

Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 11 June 2014 Aldwych House, 71-91 Aldwych, London WC2B 4HN

PRESENT:

Nick Land (Chair)
Russell Frith
Sue Harris
John Hughes
Ray King
Scott Knight
Paul Lee
Conall O'Halloran
Robert Talbut
Allister Wilson

IN ATTENDANCE:

Keith Billing	Project Director
Francesca Chittenden	Council Secretary
Marek Grabowski	Director of Audit Policy
Josephine Jackson	Technical Advisor to the Director of Audit Policy
Steven Leonard	Project Director
Melanie McLaren	Executive Director
Susan Currie	Check job title (Minute 8 only)
Stephen Haddrill	Chief Executive (By conference call - Minute 8 only)
Andrew Jones	Audit Quality Review Director (Minute 6 only)
Mark Mainwaring	Audit Quality Review Team (Minute 6 only)
Dan Rouse	Case Manager, Professional Discipline Team (Minute 8 only)
Paige Rumble	Case Manager, Professional Discipline Team (Minute 8 only)
Eileen Townsend	IAASA Observer
Aidan Lambe	CAI Observer
Pat Sucher	PRA Observer

Apologies and introduction

Apologies were noted from Lee Pillar (FCA Observer).

The Chairman welcomed Conall O'Halloran to his first meeting as a Member of the Council and Josephine Jackson who had recently joined the FRC as Technical Advisor to the Director of Audit Policy.

The Chairman reported that terms of office for Russell Frith, Paul Lee and Robert Talbut were due to expire on 1 July and accordingly it would be their last formal meeting. The Chairman thanked the three Members for the contributions they had made to the work of the Council.

1. Minutes of the previous meeting and rolling actions

- 1.1 The minutes of the Audit & Assurance Council meeting of 14 May 2014 were approved as an accurate record of the meeting.
- 1.2 The Council noted the status of the actions listed on the action log. It was noted that the 'Historical Roots of Audit' Briefing Paper' would be completed at a later date.

2. Chairman's Update

- 2.1 The Chairman reported that Citi Research and KPMG had issued useful reports that survey the implementation of the extended auditor's report and requested that copies of the reports be circulated to the Council.

3. Report of the director of Audit Policy

- 3.1 Marek Grabowski (MG) introduced his report, which was taken as read. Particular emphasis was given to the following matters.
- 3.2 IAASB Meeting 16-20 June
The Council noted the agenda of the IAASB meeting and that the focus of the meeting would predominantly be on matters relating to auditor reporting, including revisions to ISA 700,701, 705 and 706. The Council expressed concern in relation to the proposal to include an additional prohibition in ISA 701 *Communicating key audit matters in the independent auditors report to prevent the discussion of Key audit matters in the audit report if the auditor intends to express an Adverse Opinion*. MG confirmed that he shared the view of the Council and would express this view at the meeting. In response to a question, MG also confirmed that, subject to the requirements of the EU Audit Directive, the proposal should not affect the FRCs ability to adopt the ISA in a way so as not to include the prohibition.
- 3.3 The Council also noted that the IAASB would also be discussing proposed changes to ISA 570 *Going Concern* and that, whilst the proposed revisions were in the early stages, a number of technical matters would need to be resolved. MG reported that the IAASB had taken comfort from IFRIC's tentative agenda decision in respect of disclosures required in relation material uncertainties, which looked to paragraph 125 of IAS 1 as a basis for better disclosures when there are close calls on material uncertainties. It was also noted that the FRC had responded to IFRIC on the matter to set out its view that the tentative agenda decision was very unsatisfactory, including in that the FRC did not believe that the reference to IAS 1 paragraph 125 was valid or appropriate. MG confirmed that he would also raise this matter at the IAASB meeting.
- 3.5 The Council also noted that the IAASB would be having a first discussion about its work plan for 2015-16 at its meeting on 16-20 June and that steps were being taken to address concerns about the IAASBs capacity to address more of the matters being asked to consider.

- 3.6 The Council noted that the IAASB had issued an Exposure Draft of a proposed revision to ISA 720 (revised) the Auditor's responsibilities relating to other information with a closing date in Mid-July. MG invited the Council to provide him with comments responding to the FRC's Invitation to Comment (ITC) on those proposals, in order to inform the FRC response to the ED, and, in due course, to assist the FRC in developing proposals to adopt the proposed ISA 720. It was agreed that, in light of all responses to the ITC, the Executive would develop a draft response letter to the IAASB, for consideration by the Council by email as there would not be another meeting of the Council before it was due to be submitted.

