

Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 14 November 2014 at the FRC Office, 8th Floor, 125 London Wall, EC2Y 5AS

PRESENT:

Nick Land (Chair)
Jane Fuller
Sue Harris
Robert Hingley
John Hughes
Scott Knight
Maggie McGhee
Conall O'Halloran

IN ATTENDANCE:

Keith Billing	Project Director, Audit Policy
Francesca Chittenden	Council Secretary
Susan Currie	Project Manager (minute 7 only)
Paul George	Executive Director, Conduct (minute 2 only)
Marek Grabowski	Director, Audit Policy
Stephen Haddrill	Chief Executive (minute 7 only)
Andrew Jones	Director, AQR (minute 2 only)
Steven Leonard	Project Director, Audit Policy
Mark Mainwaring	Technical Specialist, AQR (minute 2 only)
Gareth Rees	General Counsel, Professional Discipline (minute 1 only)
Dan Rouse	Case Manager, Professional Discipline (minute 1 only)
Pat Sucher	PRA Observer
Jim Sutcliffe	FRC Board Member & FRC Codes & Standards Committee Chair
Eileen Townsend	IAASA Observer
Marian Williams	Director, Codes & Standards (minutes 1 & 7 only)

Apologies and introduction

Apologies were noted from Ray King, Allister Wilson (Council Members), Melanie McLaren (Executive Director, Codes & Standards) and Lee Piller (FCA Observer).

The Chair welcomed Jim Sutcliffe to the meeting.

1. EU Audit Directive and Regulation – FRC Consultation on the Member State Options

- 1.1 Keith Billing (KB) introduced a paper setting out draft sections of the FRC Consultation on Member State Options for the Council to consider. KB reported that the FRC intends to issue its consultation at the same time or shortly after the BIS consultation on the implementation of the EU Audit Directive and Regulation is issued in December.

- 1.2 The Council noted that the FRC has been working closely with BIS to ensure the effective implementation of the EU Audit Regulation and Directive and that the objective of the FRC consultation will be to identify the Member State Options BIS are consulting on which may be delegated to the FRC, and to consult on the approach the FRC may wish to take if it were to receive those delegated powers. The Council also noted that the proposed consultation questions are open questions that have been drafted to illicit views from respondents to inform the detailed consultation on the Ethical Standards that the FRC will issue in 2015. The Council suggested this objective should be made clear in the consultation materials.
- 1.3 The Council discussed the proposed questions, through discussion the following observations and suggestions were made:
- 1.3.1 *General comments*
It was suggested that the whole consultation document be reviewed to ensure sufficient background information and rationale is provided to support the proposals set out.
- 1.3.2 *Proportionality*
The Council agreed that a question, asking respondents to indicate whether they agree that the FRC should, subject to due process, be able to impose additional requirements to adopted standards to add to the credibility and quality of financial statements or to cover matters related to national legal requirements should be included in the consultation. The Council suggested that it would be helpful to make reference in the supporting commentary to the Extended Audit Reporting requirements as an example of where the FRC has established additional requirements and that the commentary should also highlight that the ability to establish additional requirements allows the FRC to innovate and enable innovation.
- 1.3.3 Whilst the Council noted that the FRC's auditing standards are:
a. designed to be capable of being proportionally applied in an audit based on the size and complexity of the entity, and;
b. that no concerns had been raised in relation to the ability to apply standards proportionally
the Council agreed that an open question should be included in the consultation to seek views as to whether, when implementing the requirements of Articles 22b, 24a and 24b, the FRC should simplify the requirements.
- 1.3.4 *Public Interest Entities (PIEs)*
The Council noted that BIS is not minded to take the Member State Option which would enable the UK to designate any entities, outside of the statutory definition of a PIE, as PIEs due to the wide ranging implications (and statutory requirements) that would fall on those entities. The Council expressed some concern with this view and highlighted that, under the statutory definition, large pension schemes would be excluded from the scope of the more stringent requirements. Noting that the decision was not a matter for the FRC, the Council discussed whether, for the purposes of the FRC Auditing & Ethical Standards, the FRC should designate other entities which should be subject to the more stringent requirements applicable to PIEs and agreed a question to this effect should be included in the consultation. The Council also agreed that respondents should be asked to identify which entities would fall within that scope. The Council suggested that, to assist respondents in

