October 2024

National Audit Office

2023/24 Audit Quality Inspection

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Purpose of the report

This report sets out the principal findings arising from the 2023/24 inspection of the National Audit Office's (the "NAO") audits of 2022/23 financial statements carried out by the Audit Quality Review team ("AQR") of the Financial Reporting Council ("the FRC"). The detailed inspection work was conducted in the period from January 2024 to May 2024 ("the time of our inspection") in accordance with our terms of reference agreed in 2024. Further information on our inspection remit is set out in Appendix 2.

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

Our report focuses on the key areas requiring action by the NAO to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the NAO's audit work. Our findings cover matters arising from our inspection of both individual audits and a review of the NAO's policies and procedures which support and promote audit quality.

1. Overview

Scope of our 2023/24 inspection

The population from which the risk-based sample of audits was chosen varied in complexity, size and risk, with 160 of the 396 audited entities having revenues of between £10 million and £500 million and 64 having revenues in excess of £1 billion.

For the sample of audits inspected, revenue/net operating income ranged from £2 million to £10 billion. One entity did not have any income and reported a net loss before tax of £3.8 million.

We examined aspects of seven individual audit engagements, all of which had year-ends dated 31 March 2023. We inspected five Companies Act audits out of 60 audits performed (prior year: five out of 70 audits) and two non-Companies Act audits out of 336 audits performed (prior year: four out of 336 audits)[1]. The NAO audits four public interest entities; none of these were inspected in the year.

In the year to 31 March 2023, there were 116 contracted-out non-Companies Act audits which the NAO excluded from selection. This is where the NAO retains overall responsibility and issues the audit opinion, but contracts with an audit firm to perform the audit. During this period, there were no Companies Act audits performed on a contracted-out basis.

Following the introduction of ISQM 1, the new standard on audit quality management, we also undertook our first review of the NAO's system of quality management, including a focused review of design & implementation, monitoring and remediation, evaluation and acceptance and continuance.

We will continue to consider and evaluate the adequacy of the number of non-Companies Act audits inspected on a voluntary basis and discuss scoping and sample sizes of all audits with the Comptroller and Auditor General (C&AG).

We currently report privately to the NAO on each audit inspected and on our overall inspection cycle. Historically, the C&AG has sought and obtained the FRC's permission to publish our overall report on the NAO's website, and we are amenable to continuing with this approach. In respect of our statutory work on Companies Act audit inspections, we also report to the FRC Board (in its capacity as the Independent Supervisor).

Summary of inspection findings

We inspected seven individual audits this year (five Companies Act and two non-Companies Act audits), which was two fewer than the prior year, due to a reduction in the number of inspections of non-Companies Act audits commissioned by the NAO.

From the AQR inspections performed, audit quality in this cycle has improved compared to the prior year, although we have not yet seen the consistent improvements in audit quality that were anticipated under the NAO's Quality Plan, launched in January 2021. Whilst the improvement in quality results is encouraging this year, the NAO should continue to focus on delivering its new Quality First plan (introduced in April 2024) and prioritise detailed and timely root cause analysis for these audit quality inspection results to aid the development of a robust and comprehensive action plan.

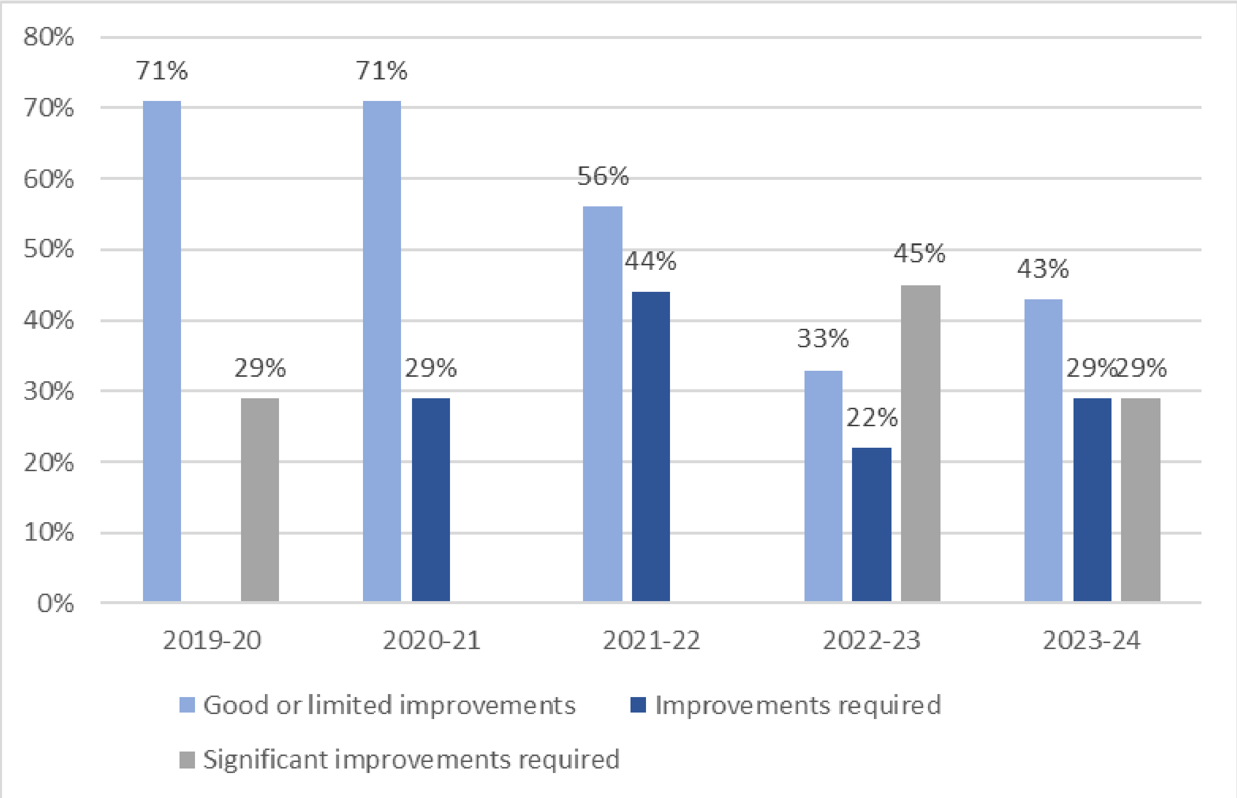
We assessed three of the seven audits inspected (43%) as requiring no more than limited improvements, an improvement from 33% in the previous year but lower than 56% in 2021/22 and

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

still disappointing compared to the average quality of the Tier 1 audit firms, where, in 2022/23, 74% of audits inspected required no more than limited improvements. We found there was a difference in the quality of the Companies Act audits we inspected (where three of the five, 60%, required no more than limited improvements) and the non-Companies Act audits (where one was assessed as requiring improvement and the other as requiring significant improvement). The findings from our 2023/24 inspection cycle results were varied. Details of key findings driving this assessment are outlined on page 11.

