

Written evidence submitted by: Haowen Fu, Leonid Sokolovskyy, Fatema- Tuz- Zohra, Chanon Nak-ai, Jiawang Gu, Jiayi Li, Yuning Cheng, Zeqing Shen, Xinyi Wu, Jiayin Peng, Ming Siew (Alliance Manchester Business School)

We are undergraduate and postgraduate students of accounting and auditing at the Alliance Manchester Business School who plan to pursue a career in public practice accounting, public sector auditing and assurance services. As part of the younger generation, we would like to articulate our vision of the good governance of accounting firms — something that highly relates to our prospective careers. We would like to have rewarding and socially purposeful careers which will depend on the long-term attractiveness of the accounting profession and its ability, particularly in the field of auditing, to attract and retain talent as well as its overall resilience and public usefulness. We want to work for the firms that exist in the public interest because they create positive economic, social and environmental impact in our society. Right now, however, we have got significant concerns with regard to the state of corporate auditing in the UK in general and the increased commercial orientation of the accounting firms in particular.

The proposed draft of a new governance code has made a step in the right direction by embedding more prominently within it the notion of the public interest. However, any such stated commitment to the public interest has to be matched by the provision by accounting firms of appropriate evidence as to how such a commitment is being operationalised in practice. In particular, to give assurance in the way the public interest is interpreted, applied and developed in the context of the auditor's working environment, the Code should be framed in ways that give us clear insight into the decisions and trade-offs that the auditors have been undertaking throughout their working lives in the name of the public interest.

In this day and age of transparency, surprisingly little is known about the inner workings of accounting firms. The large firms are eager to proclaim in their mission statements that they exist to solve important societal problems and are helping to build a better world. However, it is not clear how the public interest and professionalism dimensions are reconciled in practice with the increasingly commercial nature of the accounting firms. Of the 33 entities required to produce a transparency report, only 9 currently apply the 2016 Code. This is highly perplexing since there is a reasonable expectation that accounting firms will and should be leaders in this kind of disclosure.

In terms of improving the quality of the disclosure coming from the accounting firms, one key area of concern is the overall profitability of their auditing activities. The accounting firms might be jeopardizing their future if they start neglecting one of their core businesses as well as the continuous need to improve audit quality. In particular, we would like to know more about the financial arrangements around auditing services. What is an equitable profit for an entity working as auditors in the public interest?

Another key area is the role of independent non-executive directors (INEs). Currently, massive trust has been put into this function as the way to govern the public interest within accounting firms. Greater clarity is needed with regards to how these individuals are appointed, how independent they are, and how exactly they challenge the management of the accounting firms to safeguard and promote the public interest.

Another principal risk of auditing firms relates to accepting an inappropriate client or engagement. Different clients potentially demand different approaches to auditing based on the trustworthiness of the directors and the control environment. We would like to know more about what kind of clients are rejected and why — these are potentially the companies that do not merit our deserved confidence as the public and who need the strictest form of audits to be applied to assessments of their business operations and societal impacts.

The relationships that UK based accounting firms have with their global firm network is a potential problematic consideration for the operation of a UK based governance code. If firm culture is set largely at the global level and, for example, the firm's global business priorities change, this will have implications for the UK-based branch of the global firm, including the branch's commitment to serving the (UK) public interest. We would like the Code to encourage firms to demonstrate how any such tensions between the global and the local are managed or navigated and with what consequential impact on stated public interest obligations and commitments.

In conclusion, we feel excited to be a part of this reform, especially in terms of its potential positively to shape the future development of the audit function and a public interested, auditing profession. We support the revision of the Code so long as it seizes the opportunity both to reinforce professionalism and redefine the audit product in ways that make its societal contribution more visible and significant. In this regard, it is an evident opportunity to demonstrate how the governance of accounting firms helps to facilitate commitments to the public interest and, in the process, a real chance to generate enhanced levels of confidence in the accounting firms. Perhaps, if the Code really works, less external inspection and regulation of such firms will be needed in the future and the capacity for audit innovation enhanced.

