

AUDIT AND ASSURANCE COUNCIL

**Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 15 November 2016 at the FRC, 8th Floor, 125 London Wall, London, EC2Y 5AS**

PRESENT

Ray King (Chair)
Oliver Beroud
Paul Cox
Jane Fuller
Kari Hale
Sue Harris
Conall O'Halloran
Jerry Wedge
Lisa Campbell (IAASA Observer)
Michael Gaull (PRA Observer)

IN ATTENDANCE

Mark Babington
Marek Grabowski
Kate Acott
Keith Billing
James Ferris
Melanie McLaren (Items 1, 2 and 8)
Julia Walsh (Item 3)
Julie Long (Item 3)
Matthew Dent – Ubiquis

Apologies and welcome

The Chairman welcomed Olivier Beroud and Paul Cox as new members of the Council. Apologies were noted from Bryan Foss.

1 Minutes and Rolling Actions

Minutes of the Audit & Assurance Council Conference Call held on 4 October

- 1.1 The Chairman had one point to note, around MM's letter to the PRA regarding the FRC's perspective on the review of Practice Note 20, including the form of the audit report under ISAs 800 & 805. MM had not received a response, but she had a quarterly meeting with the PRA in the next week in which it would be discussed.

Minutes of the Audit & Assurance Council meeting held on 12 October

- 1.2 On item 7, there was a discussion over whether the Council had questioned whether audit chairs were being appropriately sceptical in response to the survey. It was felt that the scepticism had been on the Council's part. The minutes would be amended to recognise this.
- 1.3 The Council had not yet come to a conclusion on what to advise the executive for the 2017 Audit Committee Chairs Quality survey. MB said that this had been discussed at the PRG, and further meetings would take place in February 2016. MB would report to the February Council meeting ahead of the PRG. MM noted that the difficulty in getting contact details of audit chairs had been around data protection; now that the FRC was the competent authority for audit, company secretaries of public interest entities had been written to directly, seeking direct contact details. Only one FTSE 100 company had refused, and this would be followed up.

Rolling Action Points

- 1.4 The Chairman noted that the topic of preliminary statements would come to the Council in March 2017. MB said that a paper on this project had been presented to the last Council, and would go to Codes and Standards in the next week.

2 Chairman's Update

- 2.1 The Chairman reported that the Codes and Standards away day and a meeting of the FRC Board had taken place since the last Council meeting. Material from both events flowed into the paper submitted to BEIS. MM noted that Stephen Haddrill was giving evidence to the BEIS Select Committee that morning.
- 2.2 The Chairman noted that at the FRC Board meeting, three directors had been renewed. Elizabeth Corley would be stepping down in due course. A paper on governance review had been received from Anne McArthur, in light of FRC internal organisation having changed earlier in the year. There would be a full review of governance in summer 2017. One change would be that in future chairs of councils would not have to be FRC Board members. An update had been received from Gareth Rees on the various cases in progress. A review of the structure of enforcement would be undertaken by Gareth Rees over the next few months, followed by an external review by a regulatory-experienced lawyer. An announcement on stewardship tiering had been made the previous day, and tier 3 institutions would have six months to remedy the issues before being dropped from the list of stewardship-code-compliant bodies.
- 2.3 The Chairman reported that the FRC budget had also been discussed. There was a small inflationary increase, but government action could result in the FRC having to do more in the future, requiring recasting of budgets.

3 Report of the Director of Audit Policy

- 3.1 MG presented his report. He noted the status of the ISA 540 project, and explained that ISAs 800 and 805 had been adopted in the UK. The consultation on PN20 would run into December. There was a desire to bring together changes to standards once a year. This coming year, only ISA 250 would be ready to be consulted on and this would be done early in 2017. PN16 was an old practice note, and proposals would be brought forward following discussions with the BBA and ICAEW.
- 3.2 MG reported that it had been announced to the IAASB ISA 540 Task Force that the December deadline for an exposure draft of ISA 540 would not be met and that it was now proposed to seek IAASB approval of the Exposure Draft in March 2017. MG discussed the issues giving rise to this, including resourcing pressures and challenges of managing a fundamental and complex project with a very large task force membership, on a short timescale. He also noted that he had questioned the proposal that only one more physical meeting of the Task Force would be held before the March meeting of the IAASB, given what still needed to be done. MG was concerned that the current draft was not sufficiently advanced or of a quality that he would expect for a document to be approved in March 2017. This level of revision to an ISA occurred once every 10 years, and this project was responding to fundamental accounting changes. MG noted that he had been raising the timing of the project with the Task Force and its Chairs for some time, and had suggested ways to address his concerns, for example that more drafting support could be provided by technical advisors of the Chairs or other members of the Task Force or by a smaller drafting sub-group of the Task Force. Most recently, he had also expressed the need for a detailed plan demonstrating how the newly proposed deadline would be achieved.
- 3.3 MiG noted that the observer from the Basel Committee had also made those points to the Task Force chair and staff. It was disappointing that the plan to address the outstanding