Of the audits inspected in the current year which required more than limited improvements, two (one Companies Act and one non-Companies Act) were assessed as Grade 4 i.e. requiring significant improvements (prior year: four audits). This is concerning as this is the second consecutive year with Grade 4 results following two years with none. A quality assessment of significant improvements indicates that there are serious concerns regarding the sufficiency or quality of audit evidence, a greater than acceptable risk of an unidentified material misstatement, or that there are major concerns regarding the appropriateness of significant audit judgments in the areas reviewed.

*Our assessment of the quality of audits inspected**



* The table includes results of both Companies Act and non-Companies Act Audits inspected. An audit is assessed as good or limited improvements required where we identified either no or only limited concerns to report. Improvements required indicate that more substantive improvements were needed in relation to one or more issues. Significant improvements required indicate we had significant concerns, typically in relation to breaches of the Revised Ethical Standard 2019, the sufficiency or quality of audit evidence or the appropriateness of key audit judgments.

The table refers to the FRC inspection year, rather than the financial year being audited (for example, the 2023/24 column refers to the NAO's audits of 2022/23 financial statements).

Changes to the proportion of audits falling within each category can reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. For these reasons, and given the sample sizes involved, our inspection findings may not be representative of audit quality across the NAO's entire audit portfolio; nor do small year-on-year changes in results necessarily indicate any overall change in audit quality at the NAO.

Key inspection findings

Our key findings related principally to the need to:

- Improve the audit procedures over risk assessment and scoping;
- Improve the audit procedures over the valuation of harder-to-value assets;
- Improve the evaluation and challenge of management over key judgments and estimates;
- Improve the consideration and testing of journal entries to respond to the risk of fraud and management override of controls;
- Improve the audit procedures over accounting for joint venture investments; and
- Improve the consistency of the internal quality review process.

Audit quality in this cycle has improved compared to the prior year but over the last three inspection cycles we have seen a deterioration in audit quality. This follows a period in which the NAO has rolled out its Audit Transformation Programme, enhanced its audit methodology, including the development of centres of excellence, introduced new template workpapers, and developed new audit software, which was partly deployed on the audits inspected this year. Even so, any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for the NAO to take further action to ensure consistency in audit execution, and to evaluate what changes are needed to deliver the improvements required within an 18 month timeframe.

We have recurring findings relating to valuations, judgments and estimates, and journals, and there are also significant findings this year relating to risk assessment and scoping, and the audit of deferred tax and equity-accounted investments.

It is clear from the FRC's regular meetings with the C&AG that he takes a close personal interest in matters relating to audit quality and in ensuring audit teams have the necessary skills and tools to deliver quality audits. We have seen positive actions where the NAO has taken steps to address the key findings in our 2022/23 report, including the roll out of new audit programmes and checklists to assist with the audit of harder to value assets and root cause analyses to assess the reasons for all lower AQR inspection grades. During the year, the C&AG also reallocated internal management responsibilities, which contributed to a more effective and timely completion of this year's inspections.

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

The NAO must consider the effectiveness and timeliness of its previous interventions to improve audit quality, the results of the NAO's root cause analysis on the recurring findings, and why the response so far has not been able to restore quality to those levels last seen in 2019/20 and 2020/21.

In the previous three inspection cycles, we identified an unacceptable trend of poorer audit quality relating to financial services and audits of financial services-related balances of other entities. Whilst we had seen evidence of some improvement, such as the investment in centres of expertise, we asked the NAO to consider these issues urgently and identify steps to improve the quality of this work. More specifically, we noted that the NAO needed to consider whether it had the necessary skills and expertise in this area given the complexities of auditing valuation models (such as those frequently used in the determination of provisions and fair value estimates in these types of entities).

In this inspection cycle we have seen further evidence of improvement in these areas, such as the use of enhanced template workpapers for the audit of investments. Notwithstanding this and the actions already taken by the NAO, including the improved use of auditor experts on some audits, we continue to identify significant failings in the audit of these areas.

In the current inspection cycle, we inspected four entities in the financial services sector or with financial services-related balances. We assessed the work on one large department and one small sized company as requiring significant improvements. For the small sized company, the key findings were not related to the financial services-related balances. The other two audits where improvements were required were not impacted by financial services-related balances or entities in that sector, but both did have assets whose valuation involved key judgments and estimates.

We are encouraged to see the NAO's commitment to making the required improvements through the ongoing training initiatives and the continued investment in its centres of expertise and the establishment of framework agreements to provide access to external expertise. We were pleased to see that the findings which, in last year's inspections, had led to one audit being assessed as significant improvements required had been fully addressed in the audit of a similar company inspected this year. The audit inspected this year was assessed as only limited improvements required.

These findings highlight that, following its implementation of the Audit Transformation Programme, the NAO must re-assess whether the changes implemented for 2023/24 and further planned changes are sufficient to remediate the audit shortcomings identified from the inspections in the current and prior year. The NAO must demonstrate that further improvements have been made in its audits of financial services entities, and those with harder to value assets, which we will continue to inspect. In respect of the two audits assessed as requiring significant improvements and the two audits assessed as requiring improvements, the NAO has completed a thorough Root Cause Analysis ("RCA") on the issues that led to quality standards not being met. We will closely monitor and assess the effectiveness and appropriateness of the NAO's actions to address the findings raised.

Good practice

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

Good practice observations

Execution

On one Companies Act audit the team carried out media searches, identifying an impaired 'harder to value' asset which management had not identified. Experienced audit team members focused their attention on 'harder to value' assets, while staff from the NAO's 'centre of excellence' assisted with the audit of lower risk investments. On this same audit the team prepared a detailed evaluation of judgments made previously on the valuation methodology, their consistency with applicable accounting standards, and the continued appropriateness of these evaluations.

On another Companies Act audit in addition to using an auditor's expert, the audit team formed its own independent view using data captured from other NAO pension scheme audits to benchmark the defined benefit pension obligation assumptions.

