition (e.g. pavement surveys, engineering info on structures).

This year there are also additional risks of material misstatement relating to the valuation of structures assets, as 2022-23 is a full revaluation year. A full revaluation involves recalculating the unit rates for different structures based on recently completed schemes, as well as ensuring the valuation method and assumptions used remain appropriate. This introduces an additional level of judgement and potential source of calculation error compared to indexed elements.

The valuation of the SRN is a judgemental, complex and highly material estimate for 2022-23, which is subject to significant assumptions, using complex base data and methodologies. Therefore, as in previous years, we have recognised a significant risk.

Capital additions, depreciation and testing of technology assets are outside of the scope of this risk and are subject to our standard audit testing.

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Audit Response, Findings and Conclusion

Controls

- We have reviewed the design and implementation of controls operated by National Highways and Atkins over the asset valuations for the SRN. This confirmed the controls were adequately designed and implemented at year end. The key controls supporting the SRN valuation include quarterly exception reporting and corrections carried out by Atkins on roads and structure valuation runs, as well as review, investigation and sign-off for changes carried out by National Highways in response to issues identified by Atkins.

Substantive

- We reviewed the **revaluation model** (RAAVS) this year and confirmed it was operating in line with our expectations and was applying the valuation methodology and assumptions of Highways appropriately. This included reviewing Atkins work as operator of the RAAVS process as management expert for competence and independence, as required by auditing standards. This did not identify any concerns.
- We obtained assurance over **asset quantities** and their completeness through our testing of the asset databases and RAAVS, checking figures between sources to confirm consistency without omissions.
- We corroborated this by updating NAO modelling work on the road network length using *Openstreetmap* as independent data source. We have reviewed in year additions, road openings and de-trunkings to confirm the closing length for the roads had not significantly changed from the modelling figure (6,906km as at 31 March 2023 compared to 6,841km as at 31 March 2020 which is an insignificant change over 3 years). We also note that the year-on-year movement in road length is a highly insignificant 1km movement. This is consistent with our assumption that the network is slow moving in terms of area quantity.
- As part of existence sample work we reviewed the **classification of land as rural vs urban** (as this significantly affects value) and checked the land take buffer zone against the model data to confirm it is reasonable. No issues were identified from this work.
- The review of the reasonableness of **conditions data for the roads and structures** is complete. Our audit work, including discussions with our expert as to the quality of underlying data and the related depreciation methodology, has not identified any material concerns.
- We have reviewed the work of Transport Research Laboratory (TRL) in certifying the **road survey vehicles used for obtaining the road conditions data**, and performed ISA 500 procedures to confirm their expertise and independence. No issues identified.
- We have challenged brought-forward management judgements in relation to the **AUC Write-down percentages** and **Greenfield Assumptions** this year to refresh our work on high-level assumptions. Our work so far on this has confirmed the judgements remain valid.

Key audit findings

Findings from our work on significant risks.

Accounting for the Strategic Road Network

Audit, Response Findings and Conclusion

Areas of judgement – Indexation

- During 2022-23, **management chose to change the index** used from HECI (a bespoke to index) to the more readily available and public Implied Output Price Indicator (IOPI). We are reviewing the reliability and appropriateness of the index, along with the impact this change has on the financial statements and any indicators of management bias. This is a significant judgement area and our review is ongoing.
- We have confirmed the reasonableness of the **indices used to revalue roads, special structures and technology assets** and ensured that these have been applied through our indexation substantive analytical procedure and benchmarking exercises, including confirming the carry forward of previously audited QQR rates.
- Management originally used the Q3 index to revalue the SRN, however, the movement seen in Q4 when the data was published in early May, was material and resulted in a £1.77bn increase in the valuation of the SRN. This has been reported as a misstatement and management have adjusted for this.
- **Land indexation** saw a £1.3bn rise in asset value. We applied challenge here by reviewing alternative land indices held by the NAO (urban HPI and rural Knight Frank), and reviewing any differences in impact. This work will also consider the reasonableness of indices used by National Highways to index land.

Areas of judgement – Quinquennial Revaluation of Structures

We have performed additional work to review the underlying costing data and assumptions associated with the quinquennial revaluation. This includes engaging a structural engineering expert to assess the methodology used by Highways to value structures as well as an assessment of the costing rates generated as part of this exercise.

