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Response to FRC Discussion Paper on Promoting Audit Quality

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.

As users of corporate accounts, our principal concern with audit quality is that it is largely invisible to us and to other shareholders, even though it is we who pay for the audit. By generating more transparency of audit quality we believe that the audit can move away from its current commoditised nature where competition occurs solely on the basis of price.

**Figures as at end December 2006*

Overview

We welcome the consideration given by the Financial Reporting Council to the important issue of audit quality. On behalf of our clients as the beneficial owners of companies, we are keen to ensure – indeed we expect to see – high quality audits of UK companies, and their subsidiaries wherever these might be located. A high quality audit protects and enhances value for shareholders; an audit lacking in quality adds no value whatsoever.

We believe that the issue of quality – and particularly making quality visible – has a vital role to play in ensuring a properly competitive market for audit services. Only by making the quality of audits more visible and transparent to all players – not least those who pay for audits and for whose benefit they are carried out – will a more vibrant and competitive market develop. While auditing remains a black box little real competition can develop, other than on price, something which is not in the interests of audit quality nor investor confidence. For audit to move beyond being a commodity, quality must be made more visible to its ultimate customers. We believe that the work of the Audit Quality Forum – in which we are an active participant – needs to be advanced and look forward to the FRC putting many of the AQF's recommendations into effect. In particular, we refer later in this response to the AQF document on Auditor Reporting.

We have high expectations for an increase in audit quality – and greater visibility of that quality – as this was the quid pro quo for the support investors gave to the introduction of proportional liability for auditors under the Companies Act.

We are, however, concerned that the developing international model for auditing may not support audit quality. We recognise that there is a desire to increase auditing standards globally, particularly in less economically developed markets, but we are concerned that the model which is being introduced can act to dilute audit quality. In particular we would note that the IAASB's approach appears to set lower standards for auditor responsibility than those expected under the Companies Act, and appears to throw greater responsibility onto directors.

At the most fundamental level, we are concerned that 'reasonable assurance' over 'material misstatement in financial statements', as set out in ISA 200, does not fully accord with the objectives of company law for the auditor's role to help protect the company. Although this issue has been partly clarified through the adoption of ISA UK and Ireland, we believe that it should also be corrected at IAASB level as it would appear to be a flawed objective for all of those many jurisdictions that use a company law similar to that of the UK. With EU endorsement of the ISA framework potentially pending this is a critical issue.

The shift in emphasis from auditors presenting opinions to 'reasonable assurance' seems to allow for matters of presentation to be segregated from matters of substance and control. In particular we observe that it seems to pave the way for passing off all responsibility for assessments on internal control onto the directors.

'Reasonable assurance' placed in any form before an opinion to our mind undermines audit quality. It would seem to promote superficial process around financial statements above a professional reaching an opinion of substance about the business. We therefore remain concerned that true and fair view audits may be undermined by the use of the term 'reasonable assurance'.

Answers to particular questions

Q1: Are there other important indicators of an audit firm's culture that are not referred to above?

Q2: Are there pressures that could compromise the culture of audit firms that have not been identified above?

In the UK we are rightly proud of our use of principles in reporting standards as in so many areas. This use of principles rather than detailed rules adds real value by allowing auditors to look at forests rather than focusing on individual twigs on trees, and so leads to, we believe, higher quality reporting than occurs under an excessively rule-based framework. We recognise that this use of principles requires the application of professional judgement and we are eager to ensure that the audit profession continues to recognise this. English law requires auditors to apply professional judgement to high-level principles, as does the law of a number of jurisdictions. We have worked hard to maintain these legal precepts against some pressure from firms and other parties; this has led us to have some concern about the appetite of some in the profession to maintain professional standards and so maintain audit quality. We therefore welcome the emphasis in the Discussion Paper on retaining and maintaining a professional culture at audit firms.

There are two areas which we believe deserve further scrutiny.