issues, having delayed release by three months, was only to hold one additional meeting. MiG and MG were both clear this would not in their views be sufficient.

- 3.4 The Chairman asked whether MG was comfortable to take this forward, or whether he needed support from elsewhere. MG confirmed that he was. He anticipated that the Basel Committee would be raising similar issues with the Task Force and IAASB Chairs.
- 3.5 It was asked whether a new technical director was due to join the IAASB soon, as had been advertised for. MG confirmed that a process was underway.

4 IAASB Agenda – ISA 540

- 4.1 MG reported that there had been frequent criticism around the robustness with which auditors approached key estimates, such as difficult fair values and goodwill. Based on feedback to the IAASB, there were issues with work effort being overly focused on ‘significant risks’, and insufficient attention to other risks at the higher end of the risk spectrum that were just outside this category. New accounting standards had a growing focus on current value measurements. The ISA 540 standard was now quite old, and a lot had developed post-crisis. Estimates now comprise a substantial part of the Balance Sheet and Income statements of many companies. This is, therefore, one of the most widely applicable of the auditing standards.
- 4.2 MG explained that the revision to the standard to help auditors understand the sources of risks of material misstatement in relation to estimates. This required a more holistic understanding of the range of estimates. The Task Force had a lot of work to do to complete its thinking, but progress was being made. Estimation uncertainty created potential for complexity in making estimates, which required the right expertise and attention to be applied. It also created the need for management judgments in making estimates. Such judgment in general also creates opportunities for management bias, which should lead to auditor consideration of bias-related risks. Identifying where these risk factors (estimation uncertainty, complexity and management judgment) are at play in making an estimate, could assist auditors in identifying areas where there is potential for risks of material misstatement. MG thought that this new approach was ‘shaping up’ well, though the wording around the factors, how and why they occur and how they give rise to risks of material misstatement in different types of estimation process was not yet quite right. Once these explanations were satisfactorily improved, he believed the relationships with the proposed work effort would become clearer.
- 4.3 MG explained that the second aim was to address the imbalance between significant risks and other risks. The current model set out four approaches to testing significant risks and the auditor was required to apply at least one of these. These approach, though, seemed appropriate for other risks as well. The difference with significant risks was not the nature of what needed to be done, but the intensity in addressing it. One of the difficulties in broadening the work effort requirements beyond significant risks was determining which risks to extend this to. There had been long debates around this. There had been resistance to having work effort requirements that apply to all estimates or all risks of material misstatement, as there was a concern that this might be disproportionate for audits of smaller entities. The most recent discussions have focused on applying work effort requirements to all risks of material misstatement that are not “low”. MG has argued that a consequence of this focus on risk of misstatement (i.e. the net of inherent and control risk) rather than simply on inherent risk was that the work effort requirements would not apply to inherent risks which would be subject to testing of control effectiveness.
- 4.4 It was queried whether MG was seeking to pushing greater onus on the auditor to form their own view of what estimates should be included in the financial statements, or rather for the auditor to better understand the estimate in the context of what the outcomes might

reasonably be and to communicate in that context. MG explained that there is difficulty in understanding how the auditor is required to judge whether there is error in an estimate. MG explained that the current standard addresses judgmental errors rather narrowly. The standard could be improved in this area.

- 4.5 MG offered to speak further with Council members offline about this project either individually or in a small group, if helpful.

