



Financial Reporting Council

Report of the Independent Supervisor on Auditors General Pursuant to Section 1229(5A) of the Companies Act 2006

HC 352

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Financial Reporting Council

Report of the Independent Supervisor on Auditors General

This Report of the Independent Supervisor was prepared pursuant to section 1229(5A) of the Companies Act 2006. It is presented to Parliament pursuant to paragraph 10(3) of Schedule 13 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 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

- 1.1 Pursuant to section 1229(5A) of the Companies Act 2006, the Independent Supervisor must, at least once in every calendar year, deliver to the Secretary of State a summary of the results of any inspections conducted for the purposes of monitoring the performance of statutory audits carried out by an Auditor General.
- 1.2 During 2022/23, our Audit Quality Review (AQR) team's inspection of the Comptroller and Auditor General's (C&AG) Companies Act audit work comprised a review of a selection of the National Audit Office's (NAO) policies and procedures supporting audit quality that applied to these audits and reviewing the performance of selected aspects of five of the 70 statutory audits carried out by NAO staff in respect of financial periods ended 31 March 2022¹.
- 1.3 The population from which the risk-based sample of audits was chosen varied in complexity, size and risk, with 38 of the 70 companies having revenues of between £10 million and £500 million and 9 having revenues in excess of £1 billion. For the sample of audits inspected revenue ranged from £43 million to £730 million. For one audit the company does not have any revenue, by the nature of its operating framework, but has net expenditure of almost £2.4 billion.
- 1.4 Our AQR team do not select audits for inspection on a statistical basis, so changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of NAO's performance and are not necessarily indicative of any overall change in audit quality.
- 1.5 Audit quality at the NAO, as reflected in AQR inspection outcomes, has fallen for a second year. We have not yet seen the consistent improvements in audit quality that were anticipated under the NAO's Quality Plan which was launched in January 2021. The NAO must prioritise a detailed root cause analysis for these audit quality inspection results to aid the development and implementation of a robust and comprehensive action plan and to inform the Audit Transformation Programme, the first phase of which the NAO implemented from the 2022-23 audit cycle.

¹ For financial periods ended 31 March 2021 five of the 68 statutory audits were reviewed.

Audit quality key findings

1.6 The table below summarises our AQR teams' quality assessment of the inspections undertaken during 2022/23 covering the C&AG's statutory audits of the 2021/22 financial year and, for comparison, those relating to the five audits our AQR team reviewed in the previous inspection cycle.

Assessment ²	Nos of inspections in		
	2022/23	2021/22	2020/21
Good or requiring no more than limited improvements	1	3	3
Requiring improvements	1	2	1
Requiring significant improvements	3 ³	-	-
Total audits reviewed	5	5	4

1.7 The 2022/23 audit inspection results (covering companies with March 2022 year ends) indicate a further decline in audit quality. Only 20% of the audits inspected were rated as good or requiring no more than limited improvements.

1.8 The issues contributing to the poor 2022/23 inspection cycle results were varied³. They included failure to perform an IFRS15 (Revenue from Contracts with Customers) assessment over 2 major contracts resulting in a greater than acceptable risk of material error in revenue recognition, significant weaknesses in the audit of a cash flow statement resulting in the failure to detect material errors in both the current and prior year, failure to appropriately challenge significant assumptions applied to the valuation of non-current assets, and errors in an audit report with a third, more historic, period impacted by a modification not being referred to in that modification.

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

1.10 The 2022/23 AQR inspection cycle has identified some examples of good practice. On one audit the team thoroughly assessed the work undertaken by the predecessor auditor and management's previous methodology for calculating a provision. As a result of this, and the audit team's subsequent challenge of management, a material prior period adjustment was recorded. On this same audit, the use of an auditor's expert and the scoping of the expert's report provided the audit team with significant assurance over management's revised methodology for calculating the

² 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.

³ At the time of writing, one of these assessments is subject to a request for reconsideration by the NAO.

provision. Another example of good practice was the quality of reporting to the Audit Committee. On another audit, the auditor had clearly set out the complexities associated with a provision, how these had been addressed and the basis for the conclusions reached.

- 1.11 In previous inspection cycles our AQR team has identified a consistent 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's inspections identified an improvement in the audit of financial services-related balances in the Companies Act audits. It is important for the NAO to focus on ensuring consistency in the audit quality being achieved in this area across the whole audit portfolio.

Progress made in the year

- 1.12 The finding that contributed most often to last year's (and the previous 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. This issue was again raised in one of the audits that was inspected this year. Given these findings, the NAO must continue to focus on achieving quality improvements consistently across its portfolio of audits. The lack of challenge applied by the audit team in the consideration of assumptions applied by management (and their expert) in the valuation of significant and material non-current assets was a key factor in one of the 'requiring significant improvements' grades. This audit was inspected previously by the AQR during its 2019/20 cycle (also graded 'requiring significant improvements') and our 2022/23 inspection found that each of the previous AQR findings had been addressed appropriately in the subsequent audits.
- 1.13 Given these findings, the NAO must continue to focus on achieving quality improvements consistently across its portfolio of audits. To address this, the NAO has continued in its development of its Audit Transformation Programme. In particular, its first phase, a new Risk Assessment Module, was rolled-out for year ended 31 March 2023 audits taking into account the new requirements of ISA 315, so was not yet in use for the audits covered in this report. The second phase, launching the NAO's new audit software, will be applied for year ended 31 March 2024 audits and onwards. The NAO expects that these developments will deliver significant improvements in the quality of its audit work.

‘Firm-wide’ policies and procedures key findings

- 1.14 We have previously raised concerns over delays in the NAO’s Internal Quality Monitoring (IQM) process. The IQM process consists of a sample of completed audit files being selected each year by the NAO for a retrospective internal audit quality inspection. We have seen insufficient improvement made to reduce these delays. IQM in respect of year ended 31 March 2022 audits had still not been completed on 31 March 2023. Our observation is that there is insufficient priority given to quality inspections, with limited resource available in the central team to perform these reviews, and the approach of using auditors who themselves have audit delivery commitments to assist in performing the reviews is not working.
- 1.15 The AQR inspections for 2022/23 have identified one instance where ethical consideration risks relating to the long association of auditors with their audited bodies had not been properly mitigated nor appropriately reported to the audit committee. The unique legislative provisions regarding the appointment of the C&AG as statutory auditor, in our view, does not remove nor diminish the applicability of the Ethical Standard which applies to the audits being conducted.

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29 November 2023

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