

## **Audit and Assurance Council**

Minutes of a meeting of the Audit and Assurance Council of the FRC  
held on 2 March 2016 at the FRC Office, 8<sup>th</sup> Floor, 125 London Wall, EC2Y 5AS

### **PRESENT:**

Ray King (Chair)  
Bryan Foss  
Jane Fuller  
Sue Harris (to minute 7)  
Robert Hingley  
Scott Knight (to minute 7)  
Maggie McGhee  
Stephen Oxley

### **IN ATTENDANCE:**

Kate Acott	Project Director, Audit Policy
Mark Babington	Deputy Director of Audit Policy
Keith Billing	Project Director, Audit Policy
Francesca Carter	Council Secretary
James Ferris	Project Director, Audit Policy
Michael Gaull	PRA Observer
Marek Grabowski	Director of Audit Policy
Josephine Jackson	Technical Director, Audit Policy
Melanie McLaren	Executive Director, Codes & Standards
Lee Piller	FCA Observer

### **Apologies**

Apologies were noted from Kari Hale and Conall O'Halloran (Council Members).

#### **1. Minutes of the previous meeting**

- 1.1 The minutes of the meetings held on 20 January 2016 were approved for publication.
- 1.2 The Council noted the status of the actions set out on the rolling action log. It was reported that a paper on the PWC presentation 'Citizens Jury' would be brought to a subsequent meeting.

#### **2. Chairman's update**

- 2.1 The Chairman provided an update on matters considered by the FRC Board at its meeting on 27 January. The Council noted that a significant proportion of the Board agenda had been focused on implementation of the Audit Directive & Regulation (ARD) and implementation of the McKinsey Effectiveness Review. The Chairman also provided an

update on matters considered by the Codes & Standards Committee (CSC) at its meeting on 9 February. The Council noted that the CSC had considered a consultation issued by the Department for Business Innovation and Skills (BIS) relating to UK implementation of the Non-Financial Reporting Directive.

2.2 Melanie McLaren (MM) provided an update on the FRC Board's deliberations in respect of the upcoming EU referendum and possible 'Brexit'. MM reported that advice received from BIS had been to continue business as usual in respect of the implementation of the incoming Audit Regulation and Directive. MM also reported that the Board had highlighted the need to continue to strengthen and develop the FRC's relationships with European counterparts.

2.3 The Chairman invited the Council to consider a paper summarising the findings of the 2016 Audit & Assurance Council effectiveness review. The Council noted that overall the outcomes are generally very positive and that Members consider the Council to be effective. Through discussion the following actions were supported / suggested:

- Session to be scheduled to clarify / refresh members' understanding of the governance of the FRC and split of responsibilities between the various governance bodies. Session to include an opportunity to reflect on the ToR of the Council in light of FRC realignment; the Council's responsibilities in respect of risk identification and the composition of the Council.
- Approach to Horizon Scanning to be revisited; approach to provide the Council with greater opportunity to input to the development of the Council work plan.
- Consideration to be given to how to improve the link to current practice and enforcement to understand how standards are being applied in practice.
- Further consideration to be given to reducing the volume of papers through improved signposting and clearer marking of information that is essential / non-essential reading.

2.4 The Council requested a further opportunity to discuss the findings of the review in detail. The Chairman and Executive undertook to schedule a discussion before the summer as requested.

### **3. Report of the Director of Audit Policy**

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

### **4. EU Audit Directive and Regulation – Proposed Feedback Statement and Impact Assessment, and Changes to Auditing and Ethical Standards**

4.1 Mark Babington (MB) introduced a paper setting out a draft Feedback Statement and Impact Assessment, a summary of changes to the Revised International Standards on Auditing (UK and Ireland) and the Revised Ethical Standard and a table showing a comparison of the IESBA requirements and the proposed revised FRC Ethical Standards. MB reported that the documents had been updated to reflect input from stakeholders, responses to the Consultation and to reflect the advice given by the Council in February.

