Response to APB Consultation on the Auditor's Report

Introduction

Hermes is one of the largest pension fund managers in the City of London and is wholly owned by the BT Pension Scheme. We also respond to consultations such as this one on behalf of many other clients, including Ireland's National Pension Reserve Fund, Denmark's PKA, Pensioenfonds PNO Media of the Netherlands and Canada's Public Sector Pension Investment Board (only those clients which have expressly given their support to this response are listed here). We have some £35 billion assets under management and over £45 billion assets under advice.*

Hermes takes a close interest in matters of company law and regulation because they set the context for the exercise of our clients' rights as part-owners of the companies in which they invest. We seek to safeguard our clients' current rights and also to enhance the transparency and accountability of companies and their directors to their long-term owners.

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 of those who audit and monitor company performance; and
- ensure the measures used in reporting performance are relevant for owners.

At present the auditor's report contains much that is not a report from the auditor. Indeed, much of it seems designed to limit the liability of auditors by highlighting what one regulator has called "what the auditor does not do". We are strongly of the view that such elements are an inappropriate part of the auditor's report to shareholders. While we recognise auditors' desire to limit their liability, we do not believe that the auditor's report is the right place to do this. We support a move to an auditor's report which is genuinely a report to shareholders of the findings of the audit rather than one which masks this useful information with duplicated legalistic language.

These issues are sometimes referred to as 'readability'. We do not believe that the current problem with auditors' reports is that they are not readable but rather that they are not worth reading: currently the page-long or more reports published in every annual report boil down to a single sentence which is informative, and that provides simply a yes or no answer. We would welcome reports which were worth reading because they give us as shareholders some insight into our company and into the quality work which the auditors have carried out.

** figures as at December 31st 2007*

Summary

Hermes strongly believes that quality audits add value to the capital markets by maintaining confidence. However, this confidence will only be maintained if auditing is genuinely of high quality and that high quality is apparent to shareholders. Because of this, we have been active supporters of the Audit Quality Forum and various of its working groups, including the auditor reporting one which was the spur for much of the current consultation. We believe that an integral part of the improvement in audit quality which we are seeking and which we believe that the profession is keen to deliver will require an improvement in auditor reporting such that the quality is visible to shareholders. We fear that unless auditors begin demonstrating the quality of their activities openly to shareholders, doubts about the value that shareholders receive from the auditing process will build and the perceived need for auditing will be diminished.

We therefore welcome this consultation and look forward to significant changes being made to auditors' reports such that they will provide a greater window on quality auditing. As discussed in the Introduction above, we are seeking reports which are not just readable but also worth reading. As will be clear from the responses to the individual questions, we are supportive of Example 2 in the Other Possible Improvements section, which we believe makes most transparent the work which the auditors have in practice performed. It is therefore most likely to maintain the auditing profession in good standing and to promote quality auditing.

Our responses to the specific questions are below.

Amending the Auditor's Report to Reflect Changes in Company Law

Question 1: Should the auditor's report, as illustrated on pages 19 to 21, make reference to the directors' responsibility under section 393 of CA 2006 to be satisfied that the financial statements give a true and fair view?

Yes. We are strong advocates of the requirement that accounts show a true and fair view, and indeed worked hard to ensure that this requirement was retained in the new Companies Act. Provided that the outline of the responsibilities of directors and auditors is limited, such as that proposed in Example 2, we believe that it does add value to have a direct reference to the true and fair view requirement in the auditor's report.

Question 2(a): Is it helpful for the auditor's report to describe the auditor's responsibilities under CA 2006 to report certain matters by exception?

Question 2(b): If you believe it is helpful to describe the auditor's responsibilities with respect to matters reported on by exception in the auditor's report, do you also believe that, where appropriate, it would be helpful for the auditor's opinion to state explicitly that there is nothing to report in respect of those matters on which they report by exception?

We support the inclusion of the responsibilities to report by exception in the body of the auditor's report. We also strongly believe that the auditors should clearly state that they have nothing to report in respect of those issues. We believe that these areas of audit work are currently not apparent to shareholders – and we fear on occasions that they are not always at the forefront of auditors' minds. By requiring these explicit statements in the auditor's report we believe that appropriate attention will be paid to these existing requirements by the auditors and their quality work will be more visible to shareholders. In the absence of such a requirement, auditors are failing to demonstrate some of the value which their work is adding.

Other Possible Improvements

Question 3: Should the auditor's report be split into two parts as envisaged by ISA 700 (Revised)?

We support the separation of the auditor's report into two parts. We believe that this provides appropriate clarity and information to shareholders about the different roles of the auditor, and makes clearly apparent the different requirements placed on them by different legal regimes around the world. For international investors, this is a helpful step.

Question 4(a): Should the auditor's report describe the directors' responsibilities with respect to the preparation of the financial statements?

Question 4(b): If you believe it is necessary for the auditor's report to describe the directors' responsibilities, do you prefer the wording prescribed by ISA 700 (Revised) (Example 1) or would you prefer wording such as that used in Example 2?

