

Audit and Assurance Council

DRAFT Minutes of a meeting of the Audit and Assurance Council of the FRC
held on 25 March 2015 at the FRC Office, 8th Floor, 125 London Wall, EC2Y 5AS

PRESENT:

Nick Land (Chair)
Jane Fuller
Sue Harris
Robert Hingley
John Hughes
Ray King
Maggie McGhee
Allister Wilson

IN ATTENDANCE:

Kate Acott	Project Director
Mark Babington	Deputy Director of Audit Policy
Francesca Chittenden	Council Secretary
Phil Fitz-Gerald	Head of Supervisory Inquiries (minute 9 only)
Marek Grabowski	Director of Audit Policy
Josephine Jackson	Technical Advisor
Steven Leonard	Project Director
Melanie McLaren	Executive Director, Codes & Standards
Lee Piller	FCA Observer
Daniel Rouse	Case Manager, Professional Discipline (minutes 7 and 8 only)
Paige Rumble	Case Manager, Professional Discipline (minute 6 only)
Pat Sucher	PRA Observer
Marian Williams	Director, Codes & Standards

Apologies and introduction

Apologies were noted from Scott Knight and Conall O'Halloran (Council Members) and Eileen Townsend (IAASA Observer).

1. Minutes of the previous meeting

- 1.1 The minutes of the meetings held on 13 February 2015 were approved for publication.
- 1.2 The Council noted the status of the actions set out on the rolling action log.

2. Chairman's update

- 2.1 The Council noted a summary of matters considered by the FRC Board at its meeting on 4 March.

2.2 The Council noted that the FRC had appointed McKinsey to undertake a review of the effectiveness of the FRC's Audit Quality Review and Corporate Reporting Review processes. The Chair confirmed that the review will be informed by a significant stakeholder engagement programme.

3. Report of the Director of Audit Policy

3.1 Marek Grabowski (MG) introduced a paper that provided an update on development relating to UK and International auditing standards, FRC audit research activities and other FRC matters not covered elsewhere on the agenda.

International Auditing and Assurance Standards Board (IAASB)

3.2 Josephine Jackson (JJ) reported on the March IAASB meeting. The Council noted that the IAASB Board had:

- Voted unanimously in support of the Disclosures project.
- Discussed recent issues and concerns in respect of the group auditing standard and agreed the issuance of a discussion paper.
- Agreed that staff should prepare a discussion paper on letterbox audits despite expressing mixed views as to the value further work would add. It was noted that the Board highlighted a need for further reflection on the application of ISA 220 and further consideration on whether reliance could, or should, be placed on the component auditor.
- Discussed Quality Control and agreed to issue a discussion paper which would seek input as to whether there is a need for more governance in Audit firms.
- Agreed work to identify an approach through which a 'holistic' survey of ISAs could be issued.
- Discussed in detail audit issues relevant to Financial Institutions noting that new accounting standards and disclosure requirements are due and that the IAASB will need to consider how it supports auditors. The Council expressed concern with the additional cost that will arise in implementing IFRS 9 and commented that investors are likely to have difficulty in tempering accounts prepared in accordance with the Standard.
- Discussed integrated reporting and agreed to issue some form of interim guidance whilst further work on the awareness paper is undertaken. The Council highlighted the need for the IAASB to identify and agree what the market and investors want before progressing work in the area.

3.3 JJ reported that the Board had agreed to establish a working group to look at how best the IAASB could cover group audits, letterbox audits and quality control in one discussion paper.

3.4 The Council also noted that the CSC had met on 10 March and had approved publication of 'Extended Auditor Reporting - A review of reporting in the first year'. The Chair commended Steven Leonard (SL) on the report.

4. Activities since last meeting

4.1 The Council noted the list of activities since the last formal meeting.

5. Horizon Scanning

- 5.1 The Council noted that the FRC has recognised a need to improve its horizon scanning and risk identification processes and is developing a model to support those processes. The Council noted that the model will be based upon the model used by the Cabinet Office and that input from the Council will be sought at the May meeting.

