

Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 27 April 2015 at the FRC Office, 8th Floor, 125 London Wall, EC2Y 5AS

PRESENT:

Nick Land (Chair)
Sue Harris
Robert Hingley
Scott Knight
Maggie McGhee
Conall O'Halloran (from minute 5)
Allister Wilson

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
Lee Piller	FCA Observer
Gareth Rees	General Counsel (minutes 5 and 6 only)
Marian Williams	Director, Codes & Standards

Apologies and introduction

Apologies were noted from Jane Fuller, Ray King (Council Members), Pat Sucher (PRA Observer) and Melanie McLaren (Executive Director, Codes & Standards).

1. Minutes of the previous meeting

- 1.1 The minutes of the meetings held on 25 March 2015 were approved for publication subject to a minor correction.
- 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 23 April in Brussels. It was noted that the Board had:
 - Approved the Consultation paper and Exposure Draft of a new Client Assets Assurance Standard to be issued following Purdah.

- Approved the FRC Standards and Guidance Framework. It was noted that a paper summarising the implications of the Framework for Auditing Standards would be presented to the Council in due course.
- Approved Statutory Enforcement Guidelines (which include sanctions against RSBs and RQB).
- Approved Local Audit & Accountability Act Regulations.

2.2 The Chairman also reported that Kari Hale had been appointed as a Member of the Audit & Assurance Council and would attend his first meeting on 21 May.

3. Report of the Director of Audit Policy

3.1 The Council noted that the report 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 The Council noted that the IAASB Board at its meeting on 25 March had considered Letterbox audits and the need for interim measures to be developed to support particular regulatory concerns. The Council noted that there is a lack of clarity amongst audit firms as to the requirements of auditors with respect to Letterbox audits and noted that the IAASB is being encouraged to issue a pronouncement which would clarify the applicability of the auditors' responsibilities in respect of both ISA 220 and 600 (in the latter case when there is a group). The Council also noted that the IAASB's Group Audit Working Group, of which Josephine Jackson is a member, is considering a broad range of issues which include those that need to be addressed in Letterbox audits and that the work of the Group will feed in to a discussion paper to be issued later in the year. MG undertook to circulate to the Council a copy of the letter sent by the FRC's Audit Quality Review Team to UK audit firms setting out its expectations in respect of Letterbox audits.

3.3 The Council also noted:

- That MG had joined the following IAASB working groups:
 - NOCLAR (Non-compliance with Laws and Regulations) working group.
 - Integrated reporting working group.
 - IASB Liaison working group.
- A report of the 8 April Public Sector Advisory Group meeting.
- A report of the 16 April Audit Committee Chair Advisory Group meeting.
- That the ICAEW has accepted the FRC's position that it would not want the ICAEW to publish amended versions of material from the FRC's Bulletins and that the ICAEW is working with the FRC to help the FRC inform its view as to whether future illustrative auditors' reports should continue to be published by the FRC.
- That the FRC is working with Chartered Accountants Ireland (CAI) to update the Irish Practice notes.

4. Horizon Scanning

4.1 The Council suggested that the FRC should consider whether it has a role to play in respect of tax from an audit and assurance perspective. It was suggested that the FRC may wish to explore establishing principles for auditors with regards to tax avoidance.

MG and NL undertook to explore the matter with the Executive Directors of Conduct and Codes & Standards.

4.2 The Council noted that a paper on the newly developed FRC approach to Horizon Scanning would be presented to the Council in due course.

5. FRC consultation on the implementation of the EU Audit Directive and Regulation – summary of responses and consideration of matters related to ethics

5.1 Keith Billing (KB) introduced a paper that provided feedback on the responses that had been received to the consultation and highlighted areas that may be considered to be the most controversial, with regard to their potential impact, and significant considerations related to ethics. The Council noted that 41 responses had been received to the consultation representing a broad range of stakeholders. The Council also noted that in addition to the consultation responses, MG and KB had received feedback on the consultation at an Audit Committee Chair Advisory Group meeting and a meeting of the FRC's Public Sector Advisory Group.

5.2 KB invited the Council to consider and discuss the views expressed by respondents and to consider how the views could be taken in to account in revising the ethical standards. Through discussion the following points were noted and observations were made:

5.2.1 Ability to supplement international auditing standards

It was noted that the majority of respondents agreed that the FRC should be able to exercise the provisions in the Audit Directive & Regulation to impose additional requirements in the ISAs when they have been adopted by the Commission. KB reported that whilst the majority of respondents had agreed with the proposal a number of respondents had highlighted the need for formal consultation before any supplementary provisions are established.

