

Audit and Assurance Council

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

PRESENT:

Nick Land (Chair)
Ray King
Scott Knight
Robert Talbut (from minute 1.5)
Allister Wilson

IN ATTENDANCE:

Keith Billing	Project Director
Francesca Chittenden	Council Secretary
Richard Fleck	Conduct Committee Chair (by phone to minute 2)
Marek Grabowski	Director of Audit Policy
Jon Hooper	Project Director
Steven Leonard	Project Director
Melanie McLaren	Executive Director
Lee Pillar	FCA Observer
Gareth Rees	Executive Counsel, Professional Discipline Team (to minute 2)
Dan Rouse	Case Manager, Professional Discipline Team (to minute 2)
Paige Rumble	Case Manager, Professional Discipline Team (to minute 2)
Aidan Lambe	CAI Observer
Eileen Townsend	IAASA Observer
Pat Sucher	PRA Observer

Apologies and introduction

Apologies were noted from Russell Frith, Sue Harris, John Hughes and Paul Lee (Council Members).

The agenda was reordered so that the discussion on the review of the ethical framework could be taken as the first agenda item.

Standards and Guidance

1. Review of the Ethical Framework

- 1.1 MG introduced a suite of papers that had been developed to facilitate discussion on a range of 'big picture' ethical issues that were relevant to the review of the ethical framework as part of the project on confidence in the value of audit. MG invited the Council to comment on the principles vs rules debate (including the impact on auditors'

attitudes to compliance with ethics), the scope of the FRC's remit for ethics and the suitability of exemptions for audits of Small Entities.

Big picture issues

Principles v Rules

- 1.2 Keith Billing (KB) highlighted that although the Ethical Standards for auditors (ESs) are intended to be principle based, the detailed requirements within the ESs can lead to a rules based mind-set. KB suggested that this mind-set could potentially undermine the principles based 'threats and safeguards' approach that is intended and lead auditors to evaluate actions on the basis of "is this specifically prohibited" rather than "is it appropriate", and may result in auditors engaging in activities that third parties may perceive as threats to the auditors independence, objectivity and integrity.
- 1.3 The Council confirmed the validity of the concern in relation to the mind-set of auditors and discussed possible solutions, including a change to a wholly principle based approach, a change to a rules based approach or whether to retain a combined principle and requirement approach, to ensure auditors have an appropriate ethical mind-set. Through discussion the following observations were made:
- There is a danger, when standards are very structured, that individuals do not understand the rationale underpinning those standards.
 - Any principles that are developed should be objective based; it needs to be clear why the principles are there.
 - It is important to have regard to how any approach can be enforced, and how useful the outcome will be in assisting the identification of misconduct. The Council noted that it is easier to judge whether or not an individual has fallen significantly short of what could reasonably be expected when there is a precise standard which the respondent can be judged against.
 - It is important to have regard to the culture of the organisation and 'the tone at the top' of the audit firm. The firms' own transparency reports suggest the tone at the top is ethically sound, but inspection findings suggest this is not always evident down through the organisation at engagement level. Consideration should be given to which solution would facilitate greater adoption of the desired attitude by individuals throughout a firm.
 - If a principle based approach is adopted the principles need to be drafted in such a way that there is no possibility of an auditor attempting to find a way 'around' the principle or for an auditor to argue that the principle does not apply to a circumstance that the FRC intended it to.
 - There are potential issues which could arise with a wholly rules based approach when new circumstances and situations arise that have not been specifically addressed within the standards. This would be much less of an issue with a principle based approach as it would be likely that the principles could in many if not most cases be applied to any new situation.
 - Consideration should be given to the US ethical standards and how the revised FRC Ethical Standards and other UK ethical standards for auditors would compare with them.
- 1.4 In summary there was general support for an approach that combines principles with specific requirements, however, the existing principles need to be reviewed and reformulated so that they can be presented more clearly in the ethical standards. The

Council suggested that consideration should be given to the development of an overarching, 'hard hitting' principle which would be objective based and clearly spell out that when there is doubt in an auditor's mind, or an auditor questions undertaking a certain activity, it is likely that the activity under consideration is likely to be, or be perceived to be, a threat to that auditor's independence, objectivity and integrity. The staff will aim to bring updated principles to the Council for consideration in May.

1.5 The Council identified two areas within the existing framework requiring attention, these included:

- The concept of 'chain of command'; which was identified as problematic. The Council suggested that consideration should be given to taking the concept out of the existing standards and that the focus should instead be placed on the principle underpinning the concept, which ultimately, is to identify who is influencing the auditor. For some threats (such as those arising when a partner leaves a firm to join an audit client) it may be appropriate to consider a simple outright prohibition on all partners undertaking a particular action.
- Guidance relating to conflicts of interest. The Council suggested that there is insufficient guidance within the ESs in relation to conflicts of interest.

In relation to the "threats and safeguards" approach more generally the Council suggested that the revised ESs should highlight that 'standard' safeguards may not be appropriate and where relevant non-standard safeguards should be identified and the 'standard' ones should anyway be tailored to address the specific threat that has been identified.

