

## **Audit and Assurance Council**

Minutes of a meeting of the Audit and Assurance Council of the FRC held on 20 January 2016  
in the Frobisher Board Room, Barbican Centre, Silk Street, London EC2Y 8DS

### **PRESENT:**

Ray King (Chair)  
Jane Fuller  
Connall O'Halloran  
Stephen Oxley  
Sue Harris  
Kari Hale (from minute 3)  
Scott Knight

### **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
Anna Colban	Project Manager, Codes & Standards (minute 5 only)
Michael Gaull	PRA Observer
Marek Grabowski	Director of Audit Policy
Michael Kavanagh	IAASA Observer
Melanie McLaren	Executive Director, Codes & Standards
Lee Piller	FCA Observer
Dan Rouse	Professional Discipline (minute 6 only)
David Styles	Director, Corporate Governance (minute 5 only)

### **Apologies and introduction**

The Chairman welcomed Michael Kavanagh, interim CEO of IAASA to the meeting.

Apologies were noted from Bryan Foss, Robert Hingley and Maggie McGhee (Council Members).

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

- 1.1 The minutes of the meetings held on 9 November 2015 were approved for publication subject to a minor typographical amendment
- 1.2 The rolling action log was noted.

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

- 2.1 The Chairman provided a verbal report on matters discussed and decisions taken by the FRC Board at its meeting on 1 December. Particular attention was drawn to the following matters:

## FRC Realignment

- 2.2 It was noted that in order to ensure efficient delivery of, and to support implementation of the 2016-19 strategy agreed in October, the Board had agreed a number of changes to the FRC's executive structure. The Chairman reported that, from 1 April 2016, there would be an Audit Division headed by Melanie McLaren, a Corporate Governance and Reporting Division headed by Paul George and an Enforcement Division headed by Gareth Rees. The Council noted that the changes are intended to better align resources within the FRC and to enable the successful establishment of the FRC as the Single Competent Authority for Audit. The Chairman also reported that the Board would be considering whether consequential amendments to the Governance Structure would be necessary in the Autumn once the changes to the executive structure had embedded.

## IAASB

- 2.3 The Council noted that Arnold Schilder (IAASB Chairman) had joined the Board for lunch and had expressed his appreciation of the input the FRC provides to the IAASB. The Council noted that Marek Grabowski's first three-year term as a member of the IAASB would complete at the end of 2016 and that in the coming weeks the FRC would be nominating him for reappointment for a second term.

## 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.
- 3.2 Particular attention was drawn to Appendix 3 which set out detailed feedback from the IAASB meeting held week commencing 7. Through discussion it was noted that:
- The IAASB had issued an Invitation to Comment ('ITC') entitled '*Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*'. The Council would begin discussing the FRC response to the ITC at its March meeting.
  - The FRC is disappointed that the IAASB and the Quality Control Working Group has not attempted to define 'audit quality' or to include consideration of an appropriate definition of 'audit quality' in the ITC despite input from the FRC.
  - The IAASB had approved a project proposal to revise ISA 540 (Audit of Accounting Estimates) and that Marek Grabowski (MG) would be on the Project Taskforce. It was also noted that an ambitious timescale has been set for completion of the project.

## 4. Quarterly Horizon Scanning Discussion

- 4.1 The Chairman invited the Council to identify any matters the Council, and wider FRC, should be aware of. Through discussion it was highlighted that IT gives rise to significant risks for companies both in respect of the impact software and hardware failures could have on a company and in respect of the impact cybercrime could have. Through discussion it was noted that BIS had recently asked the FRC to consider the appropriateness of establishing a requirement for companies to provide a disclosure in respect of cyber security; the Council supported the suggestion that the FRC consider initiating a Financial Reporting Lab ('Lab') project on the topic. It was also noted that the FCA has formed an executive group to look at IT regulatory risks and that there may be

scope for the two organisations to work jointly to explore the issue in detail. It was highlighted that the use of data analytic tools in auditing is increasing at a rapid pace. Whilst noting that the topic is on the forward work plan the Council encouraged the FRC to progress to give this work as high a priority as possible given other commitments.

