Audit and Assurance Council

Minutes of a meeting of the Audit and Assurance Council of the FRC held on 12 December 2014 at the FRC Office, 8th Floor, 125 London Wall, EC2Y 5AS

PRESENT:
   Nick Land (Chair)
   Jane Fuller
   Sue Harris
   John Hughes
   Ray King
   Scott Knight
   Maggie McGhee
   Allister Wilson

IN ATTENDANCE:
   Francesca Chittenden  Council Secretary
   Phil Fitz-Gerald  Head of Supervisory Enquiries (agenda item 5 only)
   Marek Grabowski  Director of Audit Policy
   Josephine Jackson  Technical Advisor
   Steven Leonard  Project Director
   Melanie McLaren  Executive Director, Codes & Standards
   Lee Pillar  FCA Observer
   Trevor Rushe  IAASA Observer
   Pat Sucher  PRA Observer

Apologies and introduction

Apologies were noted from Robert Hingley and Conall O’Halloran (Council Members).

1. Minutes of the previous meeting

1.1 The minutes of the meetings held on 14 November and 28 November 2014 were approved for publication.

1.2 The rolling action log was noted.

2. Chairman’s update

2.1 The Chairman provided a verbal update on the discussions held at the FRC Board meeting in respect of the EU Audit Directive and Regulation - FRC consultation on the Member State Options. The Council noted that:
   • The Board had expressed mixed views in respect of the suggestion to develop a ‘white list’ setting out a list of permitted non-audit services. However, it was agreed that the
consultation should include a neutral question on the possible establishment of such a list.

- Subject to the minor drafting amendments to ‘neutralise’ the tone of the questions set out in the consultation document, the Board had approved the consultation document for publication.
- It was expected that the consultation would be published week commencing 15/12/2014 for a 3 month period.
- The findings of the consultation would inform a further, detailed consultation on the Ethical Standards which would be developed over the course of Spring 2015.

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.

3.2 MG drew the Council’s attention to feedback from the December meeting of the IAASB. It was noted that:

**ISA 720**

- ISA 720 (Revised) had been approved as a final standard, subject to PIOB approval would be effective for audits of financial statements for periods ending on or after December 2016. The Revised Standard is consistent with the UK equivalent and will take a similar format to the UK equivalent.

**Disclosures**

- The Board received feedback from the Disclosures Taskforce, which is chaired by MG, on the Exposure Draft responses. MG reported that the ED highlighted a need:
  - To encourage the auditor to focus on disclosures early on in the audit, and to focus not just on quantitative disclosures but also qualitative disclosures.
  - For more guidance on what the auditor should do to find evidence in support of disclosures;
  - For more guidance on what a material misstatement of a qualitative disclosure should look like.
  - For further consideration of materiality, including consideration as to whether a holistic revision of ISA 320 may be necessary.
- The IAASB is looking at how its work on disclosures can be aligned with work being undertaken by the IASB on the same topic.

**Group Audits – Letter Box**

- The Board had discussed the scope of the project and MG had expressed that there is an urgent need for clarification on the scope of the project in the public arena with respect to the applicability of ISA 600 and ISA 220 to letter box audits when the entity is a group, and ISA 220 when the entity is not a group. MG reported that whilst there had been no disagreement that ISA 600 would apply (when the audit was a group audit) or that ISA 220, as the overarching quality control standard, would always apply, the Board did not formally clarify the application of ISA 600 and ISA 220 to letterbox audits.

**Quality Control**
The Board had discussed the scope of the Quality Control project and agreed on the areas to be considered.

MG confirmed that from a UK perspective all relevant issues would be considered.

Integrated Reporting

It was noted that the Board discussion on integrated reporting had been predominantly on the scope of the project and that MG had encouraged the Board to think more broadly in terms of narrative reporting frameworks than the focus on the integrated reporting model set out in the approach proposed by the Taskforce and to consider, more fully, the types of assurance that might be desired and who might deliver that assurance.

3.3 The Council commented on the length of time taken by the IAASB to finalise ISA 720 (revised) and suggested that the FRC should encourage the IAASB to review whether the resources available to the IAASB continue to be appropriate.

