STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with Hermes Equity Ownership Management held on 15 March 2012

Background

1. Hermes told us that it was an asset manager that was wholly owned by the BT Pension Scheme. It took a long-term approach to investment, and was concerned with systemic risks, public policy, and accounting standards. It had investments across the FTSE 350, and typically represented clients with approximately a 1 per cent holding.

Engagement with auditors

2. Hermes had only rarely voted against management recommendations regarding the choice of auditors at AGMs. One situation in the public domain was TUI Travel. There had been a problem with the accounts, and the company sought to change the auditor to be the same as that of the parent (TUI AG). Since it appeared that the parent might bid to acquire TUI Travel, this caused concern for many shareholders as they did not consider the auditor to be fully independent. In addition, they were unclear as to this auditor's role in the accounting issue as it had previously audited parts of the business. Accordingly, several voted against the management recommendation.

3. Hermes considered that it was a challenge to try and influence the choice of auditor. It attempted to do this in dialogue with the Audit Committee Chair (ACC). It was possible for Hermes to have some contact with the ACC, and its success in influencing the auditor recommendation depended on the strength of its case. As a single shareholder, it could not demand too much time with an ACC, and would only seek a meeting if it had a specific concern. It would aim to get this across in a single meeting, but occasionally it might have more than one.

4. It had more influence via this route than through the exercise of voting rights at AGMs. It was a huge logistical task to attempt to coordinate sufficient shareholders to be able to defeat a management recommendation. It was not aware of any instance where this had been successful. Most shareholders were not bothered by the choice of auditor.

5. Otherwise, Hermes had very little involvement with the audit process. It might have discussions with Finance Directors (FD) that might touch on reporting, but very rarely on audit.

6. It had no contact with the auditor itself: auditors actively avoided speaking to shareholders.

Reliance on audit reports and reputations of auditors

7. In making an investment, Hermes had no formal requirement for an unqualified audit report. Typically the audit report was a trailing indicator: concerns that might affect investment decisions would be disclosed before the audit report was published. In those circumstances Hermes might well reduce its holding over time.

8. In practice, there was negligible reliance on the audit report, regardless of the identity of the auditor. It was no more than a tick or a cross after the event. Important information should be disclosed to the market during the course of the year. However, the audit did provide something of value, and the audit report could be much more influential if it contained more information than it currently did.

The costs of switching auditors

9. Companies spoke about the costs of switching. However, these were ultimately borne by shareholders. Hermes thought that more switching would produce a benefit greater than the cost. It noted that while company directors had fiduciary duties only to the company itself, investors thought more broadly about the market as a whole, and what could be done to increase investor confidence.

10. The costs of switching were incurred in management time spent to explain to a new auditor how the company functioned and to justify existing accounting decisions. However, from a shareholder perspective, this was money well spent, since it entailed more rigorous scrutiny.

11. Currently, auditor switching was so rare that it might be seen by investors as a signal that there might be an issue that would concern investors if disclosed. If switching were more frequent that would not be the case. A switch might adversely affect share prices if it started adverse rumours about the company. However, companies usually explained and allayed any concern that a switch was not driven by any hidden issue.

12. Outgoing auditors might make statements to regulators about the reason for their departure. However, currently such statements were generally not useful to investors, as they were written very defensively.

13. Hermes was aware of suggestions that choice of auditor might be driven by banking covenants. It thought that new listings were strongly encouraged to instruct one of the Big Four firms by bankers and others. However, use of the Mid Tier should be considered, and six years ago, it and five other institutional investors had written to all the FTSE 250 companies to urge them to consider use of the Mid Tier (a copy of this letter is provided below). Hermes believed there was no shareholder reason for a company to feel required to use a Big Four auditor.

14. While audit price negotiations were typically handled by the FD, shareholders would be prepared to pay more for a higher quality and more effective audit.

15. Investors might have more confidence in companies that had recently switched auditor: this should be reflected in a lower cost of capital for that company, and its shares should trade at increased earnings multiples.

Audit quality

16. Hermes' written submission stated that audit quality was currently invisible to the consumers of audit services, the shareholders. However, it thought that proposals from the Auditing Practices Board (APB) were helpful steps towards addressing this and making the audit more useful to investors and its quality more apparent. In particular, these proposals entailed not more work for auditors, but better disclosure of what the auditor had done in that particular audit and the particular issues that had been examined. The auditor should be able to make a greater range of statements of assurance than currently. While audit would always be a trailing indicator, greater confidence in historical performance would increase confidence that such perform-

ance could be continued. The value of the audit to investors was more about the enhancement of the company's reporting over the year than the year-end sign-off. The APB's version of ISA 700 deliberately allowed more disclosure; it was a minimum standard. However, many auditors interpreted it as a maximum.