First, firm size and lack of choice. We are concerned that the increasing view that there are too few large audit firms now for any one of them to be allowed to fail may undermine pressure for high quality audits. If there are 'too few to fail', what need is there for those few to maintain quality? It would seem that they are being offered a licence to trade in perpetuity; this is not acceptable to users of accounts unless the firms are held to very high standards of quality and professionalism by regulators and the limited market forces which can be brought to bear in this context of limited competition.

Second, staff retention and delegation of authority. The audit firms often complain that they find it difficult to recruit and retain talented staff into the audit side of their work. Our impression, however, is that this is a problem in the area of retention rather than in the area of initial hiring; and our belief is that at least some of the driver for this is the way in which audit work has been reduced to a mechanical process rather than one requiring judgement by front-line staff. We believe that too much decision-making has been removed from those who actually carry out the audit such that audit is seen as mechanical work rather than an interesting profession. We would argue that more authority and responsibility needs to be devolved down to those actually carrying out the audit. Professionalism flows from appropriate delegated authority. If this is done in the right way it should assist staff retention. We believe it would also promote quality in individual audits and, by driving up professionalism in general, across the market as a whole.

Q3: Are there any further steps that should be taken to build confidence in the culture of audit firms and, if so, what might they be and why are they needed?

We believe that regulators can play an important role here, and last September we responded to the Professional Oversight Board's consultation on how its inspection regime can enhance quality. We made two key points, which we are pleased to repeat here in response to this Discussion Paper:

1. That inspections of individual audits need to be carried out with care. They should not drive the perception that any decision by an auditor is liable to be second-guessed. That is potentially very debilitating for any professional, and threatens to drive a bureaucratic approach of detailed evidential paperwork so that any small decision can be justified after the event. Such bureaucracy would be expensive and waste the attention of professionals which should rather be on taking key judgements. Certainly our view was that the results of inspections of individual audits should not be made public by the POB.
2. That the POB's attention should be much more on matters of leadership focus, training, culture and appraisal. We believe that it is in these areas where inspection – and publication of the results of those inspections (perhaps starting with the third cycle of inspections of the firms) – would add significant value. These are already the most informative elements of the existing Audit Inspection Unit reports. We believe that publication of firm-specific information in these areas would open the door to greater attention to those areas which have the greatest impact on audit quality. It should also lead to competition on the basis of something other than price.

Q4: Do you agree that technical skills, personal qualities and practical experience are key drivers of audit quality?

Yes. This is why staff retention is a key driver of audit quality and why it is vital for even junior staff to gain practical experience of making audit judgements, with appropriate mentoring, support and training such that their ability to exercise professional judgement is developed over time.

Q5: Has the paper identified the issues that could result in an inadequately trained or skilled workforce for audit – if not, what other issues are there and why are they issues?

Yes we think that the paper has identified the key issues. Retention is key. It is closely related to whether staff find the job interesting or not. If they are treated like professionals, able to make professional judgements and are not buried by procedures and processes, retention and thus quality should improve. The negative implications of an excessive focus on process were noted by the DTI Inspectors and seen as a causative factor in the Transtec case.

Our impression is that this focus on process has been driven not by the regulatory regime but by financial reporting and auditing standards and a safety-first approach arising from concerns about liability.

Q6: Should there be a fundamental review of the qualification and training requirements for auditors?

One aspect that we believe needs to gain substantially increased attention in the training for the audit profession is the legal system. There was formerly much greater focus on the underpinning legal framework for the audit in training and examinations than appears to be the case now. We would note that the law is a much bigger feature of the syllabus for the Association of Accounting Technicians

in Ireland than it is for the training and examination materials that we have seen for the UK profession. We believe that this needs to be addressed, given that the law is the source of many of the principles on which audit judgements must be based.

Q7: Are there other factors that determine whether an audit process is effective?

We believe that the items covered in the Discussion Paper are comprehensive and appropriate, though we would note that we place greater emphasis on matters of culture and professionalism than we do on mechanical processes.

There is an additional factor not considered in the document: the issue of serving the ultimate client.