UK and Ireland Auditing and Assurance Standards

- 3.7 MG reported that work was underway to develop a Client Assets Assurance Standard (CAAS) and that, as agreed at the May Council meeting, a working group had been established to assist the Executive in the development of the Standard.

4. Activities since last meeting

- 4.1 The Council noted the list of activities since the last meeting and that a joint event with a focus on 'enhancing investor understanding: a new era for audit disclosures' had been held with the Association of British Investors (ABI) on 4 June.

5. ICAS / FRC Audit Skills research project

- 5.1 Allister Wilson (AW) Chair of the ICAS Research Committee provided an update on the recently concluded ICAS / FRC Audit Skills research projects that had been undertaken to consider the skill and competency requirements of auditors in today's complex global business environment. The Council noted that two research projects had been undertaken, one with a focus on the business environment in the UK, Australia and South Africa and the second, with a European focus and noted the latest draft reports of both projects.
- 5.2 AW reported that the ICAS/FRC Audit Skills Project Steering Group had met on 9 June to consider the draft reports of the two project groups and had been underwhelmed by the reports produced, suggesting that the broad range of views expressed had not been fully captured. The Council noted that the steering group had requested that the research groups refer to the data collected and revise the report to more fully reflect those views. AW also reported that the Steering group would not be publishing the two individual research reports but that the Steering Group would draft its own report, combining the findings of the two reports, which the Steering Group intend would be used as the basis for constructive debate about the 'future of audit'.
- 5.3 The Council discussed the findings of the latest draft reports as presented and made the following observations:
- a. There is a lot of discussion around the auditor's role in relation to risk, and whether the auditor should be providing assurance in relation to risk management.
 - b. There is evidence to suggest that audit is evolving, and the findings suggest that the audit can be considered at three distinct levels: processes and adherence to standards, judgment and culture.

- c. There is an issue in relation to differences in expectations between the audits of financial services organisations and non-financial services organisations.
- d. The Council was unsure whether the proposed strategy to use the outputs to open a constructive debate about the future role of audit would be appropriate, and considered that it would be more appropriate for that broader debate to be led by the FRC, as the regulator and standard setter for audits.

5.4 The Council noted that the Steering Group report would be presented to the Council for consideration in due course and suggested that the Steering Group should, in drafting the report, identify and clearly set out, what the auditor is expected to deliver in the current environment, and what skills are required to enable the auditor to do so, before consideration is given to what skills the auditor may need as the audit evolves.

5.5 The Council thanked AW for the update.

6. Audit Quality Review Annual Report 2013/14 – feedback from the team

6.1 Andrew Jones (AJ) introduced a presentation on the findings of the FRCs 10th Audit Quality Review Report (AQRR). AJ reported that in addition to the AQRR the FRC had also published individual reports on each of the four largest firms and a separate report on its overseas inspections and that as part of the 2014/15 reporting cycle the FRC also intends to publish individual reports on six of the largest major firms.

6.2 The Council noted the overall grading scores for 2013/14 and that, for 2013/14 audits, those graded 1a and 2 had been separated out (previously they had been separately scored but the grades had been merged for public reporting purposes). The Council also discussed the meaning and significance of the grades and whether these could be clarified to be more useful and carry more weight with stakeholders and investors.

6.3 Through the presentation the following points were noted and observations were made:

- There are some improvements in the 2013/14 gradings from 2012/13 with 60% of audits rated good or requiring limited improvement (including 19% rated good, compared to 13% in 2012/13).
- Entities selected for review are selected on a risk basis and therefore, it would not be appropriate, or accurate to extrapolate the findings of the reviews to the UK audit market as a whole.
- Over a five-year period there has been a gradual improvement: FTSE 350 grades are better than the population as a whole and AIM companies, banks and building societies are generally graded lower. Principal issues affecting bank and building society audits include issues around loan loss provision, challenge of management and IT control testing – a thematic inspection to address the issues will be conducted in 2014/15.
- Whilst group audits are generally good quality, more issues are identified in component audits and accordingly, component audits are generally graded lower. The Council suggested that the FRC should look in to this matter. One comment was that problems component audits may question whether the related group audit really is good if it does not identify those problems – the group auditor is responsible for the

audit as a whole and should be sufficiently involved in the work of the component auditors to be satisfied with it.

