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The Treasury Department Advisory Committee on the Auditing Profession

Dear Sir/Madam,

Hermes Equity Ownership Services is pleased to rise to the invitation from the Advisory Committee on the Auditing Profession to comment on its draft report.

By way of background, we represent the interests of major pension schemes and fund managers from around the world. Among these clients are some of the largest pension schemes internationally, including the BT Pension Scheme in the UK, the National Pension Reserve Fund of Ireland, Denmark's PKA, the Netherlands' PNO Media Stichting Pensioenfond, Australia's VicSuper and numerous others. All these clients have substantial shareholdings in US companies. We are particularly well-known for our work in the area of corporate governance, and have been active internationally in the debates on accounting and auditing standards.

We strongly welcome the attention being paid to the quality and professionalism of the auditing profession. We believe that a high quality audit plays a crucial role in ensuring that shareholders have confidence in the companies of which they are part-owners, and also helps ensure that shareholders can effectively call management to account for their work. We therefore hope that the Advisory Committee and its recommendations will succeed in fostering a more robust auditing profession.

We believe that the issue of audit quality – and particularly making that quality visible – has a vital role to play in ensuring a properly competitive market for audit services. Only by driving for greater professional judgement in the conduct of audits, which is the essence of audit quality, and by making that audit quality 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 given greater emphasis by all parties. We believe that this needs to be addressed in a number of areas: human capital and professionalism, firm structure and focus on quality, and competition in the audit market. We believe audit committees have a crucial role to play.

Human Capital and Professionalism

The very core of a profession must be that its members are willing to exercise professional judgement. This means that they require not a rulebook to follow – there is little space for judgement when the rules guide every decision – but a set of principles to be applied with the benefit of professional training and experience.

We therefore strongly believe 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. The training of accounting students needs to reflect this requirement for a professional state of mind such that those students will be able to perform quality audits when they enter the profession.

We therefore welcome the emphasis of the Advisory Committee's report on the issues of human capital and training. We believe that these are the crucial building blocks of a robust and vibrant profession which exercises professional judgement, and which will therefore drive higher quality audits. We would welcome the Advisory Committee considering whether it can and should do more to address the question of whether those well-trained students will have the scope to exercise judgement once they enter the profession. We strongly believe that this would also make the profession a more attractive one for the brightest individuals to enter, again a vital element in driving audit quality.

Some of these issues were considered by the Audit Quality Forum in its work on Principles-Based Auditing Standards, in which we actively participated. We would commend to you the final report of that working group, which can be found at <http://www.icaew.com/index.cfm?route=155445>.

Firm Structure and Focus on Quality

We also believe that the Advisory Committee needs to consider the culture of the firms which these new accountants enter. Particularly key are the focus on audit quality by each firm's leadership, initial staff training and continuing professional development, and a focus on quality in the appraisal process, rather than promotion being driven solely by an assessment of business development. There has been much good work done in the UK on the drivers of audit quality – the Financial Reporting Council's recent Audit Quality Framework can be found at <http://www.frc.org.uk/images/uploaded/documents/Audit%20Quality%20Framework%20for%20web.pdf> – and we believe that the Advisory Committee would be well advised to look at many of the issues raised in this document as areas which it might look to address in the US context.

It will be far easier to retain quality individuals in the auditing profession if they regard quality auditing as being valued by the wider market but most particularly by their firms. Our belief is that some of the difficulty firms have in retaining staff is that much audit work has been reduced to a mechanical process rather than one requiring professional judgement by front-line staff. We would argue that more authority and responsibility needs to be devolved down to those actually on the ground in the audit process. Professionalism flows from appropriate delegated authority, and 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.

We understand that consideration is being given to the form of reporting which audit firms should be required to make. We do not believe that full GAAP-compliant accounts are called for. What is much more important to the good functioning of the auditing profession and so the good functioning of the capital markets is that firms report publicly and on an annual basis on the ways in which they ensure that they carry out high quality audits (in particular those cultural issues which are discussed

above and are considered in the FRC's Audit Quality Framework). But on the issue of public reporting, we believe that the way in which audit firms need to demonstrate publicly that they are performing their proper role in the financial markets is to explain the ways in which they are ensuring they fulfil the drivers of audit quality.

