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Corporate Frameworks, Accountability and Governance
Department of Business, Innovation and Skills
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19 March 2015

Dear Sir

Auditor Regulation: Discussion document on the implications of the EU and wider reforms ("the Discussion 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 IAASB's consultation paper 'A Framework for Audit Quality', the IAASB's exposure draft 'The Auditor's Responsibilities Relating to Other Information', and the Competition Commission's 'Audit Market investigation'. In addition, we maintain ongoing dialogue with the FRC and industry bodies such as the ICAEW, as well as Big 4 firms.

We agree with the Department for Business, Innovation and Skill's objective of identifying and implementing the 'best possible regime, one that will most effectively respond to the modern, fast moving, highly developed business economy'.

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 UK Audit Regulation are as follows:

Q5. Do you agree that the Government should not expand the definition of a PIE beyond the EU minimum requirement – that is listed companies, banks, building societies and insurers? Please provide further information in support of your answer.

We agree with the Government's decision to not expand the definition of a PIE beyond the EU minimum requirement. Extending this definition to include unlisted PIEs may have onerous effects on such entities given they may not have the resources to meet such requirements.

Q6. What issues, if any, do you consider arise from the application of the provisions of the Regulation to audits of PIEs as defined in the Directive? How do you consider these should be addressed?

We do not envisage any issues from the application of the provisions of the Regulation to audits of PIEs.

Q9. Do you agree the FRC should be the single competent authority with ultimate responsibility for the audit regulatory tasks and for oversight under the 2006 Directive as amended by the new Directive and under the Regulation?

We agree that the FRC should be the single competent authority with ultimate responsibility for the audit regulatory tasks and oversight under the Directive and Regulation with abilities to delegate to authorised bodies and other designated authorities. We also agree that such responsibilities, particularly in respect of inspections, investigations and discipline and standard setting will need to be directly allocated in legislation.

Q10. What issues, if any, do you consider arise from the need to implement a new statutory framework for the setting of auditing standards and for audit inspections, investigations and discipline by the single competent authority to replace the current framework that requires the bodies' rules to provide for this? If there are any, how should they be addressed?

Careful consideration is needed to ensure a new statutory framework clearly allocates responsibilities, taking in to account:

- Available resources of the single competent authority;
- how responsibilities will be delegated to professional supervisory bodies;
- examples of instances when the single competent authority may reclaim tasks; and
- for each of the tasks, instances where the single competent authority should delegate tasks and instances where tasks should be referred back to the single competent authority.

Q16. Do you consider that for consistency with a framework of ultimate responsibility, single competent authority approval should be required for the rules of supervisory bodies?

Yes, we agree that the rules of supervisory bodies should require approval of the single competent authority for not only consistency purposes, but to ensure the bodies providing supervisory services are being managed to the same degree of quality.

Q19. What issues, if any, do you consider arise from the application of the provisions on the cap on non-audit services? If there are any, how do you consider these should be addressed?

We do not envisage any issues with the application of the cap on fees for non-audit services.

Q20. Do you agree that the Member State options in Article 4, to set more stringent requirements on the cap and on the auditor's independence where their total fee income from a PIE exceeds 15% of their total fee income overall, should be capable of being applied by the FRC in its ethical standards for auditors.

We feel it is possible for auditor independence to be compromised to some extent in situations where total fee audit from a PIE exceeds 15% of total audit fee income overall. Therefore, we would understand if the FRC looked to include this option in its ethical standards framework for auditors should it wish to maintain a more conservative approach to auditor independence requirements.

Q21. Do you agree that the FRC should have the ability to exempt an audit firm from the 70% cap for up to two financial years on an exceptional basis and on application by the firm?

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

Q22. Do you agree that the subject matter of Article 5 of the Regulation on the blacklist of non-audit services, including the possibility of setting more stringent requirements, should be included in amendments to the FRC's ethical standards for auditors?

We do not have any concerns about the FRC incorporating blacklist of non-audit services. However, we note that as outlined in the Discussion Paper, the provision of non-audit services to audit clients is currently regulated by the FRC's Ethical Standards for Auditors to a greater degree than most EU member states and consequentially, some significant non-audit services are already prohibited.