- 4.2 The Council discussed the application of the revised Auditing Standards in Ireland and noted that, as a result of delays in progressing implementing legislation in Ireland and the outcome of the General Election held on 26 February, it is highly unlikely the relevant implementing legislation will be in place by 31 March. MB reported that the FRC has raised the issue with the Department of Jobs, Enterprise and Innovation (DJEI) and that one proposal being considered is whether to issue new ISAs 700, 701 and 720 as UK only Standards (withdrawing the equivalent UK and Ireland Standards at the same time) and to update them to UK and Ireland Standards once Irish Legislation is in place.
- 4.3 MB reported that the FRC has been made aware that the ICAEW is working with the profession to produce interpretative guidance to address ambiguity in the language used in the EU Regulation. MB highlighted that this creates risk for the FRC, as guidance issued by a professional body, if flawed, could undermine a case before a tribunal, and a proliferation of guidance could also undermine the principle-based nature of the standards. The Council supported the proposal to address the risks by establishing an Audit & Assurance Council Technical Advisory Group that would bring together representatives from the profession and other stakeholders to provide input as to the areas where interpretative guidance would be useful. The Council noted that the group would be akin to the Accounting Councils' UK GAAP Technical Advisory Group and that its advice would be reported to the Council. The output of the Group could vary from a recommendation to issue guidance (formal or informal) or a staff note to the agreement of a market based consensus.
- 4.4 The Council noted that the documents under consideration would be updated to reflect the advice of the Council and presented to the CSC on 16 March, the Board Steering Group on 31 March and the FRC Board on 14 April. The Council also noted that once approved by the FRC Board it is the intention that the documents would be published as soon as possible. MB reported that, should the legislation establishing the FRC as the Single Competent Authority not be finalised by the intended publication date, the documents would be issued as 'subject' to that legislation and finalised following the implementation of the legislation.

## **5. EU Audit Directive and Regulation – Proposed Revised International Standards on Auditing (UK and Ireland)**

- 5.1 MB reported that a number of consultation questions posed in respect of the Auditing Standards had received overall support from respondents to the consultation and, in accordance with the preliminary advice given by the Council in February; the Standards had been amended as proposed in the consultation documents. The Council was invited to consider, and give its advice in respect of the proposed approach taken in responding to the remaining questions where respondents had identified issues.
- 5.2 Through discussion the following points were noted and advice was given:

*Question 15 – Do you agree with the FRC's proposed approach to incorporate the requirements of the ARD in to the text of the quality control and audit standards*

- The Council noted that respondents to the consultation had suggested integration of the requirements added complexity and volume to the standards and that steps, including the removal of all references to statutory audit, had been taken to clarify and simplify the language used. Kate Acott (KA) reported that several firms and

professional bodies had confirmed in their consultation responses that auditors did not differentiate between statutory and other audits of financial statements.

- The Council discussed in detail a suggestion from respondents to include, for some areas of work, illustrative auditor's reports that are tailored to the UK and Ireland. Whilst some Council members suggested that providing examples could result in boiler plate text it was concluded that the provision of illustrative reports is helpful in enabling the auditor to understand how the Standard could be applied and that removing all illustrative examples would create an ISA minus which would mean the UK Standard would fall short of the International Standard. Therefore, the Council supported the proposal to retain the appendices with illustrative auditor's reports in the relevant Standards, but to make it clear that the reports were not tailored for UK and Ireland and to direct auditors to the bulletin containing the UK and Irish examples.

*Question 17 - Do you agree with the FRC's proposals to adopt ISA (UK&I) 700 (Revised) and ISA (UK&I) 701?*

