Submission of Douglas Flint
Group Finance Director
HSBC Holdings plc

Background

HSBC is the largest banking group outside the United States and the third largest in the world measured by market capitalisation. At 1 April, 2005 the Market Capitalisation was approximately USD175 billion.

HSBC operates in 77 countries employing some 253,000 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 467 different central banks and regulatory authorities at a cost, in aggregate, estimated in 2004 to be approximately USD500 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 US public company acquisitions since obtaining its New York listing; Republic National Corporation in 1999 and Household International in 2003. As a foreign registrant HSBC is subject to the provisions of The Sarbanes-Oxley Act.

HSBC is widely held with in excess of 200,000 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. The views expressed herein are personal.

Implementation of Sarbanes-Oxley

I welcome the opportunity to comment on the practical implications arising from our preparation for reporting under S.404 of The Sarbanes-Oxley Act.

There is no doubt that the focus on financial reporting integrity required by Sarbanes-Oxley and the discipline of public reporting thereon is contributing to improving the exercise of Board accountability in this area. This in turn is contributing to restoring public confidence in financial reporting and the integrity of financial markets. Given this successful outcome the principal areas for review therefore should be whether:

- the actual modus operandi of implementing Sarbanes-Oxley is the optimal way to achieve the benefits described;

- the costs and management resource allocated to this task are proportionate to the benefits; and whether there are unintended consequences.

Dealing with each of these in turn:

The Modus Operandi of implementing Sarbanes-Oxley

Corporate governance within the UK is based upon principles based guidance with the concept of 'comply or explain' affording Directors the flexibility to tailor and adapt the standard governance regime to their particular circumstances if justified and explain why they believe departure from strict compliance with the standard model is of benefit to shareholders' interests. In the field of internal control reporting within the UK governance regime, guidance to Directors is principles based, covers all controls (not just financial controls) and requires Directors to report that they have reviewed the effectiveness of internal controls but does not require them or their auditors to report their conclusion on the review of effectiveness.

This position which is clearly different from what Sarbanes-Oxley now requires was much debated at the time the Turnbull Guidance to Directors on internal control reporting was established. The basis of the decision reached reflected the complexities involved in defining effectiveness and creating guidance capable of applying to all public companies regardless of size or industry as well as a belief that a principal benefit of the guidance was that it forced Directors to focus on what they saw as the key risks within their business and how these were controlled; it did not mandate a checklist of risks and related controls which somehow was seen as absolving Directors from the responsibility of coming to their own conclusions.

Herein lies, I believe, the critical weakness in the implementation of Sarbanes-Oxley. Rather than causing Directors to think deeply and broadly about where material financial reporting risks are most likely to arise in their business model or circumstances, and dealing with them, the requirements of Sarbanes-Oxley are forcing implementation design to be delegated to the external auditors who are building the implementation design from the bottom up rather from the top down. As a result the opportunity to cause Directors to consider and report where they see the principal risks is lost. This is an inevitable consequence of the requirement for auditors to reach their own conclusion on financial reporting control effectiveness within the PCAOB framework and in an environment of punitive litigation for failure.

As a result, the auditors are approaching the task in defensive mode, unable or unwilling to exercise judgement as to what can be assumed without proof or documentary evidence, in case a court with hindsight challenges the apparent omission. As an illustration of this by way of illustration, we currently delegate to our independent US counsel the translation of our SEC filing from the accounts version to the 'EDGAR' version, a mechanical exercise. We are advised by our auditors that if we wish to continue this practice Sarbanes-Oxley would 'require' them to test/audit the controls in place at our US counsel's proofing department, notwithstanding their reputation or the fact we have done this for many years now without problems.

The parallel of such an approach is surely the unthinking application of defensive tests and screenings in the medical world to prevent ruinous malpractice suits which benefit from hindsight clarity.

A second problem in implementation is the narrow focus on financial reporting controls and evidencing thereof. The skillset to differentiate financial reporting controls from more general controls is one which resides primarily within the external auditing profession; general management understands controls but does not easily differentiate controls directed to financial statement assertions as opposed to business efficiency and safeguarding assets. The implication of this is that all organisations are identifying many more controls than are rationally justified purely for financial statement integrity but inability to isolate the key financial reporting controls is adding hugely to the testing burden; the auditors have something of a conflict here as excessive testing by their clients with the benefit of risk reduction to the auditors is hardly unwelcome.

