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**By email only**

5 December 2018

Dear Mr Hayter

**Statutory Audit Market Study**

We welcome the opportunity to engage with the CMA in its review of whether the statutory audit market is working as well as it should.

HSBC is one of the world's largest customers of audit and non-audit services, with audit fees in 2017 of \$84.8 million. We are listed on the London (FTSE 100), Hong Kong, New York, Paris and Bermuda stock exchanges. Our four global businesses serve more than 38 million customers worldwide through a network of around 3,800 offices in 66 countries and territories.

The executive management team have the principal responsibility for ensuring an effective system of internal controls over financial accounting and reporting is maintained and for the accuracy and quality of financial reporting. The non-executive audit committee (AC) also plays a critical role in ensuring that the financial information we report is relevant, accurate and understandable.

Our auditors play a key role in ensuring we are able to provide our investors and other key stakeholders (including our regulators) with accurate financial information. Our audit firm needs to have a global footprint that matches our own, with sufficient breadth and depth of expertise – covering both audit and non-audit services – in our material jurisdictions. There are very few audit firms globally that can meet our requirements.

It is important that the regulatory framework ensures proper accountability for management, ACs and audit firms. We believe the UK could learn from the approach of the US Securities and Exchange Commission (SEC) and the Public Companies Accounting Oversight Board (PCAOB) in this regard. We welcome the Kingman review, and we trust that the CMA and Sir John Kingman will work together to deliver a joined up review of competition and regulation in the statutory audit market.

Finally, we would highlight that we view quality and choice in the audit market on a global basis. It is important that the CMA takes into account the global nature of the market when considering the impact and effectiveness of any proposed remedies; and that it seeks to avoid

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any outcomes that could put UK listed companies at a competitive disadvantage to their non-UK listed global competitors.

In the submission enclosed with this letter, we expand on the issues discussed on the call with Chris Jenkins on 22 November 2018. We briefly comment on the characteristics of the market identified by the CMA, since a proper exploration of these is essential to identifying remedies that will deliver the desired outcome of high quality audit that is fit for purpose. We then comment on the potential remedies identified by the CMA and others we think the CMA could consider.

We oppose structural remedies or a ban on audit firms providing non-audit services. We are not of the view that such remedies will deliver the desired outcomes.

We would be very happy to meet again with the CMA to discuss any of the points raised in this letter.

Yours sincerely

**Iain Mackay**  
**Group Finance Director**

**Jonathan Symonds**  
**Chair of the Group Audit Committee**

CC: Dr Andrea Coscelli, CEO  
Chris Jenkins, Economics Director

## **CMA AUDIT MARKET STUDY – HSBC RESPONSE TO INVITATION TO COMMENT**

### **1. CMA themes/characteristics of the market**

#### **a. Scope and purpose of audit**

The scope of the audit is key to the issue of whether statutory audit is delivering good outcomes for investors, who are the ultimate consumers of audit services, and other users of the audit report. We share the concern identified that there is an expectation gap between auditors' actual responsibilities and what some investors expect. We also think the financial statements themselves leave an expectation gap, as they have become too technically complex.

We believe the relevant authorities should consider the case for expanding the scope of statutory audit and assurances obtained by audited companies to cover other areas including certain non-financial information which and, for regulated entities, certain regulated metrics.

We recognise that this issue is beyond the scope of the CMA's review. We welcome nonetheless that the CMA intends to consider the impact of international standards on outcomes.

#### **b. Incentives**

From an HSBC perspective, we do not consider there is any misalignment of incentives between our management, audit committee (AC) and auditors. Our management and AC take very seriously their duties to the company and its shareholders – and welcome the challenge our auditors PwC are able to deliver. When we last tendered for audit services in 2013, PwC's expected ability to deliver new scrutiny and challenge to management was key to our decision to switch auditors, despite the cost and other resources involved in doing so.

