Financial Reporting Council

Minutes of a meeting of the Audit and Assurance Council of the Financial Reporting Council held on 7 September 2016 at the FRC, 8th Floor, 125 London Wall, London, EC2Y 5AS

PRESENT

Ray King (Chair – items 1-7)
Jane Fuller (Chair – items 8-10)
Bryan Foss
Kari Hale (from item 4)
Sue Harris
Scott Knight
Conall O'Halloran (from item 4)
Stephen Oxley
Jerry Wedge

IN ATTENDANCE

Kate Acott	Project Director, Audit Policy
Mark Babington	Deputy Director of Audit Policy
Keith Billing	Project Director, Audit Policy
James Ferris	Project Director, Audit Policy
Marek Grabowski	Director of Audit Policy
Josephine Jackson	Technical Director, Audit Policy
Melanie McLaren	Executive Director, Audit
Lisa Campbell	IAASA Observer
Michael Gaull	PRA Observer

Apologies and welcome

Apologies were noted from Robert Hingley (Council Member) and Lee Piller (FCA Observer). The Chairman welcomed Jerry Wedge to the Council. The Chairman announced that Robert Hingley would be standing down from the Council in the near future, and that the FRC would be looking to appoint a replacement during the autumn.

1 Minutes of the previous meeting

1.1 The minutes of the meetings held on 8 June and 6 July 2016 were agreed. The Council noted that there would be options at future Council meetings to cover topics that had not been covered due to the shortening of the away day. Marek Grabowski (MG) stated that there would be action around the SME audit at the IAASB in the near future.

2 Chairman's Update

2.1 The Chairman reported back from the Board that the FRC had changed its funding arrangements to recover more from the profession, to cover in full the cost of the FRC's audit related work. CCAB had challenged the funding proposals, although these have now been resolved. The CEO has been in liaison with No. 10 to see how the FRC could help with the new Prime Minister's agenda relating to remuneration and board composition. The work on culture had been timely in light of the Brexit vote and it had been very well received. The RSB delegations were to be put in place by the end of September. The annual, culture and audit state of the nation reports and the consultation on ISA 800 and 805 had been approved.

3 Report of the Director of Audit Policy

3.1 MG outlined the Council's agenda. MG confirmed that the Council had one further opportunity to discuss PN 20 at the conference call on the 4th of October.

3.2 Mark Babington (MB) stated that the Government will adopt the Fourth Anti Money Laundering Directive, on which the FRC has agreed to work with the Treasury, HMRC and the National Crime Agency to see what revisions were required to PN 12. A meeting had been held with DCMS, the Cabinet Office and GCHQ to discuss whether the reporting of cyber security should be mandatory within principal risks. The FRC position remains against boilerplate reporting. MB reported that 102 of the FTSE 350 had included cyber security in their principal risks.

3.3 MG reported that very little had developed in auditing since Brexit. The FRC has established a working group examining the implications of Brexit. The Council noted that parts of EU audit regulation that were not enshrined in UK law could fall away, although MG pointed out that most requirements had been brought directly within our standards. Melanie McLaren (MM) added that, having left the EU, it was expected that the FRC would seek direct representation on the IASB, representing the UK as one of the largest capital markets.

3.4 MM stated that BIS was conducting an analysis of regulations to identify where there were matters coming from European Directives that would not stand alone in a UK system. BIS was restructuring as a department, which meant that the FRC might receive less attention from BIS, due to reducing resources. MM reported that implementing ARD had been painful because BIS had been very resource constrained, and in a number of areas, reliant on FRC input in some specialised areas. The feedback stakeholders have given on ARD is that no one wanted to turn back the clock on ARD.

3.5 MM stated that a good dialogue was being developed with No. 10 and the senior policy advisors there. The FRC also has regular dialogue with the Treasury because corporate reporting was increasingly being driven through the G20, and the Treasury is the Department with the policy lead. Michael Gaull (MGa) added that the PRA had set up a unit to examine the implications of Brexit, but there had not been any major decisions yet.

4 IAASB Agenda

ISA 540

4.1 MG noted that the Task Force (TF) had a very ambitious timetable. Papers for TF meetings are generally made available with very little time to review them. There is concern about whether the December deadline to approve an Exposure Draft can be met with the expected level of quality.

4.2 The Council noted that the push to revise the standard had been driven with IFRS 9 and financial services and banking in particular in mind. MG said that the taskforce was focused on the broader range of estimates, but that had not yet been fully reflected in the drafting.