5 Audit and Assurance Technical Advisory Group

- 5.1 MB presented his routine update to the Council, including the minutes of two meetings of the TAG, one covering the issues from ethical standards, and the second covering issues relating to a number of auditing standards. MB highlighted that the process continued to yield progress, and a number of issues had been escalated to the CEAOB. MM would be meeting with them later in the month. MB noted the staff guidance note concerning disclosures in auditors' reports relating to dates of appointment which contained, in response to feedback, examples of different scenarios.

- 5.2 It was queried to what extent proportionality or cost benefit was part of the deliberation. There were points at which relatively small changes in decisions being taken could be quite profound. MB said that account had been taken of whether the position was practical to implement, inspect and oversee. An unachievable and unenforceable standard was not what was wanted. Passing matters to the CEAOB could result in an interpretation that would be difficult to enforce which was not in the FRC's interest or that of our stakeholders.

- 5.3 The Chairman noted that the process was working well, and the audit points brought to the TAG were beginning to thin out, and the ethics points would continue for a while. KA suggested that audit points could increase again once firms began to use the new standards in year-end audits.

6 AQR Draft Thematic Report – Data Analytics

- 6.1 JL explained that the purpose of bringing the report to the Council was to receive any comments, which would help drive the report towards publication in January. The report looked at the different approaches across audit firms.

- 6.2 JW reported that the objective had been to see what was happening in practice at the largest six audit firms. This had proved difficult, as firms had not been keeping particularly accurate data. A few areas of interest to the Council had been highlighted.

- 6.3 It was asked whether the summary table had been shown to the firms. JW reported that staff were in the process of doing this until Christmas. The firms had been asked to populate the landscape of what was being used. Some had logged usage of tools, but not whether tools had produced useful primary evidence. It was noted that some information might not be of use in terms of audit, but might be useful to the organisations themselves. MG said that the FRC's focus should begin with the effectiveness and efficiency of the audit. It was suggested that the FRC needed to acknowledge that 'insight' was part of the offers that audit firms made to clients in tendering. It was noted that data analytics at the planning stage could lead to better risk assessment. JW said that this had not flowed through in practice yet, though it may be more evident in the next audit cycles.

- 6.4 It was noted that given the importance of raising public confidence in audit, there was an emerging data-driven narrative. If this was applied across the board, the areas where data analytics could be used would start to be mapped, and standards raised. JL said that as it was at an early stage a soft approach to the report had been taken; it would be looked at again in two years' time, at which point it was expected that much more data analytics would be seen in practice. MG noted that there were risks in making recommendations, as those

firms below the larger firms would not be able to do this for some time. JW said that the report would be drafted in a manner that would avoid this.

- 6.5 The Chairman asked whether there was anything which had worried them. JW noted that the bedding of analytics into the audit methodology was one worry, and whether there was a gap in the audit information. MiG noted that a tool was only as good as the person using it. MB reported that staff would be looking into this with the Audit Committee Chair Independent Forum, to look into what people did with the Audit Quality Practice Aid. MB said the report presented a useful view of the maturity of the use of this new area of audit technology. MB noted that firms were introducing this because they saw it as being beneficial to audit quality. MB noted that there were practical challenges, but the biggest constraint on accelerated adoption today was still access to data. Much of the current use was in planning and risk assessment. The Chairman asked whether there would be a feedback session with the firms. JL confirmed that there would.
- 6.6 It was noted that the reference to testing of the functioning of these tools collaboratively was unclear. JL thought a big question was whether staff had the expertise to do this. A degree of confidence in the tool was needed. One of the constraints was tools being prepared in other jurisdictions. MiG noted that there must be internal assurances at the firms. JW said that there was a system of central accreditation. Each firm had their own way of giving engagement teams that confidence.
- 6.7 The Chairman noted that it was a fascinating report, and there was a lot to do in terms of managing the process. JL noted that staff expected to be able to publish in January. The Chairman thanked JL and JW.

7 Project Updates

Appendix 1 – PN 10 – The Audit of Public Sector Financial Statements – Feedback Statement and Final Draft Practice Note

- 7.1 JF reported that staff were reaching the end of this project. He presented the final iteration of the revised guidance, and a feedback statement prepared by the Public Audit Forum, to whom the revision had been delegated. There had been a three-month consultation, with ultimately 15 responses, largely focused on points of detail. JF reported on the FRC's due diligence, and presented the draft endorsement statement from the FRC.
- 7.2 It was queried who this would apply to. MB confirmed that it applied to central and local government. The Council were happy with the endorsement statement.