Q23. What issues, if any, do you consider arise from the application of the provisions on the blacklist of non-audit services? If there are any, how do you consider these should be addressed?

As stated in our responses to questions 21 and 22, given the number of non-audit service providers in the UK market, we do not envisage any issues arising from application of the blacklist.

Q24. Do you agree that implementation of the revised requirements on ensuring and documenting auditor independence in the 2006 Directive should be implemented primarily via the ethical standards, with amendments to the existing legislation as necessary only to: underpin the standards; and introduce simplifications for audits of small non-PIEs?

Yes, we agree that auditor independence is best ensured through the ethical standards rather than through additional legislation which could encourage adherence to the detail rather than the spirit of the rules.

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)

Q25. Do you agree that the existing framework on disclosure by PIEs in notes to their accounts of the audit and non-audit fees they paid their auditor should be adapted, to ensure public disclosure of the information the auditor is required to provide to the competent authority under Article 14 of the Regulation?

We feel enhanced disclosure as outlined above would be beneficial for investors.

Q27. Audit Committees must submit a recommendation to the board for the appointment of an auditor. However, under Article 16(1) sub-paragraph (2) of the Regulation, this does not apply where the Member State has provided an alternative system for the appointment of the auditor. The current alternative systems set out in the Companies Act 2006 are where: the directors appoint the auditor before the company's first accounts meeting; the directors appoint the auditor to fill a casual vacancy in the office of auditor; and where, the Secretary of State appoints the auditor because a public company failed to do so.

Do you consider that all of these alternative systems for the appointment of an auditor should continue to operate in the UK as they do at present? Are there any other systems that should also be provided for on the grounds that a competitive tender process is not appropriate?

We agree that the systems currently available for the appointment of an auditor in the UK should remain unchanged.

Q29. The Government does not intend to take up the option to provide for an extension of the maximum duration of the engagement beyond 10 years where a joint auditor is engaged. Do you agree that the replacement of a single auditor with two joint auditors, one of whom was the original auditor, should be made on the basis of a retender?

Yes, we agree that a retender is appropriate in this scenario.

Q30. We are considering whether provision should be made so that, where a PIE has stated in its annual report it will appoint an auditor based on a tender process before the expiry of the maximum duration of 10 years, it should still be able to take advantage of an extension of the maximum duration beyond ten years, following that tender.

In order for the 'maximum term' concept to work efficiently, there should be guidance and supervision of the tender process to ensure the best placed firm is selected and justification of the firm's selection should be clearly disclosed. We would want to prevent a situation where the tender process became a 'tick box' exercise and the original auditor is appointed due to familiarity without sufficient justification.

Q31 We are seeking views on the proposal that for companies that are PIEs the company's plans on retendering should be part of a new element of the annual report setting out key matters for the audit committee on the appointment of auditors. Do you agree that the report should include:

- (a) when the current auditor took up the audit engagement at that company? (Yes / No)**
- (b) when the audit engagement was last retendered? (Yes / No)**
- (c) the start of the next accounting year in relation to which the company expects that the auditor appointment will be based on a tender? (Yes / No)**
- (d) the directors' reasons for considering that the proposed year is in the best interests of the company's members? (Yes / No)**

Do you consider that any other information should be included in addition the above?

We believe inclusion of a paragraph in the annual report on the appointment of auditors would be beneficial to users of the financial reports as it would provide context on the audit arrangements. In relation to the above questions we respond:

- a) Yes
- b) Yes
- c) Yes
- d) Yes – although we question how valuable such commentary would be as selecting a date almost 10 years in the future could easily change given the uncertainties.

We would suggest additionally including the criteria the audit committee believes are important when selecting an auditor, how the committee assures itself the proposed scope of the audit is appropriate, the tender timeframe, and following appointment, justification of the choice of the successful audit firm.

