SENATE BANKING COMMITTEE - THURSDAY 9 SEPTEMBER 2004

Submission of Douglas Flint
Group Finance Director
HSBC Holdings plc

Background

HSBC is the largest banking group outside the United States and the second largest in the world measured by market capitalisation. At 3 September the Market Capitalisation was USD178 billion.

HSBC operates in 76 countries employing some 232,000 staff.

HSBC is subject to primary regulation by the UK Financial Services Authority ("FSA") on its global operations. As a US Bank Holding Company it is also subject to regulation by the US Federal Reserve. In all it is regulated by approximately 370 different central banks and regulatory authorities at a cost, in aggregate, estimated in 2003 at USD400 million.

HSBC is listed on five stock exchanges – the UK, Hong Kong, New York, Euronext Paris and Bermuda. The last two arose primarily as a result of acquisitions. The New York listing was obtained in 1999.

HSBC has made two public US company acquisitions since obtaining its New York listing; Republic New York Corporation in 1999 and Household International in 2003.

HSBC is widely held with in excess of 190,000 shareholders. It is estimated some 15 per cent of the shares are held by US investors.

Douglas Flint has been Group Finance Director since 1995 joining from KPMG; a CV is appended to this submission (Appendix I).

HSBC is grateful for the opportunity to contribute to this hearing; the views expressed are personal to Douglas Flint.

Corporate Governance and the impact of Sarbanes-Oxley.

There is no question that there is an immediate and urgent need to re-establish confidence in the public markets through which investors entrust their savings and wealth is created through efficient allocation of resources. The spectacular collapses and outrageous frauds visited on public markets in recent years demanded a public policy response.

It was inevitable that the US response would be first given that the early failures took place in its markets and also that the mechanisms exist for prompt affirmative action. It was also inevitable that the impact of US legislation would be far reaching as it encompassed the global operations of companies listed in the United States, not just their domestic US operations. The threat of litigation in US courts for failure to comply certainly has concentrated minds. It was also inevitable that other jurisdictions would explore their own responses to corporate misdeeds not only in response to the outcry which followed frauds in their own markets, but to construct frameworks more in keeping with their own domestic governance models.

As a result companies like HSBC face multiple governance codes and initiatives, some enshrined in law, others in Stock Exchange regulation and others in Best Practice codes. Inevitably there will be conflicts in what is required.

In relation to Sarbanes-Oxley specifically, there is no question that it has reminded Boards forcibly of their responsibilities and their accountability for the accuracy of public reporting; that of itself has been an immediate and welcome wake-up call across the world.

It has also reminded companies that the responsibilities they have are direct responsibilities and cannot and should not be 'delegated' to third parties such as their auditors or lawyers.

The weaknesses of the auditing profession have also been highlighted which has caused many companies to re-appraise the quality of advice they had been relying on, particularly in relation to presentation under US GAAP when it was not their primary accounting model.

However there are unfortunate consequences, perhaps unintended, which may frustrate the overriding objective of the legislation to improve public reporting. Among these I would include the following:

- The way Sarbanes-Oxley is being implemented by the accounting profession following the PCAOB guidance has become meticulously prescriptive and detailed, no doubt in response to fear of litigation for having omitted something, with prescription being seen as the best defence. From the standpoint of the company it feels like having to document everything to prospectus or litigation standard just in case that is the standard decided by the Courts to be necessary at some later point in time. The clear danger, increasingly evident, is that the process becomes the objective rather than the means to the end. It worries me that increasing resources in the big 4 auditing firms are devoted to documenting control processes in companies rather than auditing business by understanding it in the first instance. Good financial reporting comes from understanding the business being portrayed in financial terms far more than understanding the control processes through which the financial results are processed.

- Sarbanes-Oxley necessarily is written in general terms yet is being interpreted to mean or require all manner of things – and there is no-one who can challenge an interpretation with confidence. This is a real issue when implementing Sarbanes-Oxley across multiple geographies as the global accounting firms are not consistent at all in what they do. However, the auditing profession has the final say given that the auditors have been empowered as the sole authority, by virtue of their obligation to report independently on financial reporting controls.