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

Review of the NAO's system of quality management ("firm-wide")

This year, our firm-wide work focused on the NAO's implementation of the new International Standard on Quality Management (UK) 1 (ISQM 1) and the NAO's system of quality management (SoQM). The new standard requires a significantly different approach to the management of risks to audit quality. The findings below should be understood in the context of the first year adoption of a new standard. All Tier 1 firms also had some findings in this area. We focused on the following areas:

- Design and implementation;
- Monitoring and Remediation;
- Evaluation; and
- Acceptance and Continuance.

In its self-evaluation of the SoQM, the NAO concluded that except for matters related to identified deficiencies that have a severe but not pervasive effect on the design, implementation and operation of the system of quality management, the system of quality management provided the organisation with reasonable assurance that the objectives of the system of quality management were being achieved.

Our inspection identified a number of deficiencies in different aspects of the SoQM. These have been reported to the NAO, and an action plan agreed to address the deficiencies.

Our key findings in these areas related principally to aspects of:

- Design and implementation, since there was no evidence that the quality system had been fully implemented by 15 December 2022, as required by ISQM 1, and incomplete mapping of identified risks to responses to mitigate those risks;
- Monitoring and Remediation, since no monitoring of the ISQM 1 system was planned or undertaken to assess the design, implementation and operating effectiveness of responses to mitigate risks to audit quality or to assess whether such risks were sufficiently mitigated;
- Evaluation, since this was not completed and approved by 15 December 2023 as required by ISQM 1, and because it was not clear how all identified deficiencies were due to be remediated on a timely basis and how their aggregate impact was not considered severe or pervasive;
- Required communications about the conclusions reached in the evaluation, since these were not issued on a timely basis; and
- Contracted out audits, since the NAO's existing monitoring processes for contracted out audits were not clearly linked to ISQM 1 requirements.

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

The FRC, in its role as an improvement regulator, is providing additional support to the NAO from this year with the allocation of a supervisor to work alongside the NAO to assess the effectiveness of the NAO's audit quality initiatives, including reviewing the formulation and progress on action plans, root cause analysis and quality improvement plans. The FRC has also brought forward its inspection timetable to enable the NAO to respond to any inspection findings before the next cycle of audits is completed.

NAO's overall response

Audit quality is the top priority for the NAO Board, the Executive Team and the whole organisation, and these results highlight the need for our continued investment in the quality of our financial audit work. We are encouraged that the Financial Reporting Council's inspections of our 2022/23 audits recognised some improvements arising from our investments in quality, including in areas where there have been longstanding findings, however, the results are disappointing and still unsatisfactory overall.

The results demonstrate that we can and do deliver quality audits and this indicates to us that there are no fundamental problems with our audit methodology. However, these findings tell us that we need to do more so that we meet standards on a consistent basis across all our audits.

We are fully focused on meeting and keeping pace with regulatory expectations for financial audit and we are working hard to address the underlying causes of the issues found.

We reached a significant milestone of our Audit Transformation Programme in late 2023, with the rollout of our new financial audit software platform, Apex, on time and on budget. Apex helps support quality and efficiency through guided workflows, automation, and standardisation. All our audit teams are using Apex for the first time – combined with our new audit and sampling methodologies which we implemented over the last two years - for our audits of government's 2023/24 accounts which will be inspected during 2024/25.

We are continuing to work on realising fully the benefits of the substantial investment we have made in our new methodology and audit platform, including through consistent high-quality, improved efficiency and better management information, as well as enhancing our system of quality management.

In January 2024, we strengthened the management arrangements for our audit service line and, in April 2024, we launched our "Quality First Plan", our new quality improvement plan. This plan initially relates to 2024/25; we will update it as needed during 2024/25, and for 2025/26, informed by quality findings and root cause analysis, Our new plan brings together all our quality improvement and transformation activity into a single plan and delivery programme. We have established a Quality First Programme Board to oversee delivery of the plan in 2024/25 and 2025/26.

We have shaped our Quality First Plan through comprehensive diagnostic analyses informed by: external and internal quality reviews, root cause analysis reviews and colleague feedback. We've also looked externally, to learn from others in the profession. With these insights, we developed six key pillars (in our Table below) which are the core elements of our Plan. Using these, we've designed more targeted interventions to accelerate the benefits of our transformation programme, as well as introducing fresh measures to strengthen areas of our System of Quality Management requiring improvement.

Table: The actions we are taking to improve the quality of our audits: the key pillars of our Quality First Plan

Learning & culture	**Nurturing a quality first culture and improving capability** – more and better L&D, refreshed approach to engagement and comms, a greater understanding of our culture and a focus on behaviours
Resources	**Improving capacity, capability and resilience** – more resources, increased productivity, improved planning and management, better recruitment processes, a new contracting out model.
Methodology and Support	**Supporting colleagues with best practice methodology, policies and practice** – a new support model with Quality Directors and business partners; clarified and enhanced audit procedures; new sampling approach; more investment in centres of expertise; and an enhanced quality support framework for high-risk audits
Technology	**Taking opportunities to use technology to improve audit** – delivering enhancements to Apex, a new engagement portal, increasingly adopting IT controls, data analytics, new AI technologies; and improved sampling, journals and AIMS applications.
Assurance	**Robust monitoring and assurance** – accelerated "cold" and "in flight" review models; enhanced audit quality indicators and dashboards; improved root cause analysis; and better dissemination of lessons learnt.
Our context	**Influencing our external auditing environment and stakeholders** – enhanced engagement with stakeholders and audited entities to support improved audit quality.

Source: National Audit Office

As an immediate response to the feedback from this latest AQR inspection cycle, we have implemented a series of measures to support audit teams for the 2023/24 audit cycle:

- we issued an emerging findings bulletin and a mandatory quality review checklist covering all new inspection findings;
- we delivered a programme of Spring Accelerator training covering key quality issues; and
- we issued guidance for our teams to use in their discussions with audited bodies and their audit committees to support high-quality audit work.

We have completed the root cause analysis programme on the audits reviewed by AQR and the actions arising are being taken forwards under our Quality First plan and associated training programmes.

In addition, we have agreed with the FRC that they will appoint a Supervisor for the NAO, in line with practice for Tier 1 firms, to provide additional support and challenge to our quality improvement plans.

Financial Audit is a demanding, highly skilled profession. We navigate a landscape shaped by complex accounting and auditing standards, regulatory expectations for audit quality and the rising expectations of stakeholders. We are confident that we have the right initiatives in place to respond to the inspection findings and ensure we improve our audit quality and deliver high-quality audits consistently.

