

July 3rd 2012

Public consultation on the governance of the Monitoring Group, the PIOB and the standard setting boards and Compliance Advisory Panel operating under the auspices of IFAC.

We welcome the opportunity to comment on this current consultation. We believe that the role of the audit profession is crucial in maintaining public confidence in company reporting, and that therefore the governance and independence of the standard-setting boards for the profession are of similar crucial importance.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service, we also respond to consultations on behalf of many clients from around the world. In all, EOS advises clients with regard to assets worth a total of \$138 billion.

On behalf of these clients, which as long-term owners of companies have an interest in seeing that those companies report openly and honestly, we have been actively engaged in the public policy debates in relation to both accounting and audit standards. We have participated in public consultations by the IAASB and in private dialogues with its representatives, and an EOS staff member has been a member of the UK's Auditing Practices Board for the past several years.

The following comments are informed by our active involvement in these standard-setting processes.

The structure: objective, legal nature and name

Q1: Do you consider it necessary to enhance representation of the public interest? If so, which additional actions, apart from the appointment of an independent IESBA Chair and redefining the nature of non-practitioner board members, would you suggest to reinforce the mechanisms to safeguard the public interest?

We believe that over time the boards and standard-setting must shift from within IFAC, an organisation whose role is to promote the interests of the profession, to more independent structures. We see the appointment of an independent IESBA chair and redefinitions around the non-practitioner board members as steps in a positive



direction, but they must not be the end of the process. Not only must over time all the boards shift to being dominated by non-practitioners rather than practitioners as well as having fully independent leadership, but the structures must also shift to much greater independence. Being within IFAC is not consistent with full independence.

Q2: In the long term, would you favour a different and fully independent standard-setting model completely outside the IFAC structure and if so how could such a structure be funded?

As outlined above, we certainly believe that standard-setting must shift outside the IFAC structure. As for funding, it has never been clear to us why the audit profession's funding of standard-setting that helps retain public confidence in the profession – and so the continuation of the profession and its ability to charge professional fees – should be tied to the standard setters remaining within IFAC. We believe that the independence of the standard-setting process is necessary to retain market confidence, and this is in the profession's interest; independence can be maintained structurally no matter what the funding arrangements might be.

Q3: Do you consider the current three-tier system adequate for achieving its objectives, or an alternative model could be more adequate? In the latter case, which model would you suggest?

We have come to recognise and support the three-tier structure which is applied at the IASB, where the Trustees of the IFRS Foundation have responsibility for the governance of the standard-setting board and the monitoring group oversees the high level public interest. We would welcome this approach applying to the IFAC boards as well. As we have indicated above, we believe that these boards need to move out of IFAC and therefore the nomination processes need to be run, not just overseen, by the PIOB or a successor organisation. Indeed, there may be some scope for streamlining by bringing the IFAC boards (perhaps all but at least some of them – see below our comments with respect to IPSASB) under the two upper tiers currently overseeing the IASB.

Q4: Would you support the IPSASB being subject to PIOB oversight? Why? What conditions, if any, would you impose on such oversight? Would you see as a factor to take into account the fact that IPSASB deals with accounting rules instead of auditing ones?

It is a clear anomaly that the IPSASB is not subject to any independent oversight. We firmly believe that the solution that the consultation hints at for the long term, of the IPSASB sitting within the IFRS Foundation, should instead be pursued in the near term as the most appropriate structure and framework for assuring the appropriate oversight framework for the IPSASB and the standards that it sets. If this is not possible in the near term, we would be content for the IPSASB to be subject to PIOB oversight, but only so long as this was understood to be a purely transitional process to a more appropriate structure in the medium term. There would be some significant value in active consideration being given to whether there is a need for a temporary addition to the skillsets on the PIOB for this interim period.

Q5: Do you see merit in having a “Compilation document” for the whole structure? In this case, which alternative would you prefer for organising the structure and nature of the Compilation document?

We believe that a single document making clear the structures and processes would be worthwhile, and believe that this may best be delivered through a standalone charter.

Q6: Given the breadth of the current mandate, would you consider it helpful to modify the name of the structure to improve its visibility? In this case, what name would you suggest?

A change of name would be a natural part of the process of divorcing these activities from IFAC. As indicated above, we believe that this is necessary and would welcome the name changing at that point. As brief a name as possible would be welcome.

Bodies in the structure

Q7: Do you agree with the proposal that the MG should have a more strategic role?

This has been an active debate in relation to the IASB and IFRS Trustees; we believe that there need to be clear limits on the role of the Monitoring Group so that it does not generate concerns as to inappropriate influence on the independence of standard-setting. If the Monitoring Group does raise agenda items then it needs to do so only rarely and fully in public. It would be best that the PIOB (or whatever other second tier is in place) has clearly effective processes for ensuring the independence and efficiency of the standard-setting boards than that the Monitoring Group should intrude itself into the PIOB’s activities on an ongoing basis.