6. Consultation paper and Exposure Draft of a new Client Assets Assurance Standard

- 6.1 Steve Leonard (SL) introduced the draft Consultation paper (CP) and Exposure Draft (ED) of a new Client Assets Assurance Standard. The Council noted that documents had been updated since last presented to the Council reflect views and input received through meetings of the Client Assets Working Group, the Client Assets Steering Group and representatives of the FCA. SL reported that there are no substantial issues for the Council to consider and that the Client Assets Steering Group strongly support both documents. The Council noted that whilst the Client Assets Working Group also support both documents there are some reservations in respect of the extent to which the assurance provider ought to use judgement in determining the nature and extent of assurance procedures.
- 6.2 SL welcomed Paige Rumble (PR) to the meeting and reported that PR and her colleagues in the FRC's Professional Discipline team (PD) had been involved in the development of the standard. PR reported that the PD team welcome the standard and believe that the standard will support their investigations on CASS related matters.
- 6.3 The Council considered and discussed the documents; the following observations and comments were made:
- It was noted that additional material, including guidance on whistleblowing, had been added to the ED at the request of the FCA.
 - It was noted that the ED contains no guidance as to what would constitute a significant breach of the CASS Rules on the basis that every firm is unique and handles Client Assets differently; it is up to the CASS auditors to apply judgement in making this determination.
 - It was noted that the Standard is designed to provide a framework to guide CASS auditors' thought processes when making judgements and that the model is based on a Turnbull style approach to risk assessment.
 - It is not considered possible to accommodate the FCA's desire to bring forward the effective date of the standard so as to avoid an interregnum between the FCA Rules coming into force and the standard coming into force. This is due to the timescales involved in developing the standard and a desire to avoid a requirement for backdating the application of the Standard. However, it was agreed that the FRC should promote early adoption of the standard and a question on early adoption is included in the CP.
 - The Council suggested that small firms are likely to find implementation of the standard challenging and highlighted the importance of engaging with small firms throughout the consultation period. It was noted that the FCA will assist the FRC in identifying relevant small firms with which to engage.

- It was noted that the ED makes reference to the Supervisory Rules (SUP) which are more wide ranging than CASS and it was suggested that the reference should be limited to 'SUP 3 - Auditors'.
- It was noted that the requirement for Engagement Quality Review as set out in the ED had been the subject of detailed discussion at meetings of the Working Group as some members had expressed concern in respect of firms having individuals available to undertake the review. SL reported that the requirement is not intended to be overly onerous and that the ED provides significant flexibility as to who could do the review. The Council supported the approach set out in the ED.
- SL reported that the ED includes a requirement for all breaches and near-misses to be reported on a schedule that will be appended to the CASS auditor's report. The FCA had encouraged the insertion of a requirement in the Standard that the CASS auditor should report on so called "near misses" on a timely basis rather than wait to include the matter on the Breaches Schedule. SL confirmed that a question on the requirement, and specifically on the requirement to report on near-misses, is included in the CP.

The Council discussed in detail the role of internal audit and some further enhancements to the proposed requirements were suggested including:

- that the standard should make it a requirement for any work that will be relied upon as part of the CASS audit to be undertaken by an individual who is competent in CASS.
- that the standard should make it a requirement for the CASS auditor to provide its rationale justifying where reliance has been placed on any work undertaken in respect of Client Assets.

6.4 It was noted that the reference to whistleblowing in the ED has been taken from the PN21 and is intended to remind auditors of their public interest responsibilities.

6.5 Subject to the amendments proposed the Council agreed its advice to the Codes & Standards Committee to issue the Consultation Paper and Exposure Draft of a new Client Assets Assurance Standard.

7. Feedback from FRC Open Meeting to discuss the FRC's implementation of the EU Audit Directive and Regulation in its auditing and ethical standards

7.1 Keith Billing (KB) presented a paper that set out a summary of views expressed at the FRC Open Meeting held on 11 March and provided a verbal update on the written responses that had been received to the FRC's Consultation Paper (CP). The Council noted that 38 written responses have been received in response to the CP from a range of audit firms, investors and corporates.