The Discussion Paper refers to the issue of client capture, by which it means too proximate a relationship with the executives of the audited company. However, the actual client of the auditor is the company and its work is on behalf of – and paid for by – the shareholders of that company. It would only be a good thing for auditors to become ‘captured’ by these ultimate clients, rather than focusing on the directors, who are agents on whose work the auditors are employed to express an opinion.

This seems to us a further result of the focus on process rather than on expressing a professional opinion. We believe that the standards frameworks for auditing need to take a step away from their current emphasis on process and instead have a principles-based approach which focuses on the underlying role of the audit to provide an opinion on the work of the directors as agents for the shareholders. Once this occurs, we would expect greater auditor focus on their real clients rather than their apparent clients. We believe that far greater audit quality would arise as a result.

Q8: Are there threats to the effectiveness of the audit process that have not been identified above?

Overseas issues

Significant operations of UK listed companies lie outside the UK. We would expect that these operations are audited to the standard required under UK law, regardless of whether the jurisdiction in question has similar auditing and company law standards. This seems to us a fundamental requirement for the auditors to sign off the audit of the parent company, and a fundamental part of the promise made by the global audit firms. However, we are concerned that this is not always the case and we believe that this undermines audit quality at the UK parent company.

ISAs and practice

We have concerns about a number of the standards promulgated by the IAASB and fear that these may drive a compliance process approach to auditing rather than a professional judgement approach. We are concerned that they may therefore risk undermining audit quality. We might have more confidence in the standards produced by the IAASB if the governance of that organisation were more clearly independent of the profession.

In particular we are concerned by the emphasis in ISAs on reasonable assurance over financial reporting, which contrasts sharply with the duties of auditors under Company Law – as laid out in Appendix 2 of the Discussion Paper – which are concerned with substantive assessments about the company itself. The Companies Act is concerned with accounting systems as well as numerical presentation. The Companies Act audit is protecting the company itself, for the benefit of the shareholders and also of creditors and others. We note that this allies closely with the international – not just UK – academic definition of audit quality, as quoted in Appendix 3 as discovery of “a breach in the client’s accounting system”. We are concerned by the extent to which ISAs and perhaps auditing practice ignore the substantive requirements under law and focus on the presentational aspects alone. We would hope that the inspection regime would address any failures to focus on the substance.

We would note that this is not just a question of philosophical differences. There have been cases where an audit deemed that a financial reporting problem at the reporting date was not material, but this problem was in fact a major matter of business significance going forwards. In at least one case the company was brought down by a matter which auditing practice had deemed not material.

There is a further implication of this focus on reasonable assurance which severely concerns us. This is that practice seems to limit the scope of the audit such that questions of substance are not dealt with by the auditors but responsibility for them is instead passed back to the directors – often under the description of ‘internal control’. This adds to the burdens placed on directors, making that role considerably less attractive, and markedly reduces the value of the audit itself.

Q9: Are there further steps that could be taken to counter the threats to the effectiveness of the audit process?

If the IAASB is to continue to promulgate standards which are applied in the major capital markets, its governance needs significant change. A change in its governance ought to drive ISAs which are more principles-based, take account of the underlying client, and emphasise professional judgement rather than process. All these are necessary to drive greater audit quality.

Q 10: Are there any factors that determine whether audit opinions command confidence?

We believe that the disclosure of signatures of actual people, and not merely the signature of that firm, may assist in this. First, it should enable those individuals to be more personally accountable and take better judgements. Second, we think that firms are likely to allocate their better people in the light of that transparency. We believe that the Audit Quality Forum proposal that auditors make themselves personally available to answer questions at AGMs would further reinforce this personal responsibility and so bolster confidence in opinions and the audit process.

Q 11: Are there other reasons why users may not have confidence in the audit opinion?

We believe that reporting needs to be addressed. The current standard reporting form undermines the impression of value from the audit. It reinforces the

impression that the audit is a compliance process rather than a matter of professional opinion. It also drives an impression that audit is a commodity rather than a professional service, so that competition is on price rather than quality. We discuss our proposed response to this in our answer to the following question.

Q 12: Are there further steps that could be taken to reinforce confidence in an audit opinion? In particular, what changes to the form and content of the audit report should be considered?

