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Dear James

Consultation Paper – A Framework for Audit Quality

We welcome the opportunity to comment on the IAASB's consultation paper *A Framework for Audit Quality*. We agree that the issues raised in this document are of crucial importance in rebuilding lost confidence in the value and effectiveness of the audit process and of the auditing profession. Having greater clarity about the drivers of audit quality and firms' delivery against these will be of significant value for the profession but also for all those who interact with it, including audit committees and investors.

By way of background, Hermes is a leading fund manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of many long-term institutional investor clients from around the world. In all, EOS advises clients with regard to assets worth a total of \$195 billion (as at March 31 2013).

It will be clear from our comments below that we believe more attention needs to be given to audit firm business models, and particularly the shape of audit teams. We are concerned that there may not be sufficient team members between the senior audit staff and the juniors properly to deliver scepticism in practice. We would welcome greater focus being applied to this issue, both in the audit quality framework and within audit firms generally.

We answer the specific questions below.



Question 1 – Does the Framework cover all of the areas of audit quality that you would expect? If not, what else should be included?

We believe the Framework is helpfully comprehensive and that it appropriately addresses relevant aspects of audit quality. But we would argue that one area which should be given a greater degree of focus is the issue of audit firm business models, and particularly the shape of audit teams. We are concerned that there may not be sufficient team members between the senior audit staff and the juniors properly to deliver scepticism in practice. Only if the audit team has sufficient individuals with sufficient time, skills and experience will it be possible for scepticism to be delivered in practice. We attach a paper we recently presented to IFIAR which considers this issue. We would also welcome greater attention being given to whether there is an effective progression through an auditor's career so that he or she develops a broad range of capabilities; only if this occurs will we have audit partners with the breadth necessary properly to carry out their role.

Among the places where we think that consideration of these issues might be delivered in the audit quality framework are:

In paragraph 33 – two further bullet points to the effect that “The engagement team has the right mix of skills, experience and seniority” and “The engagement team members have sufficient time properly to deliver scepticism in practice.”

In paragraph 47 – add a further bullet point to the effect that “There is an effective progression through an individual's audit career such that the individual develops an appropriate breadth of capabilities, and audit teams include individuals with a full range of skills and experience.” We recognise that this aligns with section 1.2.2 (The firm promotes the personal characteristics essential to audit quality), but we believe that it adds to this in an important way.

In section 1.4.6 (Partners and staff have sufficient time to undertake the audit in an effective manner) – we would argue that this section needs to be given some active reconsideration as at present it simply notes that there is a potential problem in this respect; it does not outline how that problem can and should be addressed. We would welcome this being extended into a consideration of what firms and individual audit teams should do in order to mitigate the problems that may arise – at the very least there must be a statement to the effect that firms and individual teams need to work actively to do so.

We also argue that there needs to be a focus on exercises of professional judgement in practice as well as the process-driven approach. Among the places where we think that consideration of these issues might be delivered in the audit quality framework are:

In paragraph 42 – add a further bullet point to the effect of “Exercising professional judgement at all relevant points in the audit process.”

Question 2 – Does the Framework reflect the appropriate balance in the responsibility for audit quality between the auditor (engagement team and firm), the entity (management and those charged with governance), and other stakeholders? If not, which areas of the Framework should be revised and how?

It seems to us that the primary focus of the framework is on aspects of audit quality which are visible only to the auditor, and those which may in part be visible to those charged with governance. These aspects are at present largely invisible to investors, though we would welcome over time audit firms giving active consideration to how they can report more fully against the aspects of audit quality in their transparency reporting.

We note one aspect of the framework in this respect which we believe needs significant revision. This is **section 1.7.4** (There are appropriate arrangements with management so as

to achieve audit efficiency). In fact, we do not believe that this has any place in a document considering audit quality; at present it discusses ways in which efficiency can be increased. If this section is to be retained at all – and we would need to be convinced that this should be so – we believe that it needs to be redrafted such that it considers how audit firms can and should mitigate the risks to audit quality to which a drive for efficiency from the audited entity can give rise. This would entail wholesale redrafting.

Question 3 – How do you intend to use the Framework? Are there changes that need to be made to the form or content of the Framework to maximize its value to you?