7.2 KB invited the Council to consider and comment on points raised in discussion and in responses from investors. The Council noted that whilst 38 written responses had been received, due to the close proximity between the consultation closing date and the Council meeting only responses from investors had been reviewed in detail. Through discussion the following points were noted and observations were made:

General points

It was noted that there is general support for the proposals set out in the CP and for the proposal that the FRC maintains requirements that are more stringent than the requirements introduced in the EU Directive.

Scope of Public Interest Entities (PIEs)

It was noted that a range of views have been expressed on the appropriateness of including AIM and similar markets within the scope of Public Interest Entities (PIEs); as there is no clear consensus this is an area the FRC will need to consider in detail. KB reported that some respondents suggested consideration be given to the nature of the listing, for example whether genuine public investment was involved or possible. It was also noted that AIM have indicated that the whilst the FRC should not 'turn back the clock' and lose past achievements that support audit quality, the FRC should not take actions that would result in increased regulation and scrutiny of AIM companies.

Black list v white list

It was noted that:

- Attendees at the Open Meeting had expressed support for the development of a white list approach and a black list and that a number of attendees had advocated a combination of the two.
- Investor responses to the consultation had not expressed support for the development of a white list.
- There is general support for the development of a black list, noting that this is the approach adopted elsewhere in Europe.
- The Council discussed the views expressed and suggested that the written responses received from stakeholder groups other than investors may be more supportive of the white list approach. The Council suggested that consideration be given to establishing a middle ground whereby both black and white lists are developed and are accompanied by principles that would support audit committees in making judgements as to the whether work in the 'grey area' that is not captured by the white list or black list should be permitted. The Council noted that the FRC may also explore other routes through which the matter could be addressed, for example, through the introduction of a provision in the UK Corporate Governance Code.
- Some members expressed concern in respect of the cap which serves to constrain the extent to which audit committees could approve services not on a black list suggesting that the cap will result in auditors being unable to undertake work. KB reported that some services required by Law are exempt from the cap and that in exceptional circumstances the competent authority can permit exemption.

Extraterritoriality

The Council noted that mixed views have been expressed in respect of the proposal to apply requirements extraterritorially. KB reported that whilst there is general understanding for the principle, there are concerns as to the possible consequences and difficulties that may arise where the group straddles a number of jurisdictions. KB also reported that some commentators suggest the decision to apply UK standards extraterritorially should be a decision taken by the audit committee and should not be written in to the standards.

7.3 The Council noted that formal feedback on the written responses to the consultation would be presented to the Council at its April meeting and that the draft Exposure Draft would be presented to the Council at its May meeting.

8. FRC response to IESBA ED on proposed changes to Part C of the IESBA Code (requirements applicable to accountants in business)

8.1 KB introduced the FRC response to the IESBA ED on proposed changes to Part C of the IESBA Code. KB reported that the response, which had been reviewed by the FRC's disciplinary team, is supportive of the objectives of IESBA but recommends a number of ways in which the proposals could be improved.

8.2 MG reported that at a global level there is a call for consistency in approach across the globe, or at least within Europe and that the FRC is encouraged to raise with other member states and to agree on an approach to some of the member state options.

8.3 Through discussion of the draft response the following suggestions were made:

- The Council welcomed the draft and commented it was well written and clear.
- The Council agreed that the enhanced guidance on applying the 'fair and honest' principle in Section 320 is unclear and makes it difficult to understand what the practitioner is expected to do. The Council suggested that the response could be strengthened and agreed that IESBA should be encouraged to introduce a high level principle that practitioners can use as a basis for judgement.
- The Council noted that in some areas the Code takes a 'rules based' rather than principles based' approach and that the response encourages IESBA to review this and be consistent.
- It was suggested that on reading the ED it could be assumed that there is a clear line between work that is ethical and work that is unethical when this is not the case.
- It was suggested IESBA should be encouraged to include more guidance on what 'reasonable steps are' in respect of para 320.2 and that examples of what would be consider 'routine' and 'non-routine' pressure should be included at para 370.3.
- It was suggested that the response could be more forceful in making a distinction between acts that are illegal and acts that are unethical in respect of the proposed revisions to section 370.