We have structured our response in the following way. Question 1 discusses how the notion of the public interest is currently operationalized within the Code, highlighting its limited scope. Questions 4, 5, 6, and 10 discuss some of the more specific Code proposals in relation to the role of INEs and partner oversight in more detail.

We would be delighted to discuss with you any of the issues raised in this submission.

Yours sincerely,

Haowen Fu, Leonid Sokolovskyy, Fatema- Tuz- Zohra, Chanon Nak-ai, Jiawang Gu, Jia-yi Li, Yuning Cheng, Zeqing Shen, Xinyi Wu, Jiayin Peng, Ming Siew (Alliance Manchester Business School)

Q.1: How appropriate do you feel that the revised purpose of the proposed 2022 Code is?

The 2010 version of the Code suggested that its main purpose was to build long-term trust and to enhance competition in the market for audit. The major concern at that time was around the issue of the audit market being dominated by the four largest audit firms with potentially significant implications for market resilience, audit quality and public confidence in audit. The 2010 and 2016 versions of the codes were intended to benefit primarily investors and capital providers among other stakeholders.

In considerable contrast to the 2010 and 2016 versions, the current proposed version of the Code embraces the wider public interest dimension and is more stakeholder-centric. Over the years, the Code has become much more detailed in its specifications, however, it is not clear whether changing the scope of the Code and rephrasing its purpose in terms of the public interest actually led to any substantial change in the way the code works and its desired outcomes.

Here, we would like to raise our concerns with the way public interest is conceptualized and represented within the current version of the Code. On p.25 of the Code, it is rightly stated that the public interest is a rather abstract concept that does not have a common definition apart from having something to do with putting the common good and wellbeing of society above the interests of an individual or a small group of individuals.

However, after talking about the public interest in these rather broad terms, the Code quickly focuses on how high-quality audits are presumably in the public interest because they lead to a lower cost of capital and a more efficient functioning of the capital markets. In doing so, the Code largely presumes the concept of auditing as providing a true and fair view on a set of financial statements. In our opinion, there is a big difference between demonstrating that high quality audits are in the interest of the public and asserting that the current statutory financial audit serves the public through its impact on capital markets.

While acknowledging the importance of auditing with respect to the proper functioning of the financial markets, we would like to see a more direct link between the concept of auditing and public interest. We would like to draw on Brydon's definition of auditing as something that is fundamentally about establishing and maintaining deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.

If we embrace Brydon's definition, auditing ceases to be conceptually limited to checking and verifying information. For example, the auditors can play a greater role in advising and consulting the companies on how to build better business – and, in the process, strengthen the link between the public, auditors and audited companies by better capitalising on the unprecedented access that auditors have to the companies that they audit. Auditors can themselves review the way in which public-interest entities claim to discharge their public interest responsibilities and help the public decide as to whether the companies merit our deserved confidence. In short, there are evident opportunities for different forms of auditing in different circumstances that can serve public interest better.

The above discussion directly relates to the notion of audit quality. There is a strong presumption in the proposed Code and accompanying background text in the FRC's document that 'quality auditing' is inherently in the public interest but, unfortunately, 'quality auditing' itself is not debated in any great depth. The document suggests that quality auditing requires quality work which does not answer the question of what is quality. Auditing quality is a subjective concept that could mean different things to different people. Fundamentally, the beneficiaries of audit quality are the public which includes investors, employees, regulators, suppliers and customers. Currently, a lot of emphasis seems to be put on various quantitative measures of audit quality. We would like to see more qualitative and context-specific understanding of the nature and impact of auditing.

If we accept that one of the purposes of the Code is so that the auditors have an environment to do a high-quality audit, the question becomes is this goal best pursued through the introduction of minimum requirements as opposed to the promotion of best practices? The following extract from the Brydon Review is quite revealing in that sense.