5.2.2. 'Gold plating'

The Council noted that:

- A number of respondents presented a 'no gold plating' argument for the FRC not to go beyond the requirements of the Directive & Regulation. Respondents suggested that consistency in Europe is important and that UK companies should not be disadvantaged by a more restrictive regime than exists in other Member states. Through discussion the Council noted that there is already inconsistency in Europe and that the Audit Directive & Regulation specifically recognises that Member States may believe it appropriate to go further in particular areas.
- BIS has not indicated that the FRC should by default take the minimum regulatory positions allowed for.
- Whilst it is clear that stringent requirements can be introduced in areas where this is explicitly addressed by the Audit Regulation, it is not clear whether this is possible in all areas. In response to a query KB confirmed that the FRC is working with BIS to seek clarification on the matter and that there are relatively few areas where the FRC may seek to introduce more stringent requirements where this is not explicitly addressed in the Audit Regulation.

5.2.3. *Public Interest Entities (PIEs) and the scope of the more stringent auditing and ethical requirements*

- It was noted that: A majority of respondents considered that the FRC's more stringent current requirements should in general be retained for current FRC 'Listed' entities (subject to comments on AIM listed entities below) and that other entities that are not EU PIEs should not be subject to either the FRC's more stringent current requirements or those that are imposed on PIEs under the Regulation. However, a small number of respondents suggested extending the more stringent requirements generally to a number of other types of entity, including those that are within the current scope of major audits for purposes of the AQR inspection regime.
- There were mixed views as to whether the current more stringent FRC requirements should be extended to EU PIEs that are not FRC 'Listed'. Support for extending application of the more stringent requirement was generally based on ensuring consistency of requirements for entities of public interest.
- There was not a specific question about AIM companies (which are currently included in the scope of FRC 'Listed' entities). However, a number of respondents expressed concerns about the effects of more stringent requirements on 'Listed' entities such as AIM companies that are not EU PIEs, as many of these entities are quite small and the burdens may be considered disproportionate. Furthermore, it was argued that some of these entities are not invested in by "the public" but rather by "sophisticated investors" and/or that in some cases their securities are not always 'freely' traded or transferable in the markets where they are 'listed'. Some respondents argue that the public interest would be better served by less stringent requirements that would allow auditors to provide more or more effective assistance to such companies that could help improve the quality of their financial reporting.
- The arguments for including AIM companies are that they are listed on a recognised exchange, investments in them are held by Pension Funds, in ISAs and directly by the wider public. FRC 'Listed' entities are currently defined consistently with the definition used in the international auditing standards and the international Ethics Code. This includes entities whose securities are registered or traded on 'recognised' markets, not (as in the case of PIEs under the Regulation) just EU regulated markets. Many of the more stringent requirements in the FRC auditing and ethical standards are based on equivalent requirements in the international counterparts of these standards. The FRC's consistent approach for many years has been to ensure that the FRC's auditing and ethical standards are no less stringent than their international counterparts.

Through discussion the following observations and comments were made:

- There is a need for the FRC to respond to the concerns that have been raised and explore the scope of PIEs. In noting that PIEs and other types of entities such as debt-listed entities are not open for 'public' investment it was suggested that the FRC explore the possibility of reviewing whether the application of the definition of a 'listed' entity should include criteria relating to whether the entity's securities are freely transferable and available to trade.
- It would be useful for the FRC to explore the application of the definition of 'listed' entities in the context of equivalent markets outside of the UK.
- The Council noted that AIM has informally indicated that it is content for AIM listed entities to be subject to the more stringent requirements and suggested that the FRC

should go back to AIM formally to confirm this and ensure that AIM is fully aware of the implications of the more stringent requirements.

- There is a need for the FRC as a whole to reach a view as to the entities in relation to which it considers there to be a greater 'public interest' and for the FRC to test whether this is broadly supported by stakeholders.
- The Council did not reach a conclusive view at this time as to whether, for listed entities that are not EU PIEs, it would advise that the FRC should relax existing requirements or introduce more stringent requirements to align with the Audit Regulation. Through discussion the Council:
 - acknowledged that as matter of principle the FRC usually aligns its standards with international standards and, where there are differences, seeks to ensure that complying with FRC standards still results in compliance with international standards;
 - noted that the current FRC definition of a 'listed' entity for ethical standards requires amendment to be better aligned with the definition for auditing standards; and also so as not to restrict the definition to entities with transferable securities traded on markets in the UK and Ireland;
 - suggested that the FRC should not relax or loosen existing requirements;
 - advised that the FRC should avoid establishing too many categories of more stringent requirements, suggesting that the simplest approach should take preference.

