

Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 13 November 2013 at Aldwych House, 71-91 Aldwych, London WC2B 4HN

PRESENT:

Nick Land (Chair)
Russell Frith
Ray King
Scott Knight

OBSERVERS:

Aidan Lambe	Chartered Accountants Ireland (CAI)
Trevor Rushe	Irish Auditing and Accounting Supervisory Authority (IAASA)
Pat Sucher	Prudential Regulation Authority (PRA)

IN ATTENDANCE:

Keith Billing	Project Director
Francesca Chittenden	Council Secretary
Marek Grabowski	Audit Policy Director
Jon Hooper	Project Director
Andrew Jones	Director, Audit Quality Review Team
Steven Leonard	Project Director
Melanie McLaren	Executive Director
Gareth Rees	Executive Counsel, Professional Discipline Team

1. Apologies and introduction

1.1 Apologies were noted from Sue Harris (Council Member), John Hughes (Council Member), Paul Lee (Council Member), Robert Talbut (Council Member) and Allister Wilson (Council Member).

QUORUM

1.2 The Chairman reported that as a result of the number of apologies from Council Members, the meeting was not quorate.

1.3 The Council Members who were present agreed that the meeting would take place to discuss the items on the agenda and that any decisions taken would be circulated to the Members of the Council who were not present to be ratified. The minutes of the meeting would therefore refer to "Council Members" (meaning those Council Members who were present) rather than to "the Council" since the scheduled meeting of the Council was not properly constituted.

2 Minutes of the previous meeting and rolling actions

- 2.3 The minutes of the Audit & Assurance Council meeting of 11 September 2013 were approved as an accurate record of the meeting.
- 2.4 The note of the Audit & Assurance Away Day held on 14th & 15th October was noted.
- 2.5 The Council noted that all actions were either complete or addressed on the agenda.

Reports

3 Chairman's Update

- 3.1 The Chairman informed the Council Members that there was nothing to report that was not already covered on the agenda.

4. Report of the Director of Audit Policy

- 4.1 Mr Grabowski (MG) introduced his report which was taken as read. Particular emphasis was given to the following matters.

IAASB Project 'Reporting on Audited Financial Statements'

- 4.2 The Council noted the transcript of an FRC / ACCA led roundtable event discussion on the IAASB project and noted that further roundtable discussion, with a European focus, would take place in Brussels on 26 November.
- 4.3 It was noted that a comment had been made at the roundtable event that referred to the UK approach as an input based approach and the IAASB approach as an output based approach. Through discussion it was clarified that although there are some differences in the approach taken to KAM, leaving aside the materiality and scope, the output at the end of the audit is consistent. The Council noted that the FRC uses different language to that used by the IAASB and that there is a question in the consultation to ascertain whether users would like the FRC to adopt the ISAs and the terminology used therein and mould the additional UK requirements around the ISAs, or whether the FRC should retain the existing model and continue to have a slightly different approach but the same output. MG highlighted that notwithstanding the consultation responses, the currently discussed changes to the Directive and new Regulation in Europe would likely require the adoption of the ISAs by member states.
- 4.4 On a related point Melanie McLaren (MM) reported that the FRC has heard requests not to make any further amendments to the new standards in the short term. In response, MG confirmed that there was no intention to make any tweaks or amendments to the standards to be effective before the IAASB standards had become effective which is expected to be in 2016/17, at which stage the FRC and users will have the experience necessary to assess whether any changes are needed to the approach that has already been introduced in the ISAs (UK and Ireland).

Forthcoming IAASB Meeting 9-13 December

- 4.5 The Council noted that the agenda for the 9-13 December meeting had not yet been finalised but that the IAASB would be considering its Future Strategy 2015-2019 and related work programme, proposed changes to various ISAs to reflect how disclosures could be approached at key stages of the audit and ISA 720 Revised – *The auditor's responsibilities relating to other information*. The Council noted that the IAASB would be consulting on its future strategy and that the Council would have the opportunity to comment.
- 4.6 The Council noted that the IAASB was considering a project on professional scepticism and queried whether the project would go beyond the work the FRC had completed on the topic. In response MG informed the Council that the IAASB project would look at how professional scepticism can be addressed in standards. In that connection, he noted that the response developed by the FRC as part of the ISA monitoring project included detailed suggestions for areas to be considered in the ISAs that the FRC had developed following consultation on the earlier FRC discussion papers on Professional Scepticism. Andrew Jones (AJ) informed the Council that IFIAR were also looking at professional scepticism and through regular meetings of an IFIAR subgroup with the Heads of Audit at the big 6 firms, were attempting to identify how professional scepticism can improve audit performance and how that improvement can be measured. MG undertook to circulate the FRC response to the ISA monitoring project to the Council.

EU Policy developments:

- 4.7 The Council noted the EU Policy developments set out.