Our audit work is complete and we have received our expert's final report. Our work has found that the revaluation exercise has been performed using a limited range of recent costing information, with this focusing solely on the recent A14 project. Whilst we are content the revaluation is materially reasonable, the impact of limited data could be more significant on future valuations.

Although they were due to be undergo quinquennial revaluation this year, Tunnels have been indexed as opposed to a full revaluation due to a lack of recent tunnel costing information within National Highways. Our work is complete and focussed on:

- Challenging management on whether indexation is appropriate, particularly in the context of the QQR for other structures resulting in a downwards valuation of 12.6%, compared with a 12.6% upwards revaluation on Tunnels if indexation is applied (this is the same percentage by coincidence),
- Whether this approach constitutes a material departure from Highways' accounting policies, and
- The appropriate disclosure of this fact, taking into account the above two accounting policies.

Key audit findings

Findings from our work on significant risks

Accounting for the Strategic Road Network

Audit, Response Findings and Conclusion

Areas of judgement – Expert review of Roads and Structures

As set out in our planning report, we have sought advice from a structural engineering expert in respect of Highways' transformation of physical data into depreciation % estimate for roads and structures. Our expert's work is complete in this area, and no significant issues have been raised.

Areas of judgement – Events after the reporting date

In April 2023, the government announced the cancellation of smart motorways. As part of our audit we considered whether this represented a post balance sheet event under *'IAS 10 – Events after the reporting date'* and whether an adjustment was required. Management's judgement is that the cancellation arose after year end and was not an impairment event that existed at the reporting date.

We have reviewed the work of management in reaching this conclusion, seeking evidence to support the judgement, and we are satisfied it is reasonable.

We note that management have begun the process of obtaining approval for the write off of £62m in the 2023-24 financial statements.

Key audit findings

Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Details

Land and property is acquired as part of improving the road network. National Highways recognises a provision in its accounts relating to these acquisitions, which was valued at £406m in the draft accounts (2021-22: £296m). This provision is derived using complex underlying valuations which are inherently judgemental, and therefore the risk of material misstatement is high.

In valuing the provision, NH relies on estimates provided by the Valuation Office Agency (VOA) that often lack a robust evidence base. In 2021-22, we noted an improvement in the data quality, but we have recommended that NH work with VOA to secure better quality evidence for estimates provided, and to increase the level of knowledge sharing within the NH team in relation to the provisions accounting process. Our expert valuer was able to conclude that the estimates were not materially incorrect.

NH recognises provisions based on the stage that a scheme is at. This includes Blight being recognised at Preferred Route Announcement stage, Compulsory Purchase being recognised when a Development Consent Order (DCO)/CPO is granted, and Part 1 at the start of construction. Given the increase in challenges to DCO approvals within the 6 week challenge period after a DCO is granted (in particular for the A303 which resulted in the DCO being overturned), we requested a paper from management on whether that recognition point remains appropriate.

Audit Response, Findings and Conclusion

Controls:

We have carried out an assessment of the design and implementation of controls.

The implementation of controls has improved from the prior year. Following our recommendations, management has:

- Included monthly checks on valuations to ensure they are updated every 6 months; and
- Engaged with the Valuations Office Agency (VOA) to enhance their comments on valuations entered into the National Highways' Lands database (HAL), which stores the valuations for land. Data extracted from HAL is used to calculate the provisions value in the financial statements.

However, there were still a few instances where the valuations had not been updated in over 6 months. We have not sought to rely on controls, and instead performed fully substantive testing over the provisions and aggregation process.

Key audit findings

Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Substantive:

We substantively tested a sample of provisions which included 11 scheme level ('8888') cases and 30 cases relating to individual land parcels.

Provisions are calculated based on a valuation provided by the VOA, adjusted for manual entries and payments made against the provision. Payments consist of genuine payments where part of a provision is settled or a capital addition is made against the scheme, but can also be due to aggregation where individual cases are set up for each claimant and a deduction is made against the scheme level provision to avoid double counting.

We tested the VOA valuation by tracing the values in HAL to either a VOA valuation report or a confirmation email from the VOA outlining the basis of the valuation. We re-performed manual calculations and selected a sub-sample of payments and aggregation against the sampled provisions. For individual cases, we were able to agree the payments to our wider testing of capital expenditure.

