

Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 6 July 2015 at the FRC Office, 8th Floor, 125 London Wall, EC2Y 5AS

PRESENT:

Nick Land (Chair)
Jane Fuller (to minute 7)
Kari Hale
Sue Harris
Robert Hingley (to minute 6.4)
Scott Knight
Maggie McGhee
Conall O'Halloran (to minute 6.7)

IN ATTENDANCE:

Kate Acott	Project Director
Mark Babington	Deputy Director of Audit Policy
Keith Billing	Project Director
Francesca Carter	Council Secretary
Marek Grabowski	Director of Audit Policy
Josephine Jackson	Technical Advisor
Andrew Jones	Director of Audit Quality (minute 4 only)
Mark Mainwaring	Technical and Quality Control, AQR team (minute 4 only)
Melanie McLaren	Executive Director, Codes & Standards
Lee Piller	FCA Observer
Pat Sucher	PRA Observer
Eileen Townsend	IAASA Observer
Marian Williams	Director, Codes & Standards

Apologies and introduction

Apologies were noted from Ray King and Allister Wilson (Council Members).

1. Minutes of the previous meeting

- 1.1 The minutes of the meetings held on 21 May 2015 were approved for publication.
- 1.2 The Council noted the status of the actions set out on the rolling action log.

2. Chairman's update

- 2.1 The Chairman reported on the meeting of the FRC Board held on 1 July. It was noted that the Board had:
 - Approved, subject to some amendments, the 2014/15 Annual Report and Accounts.

- Considered a paper on succession and approved the appointment of John Coomber to the FRC Board and Codes & Standards Committee from 23 July. The Chair reminded the Council that Ray King would take post as chair of the Audit & Assurance Council, FRC Board member and Codes & Standards Committee member on 23 July.
- Considered a further paper on the recommendations of the McKinsey report. The Chair reported that whilst good progress is being made in addressing the recommendations there is some concern as to whether the FRC has sufficient resource to implement all of the recommendations fully.
- Approved various amendments to Accounting Standards FRS 100 and FRS 101, and approved a new accounting FRS 105 applicable to micro-entities. Melanie McLaren reported that the Amendments, and the new FRS 105 would be published over the following two week period.
- Considered a paper on Actuarial Oversight.
- Considered a paper on FRC strategy ahead of the Board's Strategy Away Day which would be held in September.

2.2 The Chairman also reported that recruitment exercises are underway to fill the two vacancies that will arise over the summer and that an advert would be published in the Financial Times on 9 July.

3. Report of the Director of Audit Policy

3.1 The Council noted a paper that provided an update on development relating to UK and International auditing standards, FRC audit research activities and other FRC matters not covered elsewhere on the agenda.

3.2 The Council noted a summary of matters discussed at the IAASB Board meeting held week commencing 15 June. It was noted that the IAASB had discussed Integrated Reporting and Data Analytics and had concluded that further research on both topics would be necessary to gain further insight into the developments in both areas, including in relation to integrated reporting whether there is likely to be demand (and if so the nature of that demand) for assurance before consideration is given to whether changes to existing standards or new standards are needed.

3.3 The Council noted a summary of a meeting of certain European National Standard Setters (NSS) held on 26 June at which various matters relating to the implementation of the Audit Directive and Regulation had been discussed. It was noted in discussion that there are some areas where there is potential for European harmonisation in respect of the implementation of certain aspects of the Regulation and Directive in areas where Member State options are available and that this would be explored. It was also noted that work is continuing to assess whether 'national legislation' includes rules and regulations made under law and that further clarification on this was expected from BIS in due course.

3.4 The Council confirmed its advice supporting approval of the completed Project Scoping Form in respect of Guidance for auditors in relation to abridged accounts and micro entity accounts which proposed withdrawal of the extant Bulletin 2008/4 "The Special Auditor's Report on Abbreviated Accounts" and the incorporation of guidance on accounts being

required to show a true and fair view in the form of Application and Other Explanatory Material in to the ISAs (UK and Ireland).