In essence, legislation designed to get Directors to focus on internal financial reporting integrity, by effectively granting sole authority as to what is required to the auditors, has caused design implementation to be directed principally to their liability protection; the over-engineering of documentation, test plans and evidencing the results of effectiveness testing is the result.

The proportionate allocation of management resource and cost

Financial reporting mis-statement risk before Sarbanes-Oxley was a relatively low order risk in management priorities; the higher order risks were business focussed with accounting following on as it should given its sole purpose to record the results of business decisions and outcomes. It is accepted that following reporting scandals in the late 1990's and early part of this century, there was an urgent need to remind Directors of their responsibilities for financial reporting integrity. Sarbanes-Oxley combined with successful regulatory enforcements and prosecutions have clearly achieved this.

It is in my opinion however now time to reflect whether the amount of attention directed to financial reporting integrity is disproportionate to the benefit and whether other risks are receiving less attention than they deserve as a result of rebalancing priorities. For example we estimate that in the first year of reporting under Sarbanes-Oxley some 25% of internal audit resource will be redirected from business control auditing to validating that testing required under Sarbanes-Oxley has been properly conducted. In a financial services organisation such as HSBC the scale of such diversion of internal audit resource is not a trivial matter and is one that exercises the Board.

The amount of resource allocated, not to establishing or testing control, but evidencing that this has been done is also burdensome and one can question for whose benefit this is done; in the event of material error the Directors will be held accountable as it will be apparent that the control framework failed. Again it would appear that the primary beneficiaries of the evidencing of controls testing would be the auditors who would have a defence against challenge to their independent conclusion on internal financial control effectiveness. But it must be questionable whether legislation designed to protect shareholders is optimal when the layer of protection added by requiring auditors to express an independent opinion on internal financial control effectiveness results in shareholder resources being applied to provide the maximum protection possible for auditors against the consequences of an invalid opinion. For the financial markets as a whole it must be a valid question whether the cost of this additional assurance is greater than the losses avoided as a result of it. Again using the medical analogy experience society ultimately judged that the cost of practioners protecting themselves by conducting every conceivable test on every patient was unaffordable.

HSBC expects to spend some USD50 million on external support to document controls, assist in developing test plans and support testing in countries where the necessary expertise is lacking. On top of this, internal resource reallocated to Sarbanes-Oxley compliance is estimated to be twice the external cost.

Unintended Consequences

There is much evidence of unintended consequences arising out of Sarbanes-Oxley implementation.

- auditors are nervous about giving advice on accounting matters lest it suggest the Company's own processes are inadequate to the task; yet auditors have application experience of complex accounting rules across many clients of benefit to individual preparers encountering an issue for the first time;

- preparers are more nervous about sharing problems at an early stage lest it suggest financial control weakness;

- auditors are inclined to want to delay auditing items until management has finished all its reviews so they can assess whether internal financial controls were effective - management is reluctant to say it has finished its review until the last minute to avoid a subsequent adjustment from the review process being interpreted as a significant weakness;

- audits are increasingly focussed on risk management of the auditor rather than their purpose of reporting to shareholders; increasing amounts of audit time are allocated to pure GAAP compliance and file documentation and ever less to understanding the company's buniness model. In my view this will lead to poorer auditing;

- financial accounting staff faced with ever more complex rules-driven accounting standards and ever more detailed inspection of technical GAAP compliance are questioning career paths;

- faster reporting, which we support, has added to the time pressure on financial report preparation necessitating long hours at reporting dates; the additional burden 'required' under Sarbanes-Oxley to document every change in every draft throughout the process is making the process excessively burdensome;

- there is increasing pressure to withdraw non-mandatory disclosures from financial statements which although helpful to understanding and transparency add to the Sarbanes-Oxley documentation burdens;

- over time I believe the major accounting firms will lose their best people because this type of compliance work is unlikely to appeal to them; this will diminish the audit product.

I hope these observations are helpful and I would be pleased to elaborate or discuss them if this was thought to be helpful.

Yours sincerely

Douglas Flint