The HSBC AC plays a key role in the selection and appointment of auditors and ensuring the ongoing quality of audit services received. We welcome the measures already adopted by the (then) Competition Commission and the EU to strengthen the role and responsibility of the AC. We would caution against any measures which would dilute or shift responsibility away from management or the AC (e.g. to an external body or third party representative), which we think is more likely to damage outcomes for investors rather than improve them.

#### **c. Choice and switching**

As noted, there are very few audit firms globally that can meet HSBC's requirements. Our audit firm needs to have a global footprint that matches our own, with sufficient breadth and depth of expertise in our key jurisdictions; suitable financial sector experience; and a sustainable pipeline of experienced staff and partners to meet our needs over the duration of the appointment. Our audit firm also needs to have the ability to draw in non-audit expertise in key areas (see further below).

[CONFIDENTIAL] did not all have the depth of experience required across our key jurisdictions, and needed to demonstrate to us that they could develop their capability in certain countries or regions. In choosing an auditor, we placed significantly more weight on non-price factors –

including their understanding of HSBC, engagement teams, proposed approach to the audit and strength of the firm – than on price.

We would welcome having greater choice of global firms able to provide us with high quality audit and non-audit services. More importantly though, it would harm us and may put us at a competitive disadvantage were we to have less choice. It is important therefore that any remedies proposed by the CMA do not in practice limit the ability or commercial incentives of audit firms to service the largest audit customers such as HSBC.

The CMA rightly identifies that there are significant costs to businesses of tendering and switching audit firms. These include those the CMA has identified (the tender process, loss of relationship, educating the new auditor and uncertainty in the performance of a new auditor) as well as the steps required to ensure independence of the new auditor, which include termination of certain non-audit relationships and, in our case, transferring banking relationships away from HSBC. When we switched auditors from KPMG to PwC, we expedited our tender process in order to allow for a sufficient transition period (of around a year and a half) for on-boarding PwC. PwC required this amount of time to ensure the required level of independence was achieved.

However, we do not consider the tendering or switching costs to be insurmountable. In our view, the benefits of switching auditor have outweighed the cost and resource involved in doing so.

For a global mandate the size and complexity of HSBC's, the upfront investment required by the audit firm during the tender process and, once appointed, to develop the required understanding of the business is also very substantial. In this context we note that any increase in the mandated frequency of re-tendering is likely to exacerbate the above noted challenges associated with on-boarding a new audit firm.

#### **d. Resilience of the audit market**

[CONFIDENTIAL] Were any of the Big Four to exit the market, not only might this further restrict our choice of audit firm, it would also restrict our choice of firms for non-audit services which in turn would make it harder to ensure the independence of our audit firm is maintained. It would also be very complex to transfer the audit and non-audit mandates of a firm exiting the market to another audit firm, given the requirement for auditor independence.

However this does not mean that these firms should not be held to high standards – they should and the consequences of them failing to meet those standards should be appropriately serious for both the firm and, where appropriate, its employees. It is essential that regulation and supervision of audit firms be robust and effective and that the responsible authority has the statutory and enforcement powers necessary. Action in this respect may, possibly to a very significant degree, obviate the need to consider structural reform of the sector in the UK and thus avoid any misalignment with the international market for such services.

#### **e. Regulation of audit**

We think the current regulatory framework can be improved and we welcome the Kingman review of the FRC. In our view, the UK could learn from the experiences in the US, where the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board

(PCAOB) are much more active in monitoring the quality of services provided by audit firms and taking enforcement action where appropriate against firms and individuals.

We think more timely and robust oversight of audit services is required. We would also support strengthening the regulator's powers to allow it to sanction all firms and individuals responsible for financial reporting. The statutory powers, governance structure and processes and levels of expertise and resources are matters worthy of examination.

Strengthening the regulatory framework in the right ways should help to improve public and investor confidence in audit services, which has been called into question in recent years. It could also mitigate some concerns about misaligned incentives.

## **2. CMA potential outcomes**

### **a. Increasing competition between the Big Four**

We do not think a complete ban on audit firms providing all non-audit services or requiring separation of audit and non-audit businesses would be workable or desirable.