4. AQR Audit Quality Inspection Reports

4.1 The Council received a presentation from Andrew Jones (AJ) on the 2014/15 Audit Quality Inspection Reports.

4.2 The Council noted:

- A summary of the entities inspected by the FRC's Audit Quality Review team;
- A summary of the scoring used to assess audit quality. AJ highlighted that the assessment process enables an overall, holistic assessment of audit quality to be made.
- That, in most instances, when an audit is scored '3 – significant improvement required' the FRC would follow up the review the following year, and depending on the issues, request remedial action be taken.
- A breakdown of the 2014-15 results. AJ highlighted that the results suggest audit quality is improving as more audits are being scored 2A.
- That the most significant issues identified through the reviews include:
 - A lack of challenge of management
 - Issues relating to audit report accuracy. AJ highlighted that this is a new issues which has arisen following the introduction of the extended auditor report.
 - Threats to independence
 - Direction and control of group audits
 - IT in audit
- The key messages arising from the work of the AQR team are
 - For Audit Committees to consider extended Committee reporting and to be proactive in seeking auditor explanations.
 - For Audit firms to seek remediation and to continue to develop action plans in response to AQR findings. AJ reported that the team has begun requesting firms to undertake a root cause analysis and that the team intend to work alongside firms to clarify what is expected from that analysis.
- The focus of the AQR team for 15/16 will be to look at priority sectors such as insurance, food and drink / consumer goods, companies in servicing extractive industries and business services. The team will also focus on first year audits.

4.3 Through discussion the following observations and suggestions were made:

- It was questioned whether the requirements for firms to develop and implement action plans and undertake root cause analysis will have a noticeable impact on audit quality.
- It was suggested that the team consider how root cause analysis could be used to prevent issues arising in the future by identifying characteristics of failures.
- It was noted that it is rare that the same companies and / or audit firms are repeatedly scored as a '3 – significant improvements required' and that the common theme tends to be the quality of the company.
- It was suggested that the team might wish to consider monitoring whether there is a link between the economics of the audit and the audit quality score.

4.4 The Chair thanked AJ for the presentation and AJ thanked the Council for their comments and suggestions.

5. UK Ethical Standards – first draft of proposed revisions

- 5.1 Keith Billing (KB) introduced a first draft of the revised ethical standards (ESs). It was noted that the revised ESs had been drafted to reflect the requirements of the EU Audit Directive and Regulation (ADR) and to address other issues that had been identified during the wider review of the ethical framework for auditors. KB reported that the draft reflects the advice given by the Council over the past year and, as advised by the Council, the scope has been broadened to cover other public interest assurance engagements for which the FRC issues performance engagement standards.
- 5.2 In introducing the draft revised ESs KB reported that:
- a significant number of conforming amendments have been made in response to the broadening of the scope;
 - the structure of the draft requires further review and a final draft set out in the correct structure will be presented to the Council in September;
 - some revisions to the draft are still subject to clarification of particular EU requirements and the extent to which they have been expanded.
- 5.3 KB invited the Council to discuss and give its advice on a number of matters as set out in the cover paper. KB reported that the matters had been considered by the Ethics Working Group who had met twice in June. Through discussion the following observations were made and advice was given:
- 5.4 *Scope – public interest assurance engagements*
- The Council noted and supported in principle the proposal that the Ethical Standards would be applicable to the audit of all financial statements, and that the more stringent requirements would also be applicable to PIEs and other Listed entities.
 - The Council supported the proposed definition of other public interest assurance engagements to be covered by the scope of the revised Ethical Standards noting that more consideration would be given before the September Council meeting to determine whether further amendment of the standard is necessary to ensure appropriate and proportionate application for other public interest assurance engagements for which the FRC issues engagement performance standards.
 - The Council suggested that the FRC should consider the impact the revised ethical standards will have on small firms and consider whether the current model is appropriate for small firms or whether further reliefs / exemptions should be provided.
- 5.5 *Structure of the proposed revised Ethical Standards and overarching principles*
- The Council supported the proposal to restructure the ethical standards as follows:
- Combining the five separate ethical standards into one document with subsections.
 - Emphasising the overarching principles and supporting ethical provisions at the front of the standard and making cross references to further supporting requirements and guidance (with such requirements and guidance based on the existing ESs supplemented with requirements derived from the Audit Regulation and Directive)
 - Providing cross references, in the subsequent sections based on the existing ESs, from the further supporting requirements and guidance to identify them with to the principles and provisions they support.

