Brydon Review
Orchard 1, 1st floor
Department for Business, Energy & Industrial Strategy
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London
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By email only: brydonreview@beis.gov.uk

13 June 2019

Dear Sir Donald

Independent review into the quality and effectiveness of audit

We welcome the opportunity to provide our views to your Independent Review, which we think is essential to ensuring that statutory audit and wider assurance are capable of meeting users' needs.

HSBC is one of the world's largest customers of audit services. We have significant business operations in the UK and are listed on the London (FTSE 100), Hong Kong, New York, Paris and Bermuda stock exchanges. Our four global businesses serve more than 39 million customers worldwide through a network that covers 66 countries and territories.

We have engaged with both the Competition and Markets Authority and Sir John Kingman in their respective reviews of competition in the audit market and the effectiveness of the FRC. We would reiterate that the reform of audit should be carried out holistically, taking into account the findings of all three reviews. Any reform should also take into account the global nature of audit and the global markets in which UK PLCs operate.

Furthermore, in our view it is essential to look at the accountability of management and the board. It is not enough to focus on audit in isolation. There should be an integrated assurance and accountability model on which shareholders and other stakeholders can rely:

- The first and foundational element is for management to demonstrate its accountability for the quality of financial and other reporting and the key assumptions underlying its reporting.

- The second element is for the board to explain how its governance (including the audit committee and internal audit) can provide assurance on the management assertions.

- The final element is for external auditors to provide their assurance on the financial statements and the critical business processes upon which the statements of management and the board are based.

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If this integrated assurance model were to be applied, any gaps in the scope of statutory audit should be evident, as would the areas where management or the board should seek greater assurance. We expand upon this model in the submission that accompanies this letter.

We would welcome the opportunity to meet with you to discuss the integrated assurance model we describe or any of the other points raised in this letter.

Yours sincerely

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

BRYDON REVIEW – HSBC INPUT TO CALL FOR VIEWS

In this submission we provide our views in response to those questions we feel best placed to answer.

We note that the focus of this review is the audit product. However, as set out in our cover letter, in our view it is essential to look at the accountability of management and the board. It is not enough to focus on audit in isolation.

There should be an integrated assurance and accountability model on which shareholders and other stakeholders can rely:

- The first and foundational element is for management to demonstrate its accountability for the quality of financial and other reporting and the key assumptions underlying its reporting. Much of what management needs to report on is already covered in the requirements for financial reporting, the strategic report (which should place greater emphasis on the viability of the business model), the viability and going concern statements and, increasingly, environmental, social and governance (ESG) reporting. Key risks should also be covered, as well as the reliability of the processes and controls upon which the information is based.

- The second element is for the board to explain how its governance (including the audit committee and internal audit) can provide assurance on the management assertions.

- The final element is for external auditors to provide their assurance on the financial statements and the critical business processes upon which the statements of management and the board are based.

If this integrated assurance model were to be applied, any gaps in the scope of statutory audit should be evident, as would the areas where management or the board should seek greater assurance.

Our responses to the other questions should be read in this context.

Users of audit

Q1: In our view the primary audience of statutory audit should remain a company's shareholders. Other stakeholders such as regulators and potential investors generally have different requirements that could be better met through other types of assurance.

Q2: Audit should continue to be focused on enhancing the degree of confidence of users in the financial statements, although there are other financial metrics key to investment decisions of investors that could be included within the scope of audit. An example for a financial institution might be key regulatory ratios.

Beyond this, there are a range of non-financial matters relating to the proper management and future viability of the company (for example, relating to ESG reporting) that could be made the subject of internal or external assurance, but which should not be part of the statutory audit scope.

The 'expectation gap'

Q4/Q5: We agree that there is an expectation gap in terms of what users of audit may think it covers and what it actually covers. This arises partly from a lack of understanding on the part of shareholders as to the purpose and scope of statutory audit, as well as the scope of audit being narrower than it ought to be.

Q6: In our experience there is no significant 'quality' gap between auditors' responsibilities and the execution of those responsibilities. Audit failures clearly occur and rightly receive much public focus. However, that should not be confused with the issue of any 'expectation gap', which we consider to be primarily driven by the level of understanding of investors as to the purpose and scope of the statutory audit, as well as the scope of the audit being narrower than it ought to be.