UK & Ireland Auditing and Assurance Standards

- 4.8 The Council noted the implications for the FRC's Auditing Standards and Guidance in relation to the introduction of the Strategic Report in annual reports from October 2013, in particular for ISA (UK and Ireland) 720 B and the Bulletin on auditor reports. The Council Members present agreed that it would be useful to provide guidance for firms to remind them of the changes and what the implications of those changes are.
- 4.9 The Council Members also noted the potential implications of amendments to ISA 720 (which forms the basis for ISA (UK and Ireland) 720 A), which is currently under review by the IAASB.
- 4.10 The Council Members present agreed with the proposed approach that FRC staff would look in detail at the implications of these amendments and to identify how they integrate and present to the Council in December suggestions as to how the implications could best be addressed. In response to a query MG confirmed that detailed consultation would be undertaken before any standard is amended or guidance is withdrawn.

UK & Ireland Auditing and Assurance Guidance

Should the UK and Irish Compendium Auditor's Report Bulletins be revised?

4.11 The Council entered a lengthy discussion as to whether or not there is a need for the Compendium and, if so, whether or not the Compendium should be revised. Through discussion the following points and observations were made:

- The FRC approach is to encourage expressive and creative auditor reporting, this may be undermined by the Compendium;
- The Compendium helps promote consistency in areas where consistency is an issue, particularly, for smaller firms who would only occasionally undertake audits and may be less familiar with the requirements;
- The Compendium is not thought to be a key tool for auditors in the larger firms, it is a tool used by smaller firms;
- Withdrawal of the Compendium may result in the development of a similar document by professional bodies and the FRC may be expected to have some responsibility to endorse that document;
- The Compendium provides users with practical examples which are not provided in the Standards (the IAASB examples are not included in the ISAs (UK and Ireland));
- The Compendium was initially developed to assist audit firms in ensuring legal compliance with the EU Directive, and in light of the forthcoming changes to the EU Directive it may be helpful and would be within the FRC's remit to retain and update the existing Compendium.

4.12 In light of the discussion it was agreed that a specific proposal should be brought to the Council to determine whether or not the Compendium should be retained and updated. The proposal should highlight the pros and cons of both options.

Responses to PN 14 (Housing Associations)

4.13 MG informed the Council that the consultation had closed on 25 October and the responses were due to be considered by the working party in November. The Council noted that a detailed paper summarising the responses and next steps would be presented at the December meeting.

Guidance on Client Assets

4.14 The Council Members present noted that the FCA is considering the responses to its consultation on the CASS Rules and were comfortable with the approach set out to considering the implications for our Bulletin or proposed CASS Standard.

Guidance in relation to paragraph 19A of ISA (UK and Ireland) 700

4.15 The Council Members present approved the draft communication in relation to the application of paragraph 19A of ISA (UK and Ireland) 700 subject to the addition of the following underlined statement within the further analysis paragraph: 'However, the FRC recognises that there may be important risks of material misstatement that only arise in relation to the audit of the parent company financial statements (such as risks related to investment subsidiaries that could, for example, have implications for distributable reserves.'

Research

Review of Audit – Improving confidence in the value of audit

4.16 The Council Members noted that the Codes & Standards Committee had, on advice from BIS, made the decision to postpone the announcement of the project until the EC legislative process in relation to the audit reform proposals currently at dialogue

stage had concluded. MG confirmed that, despite this postponement, work on the project was on-going and the delay would be beneficial in allowing the FRC to publish supporting papers shortly after the announcement of the project is made.

- 4.17 MG drew the Council's attention to the project plan and deliverables which had been revised in light of the findings of the YouGov Research, debate at the Audit & Assurance Council Away Day and following input from the FRC Board and Codes & Standards Committee. The Council noted that its advice on the timings of the revised plan and the scope and content of the deliverables set out in the plan would be sought at the December Council meeting and that, as the project progresses, the Council's input would be sought to assist the development of the discussion papers produced. The Council noted that the FRC intends to publish the discussion papers as soon as possible after the announcement of the project in Spring 2014.
- 4.18 The Chairman highlighted the importance of ensuring a structured and thorough research approach is undertaken to support the project on the review of the ethical standards. MG confirmed that the team understood this importance and would be implementing a thorough research project, which could be supported by a Working Group that included Council members. MG also confirmed that the Audit Quality Review (AQR) team had confirmed that they would be able to provide the information they have gathered in relation to ethical issues in order to inform the review and introductions to the firms to obtain further information. It was also noted that the NAO had confirmed that they would provide the FRC with information on matters of concern to them in the Ethical Standards, as public sector auditors.
- 4.19 The importance of ensuring that the discussion papers that are developed as outputs of the review are positive and forward looking documents which do not cast a negative light upon the role of audit was highlighted.

