Will Hayter
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By email only

21 January 2019

Dear Mr Hayter

Statutory Audit Market Study

We welcome the further opportunity to engage with the CMA as it seeks to reform the statutory audit market.

We have commented previously on the issues we observe that may impact on audit quality and the choice of audit firms available to us. In the submission enclosed with this letter, we focus on the CMA's proposed remedies.

We are supportive of the CMA's proposals to increase regulatory scrutiny of audit committees. An effective regulatory framework is key to delivering good outcomes for users of financial statements. The CMA's proposal, together with the far reaching regulatory reforms recommended by Sir John Kingman, ought to significantly improve the quality of financial reporting and audit by ensuring proper accountability throughout the financial reporting ecosystem. Alongside these reforms, the Brydon review of audit standards has the potential to propose changes to address the 'expectation gap'.

We oppose the CMA's proposals to mandate joint audit or, in the alternative, to impose a market share cap. We do not think either would deliver increased choice of auditor, particularly for the largest global companies that cannot realistically choose an auditor outside the Big Four. On the contrary, either remedy could decrease choice of auditor for these companies, which risks audit quality. We also are not aware of any evidence that audit quality would be significantly enhanced, or that it would necessarily increase the ability of smaller audit firms to undertake large audit engagements. Mandatory joint audit would, however, very significantly increase cost and resource requirements for audited firms. Depending upon the structure of a joint audit (for example, the extent of duplicate testing required or the mandated opinions) we estimate the cost to shareholders could increase by around 30-100%. In addition, there would be a significant increase in indirect costs as a result of increased management time.

As regards a market share cap, we consider that this is a blunt instrument and the antithesis of a measure designed to stimulate competition. Either this or the joint audit remedy could put UK listed companies at a disadvantage relative to their non-UK listed global competitors and

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may make a UK listing less attractive. (As a residual point, we note that *if* the CMA were to proceed with a remedy along these lines, shared audit would be less disadvantageous than joint audit.)

As regards a split between audit and non-audit functions, we are not persuaded of the need for such remedy to avoid conflicts of interest. However, we do not oppose this remedy <u>provided</u> it is implemented in a way that allows the audit firm to continue to provide certain closely related non-audit services to audit clients and to retain the wider expertise needed by an audit firm. We consider these provisos to be essential to safeguard the effective provision of audit services in future.

It is important that a holistic approach is taken to the reform of financial reporting and audit. Implementation of the remedies coming out of the three current reviews should be coordinated. Furthermore the current remedies should build upon and complement recent reforms such as the CMA's own market investigation remedies and the EU Audit Directive and Regulation. In this regard, we think the CMA should be particularly mindful of avoiding remedies such as mandatory joint tendering or a market share cap that may negate the benefit of those wider reforms.

As before, we would be happy to discuss any of the points raised in this letter.

Yours sincerely

Gavin Francis **Group Chief Accounting Officer**	**Jonathan Symonds** **Chair of the Group Audit Committee**

CC: Dr Andrea Coscelli, CEO

CMA AUDIT MARKET STUDY – HSBC RESPONSE TO UPDATE PAPER

REMEDY 1: REGULATORY SCRUTINY OF AUDIT COMMITTEES

We noted in our previous response that the regulatory framework can be strengthened.

As the CMA is aware, the Kingman Independent Review of the FRC has recommended that the FRC be disbanded and replaced by a new statutory regulator which – in addition to the regulation of audit firms – would have a range of powers and duties in respect of companies and their directors. We consider that the increased regulatory oversight of audit committees proposed by the CMA should form part of these wider powers/duties.

We welcome that the CMA is not proposing the transfer of powers away from the AC. As previously noted, we consider that to do so would be counterproductive in a number of ways.

Regulatory scrutiny of ACs should be targeted based on risk, to ensure best use of regulator resources and to avoid placing an undue burden on well-functioning ACs. An audit committee may require greater or lesser oversight based on a range of factors including:

- The audit committee itself. For example, greater oversight may be required where there are recent/ongoing failures to meet required standards/follow procedures or the regulator otherwise has grounds for concern about its competence.
- The company. For example, greater oversight may be required where there are any concerns relating to its financial position. For regulated sectors such as banking, recognising that firms are already subject to extensive regulatory reporting and other requirements, any additional scrutiny by the audit regulator should be coordinated with those other regulatory requirements to avoid duplicative or overlapping requirements.
- The audit firm. For example, greater oversight may be required where the company's audit firm has performed unsatisfactorily in a quality review carried out by the regulator.

a. Requirement for AC to report during tender process

We agree with the points (at para 4.16(a) of the Update Paper) on which ACs would be required to report. Before the reporting requirement takes effect, we think ACs may benefit from guidance from the new regulator as to the kind of evidence it would expect to see to demonstrate that an appropriate tender selection process has been undertaken.

b. Requirement for AC to report during audit engagement

We also agree that ACs should be required to report to the regulator periodically during the term of an audit firm's engagement, demonstrating how they are monitoring quality. On an annual basis, all ACs should be required to provide the regulator with the information that they themselves use to assess the quality of the audit. We do not believe it would be appropriate to mandate any other approach to such a reporting requirement, over and above that information the AC itself requires and uses.