- 4.2 MG noted that these issues have been under consideration in the US too, both in relation to the role of the auditor and in relation to additional services that professional accountants might be able to deliver. A note would be prepared in due course summarising what views as to the extent of the current auditor's responsibilities and on developments in these areas in the US. The Council suggested it would be useful to receive regular updates on any matters the US have considered that have not yet been considered or explored in the UK.
- 4.3 The Council was also encouraged to consider risks within the FRC. It was highlighted that the current Audit and Assurance team workload is substantial and that there is a risk that work the FRC has committed to may be consequently be affected. It was also highlighted that the establishment of the FRC as the Single Competent Authority and the changes to the executive structure due to take effect on 1 April may also give rise to further changes in the responsibilities and workload of the team that would need to be addressed.

## **5. FRC Culture project**

- 5.1 The Chairman welcomed David Styles (DS) and Anna Colban (AC) to the meeting.
- 5.2 DS introduced a paper summarising a market-led initiative in 2015, facilitated by the FRC, to gather practical insight from a broad coalition of stakeholders, into corporate culture and the role of boards; to understand how boards can shape, drive and assess culture; and to identify and promote good practice. DS invited the Council to provide views on:
- How firms know whether they have a consistent culture and what that culture is.
  - How auditors and companies can work together to identify and embed culture.
  - Whether there is a role for auditors to provide assurance in respect of culture.
- 5.3 Through discussion the following observations and suggestions were made:
- Culture is a difficult concept to define.
  - Culture is multi-dimensional and there are a number of elements that need to be identified and considered. Whilst a well-structured internal audit would include an assessment of some of those elements, a number of those elements are subjective and inherently difficult to measure.
  - Given the inherent difficulty that arises in attempting to measure the various elements it would be difficult for an external auditor to provide formal assurance in respect of the culture of an organisation, however, it could be expected that an auditor (whether internal or external) could make an informal assessment for discussion with the Chief Executive and Board.
  - If a Board were to attempt to make an assessment in respect of its culture, a 'scoreboard' approach might be a useful tool for identifying and measuring the various elements.
  - There are a number of elements to be identified and considered; as many of those elements are subjective they are inherently difficult to assess.

- Directors (especially NEDs) should be encouraged to meet with staff of varying levels of seniority within the organisation in order to ascertain whether there is a consistent view of culture.
- Directors should be encouraged to align the company and strategy with the culture in order to capitalise on that culture.
- Culture is set at the top of the organisation and should be communicated effectively through the organisation.

5.4 The Council welcomed that the FRC intends to publish the findings of the project as a set of observations and practical tips to help Boards identify and measure the culture of an organisation as opposed to providing prescriptive rules or guidance. The Council also supported the suggestion that, at a later stage, consideration be given to incorporating any practical tips identified in to the FRC's Guidance on Board Effectiveness.

## **6. Responses to the Consultation on the Audit Regulation and Directive**

6.1 Keith Billing (KB) introduced a paper summarising the 41 responses received to the FRC consultation on proposing revisions to Ethical and Auditing standards in response to the Audit Directive and Regulation. The Council noted that whilst respondents were generally supportive of the proposals and the feedback received was generally constructive there are some proposals that will require further consideration. The Council also noted many respondents highlighted a need to simplify and clarify the drafting of the proposed standards in order to make the standards more user friendly.

6.2 KB drew the Council's attention to a presentation setting out responses to the section of the consultation relating to revisions to the Ethical Standards (ESs) and proposed actions to address issues raised. The Council noted that the views expressed and advice given in respect of the proposed actions would be taken into consideration in drafting the final proposed revisions that would be presented to the Council in March for Advice to the Codes & Standards Committee and FRC Board.

6.3 Through discussion the following observations were made and advice was given:

### ***Question 1***

It was noted that whilst respondents expressed overall support for the proposed principle based approach, many auditor respondents had expressed concern in respect of the complexity of the standard and had requested greater clarity in respect of the relationship and distinction in status between the overarching principles / supporting ethical provisions / specific requirements. The Council was content that, to address the concerns raised, the Audit and Assurance Team (AAT) would look to improve drafting by using shorter sentences and phrases, improve cross-references from specific requirements back to the overarching principles and introduce shorter defined terms.

It was noted the FRC had received a letter from Group A firms and ICAEW setting out their intention to develop guidance to assist auditors with the application of the Principles. Through discussion it was acknowledged that there are some requirements of the ARD that are very complex and where the FRC may need to consider providing more detailed guidance.

### **Question 2**

It was noted that whilst there was broad support for the proposed structure some respondents had expressed concern that the proposed structure is overly complex, that there is a lack of clarity arising from including ESRA and that there is potential for possible confusion between requirements for PIEs and other public interest assurance engagements. The Council was content that, in order to address the concerns, the AAT would:

- Undertake a further review of the individual requirements to ensure requirements are not applied to ESRA engagements if not appropriate.
- Improve the drafting to reduce complexity and improve clarity (as set out above).
- Make it clear where aspects of the Standards are specific to certain engagements.