In a similar way, we do not believe that introducing non-executive directors onto the boards of audit firms will necessarily address the concerns about the profession. Directors are appointed to promote the success of the firm. The Advisory Committee's aim is to drive greater quality and accountability within the profession. These are two very separate aims and it is not at all clear to us that the appointment of non-executive directors will assist in driving quality and professionalism. Rather, we would suggest that quality will be driven by public accountability on the drivers of quality, both through the form of public reporting as discussed above, and perhaps through the forum of public accountability meetings where the firms might justify how they have effectively addressed the drivers of audit quality and how they intend to improve the situation further going forwards.

There is some focus in the Advisory Committee's draft paper on the issue of fraud. We believe that there needs to be greater clarity over the concerns that shareholders have with regard to fraud, as we fear that the single term 'fraud' is being used in a way which hides two separate issues and so risks distracting auditor attention from crucial matters. It is clear that auditors will never be able to detect every small fraudulent activity within a large audited entity, and it is also clear that it would not be cost-effective for them to attempt to do so. The fraud which matters rather more to shareholders – and which auditor attention needs to be directed to – is fraud at the head of an audited entity. Such fraud is much more likely to be large enough directly to affect shareholder interests, sometimes to the extent of threatening the very survival of the company. Auditor attention to such fraud is therefore vital. Such fraud is likely to be detected not by a detailed analysis of financial reporting and controls but by senior auditors spending time with management and getting to know their attitude and approach, and then applying professional judgement as to whether this is a management which may act fraudulently.

Competition in the Audit Market

We would strongly welcome smaller audit firms beginning to compete effectively in the auditing market. We would note that institutional investors do not hold the view sometimes attributed to them that companies audited by the tier of audit firms immediately below the Big 4 are uninvestable. Rather, we recognise that many of the individuals at firms on this next tier are just as strong as those in the Big 4, and we would welcome audit committees giving active consideration to appointing such firms. Indeed, we believe more generally that audit committees have a crucial role in promoting a more competitive audit market. They need to carry out more beauty parades at which they consider which auditors to (re)appoint and they need to emphasise at these beauty parades not price but quality. We believe that audit committees should report annually to the shareholders their actions to ensure that the auditor is maintaining and enhancing quality in the audit. They need to pay attention to the crucial issue of auditor independence, but they also need to consider actively the issues of audit quality. This would play an important role in the decision-making of the shareholders as to whether to reappoint the audit firm. In this light, we strongly welcome the Advisory Committee's recommendation that annual shareholder ratification of auditors should be made mandatory. We further believe that this ratification should be a genuine one and that an auditor should not continue in office unless it receives a majority of the votes of shareholders in favour of ratification.

We have discussed above our views on the drivers of audit quality. We would strongly welcome the PCAOB giving consideration to these and to requiring public disclosure of them. We believe that the work of the UK's Financial Reporting Council will provide a helpful foundation for the PCAOB's work in this regard. This is one form of the international cooperation which the Advisory Committee also recommends, and which we would also strongly welcome.

Other possible steps forward:

Individual signatures

We believe that it would be of value to shareholders to see auditors' reports signed by individuals as well as in the names of the relevant audit firm. We believe that this would add an additional level of accountability and serve to emphasise to all parties the individual professionalism which we are seeking from an audit of public company accounts. It should enable those individuals to be more personally accountable and so take on the burden of better professional judgements. Furthermore, we think that firms are likely to allocate their better people in the light of that transparency.

Federal court jurisdiction

We also understand that the Committee would welcome comments on whether some state-allowed claims against auditors should be automatically transferred to the federal courts. We would welcome this as we believe that the scope for apparently narrow and arbitrary decisions has driven defensive accounting not just in the US but elsewhere in the world. A federal court process will be seen as more consistent and more likely to avoid inappropriate decisions, and particularly avoid inappropriate allocations of damages.

We would be pleased to discuss these issues further with any member of the Advisory Committee, if either our comments are unclear or if you wish to develop them further in conjunction with us.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'Paul Lee', with a long horizontal flourish extending to the right.

PAUL LEE
Director