5.3.3. Prohibited non-audit services

- It was noted that there was strong support for a 'black list' approach that would set out services that are prohibited.
- It was noted that there was also significant support for a combination of a 'black' and 'white' list which would provide clarity as to what was and what was not allowed leaving a 'grey area' of services which audit committees would need to consider particularly carefully before approving the auditor to provide them.
- Some respondents who did not support the white list approach suggested that the provision of such lists may result in audit committees being discouraged from sufficiently considering the appropriateness of using the auditor.

Following discussion the Council advised that the FRC should explore the development of a potential 'black' and 'white' list approach for inclusion in the ED, commenting that having a 'grey' area will allow for judgment by audit committees and auditors and reduce the pressure on the FRC to make any additions to the 'black' or 'white' lists in haste.

5.3.4 Derogations to allow certain prohibited non-audit services if immaterial

It was noted that whilst there was strong support to take up the derogations to allow certain prohibited non-audit services if immaterial to the financial statements some respondents queried whether the criterion of 'immateriality' is appropriate given that there could be different views as to what this means. The Council recognised the concern raised in respect of the criterion 'immaterial' and suggested that the derogations be taken up on the basis that the effect of the services is immaterial in the sense of being wholly inconsequential or 'de minimis'. The Council also highlighted the need for guidance to address the boundaries within which the derogations would be permitted.

5.3.5 *The cap on fees for non-audit services*

The Council noted that in the consultation responses:

- There was strong support for not reducing the 70% level of the cap for non-audit services.
- There was mixed support as to whether the cap should apply to network firms rather than just the auditor of the PIE and that a small majority did not support extension of the cap to other network firms.
- The majority supported the three year rolling base period set out in the Regulation, however, many respondents did not comment on the issue that the clock resets in the event of a gap year; the few that did indicated that the clock should not be reset.

The Council supported the principle that requirements should always be applied across the network and therefore advised that it would be appropriate that the cap should be applied across the network and that the clock should not be reset.

5.3.6 *Extraterritoriality*

The Council noted that there were mixed views as to whether the FRC should require the principles of independence in the FRC's standards to be complied with by all members of the network whose work is being used by the group auditor. Whilst it was noted that there may be some practical issues in respect of this requirement the Council advised that the requirements should be applied across the network.

5.3.7 *Maintaining current more stringent FRC requirements*

The Council noted that there was support for maintaining the more stringent requirements of ES 4 (re: limits on proportion of fees from a single client) and ES 3 (rotation of key audit partners).

The Council supported this and advised that the more stringent requirements of ES 3 should also be retained despite noting that some respondents had queried whether there is evidence to support that confidence in audit has improved as a result of the introduction of more stringent requirements than in the IESBA Code.

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

- 6.1 Kate Acott (KA) introduced a paper that set out a proposed approach for the incorporation of recent changes to the IAASBs auditing standards and the provisions of the EU Audit Regulation and Directive into UK auditing standards. KA reported that, taking together the impact of the IAASB changes, which include changes relating to Auditor Reporting & the audit of Disclosures in the financial statements, and of the EU Regulation and Directive, our initial assessment was that only 9 of the 36 Auditing Standards would not be subject to some level of amendment.

Changes to International Standards

- 6.2 The Council noted that the IAASB has introduced a revised suite of auditor reporting standards (ISA 700, 705 and 706) and has introduced a requirement for auditors of listed entities to communicate 'key audit matters' in a new standard ISA 701. The Council was invited to consider whether the FRC should adopt the IAASBs revised ISA 700 and new ISA 701 standards or whether the FRC should amend the existing ISA (UK & Ireland)

700 to align the requirements to the IAASB standards. Through discussion the following points were noted and observations were made:

- Additional requirements would need to be added to the new and revised auditor reporting ISAs in order to incorporate the requirements arising from the EU Audit Directive & Regulation – it was noted that the new and revised auditor reporting ISAs include provisions which would enable amendments to be made to address reporting requirements arising from local laws and regulations.
- In addition to the amendments that would be required as a result of the EU Audit Directive & Regulation, the ISAs would require amendment to reflect responsibilities under the UK Corporate Governance Code such as the requirement for auditors to report by exception in respect of whether the annual report is fair, balanced and understandable.
- It has been FRC policy for some years to adopt the IAASBs ISAs where possible in order to achieve harmonisation and maintain the UK's position as a leader in audit quality.
- The new and revised auditor reporting standards had addressed the concerns previously expressed by the FRC that ISA 700 'would perpetuate, indeed exacerbate, the use of boiler plate language'. KA highlighted that the revisions to ISA 700 add more transparency in the auditor's report about the auditor's work by introducing the requirement for listed entities to communicate key audit matters in the auditors' report in accordance with the new standard ISA 701.
- It was noted that the revised standards would include signposts setting out the sources of the various requirements.
- The Council expressed concern that adoption of the revised ISA 700 and new ISA 701 standards should not result in the loss of the two paragraphs inserted in to ISA 700 (UK & Ireland) that encourage innovative thinking. MG confirmed that staff would consider how to incorporate these paragraphs in adopting the new and revised ISAs.