formulating an informed response, the table set out in the appendix showing which entities fall in the scope of the definition of a PIE should be moved to accompany the question and supporting commentary. It was also suggested that more detail should be given of what are the current more stringent requirements applicable to listed entities in the FRC's standards.

1.3.5 *Audit Fees*

The Council noted that Article 4 of the Audit Regulation establishes provisions applicable to the fees for the statutory audit and non-audit services provided to PIEs and that the Article specifically provides for Member states to apply more stringent requirements. The Council discussed the requirement relating to the cap on non-audit fees and the possible options for making the cap more stringent. It was observed that it is unclear, and unlikely to be clarified before the consultation is issued, what work would fall within the scope of being a 'requirement of law' and therefore, be exempt from the cap. It was also observed that the requirements will not apply for three years after becoming a PIE. The Council agreed that open questions in relation to the cap should be asked but suggested that the questions and the supporting commentary be revised to make clearer what the consequences of the cap are and to highlight the need for the competent authority to have flexibility to manage the cap, to the extent allowed, and exemptions from the cap.

1.3.6 *Non-audit services*

The Council agreed that the consultation should include a question about the possible establishment of a 'white list' specifying allowed non-audit services and that the white list should be included in the consultation document for respondents to consider. However, the Council suggested that the proposed question as currently drafted should be revised to be more 'open'.

1.3.7 The Council noted that the sanctions regime would not change significantly following the implementation of the EU Audit Directive and Audit Regulation but agreed that it would be useful to make reference to the consequences of a breach and the relevant sanctions.

1.3.8 The Council suggested that the order of attachments 4 and 5 should be swapped so that the proposal to develop a 'white list' is considered before the questions relating to the CAP on non-audit fees.

1.3.9 The Council agreed the approach to include questions that explore whether or not the prohibitions should apply to audits outside the EU and to include arguments for and against.

1.3.10 *Record keeping*

The Council noted that the retention periods currently set out in the Audit Regulations and Rules of the Professional Bodies are longer than the retention period set out in section 15 of the new Audit Regulation but agreed that the consultation should include an open question asking whether or not the FRC should stipulate a minimum retention period for audit documentation, and if so, for what period

1.3.11 *Audit firm and engagement partner rotation*

The Council noted that whilst requirements for audit firm rotation are imposed on the audited entity, auditors should have a responsibility to ensure they do not act as auditor when they are effectively barred from law by doing so and agreed that a question asking whether this

responsibility should be established in the FRC's audit and / or ethical standards be included in the consultation.

- 1.3.12 The Council noted that the maintaining the restrictive requirements for audit firm and engagement partner rotation as set out in ES3 could be considered gold plating but agreed that a question asking whether respondents agree that the requirements be maintained should be included in the consultation.
- 1.4 The Council noted that the consultation paper will explain that there are some provisions of both the Directive and the Regulation that relate to matters for which there are no Member State options and that the amendments to the Audit and Ethical standards will be undertaken to reflect the new or amended requirements in due course. The Cover paper would also explain that the FRCs' detailed consultation due to be issued in mid 2015 would address changes that are required to be made to the Auditing standards as a result of changes to the underlying ISAs.
- 1.5 The Council noted that a final draft consultation paper, reflecting the comments made by the Council and the Codes & Standards Committee, would be presented to the Council on 28 November for recommendation to the FRC Board to be issued at its meeting on 10 December.