- It was noted that, in response to concerns raised by respondents regarding the complexity of ISA 701, and in particular, the definition of Key Audit Matters, the wording of the UK plus and the requirement of the Regulation has been moved from the definition to application material, and combined in to one concept applicable to all entities who apply ISA 701, as the two are broadly aligned to "risks of material misstatements".
- It was noted that in order to achieve the above it had been necessary to interpret an aspect of the Regulation relating to the definition of a 'Key Audit Matter' but that the interpretation is consistent with the International definition and has been supported by practitioners; it was also noted that the proposal ensures the UK pluses are retained.
- The Council reaffirmed its advice to adopt the revised ISA 701 and to extend application of ISA 701 (UK&I) to those entities that are required to, and those who voluntarily, apply the UK Corporate Governance Code and PIEs. The Council also supported the approach to clarify and simplify the text of the Standard as set out.
- The Council also supported the proposal to remove the requirement 45R-1(a) in ISA 700 for auditor's reports 'to be in clear and unambiguous language' and to introduce it as a new separate requirement at paragraph 20-1 that is applicable to all entities.
- It was noted that it is still unclear how the requirement to 'explain to what extent the audit was capable of detecting irregularities including fraud' should be interpreted and that discussions with relevant bodies in other EU Member States are being pursued to establish whether a common understanding can be reached. Whilst the Council supported the proposal not to interpret the requirement and to monitor how the requirement will be applied by other regulators across Europe, the Council suggested the issue be drawn to the attention of the FRC Board. The Council also suggested the matter should be highlighted in the Feedback Statement.

*Question 18 - Do you agree with the FRC's proposals to (a) adopt the proposed ISA (UK and Ireland) 720 (Revised); (b) include requirements to allow the auditor to provide the required opinions and statements under UK [and Irish] legislation; and (c) withdraw Section B of ISA (UK and Ireland) 720 (Revised)?*

- The Council noted that, whilst the majority of respondents support the proposal to adopt ISA 720 (UK&I) (Revised) and integrate the requirements of the ARD into one single standard, respondents had expressed concern that the revised standard was overly complex. Respondents had also questioned whether the requirements go beyond the requirements of the Directive.

- The Council supported using the term “applicable legal and regulatory requirements” and removing the definition of “applicable other information reporting framework” in order to align the wording more closely to the opinion required by the Directive.
- The Council also noted that the term “broadly concurrent” had been removed which many firms and professional bodies considered to be unclear and that the wording of the requirement in 14-1 had been more closely aligned to the legislative requirements.
- The Council supported the clarification of the additional application material where respondents had raised questions over applicability and supported the clarifications that had been made throughout the standard.
- On the basis of the amendments the Council reaffirmed its advice to the Board to adopt the revised ISA 720 and withdraw ISA 720B.

*Question 19 - Do you agree with the FRC’s proposals to enhance auditor reporting in respect of the going concern basis of accounting?*

- It was noted that, whilst the proposals had been supported by the majority of respondents to the consultation, some respondents had suggested the drafting of the standard was overly complex.
- The Council were reminded that the proposals would not result in additional cost or work for the auditor.
- The Council considered and supported the clarifications that had been proposed to respond to the concerns raised, including the removal of duplicative text at paragraph 21-2(a) and the introduction of application material in its place in both ISA 570 and ISA 700 to explain that the auditor can choose to include the description of their responsibilities either in the going concern section or in the auditor’s responsibilities section.
- On the basis of the amendments the Council reaffirmed its advice to enhance auditor reporting such that where the auditor concluded that the going concern basis of accounting was appropriate and that there were no material uncertainties identified, the auditor would report by exception on those matters in the auditor’s report.
- Whilst it was noted that some investor respondents had suggested auditors should be required to make a positive assertion, the Council reaffirmed its advice that time should be allowed for the new viability statement requirements to ‘bed in’ before consideration is given to extending the requirement of the standard.

*Question 20 – Do you agree with the proposed scope of ISA 250B being limited to PIEs, or do you believe that the requirements of ISA 250B should also apply to non-PIEs in regulated sectors?*

- The Council noted that whilst the Consultation response strongly supported ISA 250B being limited to PIEs and other entities in the financial sector, some respondents noted that it was not clear who the standard applied to.
- In response to this, the Council noted the proposal to clarify the scope by amending the title of ISA 250 Section B and suggested the word ‘regulators’ be inserted as follows ‘The Auditor’s Statutory Right and Duty to Report to Regulators of Public-Interest Entities and Regulators of Other Entities in the Financial Sector’.
- Subject to the above, the Council reaffirmed its advice to limit the scope of ISA 250B to PIEs and other regulated entities in the financial services sector.

5.3 KA thanked the Council for its advice and undertook to amend the draft standards and the Feedback Statement to reflect that advice before submission to the CSC, Board Steering Group and FRC Board.