5.6 *Revisions to implement the EU Audit Directive & Regulation (ADR)*

The Council supported the proposed approach to including in the revised Ethical Standard the requirements driven by the EU ADR, noting that the proposed approach ensures anyone following the revised ES would therefore by default meet the requirements of the ADR and the requirements of a statutory audit.

5.7 *Definitions / categories of auditor*

- The Council noted there is some inconsistency in terms related to auditors as defined by the current ethical and auditing standards and by EU and UK legislation.
- The Council supported the proposal that, in order to avoid using different terms which are in substance the same and could cause unnecessary confusion, the definitions used are broadened. KB reported that the definitions set out in the draft would be finalised following confirmation from BIS as to the terminology that it will adopt.

5.8 *ES 1 (integrity, objectivity and independence)*

- The Council noted that the definitions of 'integrity' and 'objectivity' as agreed by the Council on 2014 had been included in the draft revised ES.
- The Council noted that, as previously requested, the term 'chain of command' had been eliminated and that an updated and expanded definition of 'persons in position to directly or indirectly influence the outcome of the engagement' is proposed. The Council supported the proposal to eliminate the term 'chain of command' but expressed concern with the expanded definition and what the inclusion of the phrase 'persons in position to directly or indirectly influence' could mean in practice. Whilst the Council noted that the wording had been taken from the ADR the Council suggested that paragraph 17 could be reviewed to minimise the risk of those who genuinely had no influence in being implicated. The Council also suggested it would be useful to seek advice from the FRC professional discipline team on the revised wording.
- The Council noted that guidance on the responsibilities of the leadership of the firm (paragraphs 20 and 21) had been updated to clarify that responsibility for the ethical culture covers all parts of the firm, including those not involved in providing audit and other public interest assurance services. The Council was supportive of the updated guidance.
- The Council noted that the guidance on the role of the ethics partner had been updated to clarify that the ethics partner should be someone whose decisions and advice will be respected at all levels of the firm. Whilst the Council supported the amendment the Council suggested the guidance could be strengthened to reiterate that the audit partner must be of appropriate seniority to influence at all levels of the firm. The Council also suggested that it might be useful to highlight that the ethics partner has direct reporting lines to the Board and or non-executive directors, where applicable.
- The Council did not think it appropriate to mandate or prescribe who is eligible for appointment as an ethics partner but highlighted that audit experience would be a useful attribute.
- The Council noted the current proposal, consistent with their previous advice, that the requirement for independence across a group audit had been amended to require that all network firms, whether or not involved in the group engagement and third party firms involved in the audit, should be independent of the group in accordance with the principles, supporting provisions and requirements established in the revised ES as applicable to the lead firm. KB reported that the approach establishes that, in order to use the work of other

auditors for the purpose of a group audit, the group auditor has to be satisfied that those other auditors are independent of the group in accordance with the FRC's standards; if the group auditor is not satisfied, other sources of evidence will be needed. The Council supported the approach but expressed concern that the term 'network' may not appropriately reflect the integrated structure of firms and could be misleading. In noting that the term 'network' is included in the ARD, the Council suggested that the definition of 'network firm' be included in the consultation preamble.

