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The Auditing Practices Board Limited  
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Dear Ms. O'Sullivan,

We are pleased to have the opportunity to comment on the Auditing Practices Board's consultation on non-audit services.

By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service, we also respond to consultations on behalf of many clients from around Europe and the world, including the BBC Pension Trust, Highland Good Steward (USA), the Lothian Pension Fund, The National Pension Reserve Fund of Ireland, PNO Media (Netherlands), Canada's Public Sector Pensions Investment Board, PKA of Denmark and VicSuper of Australia (only those clients which have expressly given their support to this response are listed here).

We believe that non-audit services are an important issue and welcome the step by the Treasury Select Committee to reopen the debate. We also welcome the clarity of the consultation paper, particularly the way that it sets out different categories of non-audit services.

We are largely content with the framework for the control of non-audit services that the APB lays out and applies. There are, however, two areas where we believe that greater attention is needed and where tighter rules are warranted. In each case recent events have highlighted the risks to the confidence of investors in the audit which such work represents. These are:

- **restructuring services at companies in distress.** We believe this is more akin to corporate finance and transaction advice than anything else. As we have indicated to the APB before, where the company has taken advice on its survival from the audit firm, we regard the auditor's subsequent decision on going concern as wholly compromised by a self-review threat. We therefore believe that this service should be moved into the category of non-audit services which are prohibited.



- **internal audit services.** The approach of a UK company to the provision of internal audit services by the auditor has raised some key concerns for us. The company did not help perceptions by the way it communicated the agreement with its new auditor – its focus on fee cost savings and the financial side of the agreement raised concerns of a self-interest threat; in any case, there will always be a perception among investors of an increased risk of a management threat from the provision of internal audit services. In order to manage the threat and to reduce perceptions of the threat the audit committee needs to take ownership of any such agreement and needs to manage the relationship effectively.

We answer the specific questions (below) and would welcome further discussion of any of the comments included here if that would be helpful to you.

**Q1. (a) Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?**

**(b) Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?**

We believe that in general the current framework functions effectively and engenders and maintains investor confidence that independence is not compromised. We do believe that there is a need to tighten standards in two areas – restructuring services at companies in distress and internal audit services – in order fully to maintain confidence.

Audit quality is not readily apparent to the outside world, a point we have regularly made in the discussion regarding audit reporting, so it is hard for investors to comment on the impact of the provision of non-audit services on audit quality. However, our attention to restructuring services at companies in distress was awakened by being contacted by the audit firm of a troubled company in ways which we believe were wholly inappropriate, indicating a cross-over between the work of the firm on the audit (and particularly the going concern issue) and the non-audit service. We are of the view that in this case audit quality was impacted. It is for this reason that we believe new rules are needed in this area.

**Q2. If you do consider that the provision of non-audit services has adversely affected audit quality or currently impacts confidence in the independence of auditors please identify which non-audit services are of concern.**

We believe that there are two non-audit services which need to be actively reconsidered:

- **Restructuring services at companies in distress.**

Where a company is in distress and hires its audit firm to help identify the financial way forward to secure its survival as a business, we believe that such restructuring services impinge on the auditor's independence in particular in relation to the decision on going concern. In such circumstances the going concern opinion is crucial to investor confidence and we do not welcome its quality being compromised in this significant way. We therefore believe that this service should be moved into the category of non-audit services which are prohibited.

**- Internal audit services.**

Recent events have drawn attention to this issue. While we recognise that the provision of limited internal audit services by the audit firm can have advantages, and give the audit committee greater confidence in the controls at the company, we believe that the provision of any such services needs to be driven by the concerns of the audit committee and must be only limited in scope to those areas where practical considerations make this the simplest way for the audit committee to obtain the reassurance that it is seeking. Where the provision of such services is not driven by and actively controlled by the audit committee it will severely impact the confidence of investors in the quality and independence of the audit, the audit firm, and indeed the audit committee. Some tighter guidance on this area would we believe be welcomed by all parties.

**Q3. In the light of your answers to questions 1 and 2, do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit?**

We do not think that there needs to be a change in the APB's overall approach. We believe that the framework as a whole strikes the right balance of a principles-based system with a few clear rules and serves to build investor confidence more effectively than alternative regulatory structures. We believe that there is a need for change in relation to the two limited areas discussed above. We suggest below how each should be addressed.

**Q4. If you think that there should be a change in the current arrangements, would you advocate:**

- **Complete or more extensive prohibitions on the provision of nonaudit services by accounting firms to their audit clients within the Ethical Standards for Auditors;**
- **The imposition of other requirements through the Ethical Standards for Auditors (and if so which);**
- **More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee;**
- **Better (and more extensive) disclosure in financial statements.**

We believe that the approach to the two areas about which we have very real concerns should be different.

For restructuring services at companies in distress, we believe that the only way appropriately to address the real risks in this area is a new prohibition. Going concern has gained in focus for investors and unless a clear prohibition is put in place we fear that confidence in auditor judgements in this area risks being wholly undermined.

For internal audit services, we believe that there needs to be a significant enhancement in disclosure on such activities, and in particular the nature and extent of the audit committee's governance oversight of them. In order for investors to have added not reduced confidence as a result of the provision of such services we believe that not only must the audit committee be the driving force behind the hiring of the audit firm to carry out this role, but the committee needs to make clear what it is seeking to do through such an agreement and how it enhances oversight of controls. This would form part of wider enhancements to the audit committee report which we hope will be developed over the coming years.

**Q5. In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.**

We are concerned that one company's decision-making on the auditor providing internal audit services has been driven solely by cost considerations, and as investors we find this discomfiting: we do not wish to see audit quality compromised on the basis of limited cost savings. In any case, we would need to see a proper comparison of potential costs, comparing the cost with that of outsourcing to another alternative provider as well as the cost of the company doing the work itself, in order properly to consider whether the savings are so significant that the compromise to perceived independence is worthwhile. We would note that in our view this would be a very significant hurdle to overcome.

**Q6. Are there any other views that you would like the APB to take into account?**

We have no other comments.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Colin Melvin', with a small dot at the end of the line.

COLIN MELVIN  
Chief Executive