Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes.co.uk

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2011-003; Concept Release on Possible Revisions to PCOAB Standards Related to Reports on Audited Financial Statements

Dear Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," dated June 21, 2011

By way of background, Hermes is one of the largest asset managers in the City of London. 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, including the Lothian Pension Fund, Northern Pension Fund of Ireland, PNO Media (Netherlands), Canada's Public Sector Pensions Investment Board, and VicSuper of Australia (only those clients which have expressly given their support to this response are listed here). In all, EOS's advises clients with regard to assets worth more than $140 billion.

We firmly welcome the PCOAB's attention to the important issue of audit report quality and are extremely supportive of much needed reform in this area.

Users of financial statements have become increasingly aware that the matters that determine the scope and effectiveness of the audit and which are therefore important to the auditors in reaching their opinion are not expressly addressed in the audit opinion. The audit opinion contains nothing more than a pro-forma statement about the auditing and ethical standards that the auditor has complied with, and does not relate those standards to the actual work that has been done in the course of the particular engagement. Nor does the audit committee report on such matters. As a result users lack the information to enable them to assess the extent to which it is appropriate for them to rely on the financial statements. As importantly, the audit report, by not discussing the substance of the audit work that has actually been done, does nothing to reinforce perceptions of audit quality and so does not provide a vehicle to increase audit quality. We believe that increasing the focus on audit quality is vital to increase investor confidence and to improve standards within the profession.

At present the audit report contains much that is not a report from the auditor. Rather, it is a defensive outline more of what the auditor does, and indeed, does not do – apparently designed solely to limit the auditor's liability rather than enlighten investors with regard to the audit or audited entity in question. Even the outline of what an audit involves seems designed from this negative perspective rather than a positive one. We believe that this sort of audit report not only does not provide value to investors, it does a significant disservice to the audit profession by emphasizing not the value that the auditor brings through the audit but rather highlighting what investors should not expect from the auditor. We believe that this 'perceptions gap' is more important than the expectations gap these days: through such poor reporting to investors, they are invited to expect nothing of value from an audit. If the profession genuinely wishes to foster its own future we need to ensure that rather than emphasizing what little can be expected from an audit, the audit report needs to highlight the positive value that an audit brings for investors.

We believe that a refocusing on the positive value added by the audit is needed and that will require a removal of the excess verbiage which emphasizes more what an audit does not do than the value that it brings

More useful disclosures on the audit process and audit quality will help start addressing the perception gap around the audit and emphasise audit quality in a way which over time will increase competition over audit quality. We would welcome better disclosures by all parties to corporate reporting. This is both necessary and important. But it is extremely important to focus on which parties have the primary responsibility for disclosure. We provide a brief table which we think provides a helpful insight into our thinking on this matter.

	Management	**Those charged with governance**	**Auditor**
Financial accounts	Primary responsibility		Audit opinion
True and fair view	Primary responsibility		Audit opinion
Neutrality			Primary responsibility
Associated narrative reporting	Primary responsibility		Read requirement – negative assertion ("we have nothing to add")
Adequate books and records/internal controls	Primary responsibility		Positive statement
Going concern	Primary responsibility, including to disclose key risks and process for arriving at going concern view		Secondary responsibility – exceptions opinion
Key accounting judgements	Primary responsibility		Highlighting existing disclosures, negative assertion ("we have nothing to add")
Key assumptions and estimates	Primary responsibility		Highlighting existing disclosures, negative assertion ("we have nothing to add")
Key auditing judgements		Commentary on auditor disclosure and discussion of role in assisting auditor in reaching those judgements	Primary responsibility
Key areas of debate & discussion between auditor and those charged with governance		Primary responsibility	Commentary, negative assertion ("we have nothing to add")

This implies that there are indeed matters which those charged with governance - very usually the audit committee - have the primary responsibility for disclosing, and we strongly encourage the development of regulatory regimes which facilitate and encourage such disclosure, though we recognise that such matters are not directly within the control of the PCAOB.

We have taken the opportunity to respond below to a select number of individual questions presented in the consultation but generally feel that the table above reflects our overall position on the types of enhancements we hope to see implemented in order to address the severe deficiencies present in the current audit report.

1c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

We do not believe that expanding the auditor's current role is warranted. We would welcome rather a focus on the current role and delivering effectively - and transparently - what is currently required. We firmly believe that a 'read requirement' is the appropriate level of auditor oversight of narrative reporting which accompanies the audited financial statements, and as the table indicates we welcome this work being made explicit in auditor reports. But we believe taking any further auditor assurance oversight of other matters is not warranted, and we fear it might significantly intrude into the reporting processes of audited entities.

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model.

a. Should the auditor's report retain the pass/fail model? If so, why?

b. If not, why not, and what changes are needed?