Too much separation of audit and non-audit services risks the long term viability of the audit market and could reduce quality and choice, rather than increasing it as is the aim of this category of remedies. The CMA would need to carefully weigh up these risks against the expected benefits. In particular:

- audit firms that are limited in their ability to provide non-audit services may lose the technical capability required to provide audit services to major clients, which could reduce the quality of audit services;
- it is likely to become less commercially attractive for firms to provide audit services, meaning they may choose not to do so;
- it may also become harder for audit firms to attract and retain talent, if individuals have to choose at an early stage whether to specialise in audit or other areas, which again could reduce the quality of audit services;
- clients could lose the efficiencies that can come from having some non-audit services provided by a company's audit firm.

HSBC already strictly limits the non-audit services we obtain from PwC in order to ensure PwC's independence. For example we obtain little or no tax advice or M&A advice from our auditors, and fees paid to PwC for non-audit services are well below the cap currently provided under EU law. However, there are some non-audit advisory services it is advantageous to be able to obtain from PwC, because of the close connection between these services and the expertise required to carry out our audit. These include the review of quarterly financial disclosures to the markets and annual review of actuarial assumptions behind the valuation of our Present Value in Force insurance asset. Additionally, irrespective of whether we use PwC for such services, it is essential that our audit firm possesses relevant advisory experience in areas such as the valuation of complex financial instruments, so that it can draw on relevant individuals from its consulting business when conducting our audit. It is also essential for our audit firm to possess financial sector experience in areas such as IT, cyber-security and internal control and risk systems.

In principle, some further tightening of the rules on independence by restricting the non-audit services that audit firms can provide to their own audit clients could be made to work. We would note that any such restriction would need to be flexible enough to allow for future changes to the scope of statutory audit services. Preferably it would also allow audit firms to continue to provide certain limited non-audit services where there are clear benefits to doing so and no risk to independence, and we would be happy to discuss with the CMA how this could be defined.

Additionally, given the expansion of the Big Four's businesses into services that are remote from the core business of auditing, we think it would be beneficial to clearly articulate and

reaffirm the role and pre-eminence of audit in supporting high quality financial reporting and the centrality of audit in audit firms' business models.

**b. Increasing competition from non-Big Four firms**

The CMA is considering a wide range of potential remedies under this category. We comment only on those in respect of which we have particular views.

We would welcome developments to the market that would provide us with a greater choice of firms capable of meeting our requirements in respect of audit and non-audit services. For this to happen, one or more non-Big Four firms would need to develop their global footprint, sector expertise, and audit and non-audit capabilities to a very significant degree.

However, we would be very concerned about any measures that may leave us with less choice. We think there is a real risk that some of the remedies in this category may create a perception of more choice whilst in practice limiting the ability or commercial incentives of audit firms to service the largest and more complex audit clients such as HSBC.

*Structural remedies: market share cap, breaking up the Big Four*

A market share cap is a blunt instrument that would limit rather than increase competition. There is a real risk that it could leave one or more of the Big Four unable (or unwilling) to take on an audit client the size of HSBC, which would reduce the already limited choice of audit firms available to us.

Similarly, breaking up the Big Four could limit choice or quality. In practice, we could only engage that part of the firm that remains connected to an international network. However, that firm would be smaller than at present and may be less able to provide the depth and breadth of expertise we require.

*Remedies targeted at audit clients: requiring joint or shared audits or peer review*

Based on our experience in those jurisdictions where some form of joint or shared audit is already required, we would question the benefit of joint or shared audits, compared to the duplication of effort and additional complexity and cost it would entail. For example, in France, where the practice of joint auditors is long standing, [CONFIDENTIAL]. We would be happy to share more detail on our experience in this area with the CMA if that would be helpful.

It is possible that peer review could enhance the quality of the audit and the perception of quality. However, this would need to be carefully scoped and to focus on particular elements such as key accounting judgements. It would of course increase costs and there is a risk that it could result in duplication with limited benefit to shareholders. Nonetheless we feel that peer review merits further consideration by the CMA and we would be happy to discuss with the CMA how this could be made to work.