26.1.5 An increased celebration of "good" would be both encouraging and educational. However, I part company from Professor Ramanna over the use of the concept of best practice. I believe that this concept has been a pernicious addition to the lexicon and one that allows, indeed even encourages, lazy thinking. It is too seductive for people to retreat behind a best practice defence of their actions. What matters is that the right practice has been followed and that may well be different in different companies and at different times. What matters is what is right for a particular company, with its particular problems and its particular management at this particular moment given its particular circumstances. Best practice concepts drive out innovation as it is always safer to go with the herd and claim that an action is best practice rather than take a bolder and individual step. Best practice defences are based on backward looking analysis. Of course, good practice must be faithful to an enduring set of principles. (The Brydon Review)

In conclusion, working or governing in the public interest is a massive obligation to impose on the privately-owned firms. So, what does it mean to govern in the public interest? More consideration should be given not necessarily to the definitions per se but rather to what it means to work in the public interest in specific (differing) contexts? The purpose of the Code should be to give the public, assurance on how public interest considerations are operationalized in the context of the large accounting firms. The governance structure should reflect the scale of this public interest commitment. In our view, it is not enough to assert that the firms work in the public interest. Rather, we need to focus on the tangible outcomes coming out of the Code. Accounting firms, just as the companies they audit, also need to be able to demonstrate and explain how what they do benefits the public. What caused the auditors to do something different by working in the public interest? In summary, we want a governance code that more visibly concentrated on outcomes, especially in terms of the outturn of public interested commitments being made by companies and their auditors..

Q.4: What are your views on the proposed effective date of the proposed 2022 Code?

We would like to raise a number of questions related to the sensibility of the implementation horizon.

On p.43 of the Code, it is stated that: “[a]fter an agreed transition period, firms should publish the audit practice’s profit and loss account [...] in their Transparency Reports”. The deadline for the transition period is 30 September 2024 (p.43, p22) which means that profit and loss accounts will not be required till then. In addition, the profit and loss account may be done on a “best efforts” basis in the first year of submission (p.43, p22).

We would like to get more explanations from the FRC about such a long implementation horizon for the Code which was originally published in 2010. Why has the public not already got access to this important information? Why can it not be made available immediately? It is hard to imagine that accounting firms do not already know the profitability of their auditing practices. As such, we would ask what is preventing the firms from making this information publicly available – and what is preventing the FRC from requiring such disclosure immediately? There is real potential here to make the Transparency reports that some (but not all) firms are now producing more insightful and useful; and, in short, more fitting of their title. The public should be able to know quite easily and openly how much profit is being made from the provision of a public interested audit function – and how the notion of ‘serving the public interest’ shapes the way in which firms run and manage their audit activities.

Q.5: What are your views on the priorities for engagement with investors, audit committee members and other external stakeholders and how could we encourage interaction with INEs?

The idea of having dialogue with the investors, audit committee members and other external stakeholders is welcomed. The interaction between such groups and the INEs will help the INEs to know much more about ‘public’ expectations and requirements. This subsequently will facilitate the INEs in their determination of what serving the public interest has to entail across different industries and different contexts. However, we have some additional observations to make in terms of this policy commitment.

The first observation is related to other external stakeholders. The detail of the stakeholder engagement mainly talks about the dialogue between listed companies, investors and audit committee members. While mention is made of the interaction with other stakeholders, the proposed code does not provide a clear explanation as to who are the ‘other’ stakeholders; nor did it provide sufficient guidance on how best to identify such stakeholders given that their make-up can vary across organizations and industries.

The second observation is related to the potential conflict of interest among the different stakeholder groups, and how the INEs are going to manage this. The proposed code focuses on public interest, which includes the interest of a broader stakeholder group. It would not be surprising for different stakeholder groups to have different views. The Code needs to consider how the INEs will perform in such conflicting situations. For instance, regarding the activities of the oil industry in 2018 in an article of the Guardian, it states that ‘... The oil industry is not

your friend. Whatever it might say about its ethical credentials, while it continues to invest in fossil fuels, it accelerates climate breakdown and the death of the habitable planet' (The Guardian, 2018). In this kind of situation, for INEs just to have interaction with investors, audit committee members and listed companies will not be sufficient in providing views on the 'public' interest and how best this can be served and any such commitments evaluated.

With regard to encouraging the interaction of INEs, we would also like to see better clarification of their functionality, including the way that INEs are appointed and how exactly they safeguard the public interest. Clarification and application here can help to facilitate dialogue and interaction with a broad-based set of stakeholders.