The scope of the FRCs' remit for setting Ethical Standards

1.6 The Council noted the history behind the current situation whereby the FRC holds responsibility for addressing two of the five ethics fundamental principles, and the Professional Bodies hold responsibility for addressing the remaining three fundamental principles, subject to oversight by the FRC. The Council discussed whether it is appropriate that the FRC does not hold responsibility for directly addressing all the fundamental principles in relation to audit, however, it was confirmed that this situation is not problematic in terms of enforcement. Through discussion the following observations and points of clarification were made:

- It was highlighted that currently, the FRC's ESs are limited to financial statement audit. Consideration should be given to widening the scope to include other audit and assurance services such as public sector value for money audits.
- If the scope of the ESs was widened, consideration should be given to whether or not it could enable the FRC to withdraw the separate ethical standard that is in issue for reporting accountants. If it is concluded that the separate standard should be retained, consideration should also be given to whether or not separate standards should be developed to address other assurance services for which the FRC issues engagement standards, such as CASS reporting in the future.
- It was clarified that the EU Audit Directive will not dictate who should set Ethical Standards, the decision will be reserved for Member States, however, a key theme of the Directive is to encourage independent oversight of the profession.
- The FRC, in its oversight role, could review the ethical codes/requirements set by the Professional Bodies and discuss with them if there was a concern that the codes/requirements they have set should be revised.

- 1.7 The Council concluded that whilst there are no issues that need to be addressed in the immediate term, consideration should be given to broadening the scope to include the 'assurance' role of the auditor. The Council also suggested that the FRC should, in conjunction with the Professional Bodies, consider 'packaging' all of the ethical principles in one document.
- 1.8 Presenting all the ethical principles in one document could possibly be achieved in a replacement for the Auditors' Code.

Exemptions for smaller entities (The Ethical Standard – Provisions Available for Smaller Entities (ES PASE))

- 1.9 The Council discussed whether or not small entities should continue to be entitled to the exemptions set out in ES PASE. Through discussion the following observations were made:
- Some may argue that the threats and risks to the public interest vary between small and larger entities, and accordingly, that the exemptions are justifiable.
 - The public perception of the threats to integrity and objectivity in smaller entities and what customers of smaller entities consider to be acceptable may also be different from the perception for larger entities, and again, this would suggest that the exemptions are suitable.
 - It should be acknowledged that what is classed as a 'small' entity in the UK may not be classified as a 'small' entity outside of the UK.
 - Consideration should be given to whether continuing with ES PASE presents any risk to the FRC.
 - The Financial Reporting Lab is looking at how AIM company reporting could be improved which includes a review of the auditors role in this context, the outcomes of this project may be useful to inform future decisions on the ESs for smaller companies.
- 1.10 It was concluded that it is appropriate to continue to permit ES PASE for the time being; however, the Council acknowledged that the status of ES PASE may have to be reconsidered in implementing the EU Audit Directive.

Ethical Standard 2 – Financial, Business, Employment and Personal Relationships

- 1.11 KB invited the Council to comment on a range of issues that had been identified in relation to the Ethical Standard (ES) 2, *Financial, Business, Employment and Personal Relationships*. The issues identified for discussion included the definition of 'chain of command', prohibition on secondments to long term and / or management positions at audit clients, tendering for the audit of an entity that employs a former partner and differences to the forthcoming EU Audit Directive, IESBA Code and SEC rules.
- 1.12 The Council noted a tabled possible alternative definition of the concept 'Chain of Command'; however, the Council reiterated the concern expressed earlier in the meeting in relation to the inherent problems associated with the practical application of the concept. The Council referred to its earlier suggestion that the concept be dropped and that an alternative approach be developed.

- 1.13 The Council discussed the existing prohibition on secondments to long term and / or management positions at audit clients and agreed that clarity regarding applicability of the prohibition can be problematic (linked to the issue of the 'chain of command'). The Council discussed a range of alternative solutions and safeguards that could be implemented and concluded that consideration should be given to the introduction of a blanket two year ban for all partners taking on management positions at audit clients. The Council suggested that the two year ban would address the perceived issue of independence and would be the most straightforward and practicable solution to apply. The Council also suggested that a two year period is sufficient and would be enforceable. It was suggested that a two year prohibition would also signal to firms that independence is a concern that requires consideration and that firms should also be encouraged to consider increasing the length of the quarantine period on a case by case basis. The Council recognised the consequences of such a prohibition, and the potential limitations on the employment options of partners, however, on balance members considered that the public interest and a need to improve confidence in auditing through greater transparency, and concluded that this was a solution that should be explored more fully. The Council also suggested that consideration should be given to whether or not a prohibition should extend beyond partners, noting that mentors, independent advisors and consultants may also have an actual or perceived influence on an audit.
- 1.14 The Council agreed that a similar approach to that set out above should be considered in relation to tendering for the audit of an entity that employs a former partner, noting the potential restrictions on choice such a prohibition may cause.
- 1.15 The Council discussed the issue of secondment, noting that the National Audit Office (NAO) had raised, on a number of occasions, a concern that the ban on secondments is unnecessarily restrictive to entities in the public sector. Through discussion it was agreed that whilst there is some sympathy with the views expressed by the NAO, it is difficult to justify, from a public interest perspective, that the threats associated with secondment are any less than they are in the private sector.
- 1.16 The Council noted that staff at the FRC were monitoring the progress of the EU Audit Directive and the EU Accounting Directive and that the Council would be kept informed of any issues arising from either Directive that have implications for the UK auditing standards.
- 1.17 The Council advised that the differences the staff had identified where the EU Directive and the IESBA Code appeared more restrictive than ES 2 should be addressed in the revision of the standard.