On the basis of the discussion the Council advised that the FRC should adopt the new and revised standards, including ISA 700 (Revised) and ISA 701, and add the additional requirements that are UK specific to the standards as "ISA pluses".

Implementation of the European Audit Directive & Regulation

6.3 The Council supported the recommendations that:

- The requirements of the Audit Directive are generally 'copied out' in to the requirements relevant to the auditing standards as set out in the Directive. In supporting this recommendation the Council noted that the Audit Directive does not have the direct effect of law and that the UK would have to implement the requirements of the Directive in to Law or Regulation.
- The provisions of the Regulation are incorporated into the auditing standards taking care to make it very clear which provisions are only applicable to PIEs. In supporting this recommendation the Council noted that whilst the Regulation has the direct effect of law, it is only applicable to the statutory audits of PIEs.

The Council considered that the approach set out is the most practical approach in that it would provide a 'one stop shop' for auditors.

The impact of the changes on the scope of the Auditing Standards

6.4 The Council considered a VENN diagram that illustrated the overlaps between the scope of application of the current UK and the future European and International Requirements and noted a table setting out the requirements introduced by the Audit Regulation and the IAASB's ISAs in respect of auditor reporting and communications to those charged with governance (or in the case of PIEs, the Audit Committee) and reporting to regulators. KA invited the Council to consider whether some or all of the new requirements should be applied to PIEs, listed entities and Code Companies and whether the FRC should consider departing from the IAASBs definition of listed entities. Through discussion the following points were noted and observations were made:

- Whilst it was noted that many PIEs, including AIM listed entities, may have limited resources, it was suggested that the changes are simply the introduction of reporting requirements and that the work which the auditors would be required to report upon should already be being done.
- It was noted that whilst the definition of a 'listed entity' as defined by the IAASB includes both those entities that are required to apply the UK Corporate Governance Code and EU Listed entities fall , the IAASB definition of listed entities is also wider than these two classes of entity.
- It was suggested that the introduction of the new requirements for AIM and other smaller listed entities should improve dialogue between the Audit Committee, the auditors and the entity.
- It was highlighted that there is a new requirement for PIEs to report promptly to regulators in respect of breaches of law and regulations. Whilst the Council considered that such reporting was appropriate, the Council queried who the breaches should be reported to and highlighted the importance of ensuring that the competent authority to whom such breaches are reported is in a suitable position to respond. MG confirmed that the matter would be raised in addressing the new requirement (including with the PRA and FCA who would likely be such competent authorities for certain entities).
- A concern was raised that the introduction of ISA 701 (and the corresponding changes in terminology) might result in a loss of emphasis on the requirement for reporting of significant auditor judgement and the determination of Key Audit Matters. Concern was also expressed that Key Audit Matters required to be reported under ISA 701 might not include all of the assessed risks of material misstatement required to be reported currently under ISA (UK & I) 700. In response MG advised that in adopting the ISAs, staff would as a minimum aim to include all of the new auditor reporting requirements which currently exist in UK auditing standards, and that the revised standards would be accompanied by application guidance which would explain where changes, including changes in terminology, have been made. MG undertook to present the application guidance to the Council in due course.
- The Council noted and supported the proposed approach to including the Regulation text within the body of the amended ISAs.
- The Council supported the proposal that the amended ISAs retain the additional requirement for the auditor's report to provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit and that such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole if it is determined that the FRC should have the power to exercise the option.

- On balance the Council suggested that the FRC should consider applying all of the requirements to EU PIEs, Listed Companies and Code Companies but suggested that an impact assessment should be undertaken before any formal decision is taken.

6.5 The Council supported the proposal that the FRC adopt a single implementation date for all changes to the auditing standards for periods commencing on or after 17 June 2016.

6.6 The Council noted that members would shortly been invited to participate in a Council Steering Group to consider in detail the issues that have been raised and support the executive in developing the revised standards.

7. Any Other Business

7.1 There was no other business.

8. Next Meeting

8.1 It was noted that the next formal meeting of the Audit & Assurance Council would be held on 21 May 2015.