Our testing identified the following:

- Sample errors arising due to manual entries being incorrectly calculated by National Highways by using the old methodology rather than the new guidance, or where the totals had been entered incorrectly by the VOA. Most of the errors have been found in the lower value samples.
- Valuations are required to be updated every 6 months, but we have identified some instances where they had not been updated, with one relating to a scheme that is currently paused due to a re-tendering process for a new supplier. We have also noted one instance where the new estimate was submitted in March 2023 but was not approved by year-end.

We note a general reliance on the VOA - although there has also been an improvement in this from the prior year, with additional narrative being added to the files for individual cases. We have noted some instances where the figures have not been added up correctly in the VOA report. The error rate could be reduced with more detailed review.

Through our P13 adjustments review (ETB journals review), we note that an adjustment was posted for manual entry errors etc identified in the samples reviewed as part of the process in March. Whilst this highlights a strengthened review process by the finance team, it is clear that earlier review by the lands team may reduce the number of errors picked up in the finance team and later the audit teams' sample testing.

Following completion of our sampling, we reviewed and extrapolated the errors, which resulted in a net overstatement of £3,059,135.

Key audit findings

Findings from our work on significant risks

Recognition and valuation of Land and Property Provisions

Areas of judgement – application of recognition criteria

We reviewed National Highway's application of the IAS 37 recognition criteria in detail in the prior year and in 2019-20. In the current year, we confirmed the appropriate application of National Highways' recognition policy against each sample item in the provisions sample, no issues were noted.

We challenged management on whether their recognition policy continues to be appropriate, in light of increased challenge to DCO approvals within the six-week challenge period. Management's judgement is that, although there has been an increase in challenge, this has not led to a increase in cases being quashed and therefore their policy remains appropriate. We have evaluated management's judgement, including seeking supporting evidence, and we are satisfied it is appropriate.

Engagement of an expert valuer

We have engaged an auditor's expert (Knight Frank) to review a subset of land and property valuations in detail for 5 of our samples, as well as re-review a sample they reviewed in a previous audit cycle in order to understand any progress made against our recommendations. Based on the expert's initial draft report, they have not raised any significant concerns. Their review has identified similar findings to those in the prior year: that despite the overall positive conclusion, the valuation reports could be more consistent and standardised, as well as provide greater justification and detail for how assumptions have been made and how estimates have been reached.

Knight Frank have set out their findings and provided some recommendations which we will report separately in more detail in our management letter (to the next Audit and Risk Committee meeting).

Key audit findings

Areas of management judgement

The following are the matters which we did not consider to represent significant risks to the financial statements but that the Audit Committee should be aware of, as they are areas of management judgement:

Description	Audit response	Audit findings and conclusion
Accruals	Testing in the prior year identified improvements in Highways process for recording and substantiating accrual values In 2021-22 we noted some errors in testing (extrapolating to a most likely error value of £9.3m), with most items sitting below the £500k balance sheet review threshold adopted by finance. As in 2021-22, this year we stratified our sample population in order to focus our sample on higher value accruals where the risk of material misstatement is greater. We continued to provide a presentation workshop to the business regarding sufficient evidence requirements in our accruals testing prior to the final audit. We also requested that finance business partners submitted evidence for their accruals using the NAO template form (new in 2021-22).	From our testing of accruals, we sampled and reviewed 74 items across the capital (57) and resource (17) accruals population. The capital accruals sample resulted in 12 of the 57 samples being concluded as unsatisfactory. Upon evaluation and extrapolation of these errors, the upper error limit breached materiality at £79m. As a result, we extended our sample test by 14 sample items. A further error was identified but upon updating the error extrapolation, the upper error limit came below materiality at £61m, and a most likely error of £23m so assurance could be taken. The resource accruals sample saw 15 of the 17 sample items being concluded as satisfactory, with the error extrapolation for errors identified resulting in a most likely error of £2.4m, so assurance could be taken. Errors across both populations related to inaccurate assessments of work completed at year end, not using the most up to data figure of expenditure to date, and VAT adjustments. However, the largest error resulted from NH making a debit entry (decrease) to accruals in order to represent a prepayment.
Smart Motorways	Smart Motorways were paused in the previous financial year, however, in April 2023, the government announced that the Smart Motorways programme was being cancelled. As a result, we requested that management prepare a paper setting out their view on accounting for the Smart Motorways decision in line with IAS 10 (Events After the Reporting Period).	The paper prepared by management concluded that Smart Motorways were cancelled in April 2023 and were a non adjusting event on the basis that there were no indicators of the decision at the balance sheet date. We reviewed this position and performed some independent review of media articles, internal communications and government announcements, and concluded that the position reached by management was reasonable