2. Feedback from the Audit Quality Review team

2.1 The Council received an update on the work of the Audit Quality Review (AQR) team.

2.2 Banking thematic review

Paul George (PG) reported that the review, which had focused on the audit of loan loss provision and related IT controls, had concluded and the report on the findings would be published at the end of November. PG reported that the audits of all major banks had been reviewed and the findings were generally encouraging, the majority had been graded 2 'good' and only two of the thirteen audits had been graded 3' requiring significant improvements. The Council noted that the key findings indicate:

- There is pro-activity around audit quality and evidence of more robust evidence gathering;
- Bank auditors are capturing regulatory and market risks;
- Bank auditors do use benchmarking and data analytics, though to varying degrees;
- Bank auditors are undertaking root cause analysis to understand weaknesses, PG highlighted that the report will be encouraging more of this.
- There is a need to ensure controls are in place within the audit forms so that banking specialists attend 'mandatory' financial services banking training.
- Audit Committees should be encouraged to discuss the thematic review with firms, to consider and test bank control procedures and the robustness of audit procedures.

In response to a query it was confirmed that the FRC and the PRA are in regular contact with regard to review of Bank audits and aim to be as 'joined-up' as possible.

2.3 Progress of the AQR Annual Review cycle

Andrew Jones (AJ) reported that 59% of the individual audit reviews were substantially complete and that local authority / firm wide work is due to commence in the New Year. The Council noted that whilst it is too early to conclude on overall quality there looks to be a decrease in the number of audits graded 3 and an increase in the number of audits being graded 2A 'good'. The Council also noted that emerging issues that are being identified include issues in relation to the value placed on audit quality, the role of the group engagement team, professional scepticism and ethical matters, particularly financial interests.

2.4 Extended audit reports

AJ reported that extended audit reports had been an important focus of the 2014/15 AQR reviews and that the reviews suggest the requirement for extended audit reports has been a great success. The Council noted that one issue had been identified in relation to inconsistency between what work is performed and what work is described in the report, including inaccurate descriptions in relation to the use of experts, testing of controls, auditing overseas tax liabilities and the incorrect description of impairment testing.

2.5 Small company thematic report

AJ reported that a thematic review in relation to small company reporting is underway in conjunction with the ICAEW. The Council noted that the findings identify issues in relation to the competence of preparers, disclosures outside the general ledger, technical review and the disclosure of misstatements.

2.6 Audit innovation

The Council noted that there is variable use of data analytics by audit firms because this was new technology for the audit firms and issues with the availability of IT specialists. AJ reported that other forms of innovation that had been identified include the use of audit phone apps, off-shoring and the use of the paperless file.

2.7 2015/16 Thematic review topics

AJ reported that the Conduct Committee had considered the themes for thematic review at its away day the previous week and that consideration was being given to undertaking thematic reviews to look at audit quality monitoring, engagement quality control review and audit sampling. It was suggested that consideration should also be given to looking at whether changes have been made in response to the thematic review on materiality that concluded in January 2014.

3. Minutes of the previous meeting and rolling actions

3.1 The minutes of the Audit & Assurance Council meeting held on 22 October were approved for publication.

3.2 The rolling action log was Council noted. MG reported that the FRC response to IEBSA was due to be issued that week.

4. Chairman's update

- 4.1 The Chairman introduced a note summarising the findings of the 2014 Council effectiveness reviews. The Council considered the note to be an honest and fair reflection of the review and approved the note for submission to the Codes & Standards Committee.

5. Report of the Director of Audit Policy

- 5.1 Marek Grabowski (MG) introduced 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.
- 5.2 MG drew attention to the update on the work of the International Auditing and Assurance Standards Board. The Council noted that a considerable amount of work has continued to be input to the ISA 720 and Disclosures Task Forces and that the IAASB's aspirational aim is to finalise these projects respectively at the IAASB December 2014 and March 2015 meetings. The Council also noted that Josephine Jackson had been appointed as a member of the Group Audits Task Force.
- 5.3 The Council noted the minutes of the previous meeting of the Codes & Standards Committee (CSC) and received a verbal update from Jim Sutcliffe (JS) on matters currently on the CSC agenda.