## 6. EU Audit Directive and Regulation – Proposed Revised FRC Ethical Standard

6.1 Keith Billing (KB) invited the Council to consider and give its advice in respect of the approach taken in responding to comments received to the consultation questions relating to the Revised Ethical Standards.

6.2 Through discussion the following points were noted and advice was given:

*Question 1 - Do you agree that the overarching ethical principles and supporting ethical provisions establish an appropriate framework of ethical outcomes to provide a basis for user trust and confidence in the integrity and objectivity of the practitioner, as described in the introduction to the Ethical Standard?*

- The Council reaffirmed its support for the overall approach set out in the consultation and supported the edits that had been made in response to concerns over the clarity of the Standard. The Council also supported the proposed restructure of the Introduction to Part A of the Ethical Standard.

*Question 2 - Do you support the FRC's proposals to restructure the ethical standards, as a single standard for all audit and public interest assurance engagement?*

- The Council reaffirmed its support for the approach set out in the consultation and supported the edits made throughout the document, including the introduction of more defined terms, to reduce the length and complexity of the Standard.
- The Council also supported the edits that had been made to make it explicit where requirements are applicable only to work carried out on Investment Reporting engagements.

*Question 3 – Do you agree with the FRC's proposals for the application of the FRC ES (more stringent requirements) to non-listed PIEs?*

- Whilst it was noted that the requirements of the UK plus, which set the maximum period at 5 years, with the option to extend for another 2 years, go beyond the requirements of the Regulation, the Council considered it appropriate to retain the more stringent requirement on the basis it is an established requirement.
- The Council supported the proposal to add material to paragraph 3.14 to provide examples of where an audit committee could agree to an extension of up to 2 years in the maximum rotation period of an audit engagement partner to respond to concerns raised by some respondents that the requirement could be problematic for smaller entities.
- The Council also considered it appropriate to extend the limit on total fee income from a single audit to 10% on the basis that AQR Colleagues within the FRC do not consider this to be an issue for small entities, the 10% limit is established and respondents to the consultation did not raise any concerns with the proposal.

*Question 4 – Do you agree with the FRC's proposal to retain the Ethical Standard – provisions available for Smaller Entities and to make conforming changes?*

- The Council reaffirmed its support for the proposal to incorporate the provisions in to the Ethical Standard.

*Question 6 – Do you support the extension of scope to other public interest assurance engagements, incorporating the requirements of the ESRA into the FRC ES, and do you agree that the restriction of scope of ethical requirements for investment circular work is sufficiently clear*

*in the proposed text?*

- The Council reaffirmed its support for the proposal to incorporate the provisions in to the Ethical Standard and the edits intended to make clear where aspects of the Standard relate to specific areas of work.

*Question 7 - To provide additional clarity in respect of auditor independence do you support the FRC's proposal to replace the 'chain of command' definition with the revised wording of the definition of a covered person?*

- The Council discussed in detail proposed revisions to the wording of the definition of a covered person, noting that a number of respondents had commented that the proposed definition of a covered person is disproportionate and captures trainee and junior members of the team who would not be in a position to influence the audit.
- Whilst the Council expressed some sympathy for the concerns and acknowledged that the definition of a 'covered person' is broader in scope than the scope of the 'chain of command' it was noted that the Directive requires that those who are in a position to 'indirectly' influence the audit should be captured.
- The Council considered that it would be disproportionate to include within the scope everyone who may be involved in the performance appraisal of a member of an audit firm and that the wording should be revised to clarify that the definition would only capture those who are in a position to directly influence the performance review process.
- The Council concluded that a further review of the wording was necessary to ensure that the definition only covers those who are in the position to influence the substantive conduct of the audit.

*Question 8 - Do you support the FRS's proposal regarding accepting an engagement for an entity employing a former partner or other restricted person, to comply with the requirement set out in the Directive?*

- Whilst it was noted that, under the proposed approach, the restrictions imposed on the firm are more stringent than the restrictions on the individual, the Council reaffirmed its support for the approach highlighting that the restriction on the firm is consistent with existing requirements and is established in practice, and respondents did not express any concern in respect of the proposals.
- The Council supported the proposed amendments that had been made to paragraphs 2.49, 2.51 and 2.54 to improve clarity and supported the inclusion of additional material to help explain why the requirements are also needed in relation to entities that are not yet clients.