4.3 MG identified that one of the issues that needed to be addressed was that the model used for expected credit loss (ECL) was different to a fair value model - fair value was a hypothetical price at a historic point in time, whereas ECL was information about what could happen in the future. A significant matter to consider in relation to this is the use of external data sources. The TF had pushed back on the idea that just because information was external it was better, which had been suggested by some stakeholders.

ISA 315

4.4 MG stated that the controls assessment was a very important requirement, but that the current standard contained too much text, and was very long, which meant it was not always very clear. Some SME auditors had suggested that they should only ever have to look at control activities if they intended to rely on them for assurance purposes, to make it more proportionate for SMEs. MG explained that the requirement was proportionate because auditors only had to look at control activities to the extent that it helped them meet certain objectives and SMEs generally had very simple controls. However, the working group was considering whether the requirements could be made less proscriptive, perhaps by tabulating requirements in a way that made them more readily accessible.

4.5 The Council asked whether auditors could rely on other ways of building their understanding of the entity and its control environment. MG replied that if an auditor was evaluating a control, ISA 315 would apply. MG confirmed that an internal audit was an example of an internal control. MG confirmed that auditors needed to conduct D&I when carrying out their assessment.

4.6 MG noted that the only two areas where auditors were required to look at a control activity were where there was a significant risk or where there were risks that substantive procedures alone would not provide sufficient audit evidence. The Council enquired whether the working group was only concerned where the lack of controls in an entity caused a loss for the company, rather than over company assets like relations with customers. MG replied that the audit would not cover such issues.

4.7 MG stated that the major concern with significant risks was that very few were picked up during audits and consequently there was sometimes a less appropriate focus on issues that were not identified as significant. The definition of significant risks was very circular. MG suggested options included abolishing the whole concept of significant risk, or undertaking a much more graded assessment. If the conclusion was to persist with significant risk then attention was needed with respect to the definition.

4.8 The Council stated that they did not see the classification of risks as significant or non-significant as a binary decision, but rather it was a sliding scale. They were unsure whether removing 'significant' would be helpful because audit committees, auditors and users of accounts were used to the language. The Council suggested that the IAASB might consider keeping 'significant' and have greater clarity.

4.9 The Council stated that some of the examples of principal risks were excessive and included far too many areas – it was valuable to identify a handful. The Council questioned the usefulness of defining significant risk as where the most resources were allocated. MG noted that they did not require only disclosure of significant risks.

5 Audit and Assurance Technical Advisory Group

5.1 MB stated that the TAG had agreed to have discussions on issues to reach a consensus or, for more contentious issues, to provide staff guidance to show what had been considered. One of the drivers was to avoid the need for multiple sets of guidance to be developed which would run the risk to the FRCs standards being interpreted incorrectly.

5.2 The Council noted that the discussions at TAG meetings supported a consistency of application of the standards across the profession. This offered a way of dealing with many of the questions that firms had raised, however, there were some issues that needed to be resolved at a European level. MM stated that she had written to the Commission with the issues they had identified. The Council noted that the TAG had good representation from a range of stakeholder groups.

6 Staff Guidance Notes – Ethical Standard Interpretation Issues

6.1 MB stated that the FRC had drafted guidance notes on the provision of non-audit services to non-EU subsidiaries and the prohibition of audit playing a part in management and decision making. They were also working on making available a rolling list of issues discussed at the meetings to distil the information into one accessible place to support the profession.

7 Practice Note 20 (Revised) Update – The Audit of Insurers in the UK

7.1 James Ferris (JF) introduced the update paper, asking for the council to note the following matters:

a Progress was being made but against a tight timetable and with some clear areas of judgement around the scope of the audit requirement in respect of regulatory reporting
b Discussions were also taking place about the desirability of applying ISAs 800 and 805 to the audit of private reporting for non-solvency 2 firms
c FRC was proposing to incorporate the material in PN24 (audit of Friendly Societies) – material which was almost identical to PN20 – into the revised PN and then withdraw PN24.

7.2 JF reported that the two key components of PN 20 were the audit of financial statements and the audit of regulatory reporting returns. The FRC has proposed to adopt ISA 800/805 to support reporting on these engagements, which the PRA requires to be carried out in accordance with the ISAs. The consultation closes in early October.

7.3 JF stated that they had received generally supportive informal feedback so far on the consultation. MB stated that the APB had originally been concerned that if the UK adopted ISA 800/805 they might be used to for engagements which were not appropriate under ISAs, and which might undermine true and fair reporting. In fact, informal discussions indicate that some engagements were already being conducted under ISAs (UK) which should properly be conducted using ISAs 800 and 805 - the adoption of ISAs 800/805 could therefore provide a mechanism to regularise some of those engagements.