- Concerns have been identified in relation to 'letterbox audits'; however, a revision of firm methodologies should lead to improvements in 2014/15.
- There continue to be issues in relation to the audit of fair value measurement and impairments. Causes identified include a lack of professional scepticism and insufficient challenge of management on key assumptions and business plan feasibility.
- The Council noted that the Pilot project to meet and discuss AQR findings with Audit Committee Chairs would continue in 2014/15, as tangible benefits had been identified. The Council discussed the content of the letters submitted to entities following an AQR and questioned whether those letters provide sufficiently granular information to enable the Audit Committee to effectively address the matter(s) that have been identified through the review. If not, access to a member of the AQR team by the Audit Committee Chair might be helpful; alternatively, the letters could be expanded to include more detail.
- In relation to non-audit services the report identifies instances of insufficient consideration of the implications for the auditor's independence of continuing non-audit services, when an entity becomes an audit client or becomes listed.
- Three third country auditor inspections had been undertaken in 2013/14, and whilst plans to increase the number of third country auditor inspections were in place, there were practical challenges, including navigating different legal systems.
- In response to various regulatory changes, including the recommendations of the Competition Commission, and the requirements of the EU Statutory Audit Directive and the Local Authority and Accountability Act a 60% increase in inspections are being planned.

7. Auditor Reporting Bulletin Compendium

- 7.1 The Council agreed to advise the Codes & Standards Committee that the FRC should continue its policy of publishing Compendia Bulletins of illustrative examples of auditor reports.

8. Ethics

Principles

- 8.1 The Council noted and was supportive of the proposed overarching Ethical Principles that had been revised to reflect the steer and advice given by the Council at the May meeting.
- 8.2 The proposed discussion on a review of Ethical Standards ES3 and ES4 was deferred to the July away day.

Review of Audit Firm Governance Code (AFGC) - emerging findings

- 8.3 Stephen Hadrill (SC) introduced a paper that provided an update on emerging findings from the FRC review of the Audit Firm Governance Code. The Council noted that as part of the review the Executive had undertaken a review of firms' transparency reports and had held bilateral meetings with Independent Non Executives (INEs). SH reported that meetings with senior partners from all firms and engagement with other stakeholders (including investors and the ICAEW) were also planned.

- 8.4 SH summarised the emerging themes, the Council noted that there is support for:
- Greater clarity on the INE role, the introduction of term limits for INEs and the introduction of a requirement for at least one INE to have recent financial experience.
 - A fuller explanation of the purpose of the AFGC, who and what it is for.
 - A 're-write' of the AFGC, so that it is a more clearly principles-based governance code for systematically important business partnerships.
 - Improved reporting via a reduction in the information firms are obliged to include in their transparency reports.

The Council also noted that that the initial findings identify that:

- Whilst progress has been made in improving engagement with investors there is still some way to go.
- INEs are becoming increasingly anxious about the lack of corresponding roles outside of the UK in light of the increasingly global firms.

8.5 The Council discussed whether it is possible for the culture of a large organisation to be consistent throughout, noting that the majority of INEs interviewed had highlighted the culture of partnership with some respondents suggesting that in a partnership the partners focus may be on their own individual success rather than on the success and reputation of the organisation as a whole. Through discussion it was acknowledged that the values required of an auditor, such as independence and objectivity, are not necessarily consistent with the values of a corporate and commercial organisation; accordingly, it may not be appropriate to cascade the values required of an auditor through a large, multidisciplinary firm. Despite acknowledging this difficulty, the Council highlighted the importance of having a common culture, such as integrity, in the firm at a macro level. It was also suggested that whilst sub-cultures generally would not be tolerated within most firms, differing behaviours and approaches in certain areas of the organisation, such as the audit business unit would be considered appropriate.

8.6 The Council noted that some concern had been raised during the interviews with INEs over the culture of partnerships and the perception that partners may be reluctant to challenge one another. The Council suggested that, in order to address this concern and reinforce accountability in partnerships, a clear understanding of how the governance is managed and where accountability for cascading the 'tone from the top' throughout the organisation lies. It was also suggested that a requirement for firms to 'self-certify' that an appropriate control system is in place to monitor and promote the culture of the firm could be a method through which such issues could be addressed.

8.7 The Council discussed how its work to review the Ethical Framework and introduce overarching ethical principles could be paired with the review of the AFGC, noting that a key objective of the proposed revisions to the Ethical Standards is to highlight the importance of the role of senior management in developing and applying policies to promote an appropriate culture and behaviours. It was agreed that the Executive would consider how the two work streams could be aligned and that a further draft of the report on the review of the AFGC would be brought to the Council in due course.

9. Any other business

9.1 At the suggestion of the Executive, the Council agreed that in future members should be given the choice of whether to download and print lengthy background papers that are provided in

support of papers on the agenda and that greater signposting of what is 'key reading' would be provided.

10. Next Meeting

10.1 The next formal meeting of the Audit & Assurance Council will be held on Friday 12 September 2014. An Audit & Assurance away day will be held on Wednesday 23 July 2014.