8.4 KB undertook to update the draft response to reflect the views expressed by the Council. It was noted that the revised draft response would be presented to the Council at its April meeting for approval.

9. Improving the quality of reporting at smaller listed and AIM quoted companies

9.1 Phil Fitz-Gerald (PFG) introduced a draft report and discussion document which set out the outcome of phase 1 of a project aimed at helping smaller listed and AIM quoted companies to assist their quality of reporting. PFG reported that the project was initiated following the FRC's Corporate Reporting Review team consistently finding that the quality of reports at smaller listed and AIM quoted companies were poorer than the reports of their larger counter parts.

- 9.2 The Council noted that phase 1 of the project had involved:
- Interviews with small quoted and AIM listed companies;
 - An AQR review of audit firm processes for the review of smaller companies' financial statements and their implementation;
 - A CRR review of smaller companies financial statements and the themes arising from those reviews;
 - Stakeholder engagement with preparers and their advisors, investors and other users'
 - Consideration of the corporate governance of companies; and
 - An analysis of the qualifications of those preparing and reviewing financial statements.
- 9.3 PFG invited the Council to comment on the draft report and the proposed actions. Through discussion the following observations and suggestions were made:
- The Council welcomed the project. The Council commented on the importance of promoting the quality and integrity of Financial Statements highlighting that investors of small companies place a high level of reliance on the Annual Report and Financial Statements to investors in small companies and AIM Quoted Companies as the documents are the only audited information available.
 - The Council discussed the scale of the issue and questioned whether the drafting appropriately reflects the magnitude of the issue. It was suggested that, if there is a chronic failure in the system as may be perceived upon reading the report, the proposed responses would be inadequate. PFG undertook to review the drafting in respect of the magnitude of the issue and confirmed that the matter is an issue of lesser quality rather than a 'chronic failure'.
 - The Council noted that the financial statements of small and AIM quoted companies are frequently found to include basic accounting errors as opposed to errors where complex accounting treatments have been applied. The Council questioned whether the FRC should consider establishing an IFRS 'light' however, it was noted that the companies that had been involved in the project and other stakeholders had unanimously responded to state that full IFRS remained appropriate.
 - It was noted that the FRC is not seeking to judge or challenge the governance of the companies reviewed. It was suggested that the FRC might state this in the report.
 - Following clarification of the scale of the matter the Council supported the proposed actions, however, the Council also suggested that the FRC could:
 - Seek to promote the importance of communicating with investors and highlight the successes that will flow from improved communications.
 - Explore what information investors would like to be included in the Annual Reports and Financial Statements. It was commented that preparing the Annual Report and Financial Statements is a costly and timely process, if small companies could prepare shorter reports which focus on the information the investors want the quality may improve.
 - Liaise with interested parties to ensure that routine training materials and updates are circulated to small and AIM Quoted companies so that those companies have the resources they need. It was commented that accountants at small and AIM Quoted companies often do not receive routine materials that staff at larger firms receive and have access to.
 - Consider whether there is sufficient emphasis on the importance of governance.

9.4 PFG thanked the Council for their comments and undertook to review the draft report accordingly. The Council noted that the draft report had been considered by the Conduct Committee on 17 March and would be considered by the Codes & Standards Committee on 30 March and the FRC Board in May. PFG reported that the FRC intend to publish the report in June.

10. Any Other Business

10.1 The Council approved the nomination of Mr Anthony Barrett as the new representative of the Wales Audit Office on the Public Sector Advisory Group.

10.2 The Chairman reported that John Hughes' term of office was due to end on 31 March and that this would be his last Council meeting. The Chairman thanked John Hughes for the contribution he had made to the Council and its predecessor body since his appointment in 2009.

10.3 The Chairman reported that Steven Leonard would be retiring on 30 March and that this would be his last Council meeting. The Chairman and Council thanked Steven Leonard for his work and wished him well for his retirement.

11. Next Meeting

11.1 It was confirmed that the next formal meeting of the Audit & Assurance Council would be held on 27 April 2015.