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

We would welcome audit reports becoming much more discursive and qualitative. We believe that the current binary nature of the audit opinion – in effect either a ' pass' or a 'fail'– leads to audits being less effective because companies can argue that as long as an accounting treatment is within the boundaries of acceptability they should receive a 'pass'. An audit report which gave an indication of how far the company is pushing the boundaries of accounting standards would provide much more useful information to investors, and be a basis for encouraging companies to take less aggressive stances - we believe that the alternative to this that would be most acceptable to the profession is our proposed auditor statement that the accounts do provide a neutral presentation. While this statement is a change, it is simply putting in writing an assertion that auditors make about accounts by signing them off; we also believe it is a more realistic request to make of auditors than a view as to degrees of accounting aggression. Its impact on the dynamic between the auditor and management and those charged with governance ought to be substantial and powerful. This process ought to lead to much more consistently appropriate reporting and so to less systemic risk. The sort of discursive and qualitative audit reports that this implies would avoid the all-or-nothing response to which qualifications currently give rise.

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

As the table indicates, we agree that in the first instance it should be for management, or those charged with governance (or indeed the two in combination) who have the primary responsibility for the disclosures we highlight in the table. However, we recognize that setting requirements for corporate disclosure is beyond the PCAOB's remit and we therefore believe that the PCAOB may need to require auditors to make such disclosures where the audited entity has not done so.

This is a fall-back because we would most welcome enhanced disclosure requirements of management and also those charged with governance, and we would also welcome enhanced requirements of the auditors to respond to these disclosures, probably in terms of highlighting where the disclosures are contrary to evidence highlighted in the audit, or a statement that there was no such evidence identified. The areas on which we would welcome further company disclosure, and auditor assurance in response to, would be: the up to five key areas of accounting judgment and why the relevant accounting choices have been made; which are the key assumptions embedded within the corporate reporting and what impact would alternative assumptions have made; significant changes to the business, including segmentation, capital structure, M&A divestments, and the reasons for these; risk management appetite and approach.

We believe that the auditor should have primary responsibility for disclosures on the key auditing judgments - such as the significant risks identified at the start of the audit, materiality thresholds (particularly such matters as which subsidiaries were audited directly and which not - and how this decision was reached), and the extent of reliance on another auditor or on the work of internal audit. We would welcome those charged with governance having the responsibility of commenting and responding to this disclosure.

We believe that the table provides a ready outline of our thinking in this area.

5. Should the Board consider an AD&A as an alternative for providing? additional information in the auditor's report? a. If you support an AD&A as an alternative, provide an explanation as to why.

While we are not fundamentally opposed to the possibility of the introduction of an AD&A we do not feel that it is necessarily the most effective way of bridging the communications gap which currently exists. We believe that the enhancements we are proposing to the audit report would address the bulk of current concerns and that more drastic steps are not yet warranted.

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

We believe that there would be real value in considering enhancing auditor reports in this way. However, we believe that this needs to be done with real care to strike the right balance of ensuring fuller more useful disclosures to investors while also leaving the balance of responsibilities placed appropriately between the auditor and the board. We understand there is a real risk that the auditing firms will seek to have standard language, which undermines the intent of developing audit reports which are genuinely bespoke to the individual company. It is for this reason that we are proposing auditor disclosures which are narrow and specific, requiring few words, but which cut to the heart of the judgements which investors need the auditors to be making.

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

We do not see any potential shortcomings in the provision of clarifications around the language in the standard auditors report provided the additional clarity is provided in a meaningful manner and accompanied by genuine enhancements to the quality and content of the audit report as discussed above. We do not believe though that this goes to the core of current concerns with audit reports and so do not believe that this warrants significant attention.

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

We believe that three things are fundamentally necessary:

- Audit reports need to drop any and all language which highlights what the audit does not do and what the auditor has not done.
- Audit reports need to include a report on the auditor's conclusion in respect of all the elements that the standard audit delivers, whether these are matters of positive or negative assurance. All too often the breadth of the auditor's work is not made apparent in the report, which again does the profession a disservice.
- The auditor should provide more discussion that is specifically relevant to the company. Our thoughts in this respect are considered in more depth below.

We believe that audit reports which deliver this will be of substantially more value to all users of financial reporting. We do not believe that there are users for whom such communication would not be of value – though because of the perception gap there are many who currently ignore audit reports.

In addition we ask you to refer to the table above for a more detail description of the types of enhancements we would like to see.

31 b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

While the proposed enhancements may result in marginally increased costs we firmly believe that the benefits in terms of increased confidence in corporate reporting outweigh the costs involved in such additional regulation.

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

We make the proposals outlined in this response, and particularly in the table, in the fundamental belief that this will change the dynamic in the relationship between the auditor and the audited entity, and both its management and those charged with governance. We believe that enhanced disclosure requirements of the various parties on the crucial areas of accounting and audit judgment will ensure that these issues receive greater and more appropriate attention from all parties, including investors. The dynamic this will introduce to improve reporting quality will be significant, and it will have a similar upwards pressure on audit quality also. This will increase investor confidence in individual company reporting and the market as a whole. We firmly encourage the PCAOB to take these steps to capture these very significant benefits.

Yours faithfully

Darren Brady
Manager