3.4 MG undertook to circulate an updated ‘snapshot’ of the IAASB December meeting agenda and decisions taken.

4. Activities since last meeting

4.1 The Council noted the list of activities since the last formal meeting on 14 November 2014.

5. Feedback from the Supervisory Inquiry Team

5.1 Phil Fitz-Gerald (PFG) provided the Council with an overview of the FRC Supervisory Inquiries function. The Council noted that the purpose of the supervisory inquiries team is to respond quickly to a matter of concern affecting a public interest entity. PFG reported that the team seek to understand an issue and assess whether there is a reasonable basis for investigating the issue further. If the issue is assessed as requiring further investigation, the team seek to determine which of the FRC’s disciplinary and / monitoring tools would be most appropriate for handling that investigation.

5.2 The Council noted that:

- Issues and complaints considered by the team are identified through individual complaints and the FRC whistle blowing hotline, the press and media and external / internal referrals. The team also work with colleagues within the FRC to proactively seek issues for consideration.
- Two tests are applied to determine whether or not further investigation; a) whether the issue is a matter of public interest and whether there are reasonable grounds to investigate a member or member firm. To inform the assessment as to whether there are reasonable grounds to investigate the team review publicly available information, review information from the company, review audit files, hold discussions with other regulators and with relevant parties.
- Guidelines are used to inform whether an issue is in the public interest.
- The supervisory inquiries function has no formal powers to obtain information but that full co-operation has been received from auditors and companies once confidentially assurances have been agreed.
• Experts from across the FRC are bought in to the team to assist the team in making its initial assessment.
• Roughly 15% of issues / complaints are assessed as requiring further investigation and referred to the FRC’s Conduct Committee for further investigation. Roughly 80% of issues / complaints are referred to relevant Professional Bodies.
• The FRC has Memorandum of Understandings (MOUs) with the PRA and the FCA and meet with both regulators, the Serious Fraud Office and the UK Listing Authority, on a regular basis.
• A summary of the issues / complaints considered by the supervisory inquiries team is submitted to the FRCs Conduct Committee monthly.

5.3 The Council thanked PFG for his informative presentation.

6. Assessing the effectiveness of the external audit process – guidance for audit committees

6.1 Josephine Jackson (JJ) introduced draft guidance for audit committees on assessing the effectiveness of the external audit process. The Council noted that the guidance had been developed in response to a request to provide insight in to how an assessment of the effectiveness of external audit might be conducted.

6.2 JJ reported that the guidance had been informed by discussion at roundtable events attended by key market participants including Audit Committee Members, investors, financial management and auditors and that the guidance is intended to:
• Propose a model that Audit Committees could adopt to assist them in making thoughtful judgments about the effectiveness of the external audit process (JJ noted that the model had been presented at the roundtables for discussion); and
• Highlight the different information gathering techniques that Audit Committee members currently employ.
JJ also reported that feedback from participants included a request not to develop another checklist but instead, to provide a source of information and for the guidance to demonstrate ways through which audit committees can enhance their knowledge through daily interactions with the external auditors.

6.3 The Council welcomed the guidance and the diagrammatical approach taken, commenting that it was clear and uncomplicated. The majority of Council Members supported the model set out in the guidance. Through discussion of the draft guidance the following observations and suggestions for amendments were made:
• The Council suggested there is too much focus on the need for the Audit Committee to gather information on the Firm’s Quality Control processes, where, in practice, it is expected that such information would be provided to the Committee, i.e. it can be assumed that any issues would be flagged. Accordingly, the Council suggested this focus should be toned down.
• The Council discussed in detail whether it is appropriate to refer the ‘investor mindset’ as a separate element, some council members concluded that instead it should be broadened to the ‘public interest mindset’ and be pervasive throughout the guidance.
• The Council suggested that the guidance could be strengthened by:
o Putting more emphasis on the importance of the audit plan and whether the audit plan has been challenged.

o Reducing the length of the guidance, some members commented that it was too long. Particularly in the area of Firm Quality Control which was unnecessary.

o Making reference to concepts such as ‘scepticism, management challenge, objectivity and consistency of judgement in the guidance.

- The Council considered that some of the examples of information gathering activities set out are the responsibility of the auditor and not the Audit Committee and that the focus should be on the Audit Committee requiring the auditor to communicate any matters of concern to the Audit Committee and to demonstrate the quality of the audit undertaken.

- The Council discussed the scope of entities to which the guidance would be applicable. It was suggested that a short sentence should be added to explain that the guidance is intended to support the application of the Corporate Governance Code, and accordingly, is aimed at FTSE 350 Companies, the guidance sets out best practice’ and can be applied by all entities.

