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Dear Sir

**Consultation: Auditing and ethical standards
Implementation of the EU Audit Directive and Audit Regulation (“the Consultation
Paper”)
Response from Hermes Equity Ownership Services**

Hermes EOS welcomes the opportunity to provide our comments on auditor regulation and the implications of the EU and wider reforms.

By way of background, Hermes is one of the largest asset managers in the City of London, and is wholly owned by the BT Pension Scheme, the UK’s largest corporate pension scheme. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world. In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over £134 billion (as at 31 December 2014).

Hermes EOS has contributed to a number of public policy initiatives in the area of auditing and were involved in providing feedback for the AASB’s consultation paper ‘A Framework for Audit Quality’, the IAASB’s exposure draft ‘The Auditor’s Responsibilities Relating to Other Information’, the Competition Commission’s ‘Audit Market investigation’ and most recently, the Department of Business, Innovation and Skills’ discussion paper on ‘Audit Regulation: the implications of the EU and wider reforms’.

We are supportive of the FRC’s aims to ensure the roles and responsibilities of auditors and audit committees are clear and aligned with the interests and needs of investors, that audit and auditors are trustworthy, act with integrity, serve public interest and consistently meet the objectives of audit and audit standards given changing business and economic conditions.

We strongly believe it is important to rebuild lost confidence in the value and effectiveness of the audit process and audit profession. In our view, this in part can be achieved by focusing on maintaining auditor independence through mechanisms such as mandatory tendering, increasing the accountability of auditors to the audit committee and by taking steps to improve the quality of audit reporting through enhanced disclosures and auditor commentary on matters significant to users’ understanding of audited financial statements or the audit.

Our more specific comments to some of the outlined questions and implementation of the EU Audit Directive and Audit Regulation are as follows:

Q1. Do you agree that the FRC should, subject to continuing to have the power do so after the Audit Directive and Regulation have been implemented, exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards adopted by the Commission (where necessary to address national law and, where agreed as appropriate by stakeholders, to add to the credibility and quality of financial statements)?

We support the FRC having powers to exercise the provisions in the Audit Directive and Audit Regulation to impose additional requirements in auditing standards provided the objective is to address national law and/or add to the credibility and quality of financial statements and subject to appropriate stakeholder consultation.

We strongly believe the quality of audit reports need to be improved through enhanced disclosure and auditor commentary on matters significant to users' understanding of audited financial statements or the audit.

We feel Audit Committees would benefit from additional audit reporting outlining the methodology, quantitative level of materiality applied and factors used in developing materiality levels and any other subjective factors about events or conditions that may cast doubt on the entity's ability to continue as a going concern.

Improving the quality of and investor confidence in the audit process and auditing profession is of key concern and we generally would support measures that seek to achieve this.

Q4. With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation:

(a) should they apply to PIEs as defined in the Audit Directive?

(b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

We are concerned about potential confusion resulting from differing definitions in the Audit Directive and the FRC's Ethical Standards.

As noted in our response to the discussion paper issued by the Department of Business, Innovation and Skills 'Auditor Regulation: Implications of the EU and wider reforms' ("BIS Discussion Paper") dated 19th March 2015, we agree with the Government's decision not to expand the definition of a PIE beyond the EU minimum requirement.

As such, we would recommend the best course of action for the FRC's audit and ethical standards would be to apply them to PIEs as defined in the Audit Directive.

Q5. Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?

As noted in our response to Q4, we believe the more stringent requirements should only apply to PIEs as defined in the Audit Directive.

Q6. Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?

As noted in our response to Q4 and Q5, we believe the more stringent requirements should only apply to PIEs as defined in the Audit Directive.

Q7. What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)?

Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?

We believe the FRC should maintain a 'black list' of prohibited non-audit services. We do not believe the concept of a 'white list' would be effective, given it could potentially be too restrictive, omitting and/or excluding services which may not have a material affect on auditor independence.

In addition, we agree some of the other arguments against the concept of a 'white list' presented in the Consultation Paper, namely responsibility being taken away from Audit Committees and the effect this could have on the number of audit firms willing to tender for particular audits which may reduce overall competition in the audit market and potentially the quality of audits.

Q8. If a 'white list' approach is deemed appropriate to consider further: (a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added? (b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?

As noted in our response to Q7 above, we do not believe a 'white list' approach would be the most appropriate mechanism.

Q9. Are there non-audit services in addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?

We have no further additions to the services included in the Audit Regulation.