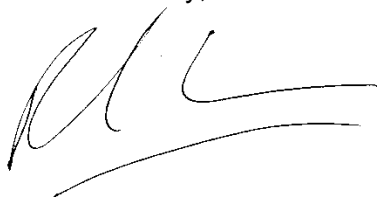
At present the framework is not addressed to investors and would not be of significant value to investors. As indicated above, we would strongly encourage audit firms to give active consideration to how they can report more fully against the identified aspects of audit quality in their transparency reporting. When and if this is delivered over time then the framework may prove of value to us and to all investors.

Question 4 - What are your views on the suggested Areas to Explore? Which, if any, should be given priority and by whom? Are there additional Areas to Explore?

We support the suggested Areas to Explore. We would welcome a particular focus on Area 2, not least covering the issues of firm business models and the make-up of the audit teams, and Area 4, particularly a consideration of how inspections can promote scepticism and judgement rather than compliance. Both topics are considered in our paper for IFIAR, as attached.

We would also note that we disagree wholly with the statement in paragraph 153 that the ultimate objective of the audit is the provision of the audit opinion. The IAASB will be aware of the importance that we place on the audit report and the efforts that we have made to help ensure that audit reports deliver value and are worth reading. Nevertheless, we believe that it is wholly wrong to suggest that the ultimate objective of the audit is the opinion. Rather, the ultimate objective of the audit must be quality reporting by the audited entity. The auditor's role is to challenge, probe and encourage management in order that the reporting which the entity produces delivers a fair and reasonable presentation of the entity's performance over the year and its state at the end of the year. The audit report and the audit opinion are a mechanism to enable this to be delivered; they are of great importance in doing so and are the only element of the audit currently visible to the investors which pay for the audit, but they do not represent an end in themselves.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Paul Lee', with a long horizontal flourish extending to the right.

Paul Lee
Director

Enc: Unleashing and encouraging the sniffer dogs

Unleashing and encouraging the sniffer dogs – presentation to IFIAR, April 2013

More than a century ago, UK judge Lord Justice Lopes made a famous statement about audit: the auditor is "a watchdog not a bloodhound". Inevitably, as in all court cases, he was responding to the specific facts of the case and was trying to manage down the expectations for vigour, aggression and detective work in searching down a problem that was well hidden and buried within the audited entity. Rather than this active and vigorous audit which the plaintiffs were claiming they were expecting, the judge suggested that by the watchdog role he was meaning a largely passive activity, standing ready to respond to identified issues but not being more active than that. He said it was appropriate to assume good faith on the part of executives, as long as the watchdog stands ready to respond if issues come to light. While, more recent cases have more strongly emphasised the need for an enquiring mind, fundamentally Lord Justice Lopes meant that there are limits to the scope of the auditor's activities and the scope of its resources, that it is unfair to expect the auditor to uncover fraud in every instance. Most investors now clearly agree that the costs of expecting the auditor to chase down fraud other than at the top level of a company are excessive compared with the limited benefits which might arise.

With due humility to a respected judge, I do not believe that he has identified the right analogy for auditors. I believe that auditors are neither watchdogs nor bloodhounds, but sniffer dogs. To be fair to Lord Justice Lopes, sniffer dogs did not exist in 1896. But this seems a better image for the role of the auditor: the sniffer dog is there studying, paying gentle attention to the broad spread of what is brought before it. It is in the main a low-key activity, but the level of energy changes when the sniffer dog smells something strange or unusual. And the dog will not - should not - give up until there is clarity as to the nature of that something strange or unusual. In many cases it will turn out to be nothing of concern, but in some cases more investigation will be required. And we expect the sniffer dog not to stop investigating until either a problem is uncovered or there is certainty that no problem exists.

There is a close link here to the current debate on scepticism in the audit. Scepticism is all about this same dogged determination to chase down the trail of something that smells wrong until either it is clear that there is no problem or the problem is wholly uncovered. As the PCAOB puts it, scepticism is an attitude including a questioning mind and a critical assessment of audit evidence. It goes to the core of the audit - and certainly to the core of what investors expect of the audit.

I am sufficiently confident that the auditing standards leave enough scope for the exercise of professional judgement that is necessary to carry forward scepticism in the audit. But for me, there remain two big questions in relation to this investor expectation of the scepticism that the audit should be delivering:

Whether the audit firm business model is now appropriately designed to deliver a properly sceptical audit.