There may be certain circumstances in which it is appropriate to require an AC to report more frequently and/or in more detail. For example, it may be appropriate to require an AC to report more frequently in the higher risk scenarios identified above. Additionally, where the regulator has concerns about specific issues, it may be appropriate to require the AC to report in more detail on those issues. However, save in these circumstances, the reporting requirement should be limited so that it does not place an undue burden on ACs and detract from their ability to carry out their responsibilities.

We agree that the regulator should have an inspection right in respect of all ACs. However, this should be exercisable only where it has reasonable grounds to suspect that the AC is failing to meet required standards/follow procedures.

c. Regulator sitting on AC as observer

On occasion it may be appropriate for the regulator to sit on an AC in an observer capacity. However, this should be limited to certain circumstances, which the new regulator should make clear in advance. For example this might apply for a certain period after process or quality issues have been identified by the regulator. We do not think an observer should be the default in all cases as it would not be a good use of the regulator's resource and may detract from the ultimate accountability of the AC.

d. Regulatory sanctions

Whilst we agree that the new regulator should have the power to issue public reprimands or direct statements to shareholders, we would caution that this should be subject to procedural safeguards such as requiring the regulator first to engage with the AC in relation to its concerns.

In addition to this remedy, and again subject to suitable safeguards, it may be appropriate for the regulator to have the power to make recommendations that need to be considered by the board as a whole or, in appropriate circumstances, put to shareholders as part of the directors' elections.

e. Regulator to make public the results of quality assessments of audit firms

We support this aspect of the proposed remedy.

f. Scope of the remedy

This remedy should apply to all PIEs, consistent with the scope of the EU rules.

REMEDY 2: MANDATORY JOINT AUDIT

We do not support mandatory joint audit, which we consider is unlikely to be effective in achieving its objectives, and which we consider would carry disproportionate costs and burden borne most heavily by those companies that are least likely to benefit from the remedy. It is also likely to have significant adverse unintended consequences.

Our comments in sections c-h relating to remedy design are without prejudice to our comments in sections a-b opposing the remedy.

a. Effectiveness and proportionality

As we understand it, the objective of the remedy would be to increase choice and resilience over the longer term, by allowing the challenger audit firms to gain experience in auditing the largest UK listed companies. In our view, this remedy will not increase the choice of audit firms available to large global businesses such as HSBC, because the remedy cannot provide the challenger firms with the required global footprint even if it does enhance their UK experience and expertise. Therefore we do not think we or many other large companies will benefit from increased choice or resilience as a result of this remedy.

Rather it would impose a burden on many UK listed companies that could put them at a disadvantage relative to their non-UK listed global competitors and may make a UK listing less attractive. Compounding this issue, the burden of this remedy may fall disproportionately on those global companies that are least likely to benefit from it. Depending upon the structure of a joint audit (for example, the extent of duplicate testing required or the mandated opinions) we estimate the cost to shareholders could increase by around 30-100%. In addition, there would be a significant increase in indirect costs as a result of increased management time.

b. Unintended consequences

Additionally, we think this remedy risks a number of adverse unintended consequences.

First, there is a risk that this remedy would decrease audit quality – and could counter the positive effect of the CMA's remedy 1 and the recommendations of the Kingman review. The CMA acknowledges that both the economic literature and empirical studies yield mixed views of the impact joint audit has on quality. This is clearly an important concern that is not limited to large global firms like HSBC.

Second, rather than increasing choice – as is its aim – there is a risk that this remedy will decrease choice, particularly for those companies that are dependent on the Big Four (or a subset of them). If a company has already appointed two of the Big Four audit firms, it would be severely constrained as to the firms it could consider in subsequent tenders, particularly when subject to mandatory rotation.

Third, there is a risk that this remedy could exacerbate the issues with ensuring independence. (And given the multi-jurisdictional nature of both audit and non-audit services provided to clients such as HSBC, this concern would only be partially addressed by the CMA's proposed operational separation remedy (remedy 5).)

c. Joint versus shared audit

If the CMA proceeds with recommending a form of joint or shared audit, as discussed with the CMA in December 2018, we consider that allowing shared audit would be very clearly preferable. In a shared audit, the client could contract with a single audit firm, with that firm/its lead partner taking overall responsibility for the audit and remaining accountable to the client, and the lead firm sub-contracting to the other shared auditor. The client should not be forced to engage two auditors separately, which would entail greater client resource and an increased risk of unintended consequences such as reduced quality and the risk of issues falling in the gaps.

d. Scope of the remedy

The CMA should exclude from the scope of any remedy those companies – including banks – that cannot feasibly use a non-Big Four audit firm. There is little merit in instead providing that banks can appoint joint auditors from amongst the Big Four, given the cost (and risk of adverse unintended consequences) this would entail, without any real corresponding benefit.

