



Financial Reporting Council

Report of the Independent Supervisor on Auditors General

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Financial Reporting Council

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The Report of the Independent Supervisor is presented to Parliament pursuant to sections 1229(5A) and 1231(1) of the Companies Act 2006. The Report of the Independent Supervisor is also presented, pursuant to section 1231(2), to:

- The Secretary of State;
- The First Minister in Scotland;
- The First Minister and Deputy First Minister in Northern Ireland; and,
- The First Minister for Wales and is laid before the National Assembly for Wales pursuant to section 1231(3A) of the Companies Act 2006.

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Report of the Independent Supervisor on Auditors General

1 Introduction

- 1.1 The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc.) Order 2012¹ appoints the Financial Reporting Council (FRC) as the Independent Supervisor of Auditors General, which includes the Comptroller and Auditor General (C&AG) and the Auditors General of Scotland and Wales and the Comptroller and Auditor General for Northern Ireland, in respect of their work as statutory auditors of companies under the Companies Act 2006 (the 'Companies Act', or 'the Act').
- 1.2 Section 1231 of the Act requires the Independent Supervisor to report on the discharge of its functions at least once in each calendar year to the Secretary of State, the First Minister of Scotland, the First Minister and the Deputy First Minister in Northern Ireland, and to the First Minister for Wales. This report also meets the statutory reporting requirements set out in the legislation².
- 1.3 Auditors General are eligible for appointment as the statutory auditors of companies under section 1226 of the Act.
- 1.4 An Auditor General who undertakes statutory audits must comply with the Independent Supervisor's 'supervision arrangements' (see section 2 below), which include arrangements for the monitoring and inspection of the performance of that audit work. To date, only the C&AG undertakes audits under the Act.
- 1.5 The year to 31 March 2021 was the thirteenth year in respect of which the C&AG undertook statutory audit work, auditing the accounts of 68 companies. The National Audit Office ('NAO') undertakes this work on the C&AG's behalf, auditing those companies that are owned by Government Departments as well as other public bodies. The responsibilities of the Independent Supervisor do not extend to the wider work of the C&AG and the term 'statutory audit' should be read as meaning the C&AG's remit under the Act.
- 1.6 The NAO is the appointed Independent Auditor of the FRC³ and provided an audit opinion on the FRC's financial statements as at 31 March 2022 which was laid before the House of Commons. Safeguards are in place to ensure the independence of the FRC's and NAO's respective roles as Independent Supervisor of Auditors General and as the auditor of the FRC. The FRC, as Independent Supervisor, is accountable to the Secretary of State and the report of the Independent Supervisor is laid before Parliament, whilst the C&AG is accountable to Parliament through the Public Accounts Commission. FRC's operations and governance are also established to maintain independence. The FRC's Audit Quality Review Team (AQR) and Professional Oversight Team (POT) personnel who undertake regulatory activities in respect of

¹ S.I. 2012/1741

² As set out in regulation 19 of the Statutory Auditors (Amendment of Companies Act 2006 and Delegation Functions etc) Order, S.I. 2012/1741 and s.1229(5A) of the Act.

³ As set out in our Annual Report for 2021/22 here - <https://www.frc.org.uk/getattachment/8caee6b0-0fe0-4489-9edc-96e24a27d277/FRC-Annual-Report-and-Accounts-2021-22.pdf>

the Independent Supervisor do not provide support to the delivery of the statutory audit, which is the responsibility of the FRC's Finance Team. Decisions and actions required by the FRC in respect of the statutory audit are considered by the Audit and Risk Committee prior to any recommendations to FRC Board, whilst the FRC's role as Independent Supervisor and recommendation of the Report of the Independent Supervisor of the C&AG to the FRC's Board are the responsibility of the FRC's Supervision Committee.