- It is perhaps curious that so much trust is being placed on the judgement of the auditors as regards financial reporting as few have any experience as preparers and the expertise in accounting system design that existed within the firms largely departed when consulting was separated due to conflicts. In a world where directors are rightly subject to increased accountability and greater scrutiny it is worth challenging whether the impact of the independent audit opinion on financial reporting controls improves the process or serves to discourage directors from exercising a judgement that shareholder interests are properly served by expanding/acquiring a business with weak formal financial reporting controls mitigated by sound business model profitability. The existence of some weakness in financial reporting controls is increasingly likely as accounting standards become more prescriptive and complex and require implementation in short timescales across wide geographies with linguistic challenges to training. Accounting Officers are therefore becoming increasingly concerned that they are exposing themselves to unknown risk as they seek to implement unfamiliar and complex new requirements. For example, the pending International Accounting Standard on Financial Instruments stretches to over 400 pages with implementation guidance. It would be unsurprising if there were implementation challenges.

- There is a governance penalty now for being US listed which is significant in terms of time and money where the cost benefit is difficult to see. The responsibilities for directors have not changed and they were able to sign their S302 certificates in 2003 without the paperchase now being required under S404. We estimate some USD30-50 million in implementation cost to compile the database of financial reporting controls we know we have but were not originally documented to describe specifically the financial statement control assertion they address. It is interesting also to note the current trend towards private equity investment in many markets where the largest professional shareholders are increasingly making a judgement that higher returns may be available from investments not subject to public reporting obligations/protections.

- Inevitably Sarbanes-Oxley is drafted with a US governance framework in mind and, when taken together with the detailed guidance issued by PCAOB, application internationally is complicated by virtue of different governance models and indeed legal frameworks which can act to frustrate the detailed requirements of the Act but without necessarily impairing the overriding objective. As an international registrant we hope that as time evolves the possibility of mutual recognition of approved governance regimes might be contemplated to avoid costly duplication of demonstrating compliance with equivalent regimes in different formats.

International Financial Reporting Standards (IFRS)

HSBC is a strong supporter of the move towards a globally recognised, robust framework of accounting both for our own reporting and as a consumer of financial information as a lending and investing operation. Partially as a result of the cumulative aggregation of different disclosure requirements across the five jurisdictions through which we are listed, together with increased regulatory requirements our Annual Report in 2003 reached 380 pages of which 40 were devoted to reconciling UK to US GAAP. With the implementation of IFRS in 2005 requiring explanation of the differences against UK GAAP as well as reconciliation to US GAAP we expect the Annual Report and Accounts for that year to grow to around 450 pages which is beyond the comprehension of all but a small segment of the professional analyst community. Indeed we are concerned that the Annual Report and Accounts has already lost its role as the primary communication medium between management and shareholders.

The training and monitoring burden necessitated as a consequence of multiple GAAP reporting is significant, and is exacerbated as a result of the impact of Sarbanes-Oxley. The impact on accounting system design of requiring data to be held to accommodate tracking of different GAAP reporting is significant and of negligible value to shareholders.

It is clear that shareholders concentrate almost exclusively on the GAAP reporting pertinent to the most liquid market in which shares trade; this suggests there is no 'silver bullet' of truth in financial reporting but that consistency and comparability are valued. In the five years HSBC has been reconciling to US GAAP, notwithstanding significant differences in reported net income for complex technical reasons in individual years, there has been virtually no shareholder interest in understanding these differences beyond the brief explanations included in the accounts. In professional shareholder face to face meetings the subject virtually never arises.

As progress is made in delivering IFRS we have a number of concerns:

- The construction of IFRS is increasingly rules rather than principles based, in part to meet concerns of preparers and auditors that, without definition, criticism could be attracted for the exercise of judgement in interpreting how to apply a standard in non-standard circumstances; as an aside we note an increasing and regrettable trend in auditing to avoid being seen to apply the intent of accounting standards in face of a possible but bizarre literal application of standards to events which were never contemplated when the standard was designed. Such legalistic construction continues to risk the corruption of accounting and thereby limits the confidence that users will have in financial reporting. Notwithstanding the difficulties involved we believe that there is need for an overriding standard akin to the UK's "true and fair view" to govern financial reporting permitting, indeed requiring, non–application of accounting standards in circumstances where the resulting accounting is materially misleading. Clearly, as in the UK, full explanation would be required and auditor concurrence or qualification added.

  In this regard I would draw attention to the remarks of Lord Penrose in his report on the collapse of Equitable Life, a significant UK life assurer on the dangers of seeking perfection in accounting before requiring change to practices known to be deficient.