*Question 9 – Do you agree with the FRC's proposal to mitigate the risk of an auditor's independence being compromised, by clarifying requirements relating to the provision of non-audit services provided before taking up appointment as auditor?*

- The Council supported the introduction of guidance to clarify how a threat to auditor independence from non-audit services can, in certain circumstances, reduce over time. However, the Council suggested the drafting should place greater emphasis on the importance of having regard to both the significance and nature of the work undertaken in determining the independence of the auditor.
- Subject to the above the Council reaffirmed its support for the proposal.

*Question 10 – Do you support the FRC's proposal to make consistent the prohibitions over providing advocacy for an audited entity in relation to tax?*

- The Council reaffirmed its support for the proposal and supported the edits that had been made to clarify the link to the ethical provisions more clearly and clarify what is meant by the term advocacy.

*Question 11 – Do you agree with the prohibition proposed by the FRC in respect of tax services on a contingent fee basis?*

- Whilst the Council noted that some respondents had queried why an outright prohibition is proposed in respect of tax services, but not in respect of other non-audit services, the Council reaffirmed its support for the proposal on the basis that experience shows there to be issues in respect of tax services and tax can have a significant impact on the financial statements. The Council requested this rationale be made clear in the Feedback statement and in the Council’s advice to the CSC and FRC Board.
- The Council supported the reintroduction of the requirements after paragraph 5.105 for an outright prohibition for listed entities that are not SME listed entities (as defined in MiFID II).
- The Council also supported the proposed edits that had been introduced to clarify that it is the outcome of the application of tax law that is uncertain.

*Questions 12 – 14 Relating to the FRC’s proposals to offer targeted relief in respect of the audits of smaller listed / smaller quoted entities.*

- The Council noted and supported the proposal that reliefs should apply to entities that are SME Listed entities for purposes of the Markets in Financial Instrument Directive II (MiFID) or that meet the same criteria.
- The Council also supported the proposal that should an entity fail the size threshold test under MiFID but subsequently fall in value and once again meet the threshold, that the entity should be immediately entitled to the relief and not have to wait for two years as previously advised.

6.3 To support the discussion of the approach to take in relation to Question 5 – ‘Do you support the FRC’s proposal for the group auditor to ensure that any component auditor, whose work they propose to use in the audit and other members of the firm’s network, meet the FRC ES or the IESBA Code?’ the Council considered:

- a document comparing the requirements of the FRC Ethical Standard with the Code of Ethics issued by IESBA; and
- a document that provided a detailed analysis of the aspects of the FRC’s Overarching Principles (OP) and Supporting Ethical Provisions (SEP) that the executive suggest might be applied by the Group auditor when assessing the independence of a network firm.

The Council noted that the proposed approach suggests that, in assessing the independence of a network firm, the Group auditor should apply the IESBA Code, ISQC1 and specified relevant incremental aspects of the FRC’s Ethical Standard.

6.4 The Council discussed the proposed approach in detail. It was noted that some might consider that:

- since the requirement would apply on an engagement by engagement basis this may result in increased workload for auditors;
- since the approach goes beyond the requirements of the Directive, it could be considered disproportionate, at least in the case of non-PIEs;
- the approach is somewhat complex; and

- the FRC could be seen to be challenging the sufficiency of the IESBA Code as an international benchmark.

However, the Council considered that, in order to achieve high quality outcomes for UK PIE audits, and to mitigate risks to that quality, the group auditor should ensure that a component auditor in the firm's network firm has considered relevant aspects of the FRC's Ethical Standards (including the overarching principles of Integrity, Objectivity and Independence) to the extent they are not addressed through application of either the IESBA Code or ISCQ1. The Council also highlighted that removing the requirement for network firms to demonstrate compliance with the more stringent requirements of the FRCs Ethical Standards could be considered as 'going backwards' and be perceived to undermine the decision to revise the Ethical Standards.

6.5 The Council considered the analysis document and requested more time to consider whether the proposals by the executive for possible application in respect of the assessment of independence for a network firm were appropriate.