5.9 *ES2 (financial, business, employment and other personal relationships)*

- The Council noted that draft revised ES had been updated to reflect that some requirements introduced by the EU apply not only to partners and employees of the firm but also to 'other natural persons whose services are placed at the disposal or under the control of the firm' and to persons 'closely associated with partners, employees and such other natural persons'.
- The Council noted that, as it had previously advised, the requirements relating to secondments are unchanged to ensure they are not less stringent than the IESBA Code and that, as previously discussed, this may remain an issue for some parts of the public sector.
- The Council noted the proposed new requirement applicable in situations where a former partner is in a senior management position in an entity that the audit firm might seek to become an auditor of. Through discussion, it was noted that the executive proposal was for a period of two years to pass from when the former partner left the firm, and that although the EU Directive requirements do not address this circumstance it is equivalent in principle to the Directive requirement when a partner leaves the firm to join an existing audited entity. The Council supported the executive proposal that a period of two years should pass but suggested a question on the matter be included in the consultation.

5.10 *ES3*

- The Council noted the draft revised ES establishes the rotation requirement for key audit partners in PIEs at five years 'on' and three years 'off', however, staff are still pursuing with BIS whether maintaining five years off as is in current national requirements in these circumstances is possible.
- The Council noted that whilst the draft revised ES establishes rotation requirements for listed companies that are not PIEs at five years 'off' further consideration will need to be given as to whether this should be aligned with PIEs if the time for PIEs is shortened to three years.
- The Council supported the proposal that relief from the requirements is provided for listed entities that are not PIEs, where their securities are not freely transferrable, cannot be traded freely by the public, or if the entity has a market capitalisation of less than £xxx. The Council noted that the market capitalisation amount is yet to be determined and supported the suggestion that in determining the market capitalisation rate that consistency with values used in other parts of the FRC will be desirable. However, the Council expressed some concern that values do fluctuate which could affect where entities fit on the scale.
- The Council supported the amendment to the requirements set out in paragraph 19, requiring that the auditor should establish gradual rotation mechanisms for senior staff to cover listed entities that are not PIEs.

5.11 *ES4 (fees, remuneration and evaluation policies, litigation, gifts and hospitality)*

- The Council supported the proposed amendment to the requirement for the cap on fees for non-audit services to be more stringent and, as permitted by the Regulation, to include non-audit services provided by network firms.
- The Council supported the proposed amendment to paragraph 44 to make contribution to the quality of engagements a key criterion for performance evaluation for members of the engagement team.
- The Council discussed a proposed new requirement relating to the provision of gifts and hospitality to clients, setting out that the key criterion is that the value should be 'trivial or inconsequential' noting that the wording had been taken from the ADR. Whilst the Council expressed some concern that the wording could be interpreted differently, the Council supported the inclusion of the requirement commenting that firms should have policies to deal with the provision of gifts and hospitality in place.

5.12 *ES 5 (non-audit services)*

- The Council discussed the proposed structure for the section on non-audit services that was initially being explored and it was noted that in this context:
 - A new section had been inserted setting out the non-audit services prohibited by the AR for audits of public interest entities
 - The new section had, consistent with the previous advice of the Council, been extended to cover all listed companies, with some reliefs as agreed for smaller AIM and similar listed companies
 - On the presumption that the extension of the requirements in the section dealing with the PIE requirements in the Regulation would cover most (if not all) of the existing specific requirements in ES 5 applicable to Listed entities, they were shown as being deleted and the remaining specific requirements in ES5 would be applied only to non-audit services provided to entities that are neither public interest entities nor other listed entities (subject to further consideration of what might be inadvertently lost by doing so).

Whilst noting that the proposed approach to the structuring of the section might not be ideal, the Council supported continuing to explore this approach as it may be most appropriate in the circumstances.

