



Lloyds Chambers  
1 Portsoken Street  
London E1 8HZ  
United Kingdom

Tel: +44 (0)20 7702 0888  
Fax: +44 (0)20 7702 9452  
www.hermes.co.uk

## **Response to FRC Market Participants Group interim report:**

### **Choice in the UK Audit Market**

#### **Introduction**

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan. We also respond to consultations such as this on behalf of the British Coal Staff Superannuation Scheme and the BBC Pension Trust Ltd and some 200 other clients. Hermes has approximately £69 billion under management and it advises with respect to a further £15 billion. Of the total, some £26 billion is invested in UK listed companies. The beneficiaries of our clients' funds are over 12 million people worldwide who depend on us for at least a part of their financial security in retirement.\*

Hermes takes a close interest in the audit market as its purpose is to provide us with comfort that those who run companies on our behalf are doing so effectively and efficiently, ensuring that they remain fully accountable. Shareholders pay for the audit and are the party for whose benefit it is carried out. We therefore have a keen interest in ensuring that the audit market provides us with a quality product.

By enhancing accountability, we hope to improve efficiency by addressing what economists call the agency problem. It is our fundamental belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. By helping make company directors accountable to company owners for the decisions they make and the actions that they take, we believe that over time we will encourage better decision-making and greater value-creation. We believe that this will benefit our clients, which need long-term real growth to meet their obligations to pension beneficiaries, and it will also make companies and economies as a whole more efficient.

In pursuit of these aims Hermes supports a flexible regime which will:

- encourage company accountability;
- encourage responsible ownership by shareholders and fiduciaries;
- ensure independence and quality of those who audit and monitor company performance; and
- ensure the measures used in reporting performance are relevant for owners.

We do not have concerns about the structure of the audit market as such. Rather, as users of corporate accounts our principal concern is to ensure that audits are carried out with appropriate quality to provide us with the assurance about company reporting that we seek. Our comments here are designed to promote a properly functioning audit market which drives higher quality in the audits we pay for.

*\*Figures as at end March 2007*

## Overview

In many ways, institutional investors are indifferent to the structure of the audit market. What we want is quality, independent audits which give us the confidence that the numbers which companies publish are reliable. An audit market – however structured – which provides this confidence will do the job for which it is intended and which its ultimate paymasters want. But there is the rub: the structure of the audit market clearly does impinge on the quality and tone of auditing. For example, the pernicious concept that the current Big 4 are now 'too few to fail' is not likely to drive those firms to ever higher quality standards.

In this context, we welcome the report of the Market Participants Group into ways in which choice in the UK audit market can be improved. We have already sought to generate more competition in the UK audit market; you will be aware that Hermes and other institutional investors last year wrote to the audit committee chairmen of FTSE 350 companies to encourage them to consider hiring Tier A audit firms as their auditors. This received a mixed response, but we believe it was important to dispel the myth that institutional shareholders regard with suspicion any company audited by a non-Big 4 firm.

There are some of the Market Participants Group's recommendations which we believe are of more significance than others. We would particularly highlight those considered in A.2, on the demand side of the market. In particular, we believe that the greatest focus should be on A.2.1, A.2.2, A.2.3, A.2.4 and A.2.6 (though we do not support the proposal of a vote on the audit committee report). We would welcome proposal A.2.3 being significantly extended so that the Market Participants Group gives active consideration to changing to a framework of dual audits. Other proposals we believe are of far less significance.

## **Comments on individual proposals**

### **Supply side**

#### **A1.1 Reviewing audit firm ownership rules**

From our discussions with existing Tier A firms, we do not believe that the current ownership rules and current limits on sources of capital are a barrier to their growth. However, we still believe that this proposal has merit as allowing different sources of capital for firms may allow the creation of entirely new structures for auditing which might mark a step-change in the current market.

#### **A1.2 Greater clarity on profitability**

We strongly believe that auditing needs to be a profitable activity, such that it is resourced properly, there is no cross-subsidy from other operations which might lead to a lack of independence or a non-competitive audit market, and that it represents a profession that remains an attractive one to participate in. However, we are not sure that these benefits require that profitability is made publicly transparent. We would suggest instead that this aim might be better served by profitability forming a part of the POB inspection process.

#### **A1.3 Liability reform**

Our view very strongly is that we need to see what impact on quality and on the marketplace the current changes to the liability of auditors has before any consideration is given to further changes. Especially given the debate on this issue in the EU at the moment, we do not believe that there is value in the Market Participants Group in pursuing this recommendation at the moment.

#### **A1.4 Greater prominence of non-Big 4 firm participants in standard-setting**

In our experience, such individuals are already involved and actively participate in such forums. We are not clear that additional effort needs to be expended in this area, especially as it is not clear to us what practical value would be served by any additional steps in this direction.

