

**REPORT OF THE INDEPENDENT SUPERVISOR ON AUDITORS
GENERAL– 23 SEPTEMBER 2021**

HC 752

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The Report of the Independent Supervisor is presented to Parliament pursuant to sections 1228(1) 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 2020 was the twelfth year in respect of which the C&AG undertook statutory audit work, auditing the accounts of 71 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 2021 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 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

¹ S.I. 2012/1741

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

³ As set out in our Annual Report for 2020/21 here - <https://www.frc.org.uk/getattachment/985d9c2a-8a6d-4c8b-8172-06858edfabab/FRC-Annual-Report-and-Accounts-2020-21.pdf>

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.

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. Lockdown for the COVID 19 pandemic did not reduce our ability to fulfil the responsibilities of the Independent Supervisor in 2020/21 as described in sections (a) to (e) of this report. Our inspections, described below, were completed remotely throughout lockdown. On that basis, we consider that we have discharged our supervision function effectively.

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

3.5 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 2020/21 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 2020/21, the AQR team's inspection of the C&AG's Companies Act 2019/20 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 four of the 71 statutory audits carried out by NAO staff in respect of financial periods ended 31 March 2020⁶. The sample chosen covered audits of varied complexity, size and risk.

Audit quality key findings

3.8 The table below summarises our quality assessment of the inspections undertaken during 2020/21 covering the C&AG's statutory audits of the 2019/20 financial year and, for comparison, those relating to the four audits we reviewed in the previous inspection cycle.

Assessment⁷	Nos of inspections in 2020/21	Nos of inspections in 2019/20
Good or requiring no more than limited improvements	3	3
Requiring improvements	1	-
Requiring significant improvements	-	1
Total audits reviewed	4	4

3.9 Over the past six years we have reviewed five higher risk and more complex NAO audits relating to financial services, including one in 2020/21, and found all five audits required improvements or significant improvements. This unacceptable trend of poorer quality audits on more complex financial services engagements needs follow up by the NAO and our AQR team have asked them to identify what steps can be taken to improve the quality of their audit work in this sector. As part of this process the NAO plans to undertake a deep and robust Root Cause Analysis (RCA) to identify and address the causes of this trend. Our AQR team will closely monitor and assess the promptness and effectiveness of the NAO's actions to address these findings.

⁶ For financial periods ended 31 March 2019 four of the 70 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.

- 3.10 The finding that contributed most to this year's inspection results related to the reliance placed by audit teams on (and the challenge of) the work performed by others, in particular that of management's experts. We found that there was insufficient assessment and challenge of the process, assumptions and inputs used by these experts. In one instance, we found that the basis for reliance on management's experts was insufficiently evidenced. As a result of these findings we understand that the NAO have already implemented a number of changes for 2020/21 audits in this area.
- 3.11 Another recurring finding from our inspections has been insufficient challenge of management by the audit team concerning key areas of judgement relating to the underlying assumptions used in valuations and estimates, particularly in the financial services audit reviewed. This contributed to our assessment of the audit assessed as requiring improvements in 2020/21 – see 3.8 above.

Progress made in the year

- 3.12 It is encouraging to see that the NAO has taken steps to address other key findings from our 2019/20 review round. These steps included: enhancements to the Audit Planning Consultation Meeting ("APCM") protocols, including that APCMs for all high-risk audits should be led by an NAO Executive Director and more recently, the introduction of Director-led APCMs for all medium-risk audits. We did not raise any concerns in respect of actions taken to resolve our prior year findings.
- 3.13 We note that in January 2021 the NAO launched a Quality Plan, which sets out the additional measures the NAO are taking to affect a cultural shift to further embed quality across all statutory audit work. The plan covers the measures being taken to support the 2020/21 audits and also outlines the interventions being taken in the medium to longer term. We understand the plan will be produced at least annually and will be refreshed accordingly.
- 3.14 As part of its commitment to further improve its transparency and accountability, we have been informed the NAO is taking action to implement measures it has outlined in its response to the Government's recent consultation paper *Restoring Trust in Audit and Corporate Governance*. We understand it is working with Parliament, through the Public Accounts Commission, so that the Commission has greater scrutiny over the quality of the NAO's financial audit work.

'Firm-wide' policies and procedures key findings

- 3.15 We reviewed a selection of the NAO's 'firm-wide' policies and procedures and have encouraged the NAO to enhance aspects of International Financial Reporting Standard (IFRS) 9 guidance, including guidance relating to risk assessment and Expected Credit Loss ("ECL") modelling for financial services sector audits. We have highlighted the importance of improvements in this area given the history of our findings on more complex financial services related balances.
- 3.16 We also reviewed the NAO's RCA process, where we identified several areas of good practice, such as the wide coverage of entities subject to the review. We also identified aspects of these procedures which should be improved, in particular enhancing the depth of RCA processes over audit issues.
- 3.17 The NAO has recently refreshed its core values which continue to prioritise audit quality. This emphasis is communicated to the audit practice, with the expectation that this will be reflected in the NAO's staff appraisal process. We have suggested that the NAO

should continue to strengthen its formalised mechanisms to incentivise staff to prioritise audit quality and to recognise staff who deliver high quality audit work.

(c) Notification by Auditors General under section 1232 of the Act

3.18 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

3.19 We issued no enforcement notices and made no applications for compliance orders in 2020.

(e) Account of activities relating to the Freedom of Information Act 2000

3.20 We received no requests for information under the Freedom of Information Act 2000 in our role as the Independent Supervisor.

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