Particularly relevant to this audience - whether the audit inspection regimes are effectively designed to encourage effective scepticism in the audit.

Audit firm business models

Increasing numbers of companies rail about the quality and nature of their interactions with their auditors. Their experience largely involves junior staff, a number not yet qualified, hidden silently behind laptop screens going through checklists. And at times these checklists further undermine corporate confidence in their auditors, as company secretaries and finance

teams complain that they are asked questions and for documentation which makes no sense and fundamentally misunderstands their business, or indeed business in general.

Alongside this low-level work is the dialogue between the audit partner and the audit committee. But companies - and indeed investors - suspect that there is only limited joining up of these two sides of the audit process. And this gap between the tick-boxing and the top-level dialogue leaves little scope for scepticism, little scope for the sniffer dog following up on something that does not smell right. It is clear that the junior staff hidden behind their laptops will not deliver that necessary questioning and scepticism; they certainly do not seem to walk the floors and talk with staff, so that they can uncover situations where the numbers that they do look at so intently do not measure up to how the company seems on the ground. Of course the audit partner is expected to join these things together and bring the tick-boxing work into the real world; but the partner will never be the individual with the capacity to have the conversations across the organisation that the physical embodiment of scepticism requires.

Audit firms and others worry that they are not developing audit staff with the breadth of experience that they are seeking. This seems to me to be the other side of the same coin - that there are not enough staff between the audit partner and the tick-boxing juniors who are carrying forward the genuine audit work, the audit work that investors actually care about, the scepticism which may uncover the issues which one expects the sniffer dog to find. It is these people in the middle - the meat in the sandwich - who will in time develop into the quality audit partners that we need in the future. That current audit partners themselves complain that such individuals are not coming through the system is a stark demonstration indeed that there is something very wrong with the business model.

The combination of these two sets of concerns and perspectives on the current nature of the audit business model give rise to a fundamental concern. For a good and effective, sceptical audit, there need to be empowered and skilled people in between the audit partner and those doing the computerised audit methodology. It is these empowered and skilled people who are the personal embodiment of the sniffer dog, the personal embodiment of scepticism. Do we have enough of these people? Does the current audit business model allow there to be enough of these people?

Inspections encouraging the sniffer dog

Audit firms complain that the inspection process risks undermining quality in the audit by an over-focus on the paperwork and the detailed requirements on sampling and so on. As an outsider to the process I can never know whether there is any truth in this complaint. It would clearly not be helpful if inspections focus on procedural minutiae rather than the big and very important picture of encouraging scepticism within the audit. Not knowing the inside nature of the inspection process, I will just set out what I think may be the right route for inspections to be designed and delivered in order to foster and encourage scepticism - how inspectors can unleash and encourage the sniffer dogs.

An inspection designed to foster and encourage scepticism would seek out evidence of scepticism in practice. That will be much less a question of the specific paperwork and much more an insight into the active and, one hopes, intelligent mindset of the audit team throughout the process. Given that inspection is inevitably an after-the-fact activity, the insight into the mindset of the audit team can only be uncovered through dialogue with the team - interviews as to their perspectives on the company. I was very struck by hearing the

comment from an audit partner who was subject to inspection by both the US's PCAOB and the UK's AIU, who said very clearly that the individual interview with the PCAOB was rigorous and felt like a much tougher inspection than the more paper-based approach of the AIU. This has to be the more effective way forwards.

To foster scepticism, inspections need to test the application of critical and professional judgement in all aspects of the audit, from the initial assessment of risks, in the audit planning process, and at all stages of the audit itself. Inspections need to seek comfort that there is enough space, scope and time - and enough appropriately skilled and empowered staff - to follow up on questionable issues that arise in the audit process so that scepticism can in fact be exhibited in practice. They also need to seek insight into how the audit partner and other senior staff encourage and support the exercise of scepticism and professional judgement throughout the audit process.

And to encourage scepticism, inspections must focus on understanding how the sniffer dog trails were followed and what was the process by which resolution was reached, whether finding that there was no underlying problem or uncovering the substance of the problem. Scepticism and professional judgement will only flourish if it is rewarded and encouraged by the inspection process. Certainly it must not be undermined by the inspection process. That must be in the minds of all who design inspection processes.