Key audit findings
Areas of management judgement

The following are the matters which we are required to report to the Audit Committee for bodies who follow the UK Corporate Governance Code.

Description	Management's judgement	Our view
Director's assessment of principle risks facing National Highways	Principal risks are owned by the Executive team and monitored by the Board. Collectively, the Board and the Executive team maintain visibility of all risks sitting at principal and secondary levels, including status and mitigation plans, through periodic risk reporting and review process. The principal risks are disclosed in the annual report and are assessed against strategic outcomes including improving safety for all, delivering better environmental outcomes and meeting the needs of all road users.	The disclosures within the annual report as to the Company's risk assessment and management processes are adequate. The Company's risk management process is considered robust. The listed Principal risks it faces that are disclosed are in line with our knowledge of the Company.
Director's assessment of National Highways' future prospects and going concern	The directors have a reasonable expectation that the company has adequate resources to operate for the foreseeable future. The financial statements are therefore prepared on a going concern basis. In forming this view the directors/management have: • Reviewed the company's future funding commitments received from government through the publication of the second Road Investment Strategy (RIS2), which sets out the £24 billion resource and capital funding that the company will receive during the five years from 2020–21 to 2025-26; • Kept DfT fully aware of commitments made which stretch beyond the period covered by the RIS2 period; • Reviewed internal budgets, plans and cash flow forecasts; and • Reviewed DfT's Main Estimate for 2022-23	We have reviewed Management's assessment and agree that the financial statements should be prepared on a Going Concern basis. We have no concerns with management's assessment or disclosure.
Internal controls	The Company establishes internal controls to mitigate risks related to fraud, error or non-compliance with laws and regulations. The Corporate Assurance function provides an objective and independent opinion on the effectiveness of internal control, and the Company participates in DfT's management assurance process.	Following our review of the Company's internal control environment and our work on the design and implementation of controls relating to significant audit risks, we conclude that the entity's system of internal controls affect financial reporting is effective.

Key audit findings

List of adjusted misstatements

Adjusted misstatements

Misstatements that have been identified, adjusted and are above our clearly trivial threshold of £300k have been set out below.

Adjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE		SOFP	
					DR	CR	DR	CR
Inventory write off	Known	£18m of inventory was previously written off a couple of years ago, but not disposed of. In year some of this inventory was disposed of and written off for a second time. This has been corrected. The same issue occurred in the last financial year.	Inventory	£'k			3,336	
			Other expenditure	£'k		3,336		
Indexation uplift to SRN	Known	The indexation figure used in the revaluation was based on Q3, however, the movement between the Q3 and Q4 indices of 1.31% resulted in a material movement to the Net Book Value of the SRN	SRN	£'k			1,770,044	
			Revaluation Reserve	£'k				1,770,044
Accruals	Known	Due to inconsistencies in how the business submitted their balance sheet returns with regards to signage (+ and -), this lead to the majority (volume) of p13 accrual adjustments in ETB004 (the post balance sheet review journal relating to accruals) going in the wrong way round (+ debit, - credit). However the total of this error had an impact of £950k understatement on the accruals balance.	Accruals	£'k				950
			Non Current Assets	£'k			950	
		Cumulative misstatements:	**Debits and credits**			3,336	1,774,330	1,770,944
			Net impact on financial statements			3,336		3,336

Key audit findings

List of unadjusted misstatements

We have identified errors in our sample test of expenditure, accruals and provisions testing, which we have extrapolated below.