Engagement with Audit Committees

As noted in previous reports, because of the statutory position of the C&AG, our reporting to the NAO differs from that of the major audit firms where we send private reports on each inspection directly to the chair of the Audit Committee and issue a public report on our overall inspection findings at each major firm.

Given the quality results in the last two years, publication by the NAO of this private inspection report and the part that Audit Committees can usefully play in assessing and monitoring audit quality, we strongly encourage the NAO to increase the transparency around our inspection reports, by improving both the communication of our inspection results and related engagement with Audit Committees.

In the following inspection cycle, for all Companies Act audits inspected, we plan to engage with the Audit Committee Chairs at planning and final stages of the inspection, which is consistent with our inspections of major audit firms. We recommend the scope of our work for the non-Companies Act audits we inspect is also extended to include this by the NAO.

In June 2023 the NAO launched an initiative with audit chairs of the bodies it audits to prompt discussions with each committee on the quality of its audit work. These discussions will allow debate on the detail in the NAO's annual transparency report and its quality findings more generally.

The NAO continues to take forward its on-going commitment to improve its transparency and accountability. A key development in recent years has been to work with the Public Accounts Commission ("the Commission"), on behalf of Parliament, so that the Commission is able to scrutinise effectively the quality of the NAO's financial audit work. The Government announced in the King's Speech that it will bring forward a bill on audit reform and corporate governance which may update the accountability arrangements for the NAO's audit quality, including the role of the Commission, through legislation.

Controls based audits

We note that, currently, the NAO adopts only limited controls (including IT controls) testing where they rely upon the design, implementation and operating effectiveness of management internal controls. In 2023/24, only 13 audits (approximately 4% of all audits conducted) tested the operating effectiveness of internal controls, including two large Government departments where controls were relied on for the first time. Controls based approaches are typically applied to the largest audits in the NAO's portfolio. We note that this proportion of controls based audits is lower than found at major audit firms (approximately 10%), reflecting the age of the systems in place within the NAO's audited bodies. We encourage the NAO to continue to seek opportunities with its audited bodies to increase the number of controls based audits, particularly on the largest entities subject to audit, providing some assurance and reliance on the internal controls environment.

NAO's internal quality monitoring results

We have previously raised concerns over delays in the NAO's Internal Quality Monitoring (IQM) process. The IQM process consists of a sample of completed audit files being selected each year by the NAO for a retrospective internal audit quality inspection. This year there has been a noticeable improvement in the timeliness with which the IQM inspections were completed, as 21 of 23 inspections of 31 March 2023 audits were completed by 31 May 2024, with the final review concluded on 12 August 2024. This is significantly slower than we see at Tier 1 audit firms. We recommend an action for the NAO to further increase timeliness so that all IQM inspections are completed before the following year-end date, so that remedial actions in response to their findings can be implemented in those next year's audits.

Overall, the NAO's monitoring found that of the 23 audits assessed, 8 (35%) were found to require improvements/significant approvements, while 15 (65%) were judged to be good or requiring only limited improvements.

Developments in audit regulation

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

2. Review of individual audits

We set out below the key areas where we believe improvements are required to enhance the NAO's audit quality. As well as findings on audits assessed as requiring significant improvements and requiring improvements, the key findings can include those on individual audits assessed as requiring limited improvements if they are considered key due to the extent of occurrence across the audits we inspected.

We asked the NAO to provide a response setting out the actions it has taken or will be taking in each of these areas.

Improve the audit procedures over risk assessment and audit scoping

Risk assessments and audit scoping are critical to ensuring that appropriate and adequate audit procedures are planned to address the risk of material misstatements.

Key findings

On one group audit, assessed as significant improvements required, the audit team:

- Did not undertake a comprehensive risk assessment, particularly in relation to pervasive IT control deficiencies in the systems whose data was used in the calculation of asset values; and

- Did not evidence nor justify how it was appropriate to exclude the subsidiary which was responsible for processing and controlling this data from its list of significant components.

NAO Actions

All the key findings on improving audit procedures over risk assessment and audit scoping relate to one inspected audit only.

We have made significant investment in our risk assessment through implementing a new methodology and risk assessment tool for the 2022/23 audit cycle in response to the revisions to ISA 315. Implementation of the ISA 315 (revised) has been a key focus of the current inspection round and we are pleased that the feedback across the seven inspections, and from our own internal quality monitoring, indicates that our new risk assessment methodology is robust and is capable of supporting the delivery of high-quality audits.

For the audit assessed as significant improvements required, we correctly identified a significant level of audit risk associated with the valuation of a hard to value asset. However, we did not identify a significant risk in relation to the data inputs to the valuation model where the new risk assessment methodology prompts you to do so. We have concluded from our root cause analysis that the related findings arose from this issue. As a result, the subsidiary responsible for the data inputs was not treated as a significant component and we did not perform design and implementation work over the controls over data inputs, including those related to IT.

In response, we have:

- revised our risk assessment on the audit in question for 2023/24;

- provided further training and guidance on how to apply our risk assessment methodology to data inputs on complex models, particularly around the classification of data inputs, as part of Spring Accelerator training in April 2024; and

- used the reporting functionality of our new audit software, Apex, to carry out enhanced central monitoring of risk assessment judgements which are subject to auditor adjustment.

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

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

Key findings

Whilst we identified an example of good practice in relation to the audit of harder to value assets, there were findings on one audit in relation to the NAO's audit work in this area, assessed as requiring significant improvement. In this case, the audit team:

- Did not undertake sufficient and adequate procedures to assess the completeness, accuracy and reliability of data used in a complex asset valuation, and did not execute significant planned audit procedures.

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

NAO's actions

We are pleased that the FRC has acknowledged the improvements we have made to our audit of hard-to-value assets in response to previous FRC findings, including through the roll out of new audit programmes and checklists, which have meant that no more than limited improvements were identified on our audit of harder-to-value assets on four audits subject to inspection.

However, we are disappointed that on one audit subject to inspection the FRC identified significant improvements required on the work on harder-to-value assets demonstrating that we need to do more to deliver high-quality audit consistently.

For 2022/23 we implemented a new risk assessment methodology which includes a more granular risk assessment, including for harder to value assets, and which should support consistency in our work. As noted in response to the FRC findings on risk assessment, for one audit we did not identify a significant risk in relation to the data inputs to the valuation model where the new risk assessment methodology prompts you to do so. The FRC finding on the insufficiency of audit procedures performed over data used in the complex valuation arose from the risk assessment. In addition to our responses above, we carried out further audit procedures to address the revised risk assessment in respect of the data inputs for the 2023/24 audit.