- Through discussion it was identified that the guidance does not provide information as to ‘how far the Audit Committee’ should go in respect of reviewing the audit plan. However, the Council agreed that this is a judgment call by the Audit Committee. The Council agreed that, in order to enable confidence in the audit plan the Audit Committee should, in addition to routine monitoring of the plan, undertake ‘deep dives’ in to parts of the plan.

- The Council suggested that consideration be given to the use of the ‘score card’ concept in the guidance, noting that the use in the guidance is not the traditional use of a scorecard and could be considered confusing.

- The Council advised that the diagram on the penultimate page was not necessary and could be taken out of the guidance.

6.4 The Council noted that the draft would be updated and circulated to those who had attended the roundtable meetings for informal consultation. Following the informal consultation the draft would then be represented to the Council in February for recommendation to the Codes & Standards Committee in March.

7. Survey of 1st year experience of extended auditor’s reports and aspirations for the 2nd year

7.1 SL introduced a paper that provided an update on the discussions that have taken place with auditing firms and investors regarding their experience of extended auditor’s reports in the 1st year, and their aspirations for extended auditor’s reports in the 2nd year. The Council noted that the update will form an introductory chapter to the Report on the survey of the 1st years’ experience of extended auditor’s reports.

7.2 SL summarised the developments that had occurred since the survey was completed and the comments that had been identified through discussion with audit firms and investors since the survey completed. Through discussion of those development and comments the following points were noted and observations made:
KPMG has announced that in the second year of reporting that it is prepared to report its audit findings on a voluntary basis in auditor's reports of listed companies that want them to do so, and that, Deloitte, in its second extended auditor's report on Vodafone plc, reported the quantum of unadjusted differences and explained what the effect on profit before tax would have been had the adjustments been booked.

The IMA Auditor Reporting Awards had been held on 24 November. The Council expressed some nervousness that audit firms would replicate the winning reports rather than experiment, the Council highlighted the importance of the report encouraging audit firms to be experimental and innovative to mitigate this. The Council also expressed concern about the potential over use of terms such as 'mildly optimistic' as they consider the term has the potential to be misleading.

Some of the other audit firms with which the team have met are waiting to see how the market responds to the disclosure of findings in extended audit reports before deciding whether or not to include their findings in their extended reports.

The Council discussed in detail the findings in respect of materiality. It was noted that investors and auditing firms are aware of the complexities associated with communicating materiality. Council suggested that the FRC should open a debate to address the issue. It was also noted that investors would like to see more information about the auditor's application of materiality, including information on why a particular benchmark has been chosen.

The Council welcomed the call for auditors to provide a commentary of the description of audit scope in order to provide more colour and agreed that the report should encourage auditors to provide more information concerning the scope of the audit.

It was noted that there is a demand for improving the granularity of reporting risks and that investors would like the discussion of risks to:-
- differentiate between routine and extreme risks,
- include discussion of intangible risks, and
- describe risks that are inherent to the entity's business model
- provide an explanation as to why there are differences between risks reported in the audit committee report and auditor report.

Through discussion it was noted that, whilst the report encourages granular reporting, detailed consideration as to what information is reported is needed to avoid readers asking 'so what?'?

That a number of those interviewed commented that, as the publication of the Annual Report does not typically "move the market", it may be more beneficial for investors if the auditor’s report were to be published with the preliminary announcement and, perhaps, in conjunction with investor relations road shows. The Council agreed with the comment and, whilst it was noted that there are numerous practical issues associated with issuing the auditor’s report with the preliminary announcement, suggested that, if there is demand for it, the FRC could facilitate debate with stakeholders to determine what it is interested stakeholders would like from interim and preliminary announcements and how those needs could be met.

The Council welcomed the findings suggesting that the requirements of ISA (UK & Ireland) 700 may result in an undue focus on the reporting of risks to the financial statements to the detriment of reporting risks arising from the quality of a company’s systems and controls and agreed a focus on the quality of company’s systems should be encouraged.
7.3 The Council welcomed the update to the report and noted that the full report would be presented to the Council to approve its advice for recommendation to the CSC in February and Board in March 2015.

8. Any Other Business

8.1 The Council noted that there are two issues highlighted in the report of the Director of Audit Policy as areas for further consideration. Through discussion the Council agreed that:

- There are a number of aspects of materiality that require detailed consideration by the FRC; and
- A discussion exploring the possibility of moving towards European Standards would be an interesting topic for a dinner the FRC is hosting the evening before the March IAASB meeting in Brussels at which MEP and Commission staff would be in attendance.

9. Next Meeting

9.1 The next formal meeting of the Audit & Assurance Council will be held on Friday 13 February 2015.