Unadjusted misstatements

Title	Error type	Description	Account Line	Unit	SOCNE		SOFP	
					DR	CR	DR	CR
Provisions	Extrapolated	Differences as a result of valuations not input correctly by VOA or manual calculations being miscalculated. Net overstatement.	Provisions	£'k			3,059	
			Expenditure (provisions)	£'k		3,059		
Accruals (Capital)	Extrapolated	Errors identified on capital accruals have been extrapolated across the stratified population. The cumulative most likely error is an understatement of accruals of £23.011m. This includes a known error understatement of £950,349	Accruals	£'k				23,011
			Non Current Assets	£'k			23,011	
Accruals (Resource)	Extrapolated	Errors identified on resource accruals have been extrapolated across the stratified population. The cumulative most likely error is an understatement of accruals by £2,397,642	Accruals	£'k				2,398
			Other Expenditure	£'k	2,398			
Prepayments	Known	Additional prepayments issue identified through review of top 10 debit accruals in the resource accruals population	Accruals					459
			Prepayments				459	
		Cumulative misstatements:	**Debits and credits**		2,398	3,059	26,529	25,688
			Net impact on financial statements			661	661	

Other audit findings

Financial statement disclosures	We have challenged management over the adequacy of disclosures in the financial statements in the following areas: • Enhancement of PFI service charge disclosure to explain the difference between the in year SoCNE figure and the prior year current service charge obligation • Enhancement of cash disclosures given the negative cash balance in year • Capital commitments - we noted that the M42 scheme (£89m) has not been included in NH's disclosure of its highest-value schemes despite being higher-value than 3 of the schemes currently disclosed. We raised with NH who do not intend to update the disclosure. As we consider capital commitments against our primary materiality threshold, no individual scheme is material and NH's inclusion of high value schemes is voluntary. We therefore considered whether the omission is qualitatively material to the users of the accounts and concluded that given the number and nature of NH's schemes and the fact that the M42 scheme is discussed elsewhere in the Annual Report that the omission is not material. We have made a number of other suggestions to improve narrative disclosures and to ensure completeness of the disclosures required under the Companies Act (2006), FReM and other relevant guidance. We will review subsequent versions of the financial statements in order to conclude that the required changes have been made.
Accounting policies and financial reporting	We have performed the following procedures with regards to the appropriateness of the judgements made by the entity on accounting policies, particularly new or changed policies • Ensured that all accounting policies are in line with IFRS. We have performed the following procedures on the appropriateness of the judgements made by the entity on the required accounting estimates: We have performed procedures on the appropriateness of the judgements made by the entity on the required accounting estimates, such as those detailed against our SRN valuation and provisions significant risks, and those specified against our accruals risk factor in this report. There are no material inconsistencies in the annual report that have not been corrected. We are content that the accounting policies are complete, accurate and compliant with the relevant standards and have been appropriately applied.
Regularity, propriety and losses	We found no issues of irregularity or impropriety during our audit.

Other audit findings Cont'd

Risk of Fraud

We shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in our auditor's judgment, relevant to their responsibilities. It is our responsibility as auditors to report to those charged with governance:

- Any risks of material misstatement identified due to fraud
- Any matters we think are relevant to those charged with governance regarding management's process for identifying and responding to the risks of fraud in the entity

The risks of material misstatement due to fraud identified and reported at planning included the presumed risk of management override of controls. We rebutted the presumed risk of fraud in revenue recognition.

Since we last reported to you we have not identified any further risks of material misstatement due to fraud.

We have nothing to report in respect of management's processes for identifying and responding to the risks of fraud.

Other audit findings

Principal risks facing National Highways	As National Highways is complying with the UK Corporate Governance Code, we are required to communicate to you our views on the robustness of the directors' assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity and its outcome, including the related disclosures in the annual report. Whilst we have not performed additional procedures to inform our view, we consider that the assessment was robust and related disclosures are appropriate.
Prospects of National Highways	In addition to the above, we are required to report to you our views about the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate. We also are required to communicate our views on the directors' statements: • in the financial statements, as to whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, including any related disclosures; and • in the annual report as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures. Whilst we have not performed additional procedures to inform our view, we consider that the directors' explanation is robust and related disclosures are appropriate .
The effectiveness of National Highways' system of internal control	Our responsibilities as auditors do not extend to providing an opinion on the overall effectiveness of the system of internal control. However, in our view, based solely upon the audit procedures performed, we consider that the system of internal control is effective

Appendices

Appendix 1 - Audit Scope

We are nearing completion of our audit of the 2022-23 financial statements in accordance with International Standards on Auditing (UK) issued by the Financial Reporting Council and with the audit planning report presented to the Audit and Risk Committee in January 2023.