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

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

Effective audit teams will critically evaluate management's key assumptions, comparing them to available audit evidence (including external benchmarks, where available) and, where appropriate, challenge management to justify the basis of those assumptions. Audit teams should also look for contradictory evidence in assessing valuations and estimates. Requiring management to prepare assessment papers, setting out the basis for management judgments, assumptions and conclusions, and which the audit team then evaluates, are a standard audit approach in this area.

Key findings

Whilst we identified two examples of good practice in relation to the audit of significant judgments, we continued to identify weaknesses and inconsistency in this area, particularly in the audit of valuations. One audit was assessed as requiring significant improvements and another two as requiring improvements due to findings in this area. On the audit assessed as requiring significant improvements the audit team:

- Did not adequately challenge and evaluate the assumptions used in recognising a deferred tax liability.

On the audits assessed as requiring improvements, the audit teams:

- Did not adequately challenge management to substantiate management's assertions relating to the recognition of expenditure and did not undertake its own analysis to assess the validity of management's judgment.

- Did not obtain and evaluate an appropriate management assessment of impairment risk and did not undertake an independent assessment of impairment risk.

- Did not obtain sufficient appropriate evidence to support the amortisation charge and associated useful economic lives of assets which were at risk of impairment.

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

NAO's actions

The recognition of good practice in relation to the audit of significant judgments demonstrates we are capable of delivering high-quality audit work, but we need to ensure that we do it consistently across the whole audit portfolio.

We have increased the emphasis on the role of people and culture in delivery high-quality audit through our Quality First Plan launched in April 2024. As part of the launch we have emphasised the importance of audit mindset in exercising appropriate challenge of management. In April 2024 we also conducted our first quality culture survey for staff, the results of which demonstrated our commitment to quality and serving the public interest whilst highlighting areas to work on: promoting a culture of trust and openness to challenge across all teams; and consistency of messaging on the importance of quality.

On the audit requiring significant improvements, we correctly identified and challenged the key judgment of deferred tax asset measurement. However, we did not recognise the need to engage specialist support and get access to industry practice in an area of judgment that we rarely encounter. In two further examples highlighted by the FRC, our audit teams accepted judgments from management which were insufficient. We sought to address the deficiency through their own audit procedures rather than challenging management to provide a fuller assessment.

These examples illustrate that a holistic approach to improving audit quality is required to deliver high-quality consistently and have informed the development of our Quality First Plan which includes a focus on Excellence in our Context. We will work with Government to articulate the quality of information required to support financial reporting and audit at the planning stage of the audit, and continue our focus from 2023/24 on effective project management to identify and resolve audit issues on a timely basis.

In response to the FRC finding on challenge of management, as part of our Quality First Plan:

- we have held sessions with Directors on the expectations for obtaining sufficient assessments of key judgments from audited entities;

- we have increased the use of external specialist support including on tax matters and will review our audit procedures in specialist areas;

- we will provide further development and training on evaluating and challenging judgments, including a Director masterclass on professional judgment to be held in Autumn 2024; and

- we will repeat our audit quality culture survey on a quarterly basis and take action based on the feedback.

We are already seeing the outcomes of this approach through matters raised through consultation and extension to delays to certifications where more time is required to obtain adequate judgments and evidence from audited entities.

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

Auditors are expected to perform appropriate testing of journals as one of the key audit procedures in response to the significant risks of management override and fraud. A lack of appropriate audit procedures and testing of higher risk factors increases the risk that a material misstatement within the financial statements would not be identified by the audit team.

Key findings

In the previous three years, we have reported that the NAO needed to improve the quality of evidence on aspects of journal entry testing. This year, we inspected the testing of journal entries on all audits inspected. We continue to identify weaknesses in this area:

- On one audit, the audit team identified 723 journals which met its risk criteria, but tested only 31 journals without sufficiently justifying why the untested journals, which had met the risk criteria, should not be subject to further testing.

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

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

NAO's actions

Following findings in previous inspection cycles we recognised that we need to make improvements to our end-to-end process for testing journals. These improvements were not in place for 2022/23 audits and require investment in software which we are planning to implement for 2024/25. However, the findings of the 2022/23 inspection also show that where we execute our journals testing in line with our process we effectively address the risk such that no more than limited improvements are identified. For six of seven audits inspected, the reviews found no more than limited improvements required in respect of our testing of journal entries.

It is disappointing that we did not execute the process as designed in one audit subject to review.

In response we have delivered further changes to improve our journals process in response to AQR feedback and rolled out further guidance and training in April 2024 as part of our Spring Accelerator programme. The changes are designed to make it easier for teams to deliver high-quality journals testing consistently.

We are developing a new journals process and app which will go further in addressing all findings raised through inspection and addressing the limitations in our existing technology which make it harder for teams to execute their work consistently. We expect to begin implementing our new approach in 2024/25.

Improve the audit procedures over the accounting and challenge over joint venture investments

Consolidation assessments are inherently complex. Auditors should assess relevant facts and circumstances to determine whether there is sole or joint control over an entity incorporated into a group's financial statements, since the accounting treatment differs based on the judgment made.

Key finding

On one audit assessed as improvements required, the audit team did not undertake adequate audit procedures to conclude that an investee should be classified as a joint venture and accounted for as such in the group financial statements.

NAO's actions

Material joint venture investments based on joint control are relatively rare in Government. Our root cause analysis has identified that quality findings from the 2022/23 inspection cycle are on issues we see infrequently within our audit portfolio, such as joint venture accounting.

The joint venture subject to inspection is a longstanding arrangement between Government and the charity sector where joint control has been in place over a sustained period, and continues to be, with limited changes that might impact control in 2022/23. We accept that we did not do sufficient work in 2022/23 to reassess the joint control judgment in respect of the joint venture, including through documenting our assessment of whether activity in the period remained consistent with joint control.

In response to the findings:

- we have used risk assessment data to identify all audits with our portfolio with material joint venture arrangements and engaged directly with the relevant audit teams for 2023/24;
- we will revise our template audit responses for 2024/25 to put greater emphasis on audit of investment in group undertakings; and
- we will set up a new Centre of Expertise for Companies Audit, building on the recent success of our Financial Instrument Centre of Expertise.

Improve the consistency of the quality control review process

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

Key findings

Compared to last year, there were significantly fewer findings on the quality review process. However, there was one audit, assessed as requiring significant improvements, where the quality control review processes undertaken were not as thorough as they should have been, resulting in a failure to identify significant shortcomings, including insufficiency of evidence, inadequate procedures and insufficient explanation.