Review of ethics framework – liaison with other parties

- 4.20 The Council Members noted a summary of a meeting that MG and Keith Billing (KB) had attended with the CCAB Ethics Group. MG informed the Council that he had explained the FRC's view that the development of further guidance in the form of frequently asked questions by the professional bodies may detract from the responsibility of the auditor to exercise judgement appropriately, and had expressed some concern about the nature of some of the draft guidance that had been shared with the FRC. It was noted that the FRC had made clear that it is not associated with and does not endorse such guidance.

Other Matters

- 4.21 The Council Members noted that the NAO may discuss in its Transparency Report the issue of management secondments by public sector auditors and its concerns about the restrictions imposed by the FRC's Ethical Standards for Auditors in this area. The Council Members debated the issue and took the view that the FRC standard, prohibiting such secondments, was valid and that they could not see a prima facie case why it would be in the interests of the public to permit such secondments within the public sector. It was noted that the matter would be referred for discussion and input by the Public Sector Advisory Group.

- 4.22 The Council Members present noted:
- That the FRC had published a consultation on potential changes to the UK Corporate Governance Code and on new guidance for board of listed companies on risk management, internal control and the going concern basis of accounting;
 - The FRC concerns in relation to the proposed ICAEW guidance for the performance of assurance work on benchmarks and indices that have been developed in response to the manipulation of LIBOR and EURIBOR;
 - That a second draft of Guidance for Directors of Non-Code Companies: Assessing and Reporting on Solvency and Liquidity Risks and Going concern information was being developed;
 - The membership of the Code Stakeholder Group, which will oversee the preparation of a new Code of Audit Practice for local public audit and the summary of issues, discussed at the Group's most recent meeting.

FRC Plan and Budget 2014/15

- 4.23 MM introduced the draft FRC plan and budget for 2014/15 for the Council to consider. In response to a query MM confirmed that there would be reference in the plan to the FRC objective of encouraging annual reports that are uncluttered. MM also confirmed that whilst the plan wouldn't include detail of resourcing there would be rationale in relation to the use of the levy.
- 4.24 MG highlighted that the draft 2014/15 plan includes some Key Performance Indicators and qualitative measures through which the FRC could assess its performance; this was not a feature of previous FRC plans.
- 4.25 The Council Members present requested that the final draft plan be circulated by email for comment. MM suggested that the Council may find a presentation from the FRC's Corporate Reporting Review Team (CRRT) useful to assist and develop the Council's understanding of the work the CRRT undertake.

Council Effectiveness Review

- 4.26 Marian Williams (MW) joined the meeting for this item. MW informed the Council that the interviews had concluded and that she was in the final drafting stages of a report setting out the findings of the review for consideration by the Codes & Standards Committee at its meeting on 22 November. MW summarised the key findings of the review as follows:
- There is a need to clarify the role of the FRC's Councils and how they fit in to the broader FRC governance structure and, more specifically, there is a need to clarify the roles and responsibilities of the Codes & Standards Committee and the FRC Board;
 - There is a need to clarify the roles of observers and to agree principles around the roles and the number of observers on FRC Councils;
 - There is a need to develop the induction process for newly appointed Members;
 - There is a lack of consistency around the nature of Council sub-groups which needs to be addressed and that moving forward sub-groups will be referred to as either 'standing groups' or 'working groups', the main criteria for differentiating between the two would be the expected life span;
 - There is a need to continue the work that is on-going to improve the quality and structure of papers presented to the Councils.

- 4.27 It was noted that Council Members would be provided with a summary or debrief of the effectiveness review following consideration by the Codes & Standards Committee.

Activities since last meeting

- 4.28 The Council noted the list of activities since the last meeting.

5. Feedback from Audit Quality Review (AQR) inspections

- 5.1 The Council Members received a presentation from Andrew Jones (AJ) on the findings of the AQR inspections and the outcomes of two thematic reviews the AQR team had conducted in relation to Fraud and Laws & Regulations and Materiality.

- 5.2 The Council Members noted the key findings that were set out in the AQR Annual Report and findings of more recent research in the same areas. The key points highlighted were as follows:

- There has been a slight improvement in the overall review scores since 2008-09, particularly within FTSE 350 Companies; this score is evidence based and includes review of documentation in the audit files, discussion meetings and exit interviews;
- The number of audits undertaken by the big four firms graded as 1 has increased from 13.7% in 2012 to 17.9% in 2013;
- Audit efficiency is becoming more important given fee reductions; appropriate controls and procedures are required to ensure these efficiencies are not achieved at the expense of audit quality;
- Initiatives to reinforce the importance of exercising sufficient professional scepticism appear to be working
- Impairment of goodwill continues to be a problem area;
- There are group auditing considerations which need to be addressed, the AQR team have found there is insufficient evidence of the group auditor's involvement in the planning process and in evaluation the appropriateness of component auditors work for the purposes of the group audit; letterbox companies continue to be a challenge;
- Further improvements are required in audits of financial services sector entities in respect of loan loss provisioning and general IT controls;
- There is evidence of auditors taking an intellectually flawed approach to certain assertions, accordingly, there is insufficient work performed on deferred revenue and to confirm the completeness of revenue;
- In relation to quality control there is insufficient evidence of the Engagement Leader taking responsibility for the audit and of the EQCR's involvement, and a failure to secure 'fit and proper' confirmations where required;
- There are weaknesses identified in relation to reporting to audit committees and in relation to the concept of the audit committee providing a genuinely independent view;
- Independence and other ethical issues continue to be a concern.