We are participants in and strong supporters of the work of the Audit Quality Forum. In the area of reporting we believe that particular attention needs to be paid to the work of the working group on Auditor Reporting. We regard this work as the first step towards ensuring that auditor reports are documents which shareholders regard as worth their while to read, which at present is not the case: not only are audit reports currently largely unreadable, because they are so couched in legal caveats, they are also perceived as not worth reading, because they contain no information of value. The step of requiring affirmative statements by auditors rather than just assumptions based on the absence of a negative statement is a positive one, but we would hope that auditors will go further, seeing an opportunity to make more fulsome disclosures as a way of demonstrating to their ultimate paymasters, the shareholders, that they are providing a valuable service.

Q13: Are there other external factors that have the potential to adversely affect audit quality?

We would reinforce the comments made about accelerating reporting timescales. We share the view that these can undermine quality. We would hope that the FRC could discourage moves to accelerate reporting as this removes the time needed for reflection and professional judgement.

We would also note that the moves towards rules-based financial reporting standards and auditing standards and away from principles-based approaches are unhelpful. Both remove the scope for professional judgement and so threaten to remove quality from the audit process.

Q14: Are audit committees discharging their responsibilities in relation to audit adequately, and if not, what further steps might be taken to make their role more effective?

We believe that sufficient statutory, common-law and Combined Code requirements are placed on directors. The duties of auditors seem to be less clear, and we are pleased that the FRC is able to take a rounded view of the execution of these responsibilities in practice, in setting standards and inspecting firms.

We would note that at present directors' responsibilities appear more international than those of the auditors, and we hope that the FRC might look to address this. For example, boards make public statements under the Turnbull Internal Control guidance on a group-wide basis, as well on the parent company itself as a legal entity. However, the scope of the audit typically restricts the auditors' opinion on internal controls to the parent company. This situation is exacerbated where there are subsidiaries in jurisdictions with notably lesser requirements on the auditor in this regard. Unless those subsidiary audits are done to the legal standard required

of the parent company under UK law, the directors have made a group-wide statement and the auditors have made a much more restricted one. This seems a marked imbalance in responsibility and not what should be expected of audit firms which project themselves as global organisations. We hope that the FRC might address this issue. Companies themselves may be able to do more by way of contract – though they may need support and guidance in this regard.

Q15: Should the FRC develop more detailed guidance for audit committees in relation to the evaluation of audit effectiveness?

We think that there is more than enough guidance on what audit committees ought to be doing, and rather less clear guidance to audit committees as to what auditors should be doing.

We think that FRC guidance could ensure that boards are properly aware of company and group contractual arrangements to ensure that audit committees are receiving the international assurance that they may assume they are getting.

Q16: Should annual reports include a summary of the work undertaken by the audit committee to evaluate audit effectiveness?

We are not convinced that this would add value to the reporting which is already done under the Smith Guidance. We believe that the auditors need to report more fully on their work rather than this more indirect report from the audit committee.

Q17: Are there further steps that should be taken to reduce the risk that these external factors may adversely affect the audit process?

We would like to comment on the issue of litigation, raised in this section of the Discussion Paper. The influence of litigation on the audit market is wholly unclear to us, and we do not understand how it can be clear to any regulator either. There are several sources of this lack of clarity:

- there may be a large difference between claims and amounts settled
- cases are generally settled privately or in closed tribunals
- some standards have obscured the contractual position
- US liability differs from the liability faced almost everywhere else in the world, as it is now largely third-party, rather than a liability to the company itself
- both financial reporting and auditing standards serve to obscure the role of the audit to provide a professional opinion on reporting to the shareholders

We believe that unless there is greater public transparency of the impact of litigation, there cannot be an effective public debate on the best way forwards. Without a public debate there should not be further steps to adjust the current model – we simply do not know whether the model is working or not. We would expect the FRC to obtain this information so that it can be clear to all parties whether or not the assertions in paragraph 7.9 are true or not. At present, we simply do not know if they are accurate.