7.4 The Council questioned whether it was acceptable to apply the full assurance model outside of financial statements. MG said that ISA 800/805 would not be applicable to those sorts of engagement, since they were still only concerned with the audit of financial information. Consideration could be given as to whether there was a need to emphasise the importance of not using a financial reporting framework that could be misleading in the final version of the standards.

7.5 MG reported that the PRA was drafting a requirement on stress tests and wanted to have a dialogue on the most appropriate form of assurance. They had suggested that ISA 800/805 would be the most appropriate form of assurance.

7.6 In relation to the audit requirement for the audit of published regulatory reports, JF noted that the PRA had scoped out the Solvency Capital Requirement (SCR) for partial or full internal model firms. The auditor was not being required to audit anything that was or was derived from the SCR, which causes an issue with the auditor's report given the interrelatedness of many of the disclosures in the published reports.

7.7 JF also confirmed that the current proposition being discussed by the PN20 working group was that the transitional measure for technical provisions was also not in scope. The transitional measure was the difference between the Solvency I position at 31st December 2015 and the Solvency 2 position for the same liabilities at 1st January 2016. Under transitional arrangements for the introduction of Solvency 2 entities are allowed to recognise any increase incrementally over a period of 16 years. Practitioners, the industry and the PRA were all keen to avoid an audit of the underlying Solvency 1 calculations (which had never previously been audited) – but without that work the auditor could not audit the transitional measure.

7.8 The PN working group was also discussing the desirability, or otherwise, of applying ISAs 800 and 805 to the audits of private regulatory reporting as well as to published SFCRs. The PRA rules did not require a 'reasonable assurance' opinion on private reporting, but the form of reports currently produced said that they were reasonable assurance and were prepared in accordance with PN 20. MG stated that the technical issue for those who would not come into the Solvency II scheme was that if there was a report purporting to be under the ISAs without reference to 800/805 it was potentially difficult to argue that it was acceptable to allow that practice when reporting in private. However, the FRC would obviously consider what the intention of the PRA was in respect of this reporting, and also ensure an outcome which was proportionate in respect of the risks related to these reports.

8 Bulletin: Compendium of Auditor's Reports

8.1 Kate Acott (KA) reported that in the past the FRC published two compendium bulletins that contained 46 examples. In the proposed new Compendium this has been reduced to eight examples, focusing on companies, the PIE sector and listed entities as these represented the bulk of those entities required to have an audit.

8.2 The Council noted that the risk with a more streamlined approach was that it may not be sufficiently effective in helping smaller practitioners maintain the quality of their auditor's reports. However, on balance, the Compendium provides enough auditor's reports to illustrate the requirements of the ISAs, but keeps boiler plate reporting to minimum so that innovation is not stifled. The Council agreed that eight was an appropriate number of examples.

8.3 MB stated that one of the FRC's priorities was to be able to publish the Compendium sooner rather than later in order to ensure that this guidance was available for use on a timely basis. The Council noted that users of accounts wanted the wording in auditor's reports to be company specific. KA responded that she had included guidance in the Compendium explaining that the FRC valued innovation.

8.4 KA explained that some outreach had been undertaken with two larger firms and one smaller firm. The feedback from the firms confirmed that there were no disagreements in principles with the planned approach to the Compendium, although there are some drafting changes which will be incorporated. KA noted that the FRC were not currently planning to undertake further outreach to smaller firms. The smaller firm had raised a query about micro-entities and whether the FRC intended to include an example in the Compendium illustrating an auditor's report for a micro-entity. KA explained that new application material had been added into the newly revised ISA 210 to help auditors of micro entities explain that, despite the fact that the legislation required them to give an opinion that was a true and fair view, it was not really a true and fair view. The FRC has received a few requests for proforma wording for the other matter paragraph recommended by the application material to be included in the auditor's report in these circumstances, but given the fact that micro-entities are not required to be audited, and the legislation goes some way to persuading them not to have an audit, the team has taken the view that it is not necessary for the FRC to provide an example of this wording.

8.5 The Council enquired whether any queries could be referred to the TAG. MB replied that the TAG was focused on examining interpretation issues. It was comforting that having engaged with a small firm they had not fed back that they wanted more examples. The Council suggested that the FRC might want to say more about reporting of findings under key audit matters. MG stated that they could not use the Compendium to go beyond what was required in the standards.

8.6 MG stated that the pressure the FRC had had for more examples had been from smaller entities through the ICEAW. This Compendium did not contain sector specific examples. KB noted that the reason why there were so many sector specific examples in the old bulletins was that they had been moved from the Practice Notes, because it was easier to update all the illustrative auditor's reports in one go rather than having to update multiple Practice Notes. KA noted that the individual Practice Notes could now be updated without full consultation. The Council agreed that they would keep the number of illustrative auditor's reports under consideration going forward, but that there was no current intention to move the sector specific auditor's reports back to the Practice Notes.