2 Supervision arrangements

2.1 Section 1229 of the Act requires the Independent Supervisor to establish supervision arrangements with respect to an Auditor General who undertakes Companies Act audit work, for:

- Determining standards relating to professional integrity and independence ('ethical' standards) and technical standards to be applied by an Auditor General and the manner in which these standards are to be applied in practice;
- Monitoring the performance of statutory audits carried out by an Auditor General; and
- Investigating and taking disciplinary action in relation to any matter arising from the performance of a statutory audit by an Auditor General.

2.2 These supervision arrangements are set out in a Statement of Arrangements and Memorandum of Understanding (MOU)⁴ between the FRC and the C&AG and include a requirement for the monitoring of the C&AG's statutory audit work by the FRC's AQR team, on behalf of the Independent Supervisor.

3 Reporting requirements

3.1 We report, in sections (a) to (e), below in accordance with sections 1231 and 1229(5A) of the Act and regulation 19 of the Statutory Auditors (Amendments of Companies Act 2006 and Delegation of Functions etc.) Order 2012⁵.

(a) Discharge by the Independent Supervisor of its supervision function

3.2 The supervision arrangements require that the C&AG and relevant NAO staff follow technical and ethical standards prescribed by the FRC when conducting statutory audits and set out the investigation and disciplinary procedures that would apply were there a need to discipline the C&AG in his/her capacity as a statutory auditor. The relevant standards are those set by the FRC for auditors as applied to the C&AG.

3.3 The supervision arrangements also require the C&AG and NAO staff to enable their performance of statutory audits to be monitored by means of inspections carried out under the supervision arrangements.

⁴ <https://www.frc.org.uk/getattachment/c276641b-a965-4cdd-b28d-1f12d7756ed7/Signed-St-of-Arrangement-and-MOU-230712.pdf>

⁵ S.I. 2012/1741

- 3.4 We meet periodically with the C&AG and senior staff responsible for the audit practice of the NAO on behalf of the C&AG. We have familiarised ourselves with the NAO procedures for discharging these responsibilities and keep abreast of any changes on an ongoing basis. The responsibilities of the Independent Supervisor in 2021/22 are described in sections (a) to (e) of this report. Our AQR team's inspections, described below, were completed remotely. On that basis, we consider that we have discharged our supervision function effectively.
- 3.5 The responsibilities of the Independent Supervisor do not extend to the wider work of the C&AG, other than in relation to statutory audit.

(b) Compliance by Auditors General with duties under the Act

Scope of 2021/22 inspections

- 3.6 As noted above, to date only the C&AG has undertaken statutory audits of companies which are within the public sector. The Auditors General of Scotland and Wales and the Comptroller and Auditor General for Northern Ireland are required to notify the Independent Supervisor if they are to undertake statutory audits of companies. No notifications have been received, and each has confirmed in writing to the FRC that they have not undertaken any statutory audits.
- 3.7 During 2021/22, our AQR team's inspection of the C&AG's Companies Act 2020/21 audit work comprised a review of a selection of the NAO's policies and procedures supporting audit quality that applied to these audits and reviewing the performance of selected aspects of five of the 68 statutory audits carried out by NAO staff in respect of financial periods ended 31 March 2021⁶. The sample of audits chosen covered audits of varied complexity, size and risk.

Audit quality key findings

- 3.8 The table below summarises our AQR teams' quality assessment of the inspections undertaken during 2021/22 covering the C&AG's statutory audits of the 2020/21 financial year and, for comparison, those relating to the four audits our AQR team reviewed in the previous inspection cycle.

Assessment ⁷	Nos of inspections in 2021/22	Nos of inspections in 2020/21
Good or requiring no more than limited improvements	3	3
Requiring improvements	2	1
Requiring significant improvements	-	-
Total audits reviewed	5	4

⁶ For financial periods ended 31 March 2020 four of the 71 statutory audits were reviewed.

⁷ Audit inspections are graded as Good; Requiring limited improvements; Requiring improvements or Requiring significant improvements. The first row of the table combines Good and Requiring limited improvements.