"Proposals, exposure drafts, and similar consultation exercises are not a substitute for normative standards. The continuing failure to produce acceptable standards and secure their implementation is a failure in a professional duty owned to the public. It is a failure in duty to shareholders in proprietary companies. It is a failure in duty to policyholders in proprietary and mutual companies. Those with the responsibility to produce appropriate standards must have it impressed on them that what is required are practical standards of general application that will provide consumers of accounting information and their advisers with ready means of assessing the financial positions of the providers of financial products. A search for perfection in his area will fail. To await agreement among the wide range of interests affected will involve interminable delay."

- We are concerned that there is as yet no clear timeframe to disapply reconciliation to US GAAP upon application of IFRS for companies enjoying a secondary listing in the US. If the real value of IFRS is to be achieved accounts prepared under IFRS must be accepted in all markets without reconciliation. We recognise there is still work to be done to prove the complete and robust nature of IFRS but it would be helpful to have confirmed that following that accreditation the reconciliation burden will be relieved.

- As a matter of policy it would also be helpful if ongoing US requirements rewarded behaviour consistent with the harmonisation agenda, perhaps by reducing the burden of producing comparative information and accelerating relief from reconciliation to US GAAP for registrants who fully adopt IFRS as opposed to those who may take available options to apply restricted versions of IFRS permitted under national discretion.

- We are concerned that although much is being done to harmonise the workflows of the IASB and FASB to ensure increasing convergence as standards are refreshed and updated there are notable differences of timescale in important areas which could lead to frustration of the harmonisation agenda. In particular we see difficulties in the areas of pension accounting, scope of consolidation and share based payment. The current difficulties in Europe finalising IAS39 are also illustrative of the theme.

Auditing Standards and Auditor Independence

HSBC regrets intensely the lack of choice in today's public auditing market with the existence of only four global firms a potentially disruptive feature. Unsurprisingly as the firms face similar issues they have a shared interest in acting together thereby evidencing the concentration of power they enjoy. As a global organisation operating in 76 countries we need a single firm to co-ordinate our audit and indeed our regulators demand it.

It is with deep concern that we see the auditing profession flexing its muscles currently within the protection of a statutory and regulatory monopoly for auditing services by threatening withdrawal of service provision to key sectors including banking if they do not receive protection from unlimited liability. I do not believe this is in any way an acceptable position to take but it is one that can only be taken in an oligopolistic industry structure.

The reality for banking organisations is even more extreme as the independence rules operate to exclude the non-incumbent firms from eligibility in the short term to take on the audit unless significant work is done by both the firm concerned and the bank to maintain independence. Given concentration in the provision of global banking services and the concentration in auditing services, arranging such standby independence is a real commercial problem. Some relief to exclude from the independence rules normal transactions on arms length terms from specified large banking organisations would be welcome and not in my view of public policy concern.

This having been said, we support the auditing profession in its objective of limiting its liability. The potential consequences of further limitation in the supply of auditing services is of concern to us both as a consumer of such services as an audited entity and as a user of audited accounts as a lending organisation. My submission to the Department of Trade and Industry charged with reviewing this matter is appended to this submission (Appendix II). I would draw particular attention to one paragraph.

" If auditors are to be allowed to restrict their liability then I believe it is also important that the audit report given is in plain English. Today's report has evolved to a list of exclusions and caveats with the actual opinion the smallest segment of the report. The very technical language used for the audit report gives auditors the ability to claim that everything they did was in accordance with auditing standards and in accordance with the applicable GAAP which is fine, except that it is unclear to the average reader of an annual report and accounts what this means. *I believe a longer form report more descriptive of what the auditor actually does would be beneficial both to understanding what the report means and as a way of focusing auditors as to what the primary purpose of the audit is."*

This comment draws together much of what is said above in that auditing has increasingly become a technical compliance service which looks to form rather than substance. This undoubtedly is driven by fear of litigation yet I suspect users still believe auditors have taken care to understand the business model as well as verifying that the financial reporting control framework operates effectively. I genuinely believe governance would be more effective if auditors were required to report along the lines set out in Appendix III, which was part of my input to the DTI review in the UK, as opposed to a technical report referring to their industry standards. Indeed such a report would in my view be more valuable to users than a supporting opinion on financial reporting controls under Sarbanes-Oxley.

Douglas Flint
6 September 2004

<u>**APPENDIX I**</u>

Douglas J Flint
Group Finance Director
HSBC Holdings plc

Douglas Flint is Group Finance Director of HSBC Holdings plc.

He began his career with Peat Marwick Mitchell & Co. (now KPMG) where he trained as a chartered accountant. He was appointed a partner of the firm in 1988.