8.7 The Council agreed to advise the Codes & Standards Committee that it approved the Compendium for publication, subject to any changes advised by Council.

9 Horizon Scanning

IAS 39 and FRS 102

Social Risks

9.1 The Council noted that remuneration was increasingly becoming a topic of interest in broader society. MM stated that in the last season there had been some significant errors in remuneration reporting that had not been picked up by the auditors. She had written to the firms that had made the errors and they were considering issuing a more general notice to auditors regarding remuneration. The Council suggested that they could issue a public letter on remuneration.

9.2 The Council stated that diversity and the governance process were important issues that were missing. Distrust in big corporates had triggered political reactions, which could give rise to a trend for CEOs to have more risk factors and towards more boilerplate and less filtering of principal risks.

Political Risks

9.3 MB stated that the OECD's proposals of country by country reporting of tax could be relevant to auditing. The Council noted that tax avoidance was relevant to judgments around tax risks and assessments. Feedback in the YouGov report identified more demand from companies for assurance over public tax reporting as an area where there was support for additional assurance engagements.

9.4 MM stated that they expected in the next two reporting seasons that companies would make more meaningful tax disclosures. MG stated that if a company was tax managing, the auditor had to make sure that those arrangements did not breach the tax rules because there would be direct consequences for the financial statements which is prohibited in by the Ethical Standard. The Council stated that the issue was goalposts moving. Tax would be a principal risk in most audit reports. The sustainability of capital allowances may also need to be expressed in audit reports.

9.5 MM enquired whether the FRC should be involved in tax from an audit perspective. The Council responded that the FRC had issued helpful guidance to companies in the spring to support the reporting timetable. If a systemic issue emerged from AQR they may have to act in a similar way.

Technological Risks

9.6 The Council suggested that an additional risk was the increased use of robotics and artificial intelligence, which could have profound implications for control systems and decision making.

Economic Risks

9.7 The Council noted that interest rates were a significant risk. MM stated that there was a systemic impact on DB pension schemes and the sponsoring employer. They were beginning to see that dealing with pension schemes was leading to different management decisions, which was putting professional advisors under some pressure. The Council noted that the Pension Institute had published a useful paper called 'Milking and Dumping'. The BHS situation had demonstrated that journalists and politicians had a limited understanding of pensions issues.

9.8 The Council noted that five-year smoothing of the discount rate had not been taken up in the past, but it might be taken up now. The deficit could be measured by the government bond rate, the high quality corporate bond rate or the lent rate according to the assets in the portfolio. The Council noted that there was an elevated risk around long-term asset values, particularly when there were artificially low interest rates.

9.9 The Council asked whether there had been a growth of non-audit services as a percentage of audit firm revenue. MM noted that there had been no change in the proportion of revenues earned from non-audit services for the year. The Council noted that there was instead a short term profit challenge for audit, where revenue has remained static but costs had increased as a result of increased investment in technology and increased tendering. MM stated that FRC analysis suggested that tenders were based on quality and fees had held up. The Council noted that most audit committees were not explicitly using tendering to reduce audit costs, but price was an important component when comparing between similar quality audit practices. The influence of the audit practice within accounting firms was declining and more profitable parts of the business were putting pressure on the audit practices to achieve efficiencies.

Environmental Risks

9.10 MM noted that there was work in progress, prompted by the Financial Stability Board, on the impact of climate change on disclosure.

Legal and Regulatory Risks

9.11 MB stated that they were increasingly seeing assurance over regulatory requirements and they questioned whether that was genuine additional beneficial assurance. The Council noted that there was interdependence between US and EU regulation. There was an environment of uncertainty where disclosure was not necessarily a safe haven.

Ethical and Cultural Risks

9.12 The Council noted that the issue of governance was not yet resolved. There was an interesting ethical point in terms of the compatibility of being an auditor with undertaking a wider monitoring role.

9.13 The Council stated that the profession was dominated by the chartered accountancy brand rather than audit. There were overarching issues in terms of the sustainability of the profession to attract top graduates and the increasing hiring of school leavers as apprentices. MM added that the FRC had been involved in discussions on how apprenticeships could be used in the profession. The Council noted that audit managers and directors were doing less non-audit due diligence and advisory work, which risked creating a narrower mind set and a demographic change in the characteristics of auditors if they did not find alternative ways of building wider experience.

10 Any Other Business

10.1 The Chairman asked if there was any other business. MB noted that they had closed the Audit Committee Chairman's annual quality survey of FTSE 350 firms.