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- 3.9 In the previous inspection cycle our AQR team identified an unacceptable trend of poorer audit quality in those higher risk and more complex audits inspected relating to financial services and audits of financial services-related balances on other entities. This year our AQR team reviewed a sample of entities in the financial services sector or with financial services-related balances and again found some evidence of poorer audit quality. We acknowledge that the NAO is working towards improvement in this area of auditing and accept that there is often a time lag for improvements in methodology to be reflected in AQR results. Nonetheless, the concerns identified by our AQR team over the audit work of more complex financial services balances, need to be carefully assessed to identify both methodology and application shortcomings, so that an appropriate response is designed and actioned upon in a timely manner. We expect the NAO to develop and implement an action plan which will see improvements in audit quality specifically in this area take effect during the coming year. AQR will continue to monitor carefully the quality of this work in the next inspection cycle.
- 3.10 The finding that contributed most to the 2021/22 inspection results related to reliance placed by audit teams on (and the challenge of) work performed by others. This included reliance placed on fund or investment management statements to confirm valuation of harder to value assets, without adequate procedures to confirm the reliability and appropriateness of these valuations.
- 3.11 In respect of the two audits assessed as requiring improvements, the NAO is planning to undertake a thorough Root Cause Analysis to identify the causes of the issues found. Our AQR team will closely monitor and assess the promptness and effectiveness of the NAO's actions to address these findings.

Progress made in the year

- 3.12 It is encouraging to see the NAO's commitment to making the required improvements through the development of an Audit Transformation Programme which is due to be rolled out fully later this year. In addition, our AQR team has already observed a number of positive changes to the NAO's IFRS 9 methodology in response to observations we raised as part of our 'firm-wide' work on the NAO last year.
- 3.13 The finding that contributed most often to last year's inspection results related to reliance placed by audit teams on (and the challenge of) the work performed by others, in particular that of management's experts. We acknowledge the NAO has taken steps to address the key findings in our 2020/21 report. For example, by running additional training and mandating consultations when dealing with highly complex areas. Our AQR team continue to identify recurring weaknesses in the NAO's audit of significant judgements and estimates, particularly in the valuation of harder to value assets – see 3.10 above.
- 3.14 The NAO continues to take forward its on-going commitment to improve its transparency and accountability. A key development during 2021-22 was to work with the Public Accounts Commission, on behalf of Parliament, so that it would be able to scrutinise effectively the quality of the NAO's financial audit work. In November 2021, for the first time, the C&AG and colleagues attended a public hearing of the Commission in which they were challenged about the NAO's quality arrangements, the C&AG's response to the most recent AQR inspection

findings, and the NAO's plans to further improve the quality of its work. Prior to this, the FRC attended a private session of the Public Accounts Commission to give evidence on the quality of the NAO's audit work. We understand the NAO expects these new arrangements to be an annual event and a key part of its wider response to the Government's recent white paper Restoring Trust in Audit and Corporate Governance.

'Firm-wide' policies and procedures key findings

- 3.15 Our AQR team reviewed a selection of the NAO's 'firm-wide' policies and procedures, including reviewing the Engagement Quality Control Review (EQCR) process. Our AQR team identified aspects of these procedures which should be improved. For example, formalising the allocation process to ensure those performing the EQCR have the required level of qualifications in auditing financial services balances.
- 3.16 Our AQR team also reviewed the NAO's Internal Quality Monitoring (IQM) process. Due to delays in the completion of the NAO's IQM reviews for the current cycle, AQR's sample selection was limited to two engagements. The NAO should, as a matter of priority, perform a Root Cause Analysis to identify the key drivers for the delays in completing the IQM review process, and develop potential solutions to ensure that these reviews are performed on a more timely basis.
- (c) Notification by Auditors General under section 1232 of the Act
- 3.17 No Auditor General was required to notify the Independent Supervisor of any other information under Section 1232 of the Act.
- (d) Independent Supervisor's enforcement activity
- 3.18 We issued no enforcement notices and made no applications for compliance orders in 2021.
- (e) Account of activities relating to the Freedom of Information Act 2000
- 3.19 We received no requests for information under the Freedom of Information Act 2000 in our role as the Independent Supervisor.

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