We have also read the content of the draft annual report and the governance statement to confirm that:

- the parts of the Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 2006;
- in the light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have not identified any material misstatements in the Strategic Report or the Directors' Report;
- the information given in the Strategic and Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- that the corporate governance statement has been prepared in accordance with the Companies Act 2006.

As part of our audit, we assessed:

- whether the accounting policies are appropriate to the Company's circumstances and have been adequately disclosed;
- the reasonableness of significant accounting estimates made by the Directors; and
- the overall presentation of the financial statements.

We are also required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Further disclosures on responsibilities:

- ISAs (UK) do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When an extended auditor's report is issued, the auditor's responsibilities are to determine and communicate key audit matters in the auditor's report.
- The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

Appendix 2- Other matters for consideration

Independence	We are independent of National Highways in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, as applied to listed entities. We have fulfilled our ethical responsibilities in accordance with these requirements and have developed important safeguards and procedures in order to ensure our independence and objectivity We reported in our Audit Planning Report issued in January 2023 that we would apply the FRC Ethical Standard as applied to listed entities for this engagement. As National Highways is not a listed entity, we have elected not to formally apply these additional requirements to this engagement. We have not changed our underlying policies on auditor independence and continue to apply more stringent requirements, aligned to those for listed entities, interpreted for the public sector context. Information on NAO quality standards and independence can be found on the NAO website: https://www.nao.org.uk/about-us/our-work/governance-of-the-nao/transparency/.
International standards on Auditing (ISAs) (UK)	We consider that there are no additional matters in respect of items requiring communication to you, per International Standards on Auditing (ISAs) (UK), that have not been raised elsewhere in this report or our audit planning report. Items requiring communication cover: • Fraud • Going concern • National Highways' compliance with laws and regulations • Significant difficulties completing the audit • Disagreements or other significant matters discussed with management • Other matters which may be relevant to the board or the audit committee in the context of fulfilling their responsibilities under the UK Corporate Governance Code
Cooperation with other auditors	Internal Audit Our risk assessment, and the development of our audit plan, was informed by the work of internal audit. We met with Internal Audit as part of our audit planning process to inform our risk assessment have reviewed Internal Audit reports issued during the year identify areas of operating and financial statement risk.

Appendix 2 - Other matters for consideration Cont'd

Communication with the NAO	Organisations we audit tell us they find it helpful to know about our new publications, cross-government insight and good practice. Our website holds a wealth of information from latest publications which can be searched, to pages sharing our insights on important cross-cutting issues. We also publish blogs and send email notifications to subscribers about our work on particular sectors or topics. If you would like to receive these alerts, please sign up at: http://bit.ly/NAOoptin. You will always have the option to amend your preferences or unsubscribe from these emails at any time.
Management of personal data	During the course of our audit we have had access to personal data to support our audit testing. The General Data Protection Regulations (GDPR) came into force in May 2018. These regulations make no difference to the C&G's access rights. The Data Protection Act provides the C&AG with an exemption from the individual rights provisions where to apply the provisions would be likely to prejudice the proper discharge of the C&AG functions. For example this would mean that we would not need to inform an individual about processing nor could an individual object to processing of their information for audit purposes where that would disrupt an efficient audit. We take our obligations under GDPR seriously. We have appointed a Data Protection Officer and all our staff are required to comply with formal data protection policies, guidelines and procedures designed to keep third party data secure and support privacy by design. We will destroy, return, or store personal data as necessary on completion of our work. We confirm that we have discharged those responsibilities communicated to you in the NAO's Statement on Management of Personal Data. The statement on the Management of Personal Data is available on the NAO website: http://www.nao.org.uk/freedom-of-information/publication-scheme/how-we-make-decisions/our-policies-and-procedures/policies-and-procedures-for-conducting-our-business

Appendix 3: Changes to audit quality management standards

In line with the audit profession as a whole, the NAO is adopting a suite of new quality management standards which have been issued by our regulator, the Financial Reporting Council. International Standard on Quality Management (ISQM) (UK) 1 was adopted in the 2022-23 audit cycle and primarily impacted the NAO's central system of quality management. ISQM (UK) 2 and International Standard on Auditing (ISA) (UK) 220, which will take effect from the 2023-24 audit cycle, will have a more direct impact on individual audit engagements. These standards are summarised below.