NAO's actions

The improvements noted in relation to the quality control review process seen from the last inspection cycle support the continued investment we are making in audit quality and reinforce our confidence in the further actions we are taking under our Quality Frist Plan to deliver consistently.

It remains disappointing that we have an example from the 2022/23 inspection cycle where the quality control review process has not operated effectively.

As part of our Quality First Plan, we have put a greater focus on learning and culture including through a planned Director Masterclass on professional judgment in Autumn 2024, and implemented a new quality support model with internal Group Audit Quality Directors and Business Partners.

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

We reviewed the firm-wide procedures, based on those areas set out in International Standard on Quality Management (UK) 1 (ISQM 1), which was applied for the first time. We reviewed the firm's implementation of ISQM (UK) 1, focusing on its risk assessment processes and completeness of risks, the design and implementation of responses to mitigate quality risks. We also reviewed the process, evidence, and outcome for the firm's annual evaluation of its SoQM. This included how other sources of information on audit quality and the firm's SoQM were considered, and how matters were aggregated. We did not independently perform, or reperform, the firm's overall annual evaluation. We performed the majority of our review based on the work undertaken by the NAO to design, implement, monitor, remediate and evaluate its system of quality management. The previous standard was International Standard on Quality Control (UK) 1 (ISQC 1).

As ISQM 1 is focused on how firms achieve iterative improvement, we considered how the NAO is developing its SoQM, including in response to the findings we shared during the inspection period. Our inspection findings in this area are reflective of our forward-looking approach as we seek to support firms in their development of effective, proportionate SoQMs.

Design and Implementation

Background

ISQM 1 required the NAO to design and implement its SoQM by 15 December 2022. This included requirements to identify risks to quality and the design and implementation of appropriate responses to address these risks, including the timing, nature and extent of responses.

Key findings

The NAO did not meet a key requirement of ISQM 1 since there was no evidence that the system was fully implemented by 15 December 2022.

In one of the areas inspected (Acceptance and Continuance) we found that of 11 quality risks identified only two had been mapped to responses which addressed those risks. The NAO must ensure that responses are identified and documented to mitigate all relevant quality risks.

NAO's actions

ISQM 1 is a significant new standard for all audit firms and we consider that an effective system of quality management is critical of delivery high-quality audit consistently. Throughout 2022, ahead of the implementation date of 15 December 2022, we undertook a project to design the new system of quality management ahead of implementation, including performing a detailed quality risk assessment, determining review arrangements and setting out responsibilities. The design of our system of quality management was approved by the Executive Team ahead of implementation and reviewed by our Audit Quality Board during 2023.

The new standard required significant interpretation on implementation, including on the provisions for scalability to size of audit practice. In implementing the standard we made design choices to focus on the high and medium quality risks within the system of quality management. The focus of our actions to improve audit quality through the system of quality management have similarly focussed on the actions and controls responding to high and medium risks to audit quality. Throughout 2023, the Financial Audit leadership have met regularly to discuss audit quality risks and responses. The actions we have taken have significantly improved the discussion and focus on quality risk through 2023.

Following the FRC review of our ISQM implementation we acknowledge that there is more to do to map out our assessment of risk and controls within the system of quality management, including for lower risks, and put in place additional monitoring arrangements to cover these. On that basis the FRC have concluded that we have not fully implemented the requirements of ISQM 1.

We continue to invest heavily in audit quality. By our own assessment, the key components of quality management are in place, including the necessary controls within our audit practice which were largely established under ISQC 1.

For example, on Acceptance and Continuance we have assessed the risk to quality management as low overall given the statutory nature of the majority of our audit engagements, and the static nature of our non-statutory audit engagements where there is a government expectation (as owner) that we continue as auditors. Our quality risk focusses on the process for accepting new engagements which are limited in number but can be complex. We have robust controls in place with all new engagements subject to review and sign-off by the C&AG following a structured assessment by the audit team and quality function.

We will respond to the inspection findings by:

- revisiting our assessment of quality risks under ISQM 1 to include ‘low’ risks;
- mapping controls to all quality risks, including ‘low’ risks; and
- assessing design and implementation of all assessed risks.

Monitoring and Remediation

Background

ISQM 1 requires an organisation to establish a monitoring process to provide relevant, reliable and timely information about the design, implementation and operation of the SoQM. The NAO’s Financial Audit Manual requires the Compliance and Quality Unit (CQU) to submit an Annual Monitoring Plan for approval by its Audit Quality Board.

Key findings

In 2023, no monitoring plan was submitted and approved by the Audit Quality Board. Furthermore, no monitoring was planned or undertaken to assess the design, implementation, and operating effectiveness for the individual internal responses to mitigate quality risks, or to assess if quality risks, across all components of the SoQM, were sufficiently mitigated.

The NAO must urgently develop and implement a monitoring process. All testing must be completed before the annual evaluation of the SoQM so that test results can be considered in the evaluation process. The Audit Quality Board must closely monitor and challenge this process and evidence its oversight.

NAO's actions

In implementing the standard, we made design choices to focus on the high and medium quality risks within the system of quality management. The focus of our actions to improve audit quality through the system of quality management has similarly been on the actions and controls responding medium and high risks to quality. As a result, our monitoring activity has focussed on internal inspections, both hot and cold reviews.

In response to the FRC inspection findings we presented a monitoring plan to the Audit Quality Board in July 2024. We will update the monitoring plan following in response to the revisions we are making to our ISQM 1 risk and control assessments.

Evaluation

Background

ISQM 1 required the NAO to evaluate its SoQM by 15 December 2023. In December 2023, the CQU prepared a report assessing the SoQM to support the annual evaluation. The report was discussed with the C&AG, who has ultimate responsibility for the SoQM and its evaluation, in January 2024.

The CQU report focused heavily on the results of 24 internal and 9 external audit inspections. Overall, 33 findings were identified as deficiencies in the SoQM, representing 59% of the findings analysed, although the report assessed none of these as severe and pervasive. It stated that action had already been taken to address three findings arising from AQR reviews, and that other remedial actions were proposed for 2024, although details of these were not provided. It also included RAG risk assessment ratings of each of the SoQM components, with brief comments supporting each rating.

Key findings

The NAO did not meet key requirements of ISQM 1 since:

- the evaluation of the SoQM was not completed and approved by 15 December 2023; and
- it was unclear how all identified deficiencies were due to be remediated on a timely basis, or how the aggregate impact of deficiencies was not considered severe or pervasive.

