

Hermes Investment Management and Hermes EOS response to FRC Consultation on Revision to Ethical and Auditing Standards 2019

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About Hermes Investment Management and Hermes EOS

Hermes Investment Management is an asset manager with a difference. Our purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services. With £36 billion¹ in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £501 billion² on behalf of over 40 international institutional investors. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients.

Our response

Question 1: Do you agree with the revised definition of an 'objective, reasonable and informed third party' and with the additional guidance on the application of the test?

We agree with the revised definition, in particular the focus on the perspective of stakeholders who are the ultimate beneficiaries of assurance, and the additional guidance on application of the test.

Question 2: Do you agree with our proposed measures to enhance the authority of Ethics Partners, and do you believe this will lead to more ethical outcomes in the public interest?

Yes, we are supportive of requiring instances where the firm does not follow the Ethics Partner's advice to be reported to the firm's independent non-executives and the firm's Competent Authority. This should include instances where the Ethics Partner was not

¹ Source: Hermes as at 30th June 2019

² Source: Hermes as at 30th June 2019

consulted on a timely basis about relevant matters, for example regarding the level of independence threats associated with non-audit fees for listed entities exceeding audit fees.

Question 3: Will the restructured and simplified Ethical standard help practitioners understand requirement better and deliver a higher standard of compliance? If not, what further changes are required?

We do not have anything to add on this question.

Question 4: Do you agree with the introduction of a permitted list of services which the auditors of PIE audits can provide?

We agree that the fees earned from audited entities for non-audit work raise concerns about independence, even with the 2016 reforms, and we support moving to a specific list of permitted services related to audit or required by UK law/regulation to ensure clarity. This is an important step in improving auditor independence, and perceptions of auditor independence. We would support such a measure even if the operational split proposed by the CMA is enacted, as an operational split may apply only to the largest firms, and it is important that full clarity is provided on what can and cannot be provided by the non-audit arm of a multidisciplinary firm. We understand that this approach has worked well in the Netherlands, where there is a complete ban on providing advisory services to audit clients except for the 'whitelist' of assurance services.³

Question 5: Do you agree with the additional prohibitions we are proposing to introduce – in learning from the experience of enforcement cases like BHS, if the more stringent PIE provisions are to have a wider application to non-PIE entities, which entities should be subject to those requirements?

Yes, we agree with the additional prohibitions, and the definition of entities of significant public interest in addition to PIEs.

Question 6: Do you agree with the removal of the reliefs for SMEs in Section 5 of the Standard, and the retention of reliefs for 'small' entities (in Section 6 of the Standard)?

We do not have anything to add on this question.

Question 7: Do you agree with the proposed removal of the derogation in the 2016 Ethical standard which allowed for the provision of certain non-audit services where these have no direct or inconsequential effect on the financial statements?

Yes, for the purposes of clarity we agree with the proposed removal.

Question 8: Do you agree with the inclusion of FRC staff guidance within the application material, and has this improved clarity of the requirements?

We do not have anything to add on this question.

Question 9: Do you agree with the inclusion of FRC staff guidance within the application material of the auditing standards, and has this improved clarity of the requirements?

³ Article 24 Law on Oversight Audit Firms (Wet toezicht accountantsorganisaties) and Article 16 Dutch Code of Ethics (Verordening inzake de onafhankelijkheid van accountants by assurance opdrachten)

We do not have anything to add on this question.

Question 10: Do you agree with the changes we have made to ISAs (UK) 700, 250 A and 250 B, including the extension of the requirement for auditors to report on the extent to which their audits are capable of detecting irregularities, including fraud.

As noted by the FRC, further revisions may be required as a result of the Brydon review, but we agree that auditors' responsibility to detect material fraud already exists as per ISA (UK) 240 and the FRC Statement of the auditor's responsibilities, although the application of those requirements is not always given sufficient focus. Auditors should start with the assumption that revenue may be materially misstated due to fraud and to perform appropriate audit procedures in response to this and other identified fraud risks. Under auditing standards, auditors are responsible for providing reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. This requires auditors with sufficient experience to identify potential instances of fraud in the financial statements. Our understanding of the challenge is that detection of material fraud is often not seen by auditors as an integral part of the audit.

We are therefore strongly supportive of the requirement added to ISA (UK) 250 A 13-1 that when performing risk assessment procedures the auditor should consider whether there are any indications of non-compliance with laws and regulations, and whether potential consequences for the financial statement, such as a fine, are accounted for. We agree that the ISA (UK) 700 requirement for auditors of PIEs to report on the extent to which their audits are considered capable of detecting irregularities, including fraud, should be extended to all audits. The incorporation of more detailed guidance in ISA (UK) 700 on reporting irregularities, corresponding to non-compliance with laws and regulations in ISA (UK) 250, is welcome and should encourage auditors to report in a manner that is useful to users of accounts.

Question 11: Do you agree with the proposed additional auditor reporting requirements, including the description of significant judgements in respect of Key Audit Matters and increased disclosure around materiality?

We would be very supportive of requiring auditors to describe the significant judgements made in respect of how Key Audit Matters were addressed in the course of the audit, particularly in relation to any discussions between the auditor and management or the Audit Committee. In particular, we would like to see auditors describing any issues where they have challenged management in circumstances where the accounts may be technically compliant with IFRS, but where they believe that the relevant treatment may be imprudent, fail to provide a true and fair view or both.

Shareholders want to see the engagement of the Audit Committee and the auditor's willingness to challenge management. More transparency around the communication and resulting judgements between auditor and Audit Committee would therefore be useful for users of accounts. Greater continuity between reports in relation to Key Audit Matters that had been disclosed in the previous year would also be useful to users of accounts. Increased auditor requirements could move audit reports further away from boilerplated language towards detail on the specific problems faced by the company and by the auditor in preparing the accounts.

We have expressed support of graduated findings in our response to the Brydon review. The use of graduated findings and increased narrative disclosures on interactions with management and the Audit Committee would be an opportunity for auditors to show how they had challenged management and how this was reflected in their report.

Enhanced disclosures in respect of materiality, including the specification of performance materiality (which is affected by the auditor's understanding of the entity based on risk assessment procedures, including their view on the effectiveness of internal controls in the entity) would be welcome. Given that we believe audit should be conducted for the benefit of investors and wider stakeholders, we would be supportive of auditors' views on the effectiveness of relevant internal controls being reported publicly, not just to audit committees. The auditor should understand the business inside out, and accordingly be able to provide scrutiny of the internal controls.

Question 12: Do you agree with the revisions we have made to ISA (UK) 720, including the enhanced material setting out expectations of the auditor's work effort in respect of other information?

Yes, the revisions should provide greater clarity on the expectations of auditors' work effort in respect of other information and aligning the standard with proposed revisions to ISA (UK) 570 on *Going Concern* to both auditors and users of accounts. In particular, the inclusion of the auditor's views on whether the information on going concern and viability is consistent with the financial statements and the auditor's knowledge obtained in the audit is very welcome.

Audit should also play an important role should its remit be widened to provide assurance on the wider corporate reporting framework. There may be some areas in which assurance might be delegated to specialists, for example in relation to cyber risk. As noted by the FRC, this should be reviewed further after the results of the Brydon review.

Question 13: We are proposing changes to the standards to be effective for the audit of periods commencing on or after 15 December 2019. Do you agree this is appropriate, or would you propose another effective date, and if so, why?

We do agree that this is appropriate, as long as clarity is provided far enough in advance that companies and audit firms have time to prepare.