- The Council noted that, as agreed at the previous meeting, the FRC requirements in respect of recruitment services for key management positions, which are more stringent than EU requirements, are proposed to be extended to PIEs.
- The Council noted that the FRC is working with BIS to establish a list of where the UK is more stringent than the EU and that it is intended the list will be published as an appendix to the ESs or published on the FRC website.
- The Council suggested that a question on whether the concept of 'audit related services' should be maintained should be included in the consultation, noting that the concept is not used in the ADR but is recognised in current UK law establishing disclosure requirements for fees paid to auditors.

5.13 KB reported that the draft revised ES presented included guidance relating to the 'white list' services identified in the December 2014 consultation, identifying them as other services for which it is generally accepted that the auditor of the entity is an appropriate provider. KB also reported that, with regards to EU derogations permitting some non-audit

services to be provided subject to certain conditions, those conditions had been amended as advised by the Council, in particular that the effect on the financial statements should be 'clearly inconsequential' rather than 'immaterial'.

5.14 The Council thanked KB for his work and noted that a further draft of the revised ESs would be brought to the September meeting.

6. **UK Auditing Standards – implementation of the Audit Regulation and Directive and Changes to International Auditing Standards**

6.1 Kate Acott (KA) introduced a first draft of proposed revisions to the Auditing Standards. KA reported that the changes come from two sources, the European Audit Directive and Regulation (ADR) and the IAASB's changes to the International Standards on Auditing (ISAs).

6.2 KA referred the Council to a table setting out a range of matters identified by the executive as requiring input from the Council and the working party. In light of time constraints KA invited the Council to consider a subset of the matters set out, noting that input on the remainder of the matters identified had been provided through discussion with the working party that morning. Through discussion the following observations and suggestions were made:

6.3 *ISQC1*

- *Remuneration policies for audit quality* – The Council noted that the Directive requires 'adequate remuneration policies... to secure audit quality' which is a significant change from the current ISQC1 which focuses more on competence and capabilities. The Council discussed the proposal to include guidance in the form of application material to explain that the adequacy of the policies should be assessed by firms in light of the requirements of the Directive and to meet the objective in ISQC1 that any system provides the firm with reasonable assurance. Through discussion the Council highlighted that Ethical Standards and the Audit Firm Governance Code go some way in addressing the issue of remuneration and suggested that going further than including the guidance material as proposed could result in users taking a 'check list' approach. Accordingly the Council supported the proposal.

6.4 *ISA 230*

- *Closing the Audit file* – The Council noted that the ADR requires the audit file to be closed no later than 60 days after the auditor's report is signed and that the AQR team have indicated they would like this time period to be reduced. Through discussion the Council suggested that, before concluding on this, an assessment of the impact, if any that a reduction in the time limit would have on audit quality would be appropriate. This assessment could be addressed as part of the wider auditing standards consultation.

6.5 *ISA 570*

- *Professional scepticism* – The Council noted that Article 21 of the Directive has a requirement for the auditor to maintain professional scepticism in particular when reviewing management estimates and cash flows for going concern purposes and that a specific requirement in respect of cash flows has been added to ISA 570 accordingly. Melanie

McLaren (MM) highlighted the need to ensure the drafting of ISA 570 in respect of going concern is consistent with the recent changes made to UK GAAP and the UK Corporate Governance Code.

- *Changes to the going concern principle in UK accounting standards* – The Council noted that UK GAAP (FRS 102) has been revised to require management, when making their assessment of going concern, to ‘take in to account all available information about the future, which is at least twelve months from the date when financial statements are authorised to issue’ and that this is in contrast to IAS1 which requires the period be ‘at least, but not limited to, twelve months from the end of the reporting period’. The Council discussed whether the UK plus requiring the auditor to disclose in the auditor’s report where those charged with governance have considered a period of less than 12 months should be removed, noting that whilst it might still be appropriate to disclose in the auditor’s report where the period is less than 12 months, the requirement would not apply for entities preparing accounts in accordance with FRS 102.
- In conclusion the Council advised that the requirement should be retained and that additional UK Application Material should be included in the ISA to set out that there are very limited circumstances where the period reported on would be less than 12 months, and in those very limited circumstances the fact that the period reported on is less than 12 months should be disclosed.