6. Activities since last meeting

- 6.1 The Council noted the list of activities since the last meeting of the Council on 22 October.

7. Audit Firm Governance Code

- 7.1 Stephen Haddrill (SH) introduced a draft report setting out the findings of the FRC review of the implementation and operation of the 2010 Audit Firm Governance Code (the 'Code'), suggested amendments to the Code and a number of questions on which the FRC would like to consult. The Council were invited to comment on the report.
- 7.2 The Council discussed the draft report in detail, the following observations, comments and suggestions were made:
- It was suggested that report could be improved if it were repositioned as a discussion document, setting out bigger, open questions to provoke debate.
 - It was noted that whilst transparency reports have been enhanced to some extent the reports are not widely read and to some are considered as compliance documents that are of little interest to most users of audit services. Accordingly, the Council suggested that consideration should be given to the introduction of a 'Turnbull' style report that would be produced by the Board.
 - It was noted that the impact INEs have had has not been as significant as had been hoped and the Council suggested to enable greater feedback from as to why this may be the case the report should set out what was expected from INEs and ask respondents whether the expectations of the INE are clear and whether the breadth of the expectations are achievable.

- The Council also highlighted the importance of the management structure and suggested it would be useful to include a question asking whether the management and governance structures of the firm allow the INE to function effectively.
- 7.3 The Council noted that the Code operates on a 'comply or explain' basis, and, as is the case with the Corporate Governance Code, the AQR team look at the extent to which the Code is followed. The Council discussed how accountability could be improved and suggested that it might be useful to consider whether there are sufficient links in the Code to the Auditing Standards to enable individuals across the organisation to be held to account. The Council also suggested that it might be useful to categorise nature of risks to the business and identify levels of responsibility in the audit firm with respect to those risks in order to reinforce accountability.
- 7.4 SH undertook to consider the comments and suggestions made by the Council in finalising the draft for presentation to the FRC Codes & Standards Committee, Conduct Committee and Board.
- 8. FRC response to the International Integrated Reporting Council consultation on assurance on integrated reports.**
- 8.1 Steven Leonard (SL) introduced a draft FRC response to the International Integrated Reporting Council (IIRC) consultation paper on the provision of assurance on integrated reports. SR reported that the draft reflects the advice given by the Council in response to a recent discussion paper issued by the IIRC with respect to the provision of assurance on integrated reports and the advice given during a preliminary discussion on the consultation at the previous meeting of the Council.
- 8.2 The Council reflected on the response and the views expressed previously, through discussion the Council reconfirmed that:
- it is questionable whether ISAE 3000 is suitable as a standard for assurance given that it lacks subject matter and is more in the nature of a Framework for Standards;
 - it is unclear to what extent there is investor and user demand for assurance to be delivered in the structured and standardised manner proposed;
 - the requirements of integrated reporting, and the provision of assurance on integrated reporting, create a significant burden.
- 8.3 The Council also noted that there is a risk that a future IIRC solution may not be aligned with the FRC's thinking and aspirations with respect to the provision of assurance on Annual Reports or on separate non-financial public reports for other stakeholder groups.
- 8.4 The Council welcomed the proposed approach (to respond at a high level and not to answer the individual detailed consultation questions), however, the Council suggested the response could be strengthened if it were reordered to position the paragraph highlighting the importance of the IIRC evidencing the demand for assurance on integrated reports early on. The Council also suggested the response could make reference to the FRC's work on 'clear & concise' reporting.

8.5 SL undertook to revise the response to reflect the comments that had been made and to re-circulate the draft to the Council for approval by email before submission to the Codes & Standards Committee.

9. AOB

9.1 There was no other business.

10. Next Meeting

10.1 The next formal meeting of the Audit & Assurance Council will be held on 13 February 2015.