**c. Improving incentives – addressing misalignment between company, auditors and shareholders**

*Strengthening the AC*

As noted above, from an HSBC perspective, there is no misalignment of incentives. Nonetheless we would support measures to enhance the role of the AC. For example, the CMA

may wish to consider the merits of requiring that the AC includes one independent expert advisor who is not a director of the company.

We would caution against any measures that would dilute or shift responsibility away from management or the AC, such as transferring AC powers to shareholders/shareholder representatives or an independent institution or other third party representative. First, we do not think a third party would be as well placed as a suitably experienced and resourced AC to understand the audit requirements of the company and to determine the audit firm's ability to deliver on quality and sustainability. This is particularly true for large, complex organisations like HSBC. The four non-executive directors who sit on our AC between them have many years' experience in finance, accounting and financial regulation, as well as an in-depth understanding of HSBC's business. Secondly, we think transferring or diluting responsibility away from management and the AC risks creating a vacuum in which no one body is responsible for the appointment and oversight of the auditors, which would be counterproductive.

#### *Improving transparency of the tender process*

We would be broadly supportive of measures to improve the transparency of the tender process, although we would question the practicability of measures such as blind tenders. The CMA will be aware that our 2013 tender process involved a series of fact finding meetings between audit firms and the company prior to submission of proposals; and in assessing proposals, a key factor was the experience of named individuals within the audit firms. In our view a blind tender requirement would have substantially impeded HSBC's ability to choose the best auditors for the job.

#### *Reforming mandatory tendering and auditor rotation*

We believe the current requirement for mandatory tendering at least every 10 years (with requirement to tender or explain from 5 years) strikes the right balance between the costs and benefits of tendering. Requiring companies to tender any more frequently than this would put a disproportionate burden on them and audit firms without delivering any incremental benefit. When we last ran a tender and switched auditors, the tender process and transition period took almost two years and involved significant management time as well as significant resource on the part of the audit firms involved both in the tender process and subsequent transition.

However, there is merit in considering the potential benefits of requiring companies to rotate auditors more frequently than once every 20 years, e.g. every 15 years. There is a risk that allowing companies to retain the same audit firm for too long may damage the credibility of the audit and does not drive quality, efficiency or competitiveness amongst audit firms.

#### *Other measures to address the expectation gap*

One reform that might be considered is greater use of 'long-form' audit reports by companies and their audit firms. The long-form reports may offer the opportunity to provide greater precision around what an audit is, and the aspects of a company's operations in which the audit does and, perhaps more importantly, does not provide assurance. This may go some way to closing the expectation gap referred to earlier.

We note also that in preparing financial statements, our management is very mindful of its statutory obligations under the Companies Act 2006 which, if effectively applied and enforced, should ensure that financial statements are relevant, accurate and understandable. Additionally, our management considers the wider range of stakeholders that may use the



financial statements, including shareholders, pension fund trustees, employees and creditors, and prepares its disclosures accordingly. Nonetheless we note that financial statements have become increasingly complex which may leave an expectation gap.

We think the CMA should consider whether the statutory framework is effective in requiring and allowing companies to prepare financial statements that are understandable and meet the requirements of wider stakeholders. As noted above, where companies are not meeting their legal or regulatory obligations, we would support strengthening the regulator's powers to allow it to sanction all firms and individuals responsible for financial reporting.

#### **d. Wider reform of the sector**

Although we welcome that the CMA is considering wider reform of the sector, we do not think the particular remedies under consideration would be workable for HSBC, given the regulated and global nature of our business.

Insurance would not provide us with the scrutiny and challenge to management that are such a key deliverable of our audit firm. Therefore, whilst there may be some benefit to companies being able to choose to obtain insurance against diminution in the value of their shares, we would not see this as a viable alternative to audit for HSBC and would not therefore support companies being mandated to obtain insurance.

As regards a National Audit Office-style auditor for the UK, we think it would be difficult if not impossible for this body to replicate the expertise we require. Additionally, given the global nature of our business, we might in any case require our global audit firm to audit our UK accounts which would result in duplication and additional cost.