6.6 ISA 570

- *Communicating with Regulators* – The Council considered a proposal to delete the current UK Application Material on communicating with regulators on the basis that the IAASB has included new Application Material in its standards about the auditor’s duty to communicate to regulators where a going concern matter is included or considered to be included in the auditor’s report. Whilst the proposal was supported it was requested that the proposed language be reviewed to ensure the UK specific focus is not lost.

6.7 ISA 700

- KA reminded the Council of its earlier decision to advise that the IAASB’s ISA 700 revised should be adopted and that UK pluses should be added rather than amending the existing ISA (UK and Ireland) 700. The Council noted that the draft standard presented incorporates the provisions of the ADR and a number of proposed additions as previously discussed.
- The Council noted that the main difference between the IAASB’s ISA 700 revised and the existing ISA (UK and Ireland) 700 is reporting and that the basis of forming conclusions are broadly similar.
- The Council supported a proposal (consistent with the requirement for Code company audits to include a statement as to whether the auditor has anything material to add or to draw attention to in relation, *inter alia*, to the director’s statement about the going concern basis of accounting and material uncertainties), for auditors to include a statement in all audit reports under ISA 700 (UK and Ireland) on the going concern basis of accounting and material uncertainties. This was on the basis that: the requirement would ensure a consistent approach across all entities in the UK and Ireland (an approach which provides greater transparency and accountability for the auditor’s work in this area); and would

require no additional underlying audit work as the additional reporting would simply be based on the auditor's work as already required under the ISAs (UK and Ireland).

- The Council supported the proposal that the auditor should be required to include in the auditor's report that they have obtained sufficient and appropriate audit evidence as required by the IAASB's extant and revised ISA 700 – this requirement had not been adopted previously in ISA (UK and Ireland) 700 but not doing so now would give rise to a UK minus.
- The Council noted that the Regulation requires the auditor to explain in the auditor's report 'to what extent the statutory audit was considered capable of detecting irregularities, including fraud' and that at a European Level, discussion is ongoing as to how the requirement should be understood. The Council supported the proposal to require a statement tailored to the particular entity's audit rather than one that was more boilerplate in nature.

6.8 ISA 701

- *Key Audit Matters* – The Council supported the proposal to add a UK plus (and extend the requirement to all PIEs) to the definition of key audit matters such that key audit matters shall include those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall audit, the allocation of resources in the audit and directing efforts in the engagement team.

6.9 Other matters

- The Council noted that the FRC is in discussions with BIS regarding the legal interaction between the Directive and the Regulation.
- KA undertook to reflect on the advice given in drafting the revisions and invited the Council to submit any comments on the proposals and matters not discussed at the meeting by email.

7. **Extended Auditor's Reports – 2nd year experience**

7.1 Mark Babington (MB) introduced a paper setting out a proposal to issue a further report surveying the experience of extended auditor's reports in 2015. MB reported that the survey would be broadly similar to the survey carried out the previous year and that it is intended the survey would highlight:

- how auditors have continue to develop auditor's reports and embrace further innovation;
- areas of continued diversity of innovation between the auditing firms;
- to encourage the continued development of auditors reports so that they better respond to stakeholders needs.

7.2 Through discussion the Council suggested it would be useful to look at audit committee reports in parallel to the survey. The Council also highlighted the importance of ensuring investors are encouraged to respond to the survey.

7.3 The Council supported the recommendation and gave its advice to the Codes & Standards Committee to develop a further survey report as set out.

8. **Any Other Business**

8.1 The Council noted a short paper setting out the proposed approach to the impact assessment that would be undertaken in support of the Auditing and Ethical Standards consultations. MB invited the Council to submit comments on the proposed impact assessment by email before 13 July.

9. Next Meeting

9.1 It was noted that an Away Day would be held on 24 July and that the next formal meeting of the Audit & Assurance Council would be held on 22 September.