Q10. Should the derogations that Member States may adopt under the Audit Regulation - to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate - be taken up?

We agree that this option should be taken up provided the services have no direct or have immaterial effect on the audited financial statements. For this to occur, we would expect clear guidance on the definitions of 'direct' and 'immaterial' to ensure derogations are granted consistently.

Q11. If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be 'immaterial' sufficient? If not, is there another condition that would be appropriate?

As noted in our response to Q10, we would expect clear guidance on the definition of 'immaterial' to ensure derogations are granted consistently.

Q12. For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?

We believe audit committees are best-placed to approve non-audit services once they have assessed threats to independence and the sufficiency of safeguards applied. As investors, we would be content with this approach provided there is disclosure around the process.

Q15. Is the 70% cap on fees for non-audit services required by the Audit Regulation sufficient, or should a lower cap be implemented for some or all types of permitted non-audit service, including the illustrative 'white list' services set out in Section 4?

We do not feel the 70% cap for non-audit service fees prescribed by the Audit Regulation needs to be amended. We feel this is a sufficient limitation given that the cap only comes in to effect after the auditor has been providing audit and non-audit services to the PIE for three or more consecutive years and non-audit services required by law are excluded from the calculation.

Q16. If the FRC is made the relevant competent authority, should it grant exemptions from the cap, on an exceptional basis, for a period not exceeding two years? If yes, what criteria should apply for an exemption to be granted?

As noted in our response to the BIS Discussion Paper dated 19th March 2015, we agree that the FRC should be allowed to grant the exemptions to the 70% cap to allow some flexibility. The FRC should clearly outline examples of situations where this would occur and we would expect these instances to be infrequent given the number of non-audit service providers in the UK market. The situations should be limited to those defined as 'emergency situations' in the FRC's Ethical Standards for Auditors.¹

We would also expect companies to disclose appropriate levels of information around why it believed the exemption was necessary and the safeguards in place to maintain auditor independence.

Q17. Is it appropriate that the cap should apply only to non-audit services provided by the auditor of the audited PIE as required by the Audit Regulation or should a modified cap be calculated, that also applies to non-audit services provided by network firms?

We would expect audit firms within the same network would operate independently, accordingly we do not believe a cap should be implemented for network firms.

Q19. Is the basis of calculating the cap by reference to three or more preceding consecutive years when audit and non-audit services have been provided by the auditor appropriate, given that it would not apply in certain circumstances (see paragraphs 5.3 and 5.15)?

The proposed term of three or more preceding consecutive years appears reasonable. We would not encourage any extension of this.

Q20. Do you believe that the requirements in ES 4 should be maintained?

We recommend the requirements in ES 4 be maintained as in our view, they provide sufficient controls with respect to non-audit service fees.

¹ Ethical Standards for Auditors, ES 5, (2011). FRC. Available online: [https://www.frc.org.uk/Our-Work/Publications/APB/ES-5-\(Revised\)-Non-audit-services-provided-to-audi.pdf](https://www.frc.org.uk/Our-Work/Publications/APB/ES-5-(Revised)-Non-audit-services-provided-to-audi.pdf)

Q21. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 4 should apply with respect to all PIEs and should they apply to some or all other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

As we have outlined in questions above, we believe the more stringent requirements should only apply to PIEs as defined in the Audit Directive.

Q23. Should the FRC stipulate a minimum retention period for audit documentation, including that specified by the Audit Regulation, by auditors (e.g. by introducing it in ISQC (UK and Ireland)?

We would support the FRC including a minimum retention period for audit documentation and would suggest it reflect the minimum of current UK practice which is six years as advised by the ICAEW in its 'Audit Regulation and Guidance'.

Q25. Do you believe that the requirements in ES 3 should be maintained?

Given the importance of maintaining auditor independence, we believe the FRC's more long-standing approach in ES 3 is warranted and does not pose significant issues for entities or auditors.

Q26. When the standards are revised to implement the Audit Directive and Regulation, do you believe that these more restrictive requirements in ES 3 should apply with respect to all PIEs and should they apply to other entities that may be deemed to be of sufficient public interest as discussed in Section 3? If yes, to which other entities should they apply?

As we have outlined in questions above, we believe the more stringent requirements should only apply to PIEs as defined in the Audit Directive.

We trust you will find our comments useful and would be very pleased to discuss our feedback with you in more detail. Thank you once again for the opportunity to provide you with our comments on the discussion paper.

Yours sincerely,



Rochelle Giugni