- 5.3 In relation to the Thematic Reviews AJ informed the Council Members that the AQR team had reviewed 26 audits undertaken by the 6 largest audit firms. The Council Members were pleased to note that a number of good practice observations had been

identified in relation to each Thematic Review and that areas for improving practice had also been identified.

- 5.4 The Council Members present noted the following challenges:
- Implementation of the Competition Commission recommendations;
 - Probable EU restrictions on the delegation of inspection activities;
 - Implementation of the Local Government Audit inspection regime in 2016.

Standards and Guidance

6. IAASB's Exposure Draft: Auditor Reporting draft response

- 6.1 Steve Leonard (SL) introduced the draft response and a covering paper which outlined the amendments that had been made to the draft response following discussion at the September meeting and outlined a number of matters for the Council to consider in finalising the response. The Council Members noted that the draft response had been revised to reflect discussion at the September meeting and in light of the few responses to the consultation paper the FRC had issued inviting comment from UK stakeholders on the IAASB proposals.
- 6.2 The Council Members noted that the deadline for response to the IAASB consultation was 22 November and that this would be the last opportunity for a full discussion on the draft response. Given detailed input from Paul Lee ahead of the meeting, it was considered that the meeting was quorate with regard to this item.
- 6.3 The two key matters considered by the Council Members present were:
- Whether the FRC should be advised to recommend that proposed ISA 700 be amended to permit the auditor to report by exception (ie along similar lines to the extant UK approach) or be amended to either require the inclusion of a description of the key audit matters or to identify them in the separate response prepared by those charged with governance. The Council debated the options presented and concluded that the FRC should recommend that the IAASB amend the proposed ISA 700 to permit the auditor to report by exception on issues identified that are not referenced in the audit committee report.–The Council Members present considered that this information should be disclosed and that reporting on it by exception would be the most practicable approach to disclosure without any unnecessary duplication. The Chairman confirmed that this view was also supported by Council Member Paul Lee who had provided comments by email in advance of the meeting. The Council Members present agreed to advise that the alternative language in paragraph 11 (with some slight amendments) should be the FRC's recommendation.
 - The proposed response with respect to the way in which the proposals address Emphases of Matter. The Council Members concurred with the staff recommendation that auditors should be encouraged to give prominence to Key Audit Matters that the auditor considers fundamental to the users' understanding of the financial statements. The Council Members considered that Emphases of Matter are sufficiently important to perhaps warrant a degree of duplication in the auditor's report and highlighted the importance of emphasising the distinction between the two paragraphs and the importance of the auditor being able highlights EOMs and draw attention to a matter that is, in the auditor's

judgement, a matter 'of such importance that it is fundamental to users' understanding of the financial statements'.

6.4 In discussing the draft response and matters highlighted for consideration the Council Members present made the following observations and suggestions to assist staff in finalising the response to the IAASB:

- The response should oppose the proposed provision of illustrative examples of key audit matters, illustrative examples are not provided in UK standards;
- The response should not support the IAASB's recommendation that the auditor communication of key audit matters should be limited to the audit of the most recent period, instead it should be suggested that the auditor's communication of key audit matters should be aligned with all areas and all financial periods on which the auditor is reporting;
- The response should broadly support the IAASBs treatment of the statements to be included in the illustrative auditor's reports relating to Going Concern but the FRC should suggest the re-ordering of the paragraph headed the "Going Concern Basis of Accounting". The Council Members suggested that wording of the FRC response should be reviewed to clarify that where the word 'we' is used, this is in reference to the auditor;
- The IAASB should not mandate the ordering of the sections of the auditor's report but should indicate a preference for the ordering in the rubric to the illustrative examples.

6.5 SL undertook to revise the draft response in light of the steer given by the Council Members present at the meeting and input from Council Member Paul Lee who had submitted comments on this item by email. The Council noted that the response would be approved by the Chairman and Executive Director of Codes & Standards prior to submission to the IAASB.

7. Horizon Scanning discussion

7.1 The discussion on Horizon Scanning was postponed to the December meeting.

8. Any other business

8.1 None.

9. Next Meeting

9.1 The next meeting of the Audit & Assurance Council will be held on Monday 16 December 2013.