Mr Flint specialised in banking, multinational financial reporting, treasury and securities trading operations, group re-organisations and litigation support while at KPMG. He joined the HSBC Group as Group Finance Director-Designate on 30 September 1995 and was appointed to the Board on 1 December 1995.

He is a Director of HSBC Bank Malaysia Berhad.

Mr Flint was born in Scotland in July 1955 and was educated at Glasgow University where he gained a B.ACC (Hons) degree. He also completed the PMD course at Harvard Business School in 1983.

He is a member of the Accounting Standards Board and on the Advisory Council of the International Accounting Standards Board and Chairman of the Financial Reporting Council's review of the Turnbull Guidance on Internal Control. He is also a member of the Institute of Chartered Accountants of Scotland and the Association of Corporate Treasurers. He is a Fellow of The Chartered Institute of Management Accountants. He also served on the Shipley Working Group on Public Disclosure. Mr Flint's hobbies are golf and tennis.

Group Corporate Affairs
July 2004

APPENDIX II

James Carey, Esq
Corporate Law and Governance Department
Department of Trade and Industry,
1 Victoria Street
London SW1H OET

12 March 2004

Dear Mr Carey,

DIRECTORS AND AUDITORS LIABILITY CONSULTATIVE DOCUMENT

In response to the invitation to comment on the above, I have set out below comments restricted to the position of Auditor Liability.

By way of background HSBC is today the second largest company listed in the UK with a market capitalisation of £92 billion. We operate in 79 countries and reported earnings attributable to shareholders of US$8.8 billion for 2003 on 1 March. Our annual audit fees for 2003 were US$36.3 million which I believe is the highest fee paid by any UK company.

I believe the issue of Auditor Liability is a serious one and one where revisions have to be made if we are to retain a robust and credible audit profession globally. This matters to us not only in relation to our own shareholders but as a major lending institution it is important that the integrity of financial reporting is protected through there being an effective audit profession.

Barriers to Entry and Choice

In my opinion there are clear substantive barriers to entry to, and expansion within, the auditing market particularly as it relates to public interest companies, that is those private companies above a certain size and all listed companies. These barriers relate to training, organisation, international connection, credibility and risk management within which unlimited liability is the most serious barrier. Even if a limitation of liability were put in place I believe the other barriers are such that it would still be very difficult for a new entrant to make any impact on the large end of the auditing market as without the credibility of a track record it would be very difficult to see how any public company could appoint an unknown quantity.

There is today already insufficient choice between firms and this is particularly so in the financial industry where the independence rules are so restrictive that almost by definition all of the firms who are not the current auditor have real independence issues. Furthermore, if individuals working in accounting firms are to be allowed to have relationships with financial institutions, by definition there will be virtually no choice, without significant disruption in changing from the incumbent auditor. There is a need to look separately at those independence rules as they relate to routine banking services (current accounts, mortgages and credit cards) but that is another subject.

If we were to lose another major accounting firm it would be a serious problem.

Arguments by the Largest Auditors

I noted with interest the arguments put forward and agree with most of them. However I think there are a number of inconsistencies in what has been said. In my view it is not at all damaging that there is a trend to exit from high risk companies as it seems to me that all businesses should seek to restrict commercial relationships with high risk counter-parties, particularly when contingent liability may arise through such association. In our business we routinely avoid dealings with companies and individuals who fall outside our risk appetite. It would be a perverse result indeed if limiting auditor liability encouraged auditors to accept high risk companies on the basis that the down-side was protected. It would be far better that high risk companies had to reform themselves sufficiently to be eligible for audit service from a 'premium brand' auditor as this discipline would improve the quality of capital markets.

I also find it a curious argument that international networks may not come to the aid of partnerships in difficulty in another country. The audit profession has so far as its clients are concerned sought to put itself forward as a global service provider. Certainly we have taken the view that we are engaging one firm when we appoint auditors and not a separate firm in each country where audits are conducted.

What I do think however is relevant for the DTI to consider is that if liability turns out to be truly global and does not respect the different local partnerships and structures which have been established then the UK audit profession is exposed to the risk of failure as a result of awards made in punitive legal systems in another country which capture for shareholders in that country (and their lawyers) the entire global value of the major firm involved.

Insurance

From our own experience in renewing and maintaining professional indemnity cover there is clear evidence that liability insurance is increasingly available only on extremely restrictive terms and at reducing levels of cover. In reality it is getting to the point where the terms of such insurance make it very difficult to justify seeking such cover as it is not clear that it would respond in the circumstances envisaged.