We believe that Example 2 strikes the right balance here. It provides useful headline information but does not go into excessive unnecessary detail. For international investors, some information is useful, but it is important that this information is not buried in excessive verbiage.

Question 5: Is it necessary for the auditor's report to contain a detailed description of the auditor's responsibilities if such information is publicly available?

No. We believe that the paragraph proposed by ISA 700 is pointless and unnecessary. We fear that elements of it are driven by liability limitation concerns rather than by a desire to demonstrate the value which auditors are adding. The repetition of these words in every audit report around the world would not serve the interests of shareholders. Quite simply, it would not be read; we therefore fail to understand why it should be published.

Question 6: Should the auditor's report refer to the auditor's responsibility to comply with the APB's Ethical Standards?

Yes. We believe it is helpful to refer to the specific Ethical Standards to which the auditors are bound. These are Standards of which in general shareholders are unaware and so making their application more apparent in this way would raise their profile and hopefully engage more shareholders in the debate as to what standards we should expect auditors to aspire. Again, it is helpful for international investors to see the different standards applied in different markets.

Question 7: Should auditors be required to state in their report, where it is appropriate, that there are no matters that they wish to emphasise?

Yes. We believe that emphases of matter are an important yet neglected area of auditor reporting. We believe that appropriately selected emphases will add real value to auditor's reports and help shareholders in their understanding of accounts. Further, we believe that a requirement to report an absence of matters of emphasis will keep this option open in the minds of both auditors and shareholders. It is a further way of auditors demonstrating the value that they are adding. We therefore strongly support a requirement that auditors state that there are no matters they wish to emphasise if that is indeed the case.

Question 8(a): Do you think that there should be a positive statement in the auditor's report concerning the adequacy of accounting records?

Question 8(b): If not, will the steps proposed by the APB to:

- **(i) require auditors to make a statement that they have nothing to report in connection with their duty to consider the adequacy of the accounting records; and**
- **(ii) provide additional standards and guidance for auditors with respect to their responsibility with respect to adequate accounting records,**

address the problem that the AQF is seeking to resolve?

We believe that the requirement to assess the adequacy of accounting records is a sadly neglected element of the work of the auditor, and we believe that it is necessary to raise its profile both among auditors and shareholders. We are aware of too many instances at companies both large and small where accounting records have not been adequately kept, and we believe that the auditing profession needs to fulfil this requirement more completely than it is doing at present. Having said that, we would be content with the auditor's report including a statement that the auditors have nothing to report in this regard. We do not believe that it is necessary that there is a positive statement.

We would welcome further attention being brought to this matter through additional standards and guidance for auditors.

Question 9(a): Should the auditor's report describe the auditor's responsibility with respect to a listed company's Corporate Governance Statement?

Question 9(b): If you believe that the responsibility should be described in a different way to Example 2 please provide your suggested description?

Question 9(c): Please indicate, stating your reasons whether you believe that the standard wording "We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures" (which has been omitted from Example 2) should be included in the auditor's report?

While the FSA Listing Rules require some auditor oversight of some elements of the Combined Code, we believe that it is on balance helpful to have this formally reported to shareholders. We are content with the description in Example 2. Again, it is a further demonstration of the value added by auditors through the audit process.

On question (c), we would regard the standard wording beginning "we are not required" as language intended to limit liability rather than add value or demonstrate value-adding by auditors – it is transparently a statement of what the auditors do not do. We therefore do not think it should be retained. Again, we believe that Example 2 strikes the right balance.

Question 10: Should the auditor's report describe the auditor's responsibilities in relation to "Other Information" in the Annual Report?

Yes. We believe that the auditors' assessment of the other information in the Annual Report for consistency with the financial statements is a crucial check and balance in the reporting of company performance to shareholders. We doubt that auditors would be content to sign off on accounts unless they had made such an assessment, and we certainly believe that this assessment – and a statement to this effect – adds value for shareholders.

Question 11(a): Which of the example auditor's reports do you prefer? Please provide the reasons for your choice.

Question 11(b): If you would prefer a different approach to these examples please provide your suggested unmodified auditor's report. (Alternatively, tick the boxes in the right hand column of the table on pages 35 to 36 to indicate

those elements of an auditor's report that you would like to see included in an unmodified auditor's report.)

As will be apparent from the above discussion, we strongly favour Example 2.

Question 12: Do you agree with the view of the IAASB expressed in the Exposure Draft of ISA 706 (Revised and Redrafted) that the widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters?

We agree that widespread use of emphasis of matter paragraphs would diminish their value. We do, however, consider that the current situation – where such paragraphs are vanishingly rare – is a step too far in the other direction. If there is something which shareholders need to be aware of to ensure that they have a full and proper understanding of the company and it financial reporting, we believe that an emphasis of matter paragraph should be included. We believe that greater, though measured, use of emphases of matter would go a long way to addressing the Audit Quality Forum's call for more bespoke auditor reporting. We are content not to push for such bespoke reporting on the basis that we expect auditors to make greater, though judicial, use of emphases of matter.