Q8: Do you agree with the objectives proposed and, specifically, with the MG having the possibility of conferring with the PIOB on the PIACs’ agendas and receiving appropriate feedback?

We believe that this needs to be handled with care; the PIOB should have the role of assuring the independence and effectiveness of the agenda-setting by the standard-setting boards. Only rarely and in extreme circumstances should the Monitoring Group intrude in this way – and it should do so in public so that this activity is fully accountable.

Q9: Do you agree with the suggested ways of improving the communication activities? Would you consider it useful for the MG to have in the special occasions above described direct involvement with PIACs?

We agree that the Monitoring Group should be more open and transparent. In particular, we strongly welcome the suggestion that it seek direct contact with stakeholders, especially investors. We are concerned that any direct contact between the Monitoring Group and the standard-setting boards might interfere with the proper role of the PIOB or whatever other second tier is in place, and so believe that this contact should be avoided or minimised.

Q10: Do you have any specific suggestions on how liaison with investors could be improved? In this sense, do you see merit in some portions of the MG meetings having the public in attendance?

We believe that the only practical way to make this happen is to seek direct dialogue with those small groups of investors which take an active interest in these issues. We do not believe that public meetings will be of practical value.

Q11: Would you find it useful that the MG engages with organisations representing governmental institutions? Would the G20 be the most appropriate or, should others bodies be considered instead?

We believe that this would be helpful and that the G20 would be the most appropriate body for it.

Q12: What is your opinion about the current composition of the MG? (i) Do you believe that other organisations (i.e., national or regional regulators) should or could be represented in the MG? If so, which criteria do you think new members should fulfil to become MG members? (ii) Should a maximum be set to the number of MG members? (iii) Would you favour a change on how the Chairperson is appointed?

We are content with the current composition.

Q13: Do you see a problem in MG members appointing full time employees of organisations represented in the MG as PIOB members?

Q14: Would you consider convenient to avoid direct hierarchical relationship between the PIOB and the MG members?

Not least for the reason of internal hierarchy, we would favour the PIOB being much more clearly separate from the Monitoring Group such that its role in the oversight structure is more clear and it is more clearly able to ensure the independence of standard-setting. Thus we do not believe that PIOB members should be full-time employees of organisations represented on the Monitoring Group, not least for the reasons of hierarchy.

Q15: Do you think that the roles and responsibilities of MG and PIOB should be further clarified? Do you have specific suggestions regarding which areas this clarification should address?

We would welcome further clarification. As indicated above, we believe that the Monitoring Group's role is to assure public accountability of the structures, and the PIOB's role is to ensure independence and effectiveness of decision-making. We believe that these organisations also need the standard-setting boards to be divorced from IFAC for this to be effective and their roles to be more clear.

Q16: Do you see merit in the PIOB undertaking a regular review of its due process and oversight framework through its strategy document?

Yes, we would welcome this.

Q17: Do you see merit in the PIOB periodically producing a strategy document that would supplement the yearly business plan and budget? What should the involvement of the MG be in the production of these documents?

Yes, we would welcome this. The documents must be those of the PIOB but there should be some scope for challenge and debate of proposals by the Monitoring Group.

Q18: Do you think that the current composition of the PIOB could be enhanced? Would you consider convenient that the PIOB's composition is reviewed each time a new body becomes full member of the MG?

We believe that there is scope for enhancement, by making the PIOB much more clearly separate from the Monitoring Group. We agree that reviewing the composition regularly, and certainly when the PIOB's responsibilities change, is necessary.

Q19: Would you consider the current composition of the PIACs appropriate? Do you see merit, in the context of a second effectiveness review, in exploring the idea of having a majority of non-practitioners and a majority of public members?

There is an assertion early in this section of the consultation that deserves more consideration rather than being dismissed. The discussion on 'Role' in effect says that standards in these three areas need to be set and that therefore "there is no doubt" about the need for three boards. We believe that there would be some value in a fuller questioning of this. While agreeing that standards do need to be set in these three respects, it is not necessarily as certain that this requires the existence of three separate boards to carry out this work. We would welcome the Monitoring Board and PIOB giving active consideration as to whether the infrastructure could be simplified (and perhaps costs reduced) by a streamlining of the boards. In particular, we believe that there must be active consideration given to whether educational and ethical standards could be set by subcommittees of the IAASB rather than requiring the infrastructure and complexities of three separate boards – or whether the three boards could be reduced to perhaps two in some way. We do not take a decided position on this, but we think it needs to be considered and not dismissed as the current consultation implies.