ISQM (UK) 1
Quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements

Effective from 2022-23

This standard required the NAO to design, implement and operate a system of quality management for audit engagements. This has included:

- establishing quality objectives;
- identifying and assessing the risks that could threaten the achievement of those objectives; and
- designing and implementing responses to mitigate those risks.

In implementing ISQM (UK) 1, we have reassessed, refreshed and updated our existing quality control procedures into a proactive, whole-system quality management approach, incorporating our annual Financial Audit Quality Plan. More information on our approach to quality management is provided through our annual Transparency Report.

ISQM (UK) 2
Engagement quality reviews

Effective from 2023-24

This standard sets out the process for appointing engagement quality reviewers, the eligibility criteria for appointment and the process of performing, documenting and concluding engagement quality reviews.

An engagement quality review is an evaluation of the significant judgments made by the engagement team and the conclusions reached thereon, which is carried out during the audit by an independent Director.

Engagement quality reviews are performed on certain audits where required by standards or as a discretionary quality response.

ISA (UK) 220
Quality management for an audit of financial statements

Effective from 2023-24

This standard:

- embeds the concept of quality management at the engagement level;
- contains requirements relating to professional scepticism; and
- strengthens the role of the Engagement Director and their responsibilities for direction, supervision and review of the audit.

Appendix 3: Changes to audit quality management standards

What do the new quality management arrangements mean for audited entities?

From 2023-24 audits onwards, quality management standards will require engagement teams to consider explicitly what actions are required to be taken as part of the audit engagement in response to quality risks that are identified by the NAO's system of quality management and findings from the NAO's ongoing programme of quality monitoring. This may result in changes to audit procedures which have been carried out in previous years, reflecting the responses the engagement team considers necessary to address the quality risks.

The aim is that these changes will enable you to have greater confidence in the quality of our audit.

Feedback on the quality of audit work

Where relevant, our quality responses are informed by feedback received from audited entities. As set out in the terms of our engagement with you, it is our desire to provide you at all times with a high quality service to meet your needs. If at any time you would like to discuss with us how our service to you could be improved or if you are dissatisfied with any aspect of our services, please raise the matter immediately with the Engagement Director. If, for any reason, you would prefer to discuss these matters with someone outside the engagement team, please contact the NAO's Director, Financial Audit Practice and Quality [redacted] We undertake to look into any complaint carefully and promptly and to do all we can to explain the position to you.

Good Practice in Annual Reporting

The Audit Committee plays a key role in scrutinising the Annual Report and Accounts, ensuring the quality of disclosures and its understandability for users.

To support the Audit Committee in this role, we have published our [Good Practice in Annual Reporting] guide.

The Guide, issued in January 2022, provides specific examples of best practice we identified during our review of a sample of 2020-21 annual reports. The good practice principles are grouped under the following headings: supporting accountability, transparency, accessibility and understandability and these should be evident across the common sections of an annual report (below).

Could you be a winner in 2021-22?
If you would like to nominate your organisation for the Building Public Trust Awards for your 2021-22 Annual Report and Accounts, please speak to your NAO Team or contact us at Building.Public.Trust@nao.org.uk.

Good Practice in Annual Reporting

Essential features of a good annual report

Supporting accountability

- telling the story of the organisation in a fair and balanced way;
- compliance with the relevant reporting requirements; and
- clear action points to take forward.

Transparency

- frank and honest analysis;
- consideration of the challenges an organisation is facing;
- appropriate use of data; and
- quantification of risks and performance measures.

Accessibility

- highlights key trends in the financial statements;
- concise summaries of key points; and
- consideration of how the organisation engages with key stakeholders and meets their needs.

Understandable

Use of:

- plain English to explain difficult concepts;
- infographics and diagrams to communicate important messages; and
- clearly integrated structure to help users navigate it effectively.