Since the NAO had not completed walkthroughs or sample testing (monitoring) of its responses to quality risks as at the annual evaluation date, there was insufficient evidence to support the NAO's conclusion on the effectiveness of its system of quality management.

The proposed remediating actions were not clearly defined so it was not clear if the associated actions were appropriate or if they had been implemented. The lack of specificity meant it was not possible to determine whether appropriate action was taken to remediate a deficiency.

The CQU's report did not consider a sufficient range of other potentially relevant sources of information such as ethical and compliance breaches, staff and culture surveys and/or complaints.

There was insufficient evidence provided with the CQU report to support the risk rating assessments of each ISQM 1 component. In particular, no information was provided on whether identified deficiencies existed in these components and, if so, the remedial actions taken/planned to be taken.

NAO's actions

We acknowledge that we did not complete the sign-off of the annual evaluation, in line with our planned timetable, by 15 December 2023. For operational reasons, including the impact of the late conclusion of our internal and external inspection cycles for 2021/22, we were unable to complete the final governance and sign-off stages within the timescale we set.

We have put in place plans to complete the 2024 evaluation by December 2024. With the support of the FRC we have substantially accelerated the timeline for the external inspection cycle for our 2022/23 audits. We have also accelerated the timeline for completion of our internal inspections. Both internal and external inspections are complete.

The annual evaluation was completed by, and recommended to, the C&AG by our Director for Audit Risk and Compliance, who is responsible for our monitoring activity within the System of Quality Management and has access to all relevant information. The evaluation was the first to be completed under the requirements of ISQM 1 and we welcome the feedback on how we can improve the process for 2023/24 and beyond. For 2022/23, the evaluation was necessarily informed by the available monitoring results and focussed primarily on the outcomes and findings of internal and external inspections, our root cause analysis, and emerging issues arising from our hot review programmes. Our evaluation also made clear that we had more to do, including assessing whether measures we had put in place effectively remediated the deficiencies that arose, noting that these would be addressed during 2024. Results from other sources, including ethical breaches and staff surveys, were taken into account but didn't feature in the detailed analysis due to the low incidence or significance of issues arising from these interventions.

We will explicitly ensure we provide a more effective audit trail to this wider range of inputs into our overall evaluation for 2023/24.

Required Communications

Background

The NAO's ISQM 1 evaluation concluded that the NAO's SoQM had 'identified deficiencies that have a severe but not pervasive effect.' In such instances, ISQM 1 requires communication with external parties on a timely basis. The NAO's Financial Audit Manual states that external parties include the Financial Reporting Council and The Public Accounts Commission.

Key findings

The NAO did not demonstrate that it had met the requirements of ISQM 1 and its own policies and procedures, since no communications had been issued to external parties about the ISQM 1 evaluation before we started our inspection.

NAO's actions

As noted, we determined through our implementation of ISQM that the FRC and The Public Accounts Commission (TPAC) would be the relevant external parties to whom to communicate the outcome of our evaluation.

In taking this forward, it was our intention to provide the FRC with our annual evaluation as part the evidence pack we provide during the inspection cycle. We did so in February 2024. We note that the evaluation report was approved by the C&AG in January 2024 and we provided the evaluation to the FRC's AQR inspection team in February 2024.

Through the governance arrangements put in place with Parliament, we engage with TPAC on audit quality through an annual evidence session of the Committee. Given this, our intention was to provide TPAC with our evaluation as part of the expected session on financial audit quality. However, the 2023/24 session was postponed due to the late running of the external inspection cycle and therefore not completed prior to the General Election.

In response to the findings, we will update our policies to clarify the process for notifying the FRC and TPAC and provide formal notifications from 2024/25.

Contracted out audits

Background

The NAO identified a quality risk relating to contracted out audits and the need to enhance overview of contracted out audit work to respond to the revisions to ISA 220. It had existing monitoring processes in this area, but these were not clearly linked to ISQM 1 requirements.

Key finding

There was no evidence of (a) how the existing NAO monitoring processes over contracted out audits were linked to the identified ISQM 1 risks; (b) the results of ISQM 1 monitoring and testing of these processes; or (c) how these had been fully considered in the annual evaluation

NAO's actions

Through longstanding agreement with Parliament, we contract out around 20% of our financial audit work to private sector audit firms (four Tier 1 firms and one Tier 2 firm). For contracted out audits, the C&AG retains responsibility for the audit opinion and the work of the private sector audit firm is subject to review by the NAO engagement team. We also contract with firms to provide specialist advice relating to our audits on topics such as complex financial instruments and property valuations. We have robust arrangements in place to monitor the work performed for us by the private sector firms.

Through our implementation of ISQM 1 we identified a quality risk in relation to our model for contracting out audits. The quality risk was identified due to findings from our internal inspection process in relation to the effectiveness of NAO audit team's review of work performed by the contracted firm, and due to the need to update our audit process to comply with the revisions to ISA 220 on direction, supervision and review. We responded to the identified risk for 2023/24 by redesigning our audit process for contracted out audits to comply with ISA 220 (revised) and delivering training for all teams on the requirements.

We have assessed audit firms delivering contracted out auditors as service providers under ISQM 1 and have extensive quality arrangements in place to manage risk for contracted out audits. Our monitoring arrangements involve:

- Monitoring the external inspection findings for each firm and using these to inform our ISQM service provider assessment risk assessment and associated actions.
- Oversight from the relevant NAO portfolio/engagement director. This provides an effective review of the quality of an audit prior to certification.
- NAO engagement director review is informed by a central quality risk briefing for each firm.
- Monthly meetings with each firm and our Director of Financial Audit Operations.

- Contracted-out audits fall within the remit of our cold and hot review programmes.
- Contracted out audit provider performance is covered by our client feedback survey which informs our engagement with each firm.

In response to the FRC findings, we will formally capture the quality activities set out above as part of our reconsideration of the ISQM risk assessment, and capture them in our monitoring and evaluation for 2025.