KB highlighted a concern raised by two firms who suggest that the proposals result in the 'gold plating' of requirements for SIR and CASS work and that the inclusion makes the standard unnecessarily complex. Following a brief discussion it was suggested that the AAT should reassess the position once work to improve clarity and reduce complexity has completed. It was also suggested that the AAT should seek to hold outreach events with those who have raised concerns to ensure the approach sufficiently addresses the concerns.

### **Question 3**

It was noted that whilst most respondents expressed support for the proposal to extend the application of the FRS ES (more stringent requirements) to non-listed PIEs some suggested the extension is unnecessary and others suggest the extension should go further. The Council advised the proposal should be retained and advised that the FRC should, as requested by some respondents, consider providing transitional relief where the requirements are being applied for the first time to small non-listed PIEs.

### **Question 4**

It was noted respondents expressed strong support for the proposal to retain the Ethical Standard Provisions available for Smaller Entities and the proposal to make conforming changes to the Standards.

### **Question 5**

It was noted that respondents expressed mixed support for the 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 ESs or IESBA Code. KB reported that a number of auditors and professional bodies had expressed concern in respect of cost and the fact the FRC ESs are more stringent than the IESBA Code.

The Council discussed the concerns raised and suggested that cost should not be a cause of concern. However, the Council supported the suggestion that the FRC undertake a detailed gap analysis to identify where the FRC ESs are more stringent so to enable a better understanding of the incremental requirements non-UK network firms would be expected to comply with and take a fully informed decision.

### **Question 6**

It was noted that whilst there was overall support for the proposal to extend the scope to other public interest assurance engagements, a significant number of auditors expressed concern that incorporating the requirements of the ESRA would add complexity and that material specific to investment circular reporting would not be sufficiently clear.

The Council supported the proposal to address the concerns by making it clearer which requirements apply to all engagements and which either do not, or only apply to ESRA engagements.

It was also noted that some auditors had expressed concern that the proposals would create practical difficulties for private reporting engagements and that further information on this would be sought.

#### **Question 7**

It was noted that there whilst there was overall support to replace the 'chain of command' definition with revised wording of the definition of a person in a position of influence some considered the new definition to be too complex and not 'principles' based. KB reported that the AAT would revisit the wording of the revised definition but highlighted that some of the concerns raised relate to persons the EU require to be included and whom the FRC cannot exempt.

It was also noted that, in response to a request from one firm for new material to clarify who can act as a Trustee, the existing guidance would be updated to present tense and reinstated.

#### **Question 8**

It was noted that whilst the majority of respondents expressed broad support for the proposals in respect of accepting an engagement for an entity employing a former partner or other restricted person, some respondents called for greater clarity.

Through discussion it was noted that the:

- Proposed restrictions would apply for a period of two years.
- There will be practical implications for nominations committees to consider.
- Proposal goes beyond the requirements of the ARD for non-PIE entities and therefore would be 'gold plating'.

The Council supported the suggestion that the proposal be retained but suggested that a clear statement as to who would be caught by the restrictions be provided.

#### **Question 9**

It was noted that whilst the majority of respondents support the proposal to mitigate the risk of an auditor's independence being compromised by clarifying the requirements relating to the provision of non-audit services provided before taking up appointment there were some calls for greater clarity in respect of when an audit is 'accepted' and for how long a 'threat exists' and calls to provide for exceptional circumstances.

The Council supported a review of whether the guidance could be enhanced and supported the suggestion that the AAT explore whether an independent review by a previous auditor of information where the new auditor would have a self-review threat could be an adequate safeguard.

It was also noted that consideration would be given to recognising special circumstances in the public sector where there is no or limited choice.

**Question 10**

It was noted that auditors and professional bodies expressed strong opposition to the proposal to make consistent the prohibitions over providing advocacy for an audited entity in relation to tax on the basis that:

- An outright prohibition on tax advice would have a disproportionate effect on SMEs.
- The proposal is not principle-based.
- The proposal goes wider than the EU requirements.

On the basis that the aim of the proposal is to encourage consideration of threats and is supported by public sector and investor respondents, the Council advised that the prohibition should be retained.

The Council advised that the AAT should seek to include greater clarity as to what would or would not constitute 'advocacy' and make clear that advice that does not constitute advocacy is not automatically prohibited. The Council also suggested the AAT should clarify that the prohibition is wider in scope than tax matters.