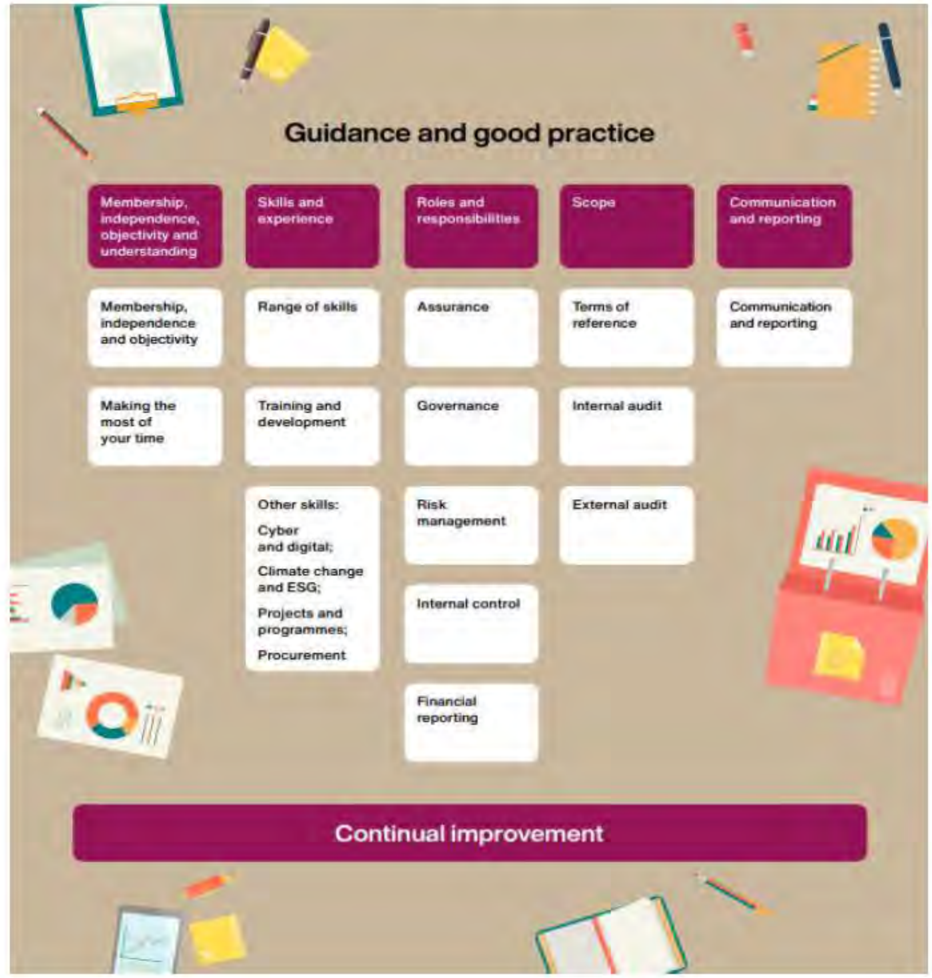
Audit and Risk Assurance Committee Effectiveness Tool

Audit and Risk Assurance Committees (ARACs) play a crucial role in supporting the effective governance of central government departments, their agencies and arm's-length bodies.

ARACs are operating in a highly challenging context. Government organisations are managing many risks and are required to be resilient to a number of new and increasingly complex pressures. This has created an environment where audit committees need to be dynamic and responsive to the changing risk profiles and demands of their organisations.

Our new and enhanced effectiveness tool is a comprehensive way for ARACs in central government to assess their effectiveness on a regular basis.

The tool provides a way for ARACs to assess their effectiveness against more than just the basic requirements. It provides aspects of good practice to allow ARACs to develop beyond the basic requirements of their role.



Our effectiveness tool outlines six areas for self-assessment:

- **membership, independence, objectivity and understanding**
- **skills and experience**
- **roles and responsibilities**
- **scope**
- **communication and reporting**
- **continual improvement**

Outcome Analyser

To gain an overall view of ARAC effectiveness, it is important that the individual views of all members are considered as a whole. Therefore we have created an accompanying outcome analyser which allows you to:

- generate an overall view of ARAC effectiveness; and
- drill down and analyse specific areas of strength or improvement on a section, sub-section and individual question level.