6.6 Three further issues were identified and considered in respect of the proposed revisions to the Ethical Standards.

- The first issue related to the introduction of additional material in respect of the 70% cap on fees paid to an audit firm in respect of non-audit services. The Council advised that the second sentence of the additional material adds unnecessary complexity and that the risk that sentence is attempting to address could be dealt with in a different manner. The executive undertook to make appropriate revisions to the text.
- The second issue related to Section 2, paragraph 2.2 –the requirement that 'any persons closely associated with any such partner or other covered person, shall not have a material direct financial interest in, or engage in any transaction in, any financial instrument of any entity relevant to such an engagement of the firm'. Through discussion it was clarified that whilst the requirement appears to go beyond the requirements of the Directive, the text reflects BIS's interpretation of the Directive and therefore is the wording that BIS proposes to put in to legislation. MM reported that the interpretation has been included in the relevant BIS consultation and that stakeholders might wish to highlight any concern in respect of that interpretation directly to BIS in the consultation feedback.
- The third issue related to the drafting of the standard in respect of collective investment vehicles; it was suggested the drafting be revised to improve clarity.

6.7 The executive undertook to update the Feedback Statement, Impact assessment and draft Ethical Standards to reflect the advice of the Council, and undertook to schedule a conference call to finalise the Council's advice in respect of the assessment of the independence of a network firm ahead of the March CSC meeting.

## 7. **Discussion – IAASB Invitation to Comment 'Enhancing Audit Quality in the Public interest – A Focus on Professional Skepticism, Quality Control and Group Audits' (the 'ITC').**

7.1 Josephine Jackson (JJ) introduced a paper setting out an outline of the FRC response to the ITC ("outline response"). JJ reported that the ITC addresses issues and concerns raised by stakeholders, including regulators and oversight bodies, and sets out how the IAASB currently addresses those matters and possible actions the IAASB could take in

response to those matters. The Council noted that the matters raised in the outline response to the ITC is consistent with views expressed previously by the Council and/or are set out in publications issued by the FRC and live discussions that are being held.

7.2 JJ reported that the deadline for comments to the ITC is 16 May and that the Council would be asked to approve the final FRC response at the 11 May Council meeting.

7.3 The Council discussed the ITC and supported the proposed outline response. More generally, in respect of the three areas, the following advice was given:

#### *Quality Control*

- The Council supported the proposal to encourage the IAASB restructure ISQC1 to incorporate a Quality Management Approach (Firm Level) and also incorporate a more proactive approach to audit quality at the engagement level in ISA 220. The Council noted that a more proactive approach to audit quality at the engagement level is encouraged in the FRC's Practical Guide for Audit Committees.

#### *Group Audits*

- The Council supported the proposal for the IAASB to review the scope of ISA 600.

#### *Professional skepticism*

- The Council supported the proposal to encourage the IAASB to explore ways through which professional skepticism can be embedded in all stages of an audit. Suggestions would include providing clarification as to what professional skepticism means and being more specific of what should be expected of auditors.

7.4 The Council also noted their support for the following matters raised in the outline response:

- Highlighting the need to consider the impact of technological advances in respect of all three issues.
- Supporting the need to 'future proof' auditing standards.
- Encouraging the IAASB to explore how the culture of a firm impacts professional scepticism and whether the issues identified could be addressed through a review of performance management processes.
- Encouraging the IAASB to ensure that ISQC1 clarifies that firm's need to appropriately balance public interest and professional integrity with the commercial interests of the firm.
- Embedding the user perspective more widely.
- Reflect on the evidence gathered in support of the development of the Audit Firm Governance Code.

7.5 JJ thanked the Council for its input and support.

## **8. Any Other Business**

8.1 The Council was reminded that a Governance event for all FRC Board, Committee and Council members would be held on 9 March.

8.2 There was no other business.

**9. Next meeting**

- 9.1 The Council noted that the next formal meeting of the Audit & Assurance Council would be held on 6 April 2016.
- 9.2 The Council noted a request to start the 7 September meeting at the earlier time of 8.45am to conclude at 11.45am.