**Question 11**

It was noted that the proposal to prohibit the provision of tax services provided on a contingent basis was strongly opposed by audit and professional body respondents and supported by investor, public sector body and corporate respondents. KB reported that auditor and professional body respondents suggest there is no justification for outright prohibition of tax but no other non-audit services and it would be disproportionate because there are some tax services that do not give rise to unacceptable threats to independence.

Following a detailed discussion of the issues raised the Council agreed there would be merit in considering alternatives to an outright ban on all tax services that are provided on a contingent fee basis. The Council supported the suggestion that the AAT explore retaining the prohibition for PIE and Listed Entities and introducing materiality criteria (in respect of the level of threat and level of fee) for other entities wishing to provide tax services. The Council suggested, should this alternative approach be taken forward, consideration would also have to be given to whether or not guidance to assist auditors in making those materiality judgements would be necessary.

**Questions 12 to 14**

It was noted that the majority of respondents:

- Supported the proposal to offer targeted reliefs in respect of the audits of smaller listed / smaller quoted entities.
- Consider the proposals to be targeted at the right level.
- Consider that the reliefs should continue not to apply to entities which exceed the threshold and then subsequently fall below the threshold for a period of two financial years following the financial year in which the reliefs first ceased to apply.

The Council discussed the proposals in detail and it was noted that:

- The reliefs would result in the FRC ESs being less stringent than the IESBA Code in some areas related to NAS;
- This would be inconsistent with the FRC statement that the IESBA Code is a minimum standard that the FRC would add to the Code;
- There are issues relating to securities not open to trading by the public and AIM listed entities that would need to be considered.

The Council reaffirmed its support for the principles underpinning the proposals and suggested the AAT consider how best to address the issues raised whilst retaining the reliefs.

- 6.4 Kate Acott (KA) invited the Council to consider key issues raised by respondents relating to proposed revisions to the auditing standards. It was noted that respondents expressed strong support for the majority of proposals set out in the consultation.
- 6.5 Through discussion the following observations were made and advice was given:

**Question 15**

It was noted that whilst the majority of respondents expressed strong support for the proposed approach to incorporate the requirements of the Regulation and Directive into the text of the quality control and auditing standards, some raised concerns about the complexity this would bring and the added cost burden and some suggested that the integration might adversely affect firms who do not audit PIEs.

The Council supported the suggestion that the proposed approach should be retained on the basis that the drafting be reviewed to improve clarity and consideration be given to providing application material to set out how the ARD and ISA requirements inter-relate and where the requirements overlap.

It was also noted that some respondents had expressed concern over the inclusion of UK+s and that an explanation of our rationale for retaining those that are incorporated into final draft standards would be addressed would be brought to the March meeting, along with an explanation of associated costs and benefits.

**Questions 17a and 17b**

It was noted that the majority of respondents supported the proposal to adopt ISA (UK&I) 700 (Revised) and ISA (UK&I) 701 and to extend the application of ISA (UK&I) 701 to entities that are required or choose to report on how they have applied the UK Corporate Governance Code ('Code Companies'), as well as to PIEs.

It was noted that those who did not support the proposals expressed concern in respect of:

- The retention of the UK+s, suggesting that the proposal to extend the UK+s to all entities is disproportionate and would add little value.
- The implementation of the Key Audit Matters (KAM) concept and the retention of the UK+ on auditor reporting of risks.
- The reduced flexibility and increased boiler plate language adoption of ISA (UK&I) 701 (Revised) may result in.

In noting that the majority of respondents to the consultation expressed strong support for the retention of the UK+s in the relevant ISAs and noting that no new arguments have been provided for not doing so, the Council supported the suggestion that the proposals should be retained. However, to address some of the concerns raised the Council encouraged the AAT to consider further simplifications in respect of the definition of KAM, including considering moving the UK+ material in respect of the definition of KAM to application material.

### **Question 18**

It was noted that whilst the majority of respondents expressed strong support for the proposal to adopt the proposed ISA (UK&I) 720 (Revised) and include requirements to allow the auditor to provide the required opinions and statements under UK and Irish legislation, concerns were expressed by a small minority of respondents in respect of:

- That the standard is confusing and should be re-exposed first.
- Users may misinterpret the requirement to report on Other Information as a form of assurance.
- That there is a lack of guidance on the implementation of the ARD requirements and that the standard should clarify that only limited assurance is required.
- That the requirements in the standard go beyond those required by the ARD.
- The standard contains unclear definitions and confusing language.