Audit and wider assurance

Q7: As the review notes, audit is a sub-set of assurance activities which relate primarily to the financial statements. In order to address the expectation gap associated with statutory audit, consideration should be given not only to widening the scope of statutory audit but also to the forms of internal and external assurance that could be given outside of the audit process. The nature of the assurance required will vary depending on the user of that assurance; for example, regulators' requirements often differ from those of investors, employees, etc. It may also vary by industry. Companies should be encouraged to utilise external assurance in more situations to enhance the confidence of stakeholders. Mandatory assurance activities outside of the statutory audit could also be considered.

As noted above, if an integrated assurance model were to be applied, we think the areas where management or the board should seek greater assurance should be evident.

Q10: External auditors should be able to use evidence obtained from work performed by internal auditors, provided that they have satisfied themselves as to the robustness of the internal audit process and findings.

Scope and purpose of audit

Q12: We would be supportive of directors being required to make a more explicit statement in respect of risk management and internal controls. See our comment above about the need for an integrated assurance model in which the board would be required to explain how its governance can provide assurance on the management assertions.

As a company listed on the New York Stock Exchange, we are subject to the requirements of the Sarbanes-Oxley Act, which makes directors individually accountable for the accuracy of financial statements and requires directors to report on the effectiveness of internal controls. We also follow the COSO framework. We think there is merit in considering how some of the key principles of SOX and COSO might be adapted for UK listed companies.

Q15: In our view, the current regulatory framework relating to 'going concern' is fit for purpose. Proper, sufficiently specific disclosure of any identified material uncertainties is key.

Q17: The existing requirement on the board to make a viability statement about the sustainability of the company's business model is fit for purpose, although there may be merit in reviewing its application. As with 'going concern', disclosure of factors which may affect an uncertain future are essential and this might be an area of focus in any review. See our comments at the start of this submission about the need for an integrated assurance model, in which the accountability of management and the board would be strengthened.

Q18/19: We think there would be value in making the viability statement subject to assurance, although ensuring that any such requirement is not perceived to dilute the responsibility of the board. We consider that external audit firms, but possibly others as well, could provide such assurance as happens already in areas that are dealing with an uncertain future requiring significant judgement of the company.

Q21: We agree that there is a case for requiring companies to obtain assurance on matters beyond the annual financial statements. We would see the purpose of this as less about increasing reliability of the statutory audit of financial statements, and more about increasing the usefulness of audit and assurance more generally and therefore reducing the expectation gap. For example, we already obtain assurance on some aspects of ESG. As noted at the start of this submission, it is our view that if an integrated assurance model were to be adopted, the areas where management or the board should seek greater assurance should be evident.

Audit product and quality

Q23: We agree that the value and quality of the audit product is key and should be considered separately from the effectiveness of the process. In order to deliver value to shareholders, audit and wider assurance should cover a wider range of key issues relating to the running of the company, and must be communicated in a manner that is relevant and understandable to its intended audience.

Q25: It is our view that investors favour a binary audit opinion and would not want more graduated disclosure. However, an auditor's comments accompanying its opinion are also very important, and we think there is more that could be done by auditors to improve the clarity and straightforwardness of their audit opinions.

Communication of audit findings

Q33: We would be supportive of more open dialogue between the auditor and shareholders. Our auditors attend our annual general meeting and we think this should be mandated for all auditors of listed companies. We also think it is useful for auditors to seek to get a better view *ex ante* of what investors are interested in.

At this stage, we are not persuaded by the benefits of an annual assurance meeting attended by wider stakeholders. As noted above, different stakeholders' assurance requirements will differ, therefore we think a tailored approach to communication is required.

Other issues

Q45: Our auditor PwC uses technology extensively in their audit work for us. For example, they use technology/analytics to review millions of transactions. Technology can provide an additional, higher level of assurance, insofar as it allows a level of testing that would not be practicable or efficient to carry out manually. It can also provide supplemental, valuable insights for both the auditor and management, and it can also improve efficiency/reduce costs.

Q53: We would be supportive of shareholders being provided with an *ex ante* forum to express their anxieties to auditors. We think this could help to ensure that the audit product provides value and is relevant to shareholders as its primary audience. However, we do not think shareholders should approve planning matters for each audit, which should remain the primary responsibility of executive management.

Q58: It will of course be important to ensure that the benefits of any reforms justify the costs and that proper consideration is given to potential adverse unintended consequences. Such assessment will be particularly important for major reforms such as introducing mandatory assurances or extending the scope of directors' individual accountability.

We have commented previously in our engagement with the CMA on the likely disproportionate costs of introducing mandatory joint audit, which we think would outweigh any benefits. We also think this remedy could counter (or neutralise) the positive impact on quality that should otherwise result from the recommendations of Sir John Kingman and that we would expect to come from this Independent Review.