As a result of this and as a result of increasingly rule based accounting standards there is clear trend towards technical or defensive auditing which is ever more directed towards documenting, ab initio, a defence that would stand up any court in respect of each audit decision taken on every minute aspect of the accounts, as opposed to considering more broadly the 'true and fair view' of the profit and of the financial position.

This will over time lead in my view to auditors that do not have the experience to make the quality of judgements required to be an effective auditor and leave companies and their shareholders with "box-tickers" who assess compliance with a lexicon of accounting rules but do not understand whether the result of such 'compliance' makes sense.

The fact that no audit firm has yet collapsed as a result of a claim made against it in the UK is probably only a matter of timing and it would be improper to be complacent that because it has not happened it could not happen. We have to remember that the UK economy has been very successful in the last decade, did not have within it the telecoms and tech sector companies that contributed to the major scandals in the US and poor auditing usually comes to light most vividly in an economic downturn other than in cases of fraud.

Possible Solutions

I believe the most appropriate response is Option C in the Consultative Paper which allows auditors to limit their liability contractually, subject to rules being set by the Secretary of State. I think it is particularly important that legislation should cover the minimum multiple of the audit fee, as without legislation there is a clear incentive for the four firms to stand together with a low multiple. I believe that the appropriate multiple is of the audit fee alone rather than all other fees or as a multiple of the turnover of the auditors as it would focus shareholders' attention as to how much is being paid for the audit and therefore what degree of work is being done Clearly somebody who only pays £100 for an audit cannot expect to have got very much in return and therefore they should not have much ability to recover for having allowed such a weak audit to be undertaken. In my judgement the minimum multiple has to be at least 10 times to be meaningful.

Alongside this of course would need to be governance ensuring that fees to the auditors were not transferred to non-audit engagements and I envisage a world in the future where there is an ever more restrictive list of services that auditors can provide.

The Audit Report

If auditors are to be allowed to restrict their liability then I believe it is also important that the audit report given is in plain English. Today's report has evolved to a list of exclusions and caveats with the actual opinion the smallest segment of the report. The very technical language used for the audit report gives auditors the ability to claim that everything they did was in accordance with auditing standards and in accordance with the applicable GAAP which is fine, except that it is unclear to the average reader of an annual report and accounts what this means. I believe a longer form report more descriptive of what the auditor actually does would be beneficial both to understanding what the report means and as a way of focusing auditors as to what the primary purpose of the audit is.

I have set out in an attachment to this email suggested areas which might be covered. The language is very draft and purely to make a directional suggestion. The matters covered are drawn from the ASB's "Exposure Draft on the Operating and Financial Review" and the PCAOB's guidance for the purpose of Sarbanes-Oxley.

I also believe consideration should be given to making the individual audit directors/partners who take responsibility on behalf of their firms to sign the report personally on behalf of the firm as again I believe that gives much clearer accountability for the audit report.

I would be pleased to discuss this submission if you would find it helpful.

Yours sincerely

Douglas J Flint
Group Finance Director

APPENDIX III

`INDEPENDENT AUDITORS' REPORT

We have audited the Financial Statements on pages x to y.

In planning our audit of ABC plc we have considered to the extent necessary to form an opinion on the accounts the nature of the company's business, its objectives, the strategies adopted to achieve these objectives and its competitive position in the markets in which it operates.

We have also obtained an understanding of, and evaluated, management's process for assessing the effectiveness of the company's internal controls over financial reporting. In particular we have considered and tested the following controls, for which management is responsible, which cover:

- Relevant assertions related to significant accounts and disclosures in the financial statements.

- Controls over initiating, authorising, recording, processing and reporting significant accounts and disclosures and related assertions embodied in the financial statements.

- Controls over the selection and application of accounting polices that are in conformity with generally accepted accounting principles.

- Antifraud programmes and controls.

- Controls, including information technology general controls, on which other controls are dependent.

- Controls over significant non-routine and non-systematic transactions, such as accounts involving judgements and estimates.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorise, record and process journal entries in the general ledger; and to record recurring and non-recurring adjustments to the financial statements.

In our opinion:

- the performance of the company for the year ended 31 December, 2____, is fairly represented in the Financial Statements set out on pages x to x;

- The Financial Statements and financial disclosures and notes, taken together with the management discussion and analysis on pages x to x disclose fairly the main influences on performance and highlight the trends important to an analysis of the company's business model.

- The Financial Statements and financial disclosures and notes, taken together with the management discussion and analyses on pages x to x give a true and fair view of the financial position of the company and highlight factors affecting, or likely to affect, that position.

XYZ Audit plc