We would welcome active consideration being given to requiring that a majority of the boards be non-practitioners and public members.

Q20: Do you consider best practice a nine years period for rotation of the representatives of CAG member organisations?

Yes we agree that this is best practice.

Funding

Q21: Would you agree that it is not realistic at the current time to attempt to alter the funding structure of standard setting activities in any substantial fashion?

We agree that this is right.

Q22: Do you consider appropriate that IFAC finances the largest part of the PIOB budget? If not, do you consider appropriate that IFAC launches an external fundraising having some contributions of the MG members in the mean time?

As indicated above, we believe that one of the major beneficiaries of fully independent standard-setting in this area is the audit profession as it benefits from public confidence that it is genuinely a profession working to independently set high standards. This enables auditors to charge professional-level fees and have a high standing in the business community. Thus, while we believe that the standard-setting boards need to be divorced from the IFAC infrastructure we do not agree that this necessitates a shift from the current funding model. As long as the structures are in place to maintain genuine independence, funding from IFAC is appropriate. Over time, we would welcome other bodies providing portions of the financing, and believe that the IFRS Foundation model is a good one – indeed, as indicated above, some greater coming together of these structures may make sense.

Q23: Do you think it feasible to have a similar funding structure in place for the PIOB to that in place for funding the IFRS Foundation?

Over time, yes. One natural step may be over time an integration of the two bodies.

Q24: Do you see the need for and/or merit in having a permanent Secretariat for the MG? In this case, do you think IOSCO should provide resources for a permanent Secretariat to the MG?

No. We do not believe that the Monitoring Group's role should be so substantial as to require a permanent secretariat.

Final questions

Q25: How do you think the governance of the international auditing, ethics and education standards setting process could improve audit quality? What are the main objectives that those responsible for governance should take into account?

We believe that the issue of audit quality needs to be addressed now by considering fundamental questions such as scepticism, training, the structure of audit teams and behaviours within the audit process. These require fundamental reassessments of the current approach and we believe that this will be difficult while the standard-setting boards sit within the IFAC structure, and addressing this is likely to be a pre-requisite for genuine progress on many of the drivers of audit quality going forwards.

We note that the consultation refers to the possibility of assurances being given in relation to fraud or to responsible behaviour with regards to environmental, social and governance matters. We do not believe that audit quality will be enhanced by distracting attention in these directions and would welcome the profession and its standard-setting boards focusing first on delivering quality within the core responsibility of the audit profession – the audit of financial reports.

Q26: What is your opinion about the current structure? Do you think the current structure is appropriate in order to improve audit quality? If not, what changes, suggestions or remarks would you propose?

As indicated above, public and particularly investor confidence in the standard-setting process and the standards themselves requires the divorce of the standard-setting boards from IFAC. This would give the boards the best chance to assess issues independently of historical precedent and give a firmer basis for rethinking certain issues from the fundamentals.

Q27: Do you agree that the current levels of empowerment and responsibility of the bodies that compose the current structure (MG, PIOB and PIACs) are appropriate? If so, do you have any suggestions for improving the dialogue and interaction between the different bodies? If not, how these levels of empowerment and responsibility could be improved?

As indicated above, we believe there needs to be a clearer demarcation of the roles of the PIOB from the Monitoring Group such that it can deliver its role of ensuring the independence of the standard-setting process. This demarcation should ensure that interactions between the PIOB and the Monitoring Group need to be formal rather than the informal relations which are facilitated by the current representation of Monitoring Group organisations on the PIOB – we believe that such formality would have some real value.

Q28: Do you think that there is any other overall structure that could achieve improvement in audit quality more efficiently? If so, what could they be and how might they be financed?

We believe that the following routes need to be actively considered:

- Whether there is a need for separate boards for audit, educational and ethical standards, or whether these could be carried out by a single board with subcommittees. We believe that this is worth considering not just for the potential cost benefits but because of the advantage in streamlining standards themselves and ensuring consistency between them.
- A closer relationship or integration with the IFRS Foundation, its trustees and its Monitoring Group. Certainly we believe that this is the natural home for IPSASB (and would note that the negative response to the IFRS agenda consultation regarding public body accounting standards is likely to have been driven more by a concern not to allow the IASB to become distracted than by the view that

public accounting standards are unimportant or satisfactory as they stand); we believe that it may also make sense for the IAASB and other standard-setting boards (or subcommittees). This might simplify the funding challenge as well as allow economies of scale in the oversight and governance processes.

- Given the importance of high quality standard-setting and regulation to the long-term future of the profession we believe that the bulk of the funding for the standard-setting boards should come from the profession, notwithstanding a divorce of those boards from IFAC. Other professions and businesses fund their regulators and standard-setters and we believe that, provided the structures ensure independence, this should not harm the effectiveness of standard-setting.