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Response to FRC Consultation on Audit Competition and Choice

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 FRC 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 FRC.

*Funds under management figures are at March 31st, funds under advice at August 1st 2006

Overview

We welcome the consideration given by the Financial Reporting Council to the important issue of competition and choice in the audit market. We welcome also the opportunity to participate in the debate.

We would note that we have taken what we believe are the key steps possible for us at this stage. First, we have been actively involved in the debate on audit quality. We believe that 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. Quality will be central to promoting genuine choice in the audit market. 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. We are deeply disappointed that the ideas on audit quality developed by the Audit Quality Forum have not yet been actively progressed and we would urge the FRC to promote these as a necessary part of its work on audit choice.

Second, we have worked to dispel the myth that investors are unwilling to invest at companies audited by firms other than the big four. We, together with five other institutions, recently wrote to the audit committee chairmen of the FTSE All-Share companies to make clear our willingness to see them consider being audited by Tier A audit firms.

We are keen to play our role in promoting more competition and genuine choice in the audit market. We believe that we are doing so and welcome the FRC's role in promoting the importance of this issue so that others too can play their parts.

Answers to particular questions

Q1: Do you agree that the focus of the debate should be on the degree of choice in the market for audit services to large public companies, rather than other features of this market?

We do not believe that the issue of audit competition can be divorced from the issue of audit quality. Indeed, we would go further: we do not agree that a lack of choice is a threat to quality; rather, the lack of visibility for most parties on the quality of audits acts as an automatically commoditising factor which drives competition solely towards price issues and thus can generate barriers to entry for new players. A lack of visibility on audit quality stifles innovation and so undermines audit choice. We would therefore suggest that the FRC needs to look still more actively at the issue of audit quality – including by developing some of the work of the Audit Quality Forum – as a necessary element of its work on audit competition.

Q2: What do you regard as the most important criteria for evaluating any opportunities for mitigating risks arising from the level of choice in the audit market?

As we have stated, we do not believe that audit competition issues can be addressed unless the allied issue of visibility of audit quality is also addressed, and would welcome all parties considering how they can work to advance this agenda. We agree that regulatory intervention is generally less effective than market-based solutions, and therefore in general strongly favour the latter. However, where there is a market failure, regulatory intervention may be necessary to generate change. We believe that there may well be a market failure in the audit market, precisely because of the invisibility of audit quality, particularly for the shareholders who pay for the audit and for whose benefit it is carried out. We would therefore welcome further steps to make transparent audit quality such that there is real choice and so real competition in the audit market.

Q3: We invite views on how different groups, acting individually or collectively, could increase the propensity of non-big four or new firms to seek to be major players in the market for audits of large companies.

Q4: We invite views on how the propensity of companies and their audit committees to purchase audit services from non-big four firms could be increased.

Q5: We invite views on the steps necessary to promote choice.

At the moment, there is little choice which is apparent to any participant in the audit market. Audit has become a homogenised, commoditised offering and without some greater visibility of audit quality and without competition on quality it is hard to see how any real choice on audit can develop and therefore how greater competition for audit services will occur.

Therefore while we and other players can make clear that the door to FTSE All-Share audits is very much open to the Tier A audit firms – as indeed we have – this is only a small aspect of what is needed. We need to generate a vibrant and innovative audit market where firms compete on quality rather than on price. We need to work to make audit quality more visible to shareholders such that the

shareholder approval of the appointment of the auditors becomes once again a meaningful decision. We would therefore welcome:

- the FRC and other regulators actively promoting the work produced by the Audit Quality Forum and developing their own proposals for enhancing audit quality and making that quality more transparent to all parties
- the Tier A firms, and indeed the Big 4 firms, explaining to shareholders the ways in which their service offering is different and will generate higher quality audits

Q6: We invite views on steps that could be taken to mitigate the risk of unnecessary withdrawal of a firm from the market.

Q7: We invite views on steps that could be taken to mitigate the effects of a voluntary or involuntary withdrawal of a firm from the audit market.

The best way for any audit firm to ensure that its reputation is not at risk is to provide quality audits. It is to have talented, well-trained staff of an appropriate level carrying out those audits, and to ensure that the structures surrounding the provision of audits promote quality above other considerations. Audit firms' reputations have not been enhanced by their focus on mitigating liability issues to the exclusion of all else, including audit quality. That has always seemed a strange approach to us, particularly in relation to UK audits when the protection from liability offered by *Caparo v Dickman* is so high.

We would not welcome there being added competition issues in the audit market because of the withdrawal of one of the larger players, but if this is caused by a failure to provide quality audit services it is probably the most appropriate result for that firm.

It cannot be right for regulatory action to maintain in existence an audit firm that is failing to provide quality audits.