The Council supported the proposal to address the concerns raised by explaining more clearly in application material how the use of ISA terminology is inter-related with the Directive terminology relating to compliance with legal requirements. The broader definition of Other Information would also be adopted.

### **Question 19**

It was noted that whilst investor respondents expressed strong support for the proposal to enhance auditor reporting in respect of the going concern basis, some auditor and professional bodies expressed opposition. Opposition was expressed on the basis that reporting by exception results in boiler-plate reporting which adds little value to the audit report and the new UK+s go beyond EU requirements. There was also concern that the requirements to describe the auditor's responsibilities and to consider a KAM in respect of going concern overlap with existing requirements/application material in ISAs 700 and 701.

To address the concerns raised the Council supported a review of the overlap between the requirements in ISA 570 and ISAs 700 and 701 with the intention to eliminate any overlap.

It was also noted that the Investment Association suggested that the FRC should go further and require the auditor to express an opinion on the matters.

On the basis that of the FRC had only recently put other initiatives in place, such as viability statement requirements, that had not had time to become embedded, the Council did not consider it appropriate to take the proposals further at this time.

The Council reaffirmed its advice to enhance auditor reporting as proposed in the consultation document.

### **Questions 16 and 20-23.**

The Council noted the responses received in respect of the above questions and supported the actions proposed to address those comments.

## **7. PN 27 (I) The Audit of Credit Unions in the Republic of Ireland**

- 7.1. MB reported that the FRC is working with colleagues from the Chartered Accountants Ireland (CAI) to update the suite of Irish Practice Notes and invited the Council to consider a revised PN 27 (I). MB reported that the PN had been updated to reflect the clarified ISAs and to reflect regulatory changes in Ireland.

7.2. The Council noted that the revised PN does not include any additional regulatory measures, and therefore, is not out of line with the Board's deregulatory challenge. The Council also noted that the draft had been discussed with the Central Bank of Ireland which had confirmed that it was content with the way in which Irish law and regulation had been addressed.

7.3. The Council approved its advice to the Codes & Standards Committee to approve the revised PN 27 (I) for consultation.

## **8. Work proposals in respect of PN 10 (Revised) The Audit of Financial Statements of Public Sector Bodies in the United Kingdom and PN 15 (Revised) The Audit of Occupational Pensions Schemes in the United Kingdom**

8.1 Mark Babington invited the Council to provide its advice to the Codes & Standards Committee to recommend that the FRC commence work to review, and if necessary update, PN 10 (Revised) and PN (15). MB reported that both Practice Notes were reaching the five-year review period. Through discussion the following observations were made:

### *8A PN 10 (Revised) The Audit of Financial Statements of Public Sector Bodies in the United Kingdom*

- The FRC has begun discussions with relevant stakeholders, including the Public Sector Advisory Group (PSAG), to establish whether the PN should be updated to reflect recent changes in the public sector audit landscape. Those discussions indicate there is a need for a review / update of the PN.
- Consideration is being given to implementing the revised FRC SOP policy and is looking for an appropriate and competent body to take responsibility for the review. The Public Audit Forum has been considered.

### *8B. PN 15 (Revised) The Audit of Occupational Pensions Schemes in the United Kingdom*

- The Pensions Sub-committee of the ICAEW had written to the FRC requesting that the PN be revised to address significant developments since its last revision.
- The FRC agree that the PN is out of date and that there are developments that could be addressed in an update of PN, particularly in respect of master trusts.

8.2 The Council provided its advice to the Codes & Standards Committee to progress work to review PN 10 (Revised) and PN 15 (Revised). The Council also provided its advice to the Codes and Standards Committee that responsibility for the review of PN 10 (revised) could be delegated to an appropriate and competent body in accordance with the revised FRC SORP policy.

## **9. Any Other Business**

9.1 The Council discussed a statement issued in early December by the Enhanced Disclosure Task Force (EDTF) relating to statements made about encumbered assets. Through discussion it was observed that the statement could be considered inconsistent with the requirements of IFRS 17 and could lead to the publication of misleading information. The Council advised that the AAT explore the issue further.

9.2 The Council noted that the 2015-16 Effectiveness Review process was underway and that Members could expect to receive an effectiveness review survey to complete before the end of the month.

9.3 There was no other business.

**10. Next meeting**

10.1 The Council noted that the next formal meeting of the Audit & Assurance Council would be held on 2 March 2016 at the FRC Office.