We disagree that allowing banks to use two of the Big Four audit firms would increase resilience of the audit market for financial services, since clients will continue to favour those firms amongst the Big Four that already have the best sector expertise.

e. Whether one of the joint auditors should be a challenger firm

As the CMA acknowledges, there are some types of companies such as banks for which the challenger firms might not have the required skills. We agree with this. As noted above, in our view the CMA should exclude from the scope of this remedy those companies that cannot feasibly use a non-Big Four auditor.

However, were those companies to be included within the scope of any remedy, then it would be essential to allow them to appoint joint auditors from amongst the Big Four. Otherwise, given that the challenger firms do not currently have the competence to audit certain companies such as banks, there would be a serious risk to audit quality were banks required to appoint a challenger firm for even a limited proportion of the audit.

f. Sharing work between audit firms

The CMA should avoid making any joint audit remedy overly prescriptive, which could increase the risk of it having unintended consequences such as a negative impact on quality. Companies should be given the discretion to determine the split of work or fees, and to vary this year on year as needed. The CMA (or new audit regulator) could issue guidance as to how companies should determine the split. Companies/their audit committees could be required to explain to investors how they have arrived at the split.

g. Staggered appointment

The CMA should let companies choose the timing of their audit firm appointments. We would note that if required to appoint each of the joint auditors at a different time, this could further reduce the choice of audit firm in each tender and particularly upon mandatory rotation.

h. Liability framework

As noted above, it would be far preferable to allow for shared audit rather than mandating joint audit, whereby the lead firm/its lead partner would remain accountable to the client. Within this framework, the parties should also be able to agree the liability position contractually to the extent permitted by law.

REMEDY 2A: MARKET SHARE CAP

We oppose a market share cap. It would seem to run counter to the CMA's aims of increasing choice and quality. It is also a blunt instrument with little or no economic underpinning and high risk of unintended consequences.

As the CMA acknowledges, for the duration of any cap, it would be likely to reduce choice for some companies. And as the CMA also acknowledges, weaker competition could result in a reduction in audit quality. This reduction in choice and quality could be particularly significant in sectors such as financial services/banking where few firms have specialist expertise.

We agree it is possible that over the longer term, challenger firms might grow and achieve new competencies. However, for the same reasons given in relation to joint audit, we do not think we and other global companies will benefit from this within a foreseeable timeframe.

Additionally, a market share cap is likely to result in increased cost. Given the global nature of our business, if a market share cap precluded us from using our global audit firm (currently PwC) in the UK, we would nonetheless require our global firm to have close oversight of the work carried out by our UK audit firm. Therefore this remedy could also result in some of the additional costs associated with joint audit.

REMEDY 3: ADDITIONAL MEASURES TO REDUCE BARRIERS FOR CHALLENGER FIRMS

We have no specific comments on this proposed remedy.

REMEDY 4: MARKET RESILIENCE

We do not think it is practicable or desirable to prohibit audit clients (or staff) from moving to another Big Four firm in the event of a market exit by one of the Big Four. As the CMA acknowledges, some companies such as banks cannot feasibly use any of the challenger firms for their audit. This is not something that could change quickly, even if the staff were to move from the exiting Big Four firm to a challenger firm. It would be essential therefore that clients be permitted to move to another Big Four firm.

Moreover, a Big Four exit might be likened to a crisis situation where a rapid transition to a new auditor which minimises any interruption of audit services and quality should be of paramount concern. This does not seem like an obviously sensible time to force the audit client to start using a non-Big Four firm for the first time.

REMEDY 5: FULL STRUCTURAL OR OPERATIONAL SPLIT

From a client perspective, we consider it essential to be able to obtain certain non-audit services from our audit firm; beyond this, it is key that our audit firm retains certain non-audit expertise within the audit firm, whether or not providing those services to its audit clients; and beyond this, our audit firm should have access to individuals having certain wider non-audit expertise.

In our view, this is much more likely to be feasible in an operational split than in a full structural split. We also think it is beneficial to allow for movement of staff between the audit and non-audit functions.

a. Restriction on audit firms providing non-audit services to audit clients

If the CMA proceeds with its proposed remedy on mandatory joint tendering, it would be necessary to relax the current restriction on providing non-audit services to audit clients. Otherwise there is a real risk that the independence rules will become unworkable. However, the CMA will also need to consider the international context given that the UK independence rules emanate from EU law.

b. Which NAS should the audit firm be permitted to provide?

In principle, the audit firm should be able to provide its audit client with any piece of work that (i) helps the auditor perform a more effective audit because it enhances their understanding of an area, and (ii) for the company is the most effective/efficient approach. This will vary from one sector to the next. It may also change over time. Therefore, the CMA (or new audit regulator, if this falls to them to determine) should ensure its remedy includes enough flexibility.

Should the CMA proceed with recommending this remedy, we would be happy to comment on the CMA's (or new audit regulator's) more detailed proposals for those non-audit services that should be within and outside the ring-fence.

REMEDY 6: PEER REVIEW

Any peer review should focus on those audits presenting particular risk, where it is likely to have the biggest beneficial impact.