Q32. We are considering whether, where the statement under point (c) above is included in the company's annual report, and the incumbent auditor is reappointed on the basis of the planned tender process before the expiry of the 10 year maximum duration (eg at 7 years), the next tender process should be expected to take effect:

- (a) after the same period has expired again (ie year 14 in this example);
- (b) after a further 10 years has expired (ie year 17 in this example); or
- (c) after the same period has expired again, though with the potential to extend it by the full 10 years via further notice from the audit committee in the annual report (ie in this example at year 14 though this could be extended to year 17)?

Which option would you prefer?

We agree with option b) a further 10 years, given this is the maximum period. However, we feel the Audit Committee should be able to exercise its discretion as to the most appropriate timing of a tender process given its knowledge of the business, as well as any relevant external factors and its responsibilities as the Audit Committee.

Q35. What issues, if any, do you consider arise from the inclusion in legislation on audit reporting of a requirement for the auditor to include a statement in the audit report where there is a material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern? How do you consider these should be addressed?

We do not envisage any issue legislating this requirement given it is consistent with the International Standards for Auditing (UK & Ireland) ("ISA").

Q36. Do you agree that the provisions of Article 10 of the Regulation on the audit report should be included in amendments to the FRC's ISA?

We agree that the FRC's ISA should be amended to reflect the requirement for additional disclosures in audit reports by statutory auditors of PIEs. We strongly believe that the quality of audit reporting needs to be significantly improved to increase the relevance and reliability of audit reporting and the underlying financial statements. We believe further disclosure, specifically with regards to risks of material misstatements and how these have been addressed by auditors, will enhance the quality of audit reports, making them substantially more valuable to users of financial reports.

Q37. What issues, if any, do you consider arise from the application of the provisions of the Regulation on the audit report? If there are any, how do you consider they should be addressed?

We do not envisage any issues.

Q38. Do you agree that the provisions in Article 11 of the Regulation on the additional report to the audit committee should be included in amendments to the FRC's ISA?

We would support the inclusion of the provisions from Article 11 of the Regulation in the FRC's ISA.

Q39. What issues, if any, do you consider arise from the application of the provisions of Article 11 of the Regulation on the additional report to the audit committee? If there are any how should they be addressed?

We do not envisage any issues. In our opinion, Audit Committees would only 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.

Q44. Do you agree that the implementation of EU requirements on technical standards should be primarily through changes to the FRC's ISAs?

Yes, we agree that the implementation of EU requirements on technical standards should be primarily through changes to the FRC's ISAs.

Q46. What issues do you consider arise from the implementation of EU adopted ISAs in the UK that UK representatives should raise with the European Commission?

In our view, a potential issue is maintaining consistency in ISAs adopted by the UK and EU and their application.

Q47. Do you agree that following any adoption of ISAs by the European Commission, the FRC should have the discretion to:

(a) apply standards where the Commission has not adopted an ISA covering the same subject-matter; (Yes / No) and

(b) impose procedures or requirements in addition to adopted ISAs if these national procedures or requirements are necessary to give effect to national legal requirements or to add to the quality of financial statements? (Yes / No)

a) No, we believe international business would benefit from having a consistent set of international auditing standards and would therefore hesitate to allow the FRC to unnecessarily amend the standards, resulting in discrepancies.

b) Yes, however, should the FRC be given powers to amend procedures and requirements necessary to give effect to national legal requirements or to add to the quality of financial statements, we would expect the FRC to be given clear guidance as to when it may intervene and would want this to be limited.

Q48. What issues, if any, do you consider arise from the implementation of the new requirements on audit committees via amendments to the existing DTR 7.1 in the FCA Handbook (for companies with securities admitted to trading on a regulated market)?

We have concerns over the practicalities of requiring all audit committee members to have competence in the sector the entity operates in. Whilst we agree having relevant sector experience is invaluable in members of the audit committee, we would place greater emphasis on members having financial experience. Boards should be comprised of directors with diverse skills and experiences. The requirement for all audit committee members to have sector experience is overly restrictive and will severely limit the universe of potential candidates for these roles.

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,

A handwritten signature in black ink, appearing to read 'Rochelle', written in a cursive style.

Rochelle Giugni