2. Minutes of the previous meeting and rolling actions

- 2.1 The minutes of the Audit & Assurance Council meeting of 19 March 2014 were approved as an accurate record of the meeting.
- 2.2 Marek Grabowski (MG) informed the Council that the FRC Board had approved the public announcement of the 'plans to improve confidence in the value of audit' project subject to minor amendments. MG confirmed that the announcement would be

published towards the end of April and that the final version would be circulated to Members.

- 2.3 The Council noted that all other actions were either complete or addressed on the agenda.

Reports

3. Chairman's Update

- 3.1 NL provided a summary of a two-day PCAOB Public Meeting on its Auditor's Reporting Model Proposal at which he had sat on one of the Panels. The Council noted a written summary of the meeting and that the PCAOB's proposals had generally been well received by the US investor community; however, there remained some concerns amongst the US preparer community that the proposals limit their ability to write about the company.

4. Report of the Director of Audit Policy

- 4.1 Mr Grabowski (MG) introduced his report which was taken as read. The Council noted that:
- MG and NL had chaired a meeting of a number of European auditing standard setters on 27 March and that note of the meeting would follow in due course. MG informed the Council that the meeting had been useful and that it had highlighted a number of areas of common interest and challenges.
 - The proposal for amendments to an EU Directive on non-financial information had been issued and the final text requires only that the statutory auditor checks that the non-financial statement has been provided. It was noted that Member States are given the option to require that the information in the non-financial statement is verified by an independent assurance provider and that the FRC would continue to monitor any developments in the UK.
 - The proposal to develop Client Asset Assurance Standards (CASS) had been approved by the Codes & Standards Committee (CSC) at its meeting on 26 March and that MG and Steven Leonard were due to meet with the FCA to discuss the preliminary thinking around the development of those standards. MG informed the Council that an outline project plan would be presented to the Council for consideration in May.
 - Bulletin 4 'Recent Developments in Company Law, The Listing Rules and Auditing Standards that affect UK auditor's reports' had been approved by the CSC and published on 10 April.
 - The CSC had approved the withdrawal of Bulletin 2009/3 'the Auditor's Statement on the Summary Financial Statement in the UK' and that it would be withdrawn shortly.
 - Work to progress the ICAS/FRC Audit Skills Project was ongoing and the project steering group had met on 24 March and received presentations from the two project groups on progress made to date. MG informed the Council that the final reports were expected in June and would be presented to the Council in due course.

- 4.2 The Council noted a potential research project in the US considering the recently implemented UK extended auditor reports. The Council considered that the outcomes of the project would be interesting but questioned whether the outcome of such a project would be developed in time for it to be of use to the FRC. The matter would be considered further if and when a proposal was received.

5. Horizon scanning discussion

- 5.1 The Council noted that some concern had been expressed in relation to the number of audits that engagement partners are involved in and whether or not the quality of the audit completed is sufficient given the demands on an audit engagement partner's time and focus. The Council suggested that that the FRC should in the first instance consider the matter through seeking input from the AQR team.

6. Activities since last meeting

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

7. New Standards for Investment Reporting (SIRs) for reporting on Quantified Financial Benefit Statements

- 7.1 MG introduced a paper which sought the Council's advice as to whether the FRC should be advised to develop a new Standard for Investment Reporting (SIR) for reporting on Quantified Financial Benefit Statements.
- 7.2 The Council noted that further research to scope the project in detail and to assess the level of wider stakeholder support for a new SIR in the area was required, and that on completion of the research, the project would need to be reconfirmed.
- 7.3 On the basis of the staff analysis of the project against the FRC principles for the use of Codes, Standards and Guidance, and an acknowledgment that the FRC is the appropriate body and would be expected to develop such Standards, the Council confirmed its advice to the CSC that the Standards be developed, subject to the outcome of the research exercise set out.

8. Announcing plans to increase confidence in audit

- 8.1 The Council noted the paper that had been discussed by the FRC Board at its meeting on 9 April and noted the outcome of that discussion. MG reconfirmed that the final communication announcing the project would be circulated to the Council once the minor amendments requested by the Board had been actioned.

9. Any other business

- 9.1 None.

10. Next Meeting

- 10.1 The next meeting of the Audit & Assurance Council will be held on Wednesday 14 May 2014.