Approach to reviewing the NAO's quality control procedures

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

Current year (2023/24) ISQM 1	Prior year (2022/23) ISQC 1	Two years ago (2021/22) ISQC 1
• Design and implementation; • Annual Evaluation • Monitoring and Remediation • Acceptance and Continuance	• Engagement director and staff matters • Acceptance and Continuance • Ethics and Independence • Tone at the Top	• Engagement quality control review • Consultations • Audit documentation • Internal Quality Monitoring

Appendix 1: NAO's internal quality monitoring results

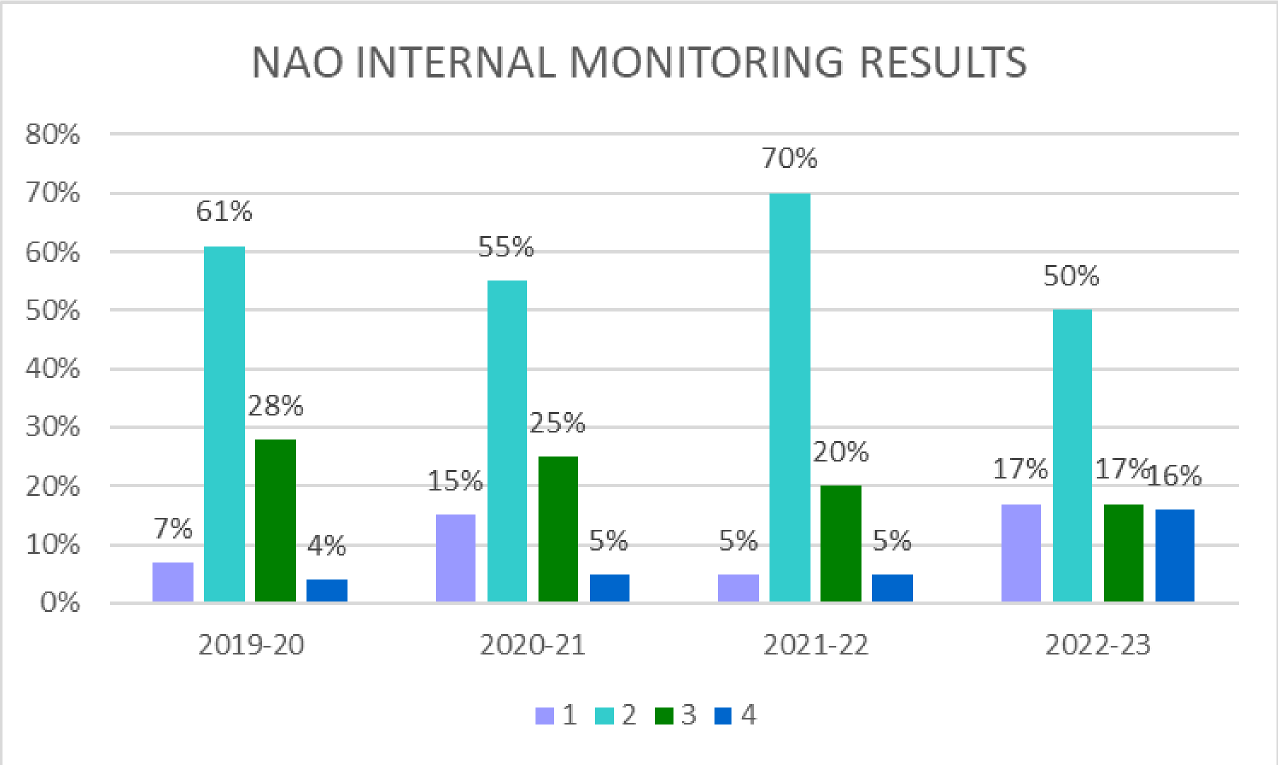
This appendix sets out information relating to the NAO's internal quality monitoring for individual audit engagements. It should be read in conjunction with the NAO's Transparency Report, published on 31 July 2024, which provides further detail of the NAO's internal quality monitoring approach and results and its wider system of quality control. We consider that publication of these results provides a fuller understanding of quality monitoring in addition to our regulatory inspections, but we have not verified the accuracy or appropriateness of these results. In 2023/24, the NAO inspected 23 of its 2022/23 audit, which represented 6% of all audits undertaken. The number of inspections carried out in the previous three years ranged between 20 and 26, representing a similar proportion of all audits undertaken in each year.

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

Results of internal quality monitoring

The NAO's internal quality monitoring cycle had concluded in August 2024. The results of this programme and comparisons to previous years, are set out below, where there has also been a deterioration in observed audit quality in 2022/23 compared to the previous years.

We strongly recommend the NAO to continue to perform a full RCA on these audit inspections to identify audit quality themes and resolve to establish a plan to address these matters for 2025 audits.



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

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

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

NAO's approach to internal quality monitoring

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

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

Appendix 2: Information on inspection remit

We inspect the NAO and report our findings annually and privately to the Comptroller and Auditor General (C&AG), as head of the NAO, and also to the Independent Supervisor in its monitoring role in respect of Companies Act audits. Historically, the C&AG has sought and obtained the FRC's consent to publish the report on the NAO's website, and we are supportive of this public transparency and will continue to provide permission for publication whenever permission is sought.

The C&AG audits, under statute, the financial statements of all central government departments, agencies and other public bodies and reports the results of these audits to Parliament. The C&AG is required to form an opinion as to whether the financial statements of audited bodies are free from material misstatement and comply with the relevant reporting requirements and also to provide a regularity opinion. The regularity opinion confirms whether, in all material respects, the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament.

The C&AG also performs audits of the financial statements of certain government-owned companies, incorporated under the Companies Act, which perform a public function for which the C&AG is authorised to conduct audit work by the FRC (in its role as Independent Supervisor). Responsible Individuals within the NAO form an opinion, on behalf of the C&AG, on whether the company's financial statements are free from material misstatement and comply with the relevant reporting requirements.

Our inspection included reviewing the performance of the NAO's:

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

- Audit work supporting opinions on the financial statements of non-Companies Act audits (which the FRC carries out on a contractual basis). The number of non-Companies Act audits we inspect is determined by the NAO; and

- Firm-wide procedures, based on those areas set out in International Standard on Quality Management (UK) 1 (ISQM 1).

We do not inspect non-Companies Act audits which the NAO has contracted out to external audit firms, or the audit work undertaken to assess an entity's compliance with the income and expenditure rules set for it by Parliament.

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

Companies Act audits

- If an NAO audit is assessed as requiring more than limited improvements, the FRC can consider whether action should be taken under the Auditor General Disciplinary Rules 2012 or the Audit Enforcement Procedure.

Non-Companies Act audits

- The FRC monitors the audit quality of non-Companies Act audits performed by the NAO, by arrangement. Those arrangements are limited to providing audit quality monitoring and do not extend to providing enforcement or disciplinary measures. However, we would write to the C&AG if we identify deficiencies in audit quality which would have led to disciplinary action if similar deficiencies had been identified in an audit undertaken by an audit firm regulated by the FRC.