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## **Response to POB Consultation on** **Public Reporting on Audit Quality Monitoring**

### **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 £65 billion under management and it advises with respect to a further £12 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 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.

Our answers to the questions posed by the POB are below. We would draw attention to our comments in the overview section and would welcome discussion on any of the issues raised here if that would be helpful to the POB.

\*Funds under management figures are at June 30th, funds under advice at August 1st 2006

## **Overview**

We welcome the opportunity to comment on how the quality monitoring inspections by the Professional Oversight Board's Audit Inspection Unit should be publicly reported. We are attaching a copy of our response to the recent FRC consultation on audit competition. As this makes clear, our strong view is that competition in the audit market will only be improved if there is more transparency over audit quality; in many ways, the two issues cannot be separated. Only if there is greater transparency over audit quality will there be a possibility that audit will shift from its current commoditised nature into an activity where competition on matters other than price is possible.

The issue of audit quality has been considered at length by the Audit Quality Forum's working group on Principles-based Auditing Standards, in whose discussions Hermes actively participated. We were clear in those discussions that audit quality arises not from strict obedience to formal processes but from a state of mind. Even a brief intelligent inquisition by well-trained and experienced professionals will add a great deal more value than a lengthy form-filling procedure. Sadly, our impression is that the audit firms have tended more towards a focus on regimented procedures and less towards the creation of a professional culture.

We therefore welcome the primary focus of the Audit Inspection Unit on matters such as culture and training. We believe that improvements in such areas are the best way of driving higher quality audits in the UK. Particularly key are the focus on audit quality by firm leadership, initial staff training and continuing professional development, and a focus on quality in the appraisal process.

In this context, we are receptive to arguments that publishing the results of inspections of individual audits might drive a legalistic focus and potentially encourage firms further towards mechanistic processes. We also think that publication of such information will inform the market less about audit quality than some other disclosures would.

Rather, we believe that publication of the findings of the AIU with regard to leadership focus, training, culture and appraisal would add significant value. These are already the most informative elements of the existing AIU reports but would open the door to greater competition in the audit market if they were made firm-specific. We would welcome this beginning with the third cycle of inspections of the firms, as that should give firms sufficient time to begin the process of addressing these issues.

## **Answers to particular questions**

### **Q1: To which of the arguments set out above do you attach most weight and why? Are there other significant arguments which we have not included?**

We highlight our comments above in the overview section of this response. It will be clear from a consideration of this that we recognise the need to avoid incentivising further defensiveness and mechanistic procedures. We therefore do not believe that publication (beyond the audit committee, as discussed below) of the results of inspections of individual audits would be helpful.

We do believe, however, that there is a need for greater transparency from the audit inspection process. This is a necessary step towards increasing the public knowledge about audit quality and so to driving up standards. As such, we believe it is also a necessary step to improve competition in the market for audit services. If this transparency extends to matters of culture, such as emphasis on quality from the leaders of the firm, training, and appraisal and promotion processes, we believe that it will provide useful information to the market. Importantly, the knowledge that such publication is approaching will help accelerate moves by firms to address the AIU's criticisms.

At present it is possible for less strong firms in the area of quality to hide behind the anonymity of the AIU process. We believe that this needs to change, as a driver for higher quality in audit and also as a driver for greater competition in the audit market.

### **Q2: Which of the options do you favour, and why? In particular, do you consider that the nature of weaknesses at a named firm should be disclosed only after the firm, in the opinion of the Oversight Board, has failed to respond positively and promptly to recommendations made to them by the AIU or has failed to cooperate with the AIU?**

We believe that publication by the POBA of measures which are at the heart of audit quality (culture rather than process) would be the best way to approach this. Therefore, of the options we would favour Option F (summary report on each individual firm), provided that publication is restricted to the aspects of the firm-wide review relevant to issues of culture, training and appraisal rather than focusing on any individual audit or audit processes.

The reporting should, we believe, focus on ongoing problems and particularly those areas where firms have failed to respond to recommendations from the AIU. We believe that this publication should only start on the third round of inspections of any individual firm, so that each firm has a chance to begin to respond to those recommendations.

### **Q3: Do you think that information from AIU inspections on individual audit firms and/or their audits of individual companies should be made available to audit committees? If so, what do you think is the most appropriate way of achieving this?**

We believe that the results of individual audit reviews must be shared in some form – perhaps in summary form as the text suggests – with the audit committee of the company in question. This will provide necessary information and important context for ongoing decisions by the audit firm and with regard to the audit mandate.