17. Hermes thought that there were two key issues regarding audit quality. First, auditing judgements, ie which avenues to pursue. It expected the auditor to show judgement in how far to pursue any particular issue. Second, accounting judgements: these were made by company management, but it was up to the auditors to test and challenge them. If the audit gave more detail on both these judgements, that would be very useful to investors.

18. Hermes had no concerns regarding the use of different auditors within a group (ie for the holding company and subsidiaries), as long as they interacted effectively and the audit was done well. It noted that current statistics might be misleading, since a Mid Tier firm might be shown as the group auditor, when in fact one of the Big Four audited many of the underlying subsidiaries.

19. In terms of seeking additional assurance regarding an investment (beyond that provided by the audit), Hermes had once called for a special audit in Germany.

Auditor independence

20. It was very difficult for an investor to form an accurate opinion of auditor independence. Once the regulator was involved, it would be very apparent that there was a problem. As noted, auditors never spoke to shareholders. There might be an intimacy of relationship between the auditor and company management that might compromise independence. The best auditors succeeded in forming a good relationship with management and yet still challenged and changed accounting judgements where necessary. However, not all audit engagement partners managed to do both.

21. With regard to non-audit services, Hermes accepted that there were a class of services that only the auditor could provide efficiently. Equally there was a class that it should be barred from providing, and there were some grey areas. Hermes thought that the issue of providing tax services had not yet been adequately addressed by regulation. Most investors needed more convincing that auditors should be able to provide tax services.

22. Hermes did not know if auditors provided bundles of services (ie audit and non-audit services) but would be surprised and disappointed if this was the case.

23. With regard to the effectiveness of audit committees, Hermes considered that this was largely down to the strength of individual ACCs. Many audit committees did not realize that squeezing an audit fee was not in fact in the interests of the audit committees. Hermes said it was in their (ie investors') interests to have the most effective audit possible and that they would be prepared to pay more for this if required. This assumed that fee was demonstrably linked to quality.

24. The best ACCs gave time to the auditor to speak, discuss fully any issues encountered during the course of the audit process, and make time for debate with the committee of the key issues. The ACC should build a strong relationship with the Audit Engagement Partner, and invite alternative views.

Regulation

25. Hermes emphasized that regulation should be seen as a minimum requirement, not a maximum. It was concerned that some auditors thought that the only judgement that they needed to exercise was in the initial choice of areas to examine—it had been told this even by the head of audit at a leading firm. After that, the checks were a mechanical exercise. This was a troubling mindset within parts of the auditing profession.

26. Referring to the saying that an auditor should be ‘a watchdog not a bloodhound’, it considered that instead the auditor should be a sniffer dog, following anomalies to discover if they revealed genuine problems with the state of a company. Share-holders had some role to play but principally it was down to the profession and to regulators to effect such a cultural change. A debate was beginning, designed to achieve this.

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Name
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3 July 2006

Dear [audit committee chair]

Auditor appointment

We have followed and participated in the ongoing debate regarding audit quality and competition in the audit market. In particular, we have taken note of the recently published Oxera study into the area on behalf of the Financial Reporting Council and Department of Trade & Industry.

It is our view that having only four service providers is not conducive to a properly competitive market for audit services. It has sometimes been suggested that companies feel obliged to choose one of the 'Big 4' as their auditor because of shareholder pressure to use those firms. We are writing to you to make clear that we do not believe that all public companies need to use the Big 4 firms as their auditors. On the contrary, we would welcome more companies in which we invest accessing the skills and capabilities of the next tier of audit firms.

Using such 'Tier A' firms will not be appropriate for all companies. But for those not among the largest and most complex, we believe that Tier A firms may offer a cost effective and valid option for your audit work.

We are aware of the similar letter sent by the Association of British Insurers, of which half of us are members. This letter is intended to be complementary to and supportive of that letter. We would welcome your audit committee considering these views when you are next reviewing your auditor.

Yours sincerely

Frank Curtiss
Head of Corporate Governance
RAILPEN Investments

Ian Jones
Head of Responsible Investment
Co-operative Insurance Society

Karina Litvack
Director, Head of Governance & SRI
F&C Asset Management

Colin Melvin
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Peter Moon
Chief Investment Officer
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Iain Richards
Head of Governance and Public Policy
Morley Fund Management