

**REPORT OF THE INDEPENDENT SUPERVISOR ON AUDITORS  
GENERAL– 7 OCTOBER 2020**

**HC 817**

# **REPORT OF THE INDEPENDENT SUPERVISOR ON AUDITORS GENERAL— 7 OCTOBER 2020**

The Report of the Independent Supervisor is presented to Parliament pursuant to sections 1231(3) and 1252(10) of, and paragraph 10(3) of Schedule 13 to, 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.

Ordered by the House of Commons to be printed on 5 November 2020

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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 2012<sup>1</sup> 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 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 responsibilities 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 meets the statutory reporting requirements<sup>2</sup>.
- 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 2019 was the eleventh year in respect of which the C&AG undertook statutory audit work, auditing the accounts of 70 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 Auditor Generals' remit under the Act.
- 1.6 The NAO is the appointed Independent Auditor of the FRC<sup>3</sup> and provided an audit opinion on the FRC's financial statements as at 31 March 2020 which were 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. For example, 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 Audit Quality Review Team (AQR) and Professional Oversight Team (POT) personnel who undertake the regulatory activities for Independent Supervisor do not provide support to the delivery of the statutory audit, which is supported by the FRC's Finance Team. Decisions and actions required by the FRC in respect of the statutory audit are considered by the Audit Committee prior to any recommendations to FRC Board, whilst the FRC's role as Independent Supervisor and

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<sup>1</sup> S.I. 2012/1741

<sup>2</sup> 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.

<sup>3</sup> As set out in our Annual Report for 2019/20 here - <https://www.frc.org.uk/getattachment/d3201f4b-2946-4e50-aa27-3a131ae17750/Annual-Report-2019-20.pdf>

recommendation of the Report of the Independent Supervisor of the C&AG to the FRC's Board is the responsibility of the FRC's Conduct 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;
- 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)<sup>4</sup> 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 section 1231 of the Act and regulation 19 of the Statutory Auditors (Amendments of Companies Act 2006 and Delegation of Functions etc.) Order 2012.<sup>5</sup>

(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 the C&AG specifically and for auditors generally.

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 2019/20 as described in sections (a) to (e) of this report. Our inspections, described below, were largely complete before lockdown occurred.

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

<sup>5</sup> S.I. 2012/1741.

3.5 The responsibilities of the Independent Supervisor do not extend to the work of the C&AG, other than in relation to statutory audit.

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

*Scope of 2019/20 inspections*

3.6 As noted above, to date only the C&AG has undertaken statutory audits of companies which are within the public sector.

3.7 During 2019/20, the AQR team's inspection of the C&AG's Companies Act 2018/19 audit work comprised updating its understanding 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 70 statutory audits carried out by NAO staff in respect of financial periods ended 31 March 2019 (we had also reviewed four 2017-18 audits during 2018/19). The sample chosen covered audits of varied complexity, size and risk. Given the increased number and complexity of the statutory audits performed by the C&AG, including five Public Interest Entity (PIE) audits, we keep under review the number of statutory audits that we review each year.

*Audit quality key findings*

3.8 The table below summarises our gradings of the inspections undertaken during 2019/20 covering the C&AG's statutory audits of the 2018/19 financial year and, for comparison, our gradings of the four audits we reviewed in the previous inspection cycle.

<b>Assessment<sup>6</sup></b>	<b>Nos of Audits in 2019/20</b>	<b>Nos of Audits in 2018/19</b>
Requiring no more than limited improvements	3	2
Requiring improvements	-	2
Requiring significant improvements	1	-
Total audits reviewed	4	4

3.9 A recurring finding from our inspections has been insufficient challenge of management, and of management's experts and specialists, in key areas of judgement, in particular of assumptions used in valuations and estimates. This contributed to our assessment of one audit requiring significant improvement in 2019/20.

3.10 We have recommended that NAO undertakes a deep and robust root-cause analysis to identify and address the underlying causes of our findings. We will monitor the promptness and effectiveness of the NAO's actions to address the findings raised. Further, we have encouraged the NAO to consider what cultural changes are needed within the NAO to improve challenge in areas of judgement and estimates.

3.11 We will closely monitor and assess the promptness and effectiveness of the NAO's actions to address the findings raised in our audit inspections.

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<sup>6</sup> Audits 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.

- 3.12 As in prior years, we continue to recommend that the NAO closely monitors independence threats, concerning business relationships and develops appropriate responses. There has been no change in the NAO's existing business relationships and the NAO continues to disclose leasing arrangements of its London headquarters building in its Annual Report and Accounts. None of these leases are significant to the NAO.
- 3.13 We understand that the NAO regularly reassesses its plans to ensure it has sufficient suitably qualified and experienced Responsible Individuals (RIs) appointed to perform statutory audit work. As the number, size and complexity of audits are increasing workloads, we highlight the sufficiency of RI numbers as a key consideration, which may also reduce the NAO's capacity to progress matters identified in our inspections.

*Progress made in the year*

- 3.14 Last year we recommended that the NAO perform root-cause analysis on the audits we assessed as requiring more than limited improvements. The NAO has taken steps to address the key findings we highlighted in 2018/19. These steps included: enhancing guidance on group audits, including how group audit teams should direct, oversee and review a component auditor; clarifying audit work programmes so that audit teams do not deviate from the NAO's approved methodology; and removing the concept of reliance on high-level controls. In the current year's inspections, there were no significant findings in these areas.
- 3.15 The NAO has also increased the depth and extent of planning consultations to enhance risk identification and the audit response. We did identify inadequate risk assessment on one audit, which had an impact on the audit work and our findings.

*'Firm-wide' policies and procedures*

- 3.16 In reviewing the NAO's policies and procedures for ensuring audit quality, we identified areas of good practice in acceptance and continuance and following up on training. The NAO was completing an exercise to update its audit methodology in respect of the new International Standards on Auditing, which are effective in December 2019 and January 2020, with a view to updating its Financial Audit Manual in time for the 2020/21 audit cycle. The implementation of changes will fall within the scope of our inspections of 2020/21 financial statements.

*(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 2019.

*(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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