## **Demand Side (reducing the risks of choosing a Tier A firm)**

### **A.2.1 Greater transparency on individual firm quality**

For us, this is one of the most important areas for additional work. We greatly welcome the recent announcement by the POB that it will seek to disclose firm-specific information on quality that is revealed in the course of its inspections. This would be an important step in enhancing quality and the transparency of quality and it reflects an earlier recommendation we made. We would note that in our view this transparency needs to be not of issues related to individual audits (because we fear this would have a pernicious defensive effect on those audits) but rather transparency of the bigger picture issues of culture, tone at the top and training. We will strongly encourage the POB to pursue this disclosure because we believe that it will ensure that auditing is less of a black box and therefore will open the door to much greater competition on the basis of quality rather than on price.

### **A2.2 Better handover of responsibilities from the old to the new auditor**

We believe that this is an area worth exploring, especially as one of the principal barriers to changing auditor which we see reported to us is the loss of knowledge and information. Any way in which this can effectively be mitigated should be explored.

### **A2.3 Guidelines on appointing auditors from more than one network**

We believe that such guidance would be helpful. There is rather more variability in the quality of firms within international networks than firms are generally willing to acknowledge, and so companies ought to have more courage in insisting on meeting the staff from key jurisdictions who will carry out the audit role, and on occasions refusing to accept them. This does, however, potentially introduce disconnects in the auditing process and guidance in managing this – both for the firms themselves and for the audit committees – would be extremely valuable.

We would also ask that the Market Participants Group actively explores a potentially more significant variation on this proposal: that consideration be given to whether there should be a dual audit process such as that employed in France. Our discussions indicate that this is not markedly more expensive a framework than the single audit structure (as a generalisation, the duplication of work occurs only at the topco level) but that companies regard the benefits of the discussion and debate which the structure engenders as significantly outweighing those limited costs. The likelihood is that a dual audit would be carried out by one Big 4 firm and one Tier A firm, thus significantly changing the market dynamic. Dual audits would also dramatically reduce the risks inherent in changing auditors as there is a natural source of continuity.

If we are seeking to consider ways in which the audit market might be significantly opened up to greater competition, we need to consider such radical changes. We would welcome the MPG giving active attention to such reforms.

## **Demand Side (increasing the accountability of the audit committee)**

### **A.2.4 Clearer information on selection decisions**

Current audit committee reporting is limited in the area of auditor selection, which means that there is little basis on which shareholders can call them to account. We would welcome this changing as we believe that there can only be a benefit from encouraging a greater dialogue between audit committees and shareholders in general and on this vital decision in particular.

### **A.2.5 Disclose any 3rd party limits on auditor choice**

We would expect that this would naturally form a part of the open and transparent disclosure by audit committees of their auditor selection decisions.

### **A.2.6 Increased shareholder engagement on auditor selection**

As we have stated, we would welcome greater dialogue between shareholders and audit committees on the issue of auditor selection. We are very willing to play our part and look forward to increasing our contact with audit committee chairs, on this and other issues.

While we are strong advocates of votes on the remuneration report and welcome the greater dialogue which such votes have engendered, we do not believe that a vote on the audit committee report is either appropriate or necessary. This is particularly so given that the ultimate decision on the appointment of the audit firm is in the hands of the shareholders and that seems to us a more appropriate and direct route for expressing concerns about auditor appointment than the more indirect non-binding vote on the audit committee report. Where we believe it is appropriate, Hermes has and will continue to oppose the re-election of auditors at companies in which we invest.

## **Choice within the Big 4**

### **A.3.1 Review auditor independence rules and whether they have an impact on choice**

We would welcome more attention being paid to this issue as we understand that some of the less important and detailed aspects of auditor independence standards do have a practical impact on competition and perhaps thereby on quality. Where the benefits are limited, we would welcome consideration being given to reform to ensure that competition is not adversely affected in this way.

### **A.3.2 Review guidance to boards on auditor independence**

We would welcome work being done to ensure that the Smith Guidance on independence is consistent with ethical standards for auditors such that they do not impose further limitations on competition and perhaps thereby on quality.

## **Reduce the risk of an audit firm leaving the market**

### **B.1 Develop regulatory protocols on approaches to different levels of audit firm issue**

We believe that there would be some value in regulators giving consideration to the appropriate levels of response to differing levels of perceived problems.

### **B.2 Compliance with the Combined Code by audit firms**

We do not believe that this proposal should be pursued. There is a need for transparency by audit firms, so as to engender confidence in them and their statutory role. But the Combined Code sets standards and structures for the transparency of listed companies to their owners; these standards and structures are therefore not in any way appropriate to private partnerships. We do the Combined Code a disservice if we expect it to extend across such a range of organisations.

## **Limit the impact of an audit firm leaving the market**

### **C.1 Boards should consider the implications of the withdrawal of an audit firm from the market**

We are not sure that there is a great deal of substance that boards can do to fulfil this proposal and therefore are not sure that it should be pursued with any vigour.