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Office of the Secretary
PCAOB
1666K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 034

Proposed Auditing Standard – "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards" ("reproposal")

Hermes EOS welcomes the opportunity to provide our comments on this consultation on PCAOB's reproposal of the auditor reporting standard.

By way of background, Hermes is an asset manager in the City of London, and is wholly owned by the BTPS, one of the UK's largest corporate pension schemes. 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 PNO Media (the Netherlands), and VicSuper (Australia). In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over $252.5 billion (as at 30 June 2016).

We welcome the PCAOB's reproposal of the auditor reporting standard, which would retain the pass/fail opinion of the existing auditor's report but would make significant changes to the existing auditor's report, including the communication of critical audit matters arising from the audit and new elements related to auditor independence and tenure.

The auditor's report is the primary means by which the auditor communicates information regarding the audit of the financial statements to investors and other financial users. As currently designed, however, the auditor's report conveys almost no information obtained and evaluated by the auditor as part of the audit. The report features boilerplate language, that largely remains the same regardless of the risks a particular company might be dealing with or the specific problems that auditors encountered in performing the audit.

The reproposal will certainly enhance the form and content of the Auditor's Report, by making it more relevant and informative to investors and other financial statement users. In the UK[1], investors (like ourselves) have welcomed extended auditor reporting, and greatly value the enhanced information it provides.

[1] In June 2013, the Financial Reporting Council ('FRC') revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code. In April 2016, the FRC adopted a final rule updating its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, including the IAASB's definition of key audit matters.

In addition, the reproposed standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which would be based on work the auditor has already performed.

Critical Audit Matters

Board of directors and audit committee oversight of the financial reporting process can further reduce the information asymmetry by enhancing the quality of the information disclosed. The communication of critical audit matters would inform investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgement, including the principal considerations for determining the matters and how the matters were addressed in the audit.

The communication of critical audit matters in the auditor's report would also help investors and analysts who were interested in doing so engage management with targeted questions about these issues. In the UK, we increasingly use the information provided in the expanded auditor's report to engage with audit committees.

In its latest report on this issue[2], the FRC notes that investors greatly value the information provided in expanded auditor reporting. It adds to the mix of information that can be used in investor's capital allocation and engagement decisions. We would endorse the following findings:

"In the second year of expanded auditor reporting in the UK, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's report provided discussion of significant risks that were more tailored to the company under audit, thus avoiding generic or standardized wording."

Determination of Critical Audit Matters

Definition of Critical Audit Matter

..any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts and disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgement.

Under the reproposal, critical audit matters would be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). Investors are interested in matters of this nature that are resolved directly with management, without necessarily being communicated to the audit committee.

Therefore, we would prefer disclosure of matters communicated with management and non-executive directors, beyond the audit committee members. The IAASB's standard requires the auditor to communicate key audit matters selected from matters communicated with those charged with governance[3].

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[2] FRC - Extended auditor's reports – A further review of experience – January 2016

[3] Role of persons entrusted with the supervision, control and direction of an entity: highest level of management including the executive and non-executive directors and the audit committee.

Factors

A factor based on the extent of interaction with the audit committee can be a meaningful indicator and be useful information for the investor.

Because the determination of critical audit matters is principles-based, the standard does not contemplate circumstances or matters that, if present, would always constitute critical audit matters. To illustrate, revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks; however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgement, it would not be a critical audit matter.

Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, the information provided is useful in evaluating financial performance and highlighting these differences is informative. Prior period critical audit matters are important information for investors, so we would prefer to keep the 'should consider' requirement in reproposed standard.

Communication of Critical Audit Matters

The communication of critical audit matters may help focus the audit committee's oversight efforts. By assessing what is critical and therefore required to be communicated there is likely to be a debate, allowing the audit committee to engage more effectively with the auditor and management about the matters identified as possibly critical audit matters and the adequacy of the company's related disclosures.

The introductory language is clear that the auditor is not providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

Elsewhere, including audit procedures in the description of a critical audit matter would definitively make the auditor's report more informative and useful.

Given the experience in the UK, having no critical audit matters should be extremely rare.

Liability Considerations Related to Critical Audit Matters

The communication of critical audit matters is about disclosure of risks and challenges. We believe that non-communication of such matters would be more problematic from a litigation point of view.

We trust that our comments are useful and we are very happy to discuss any of the points that we have raised with the PCAOB further. Please contact roland.bosch@hermes-investment.com should you wish to do so.

Yours faithfully

Roland Bosh