Appendix 2 - PN 12 – Money Laundering – Project Scoping Form – Update for 4 AMLD

- 7.3 MB noted that a project was needed to look at Practice Note 12, concerning money laundering. The fourth anti-money laundering directive was being transposed into UK law, with an implementation date of June 2017. Staff were working with the Treasury, the NCA and HMRC to make sure the requirements were tied together. The Council gave its advice that this work should be approved to begin.

8 Draft Consultation Responses

PIOB Strategy Consultation 2017-19

- 8.1 MM highlighted that the governance and independence of the audit standard setting board had never been entirely satisfactory. There was a general will to reform, and it was felt important to put in a strong response to the IOB Strategy Consultation.
- 8.2 MB explained that IOB's function was to provide oversight of the standard-setting process. The consultation posed the question of whether there were other ways the IOB should do this, other than due process. The FRC had suggested one way to play a greater role would be to look at the forward strategy of the standard-setting boards. The standard-setting

boards were both strategic and executive, and there was a question about whether those roles were compatible. Another issue was the membership of these boards, subject to nomination through the IFAC nominations committee, and whether the nominations committee should have an independent chair.

- 8.3 MB reported that the FRC response needed to be submitted by 26 November. The draft response was very supportive of the work of the PIOB, and made recommendations to strengthen their contributions and enhance the focus on the public interest by standard-setting bodies. MG noted that the PIOB had not asked any questions about the way it was established by the monitoring group, but this would be dealt with separately. MiG noted that some of the bigger issues not covered in the consultation were overall funding, governance structure shape, and the balance of board members to staff. MB acknowledged the narrowness of the consultation, but the FRC would have an opportunity to input to the broader review by the monitoring group. This was not yet subject to public scrutiny but was alluded to in the PIOB consultation document.
- 8.4 The draft response was generally considered appropriate, but the current PIOB arrangements seemed somewhat complicated, lacked some transparency, and might well not be the outcome, if they were designed afresh today from a blank sheet. The Chairman noted that simplification was a priority.
- 8.5 The Chairman asked what the next stage would be. MB said that the response needed to be submitted by 26 November. He would circulate this to the Council members before sending.

IAASB Discussion Paper – Supporting Credibility and Trust in Emerging Forms of External Reporting

- 8.6 MB reported that JF had set out the main questions being asked in the discussion paper and the key factors. JF said that staff were considering the issues to address in the draft response. MG explained that there was a growing trend internationally for greater demands on companies to address and report on their business model and risk more broadly, and to report not just their financial performance but across a range of performance measures. Non-financial reporting was becoming more prevalent and important to stakeholders but this was happening on different scales and in different ways in different jurisdictions. The IAASB had been asked to write a standard for auditing such emerging forms of reporting, such as integrated reports. It was unclear where there was demand for such assurance, hence the IAASB had shifted to broader reporting, including non-financial and business model. The paper was to explain the key issues which would need to be considered. There was no specific proposed plan for standard-setting activity by the IAASB on the back of this paper alone, but it sought to explore the issues that would have to be addressed if such assurance were to be technically feasible and, in light of that, whether there was likely to be demand for it.
- 8.7 It was noted that this was something worthwhile to explore. The Council discussed what assurance demand there might be from investors. It was noted that there was no particular demand for auditing of non-financial reporting in the UK at this time. Such reporting should be entity-specific. Assurance on some of the information, such as certain climate disclosures (for example, greenhouse gas statements), when prepared based on established reporting standards, could be welcomed by some stakeholders. MB asked Council members to feed further thoughts to JF.

9 Any Other Business

- 9.1 MB noted that the Codes & Standards Committee had published revised procedures on how it dealt with standards, statements of practice, practice notes, SORPs, etc.

- 9.2 MB noted that as part of the annual plan and budget work, staff were investigating the concept of an audit lab, in a similar vein to the Financial Reporting Lab, to allow a dialogue between stakeholders, and address the expectation gap. This was being led by Marian Williams, if any Council members wanted to be involved.
- 9.3 There being no other business, the meeting was closed at 12.20.