Q.6: To what extent do you support the changes proposed in the areas of partner oversight and accountability to owners?

We support to some extent the proposed changes made in case of partner oversight and accountability. There is a clear distinction between governance and management, by separating the chair of the board from the CEO. The focus on accountability and how it differs across companies is welcome. However, we are concerned about how best to ensure partner oversight by the Board members and INEs. The proposed Code states that the majority of Board members will be partners without significant management responsibilities. Though non-performing, as they are owners of the firm, we would have concerns regarding their independence as overseers of audit activity – and would like to receive more assurance as to how such 'independence' can be assured/enhanced.

Q.10: Do you think that the proposed 2022 Code is clear enough about the role INEs play in the Firms?

The proposed Code emphasises the role of INEs in the determination of public interest in different contexts. We support these initiatives to have opinions from a different group of people who do not have direct interest in the profitability of the audit firms. This is a good way to ensure audit quality and subsequently ensure the sustainability of the firms. That said, we have some further observations which we think will have an impact on the efficient implementation of the Code.

The idea behind the Code is that increased audit quality will safeguard the public interest. To achieve this, the code requires the INEs to reflect and form their own views on the public interest in and across different contexts. This responsibility puts an emphasis on the qualifications of the INEs, which is not explicitly considered in the Code. As students of the academic literature on public interest, we are well aware that defining the public interest in various contexts is not easy and that there is no one precise or exact definition – but is something that has to be assessed in relation to the commitments made by those entities (companies and their auditors) claiming to work in the public interest. INEs need to be well informed with regards to such literature and sensitive to the socially constructed nature of the term 'public interest'. In turn, this requires them also to have considerable, appropriate, knowledge about

different industries and their respective stakeholders. Such depth of knowledge is also vital in relation to the very important responsibility that INEs associated with global accounting firm networks will have in terms of assessing 'global governance standards and the impact of the network on the UK firm and the public interest in the UK' (page 34, provision 32). In summary, we believe that, without such a scale of knowledge and experience, it will be very difficult for the INEs to perform effectively. Principle O of the proposed code specifies that INEs should have diverse skills and expertise, but lacks detailed provisions on what are the exact requirements regarding such skills and expertise. Coupled with the absence of detailed provisions regarding the appointment of INEs, this gives us a good degree of concern regarding the capacity for the proposed code to deliver in terms of its claimed/anticipated benefits. We feel that more could be said here in terms of the functional expectations of INEs and believe that it will be very important for their activities to be the subject of detailed, independent research going forward as so much appears to depend on them.

In particular, more consideration needs to be given to the number of INEs hired. Provision 30 of the proposed Code mentions that INEs are responsible to '... assess the impact of firm strategy, culture, senior appointments, financial performance and position, operational policies and procedures including client management processes, and global network initiatives on the firm and the audit practice in particular....' (page 33, provision. 30). We would question whether having a minimum number of three INEs will be sufficient enough to fulfil their specified responsibilities, especially given the requirement to assess and consider the public interest in different contexts. Without having knowledge and experience of different industries, it will be challenging for these three INEs to work efficiently and serve to ensure the operation of effective governance in accounting firms.

Provision 31 of the proposed code describes the appointment process of the INEs. The nomination committee will include at least one INE. We are concerned about the neutrality in the appointment of the INEs. Having the partners or hired employees of the firm included in the nomination committee will also create a doubt in terms of the impartiality of the appointment process and the independence of the hired INEs. We think the proposed Code could give greater consideration to the threats and safeguards relating to the appointment and functioning of INEs. For instance, IFAC's Code of Ethics for Professional Accountants has a list of probable threats to independence and safeguards to the threats in case of client acceptance. We think the proposed code needs to provide similar kind details regarding the appointment and independent functioning of the INEs. A more visible recruitment process will remove the confusion in the appointment process and hopefully enhance both the perceived and actual independence of the INEs.

Just like the hired employees, the INEs are also paid by the audit firms. We expect there could be threats in the independent performance of the INEs. Provision 37 provides a little, but not enough detail regarding dealing with the disagreements between the INEs and the firms. We think this kind of disagreement will be a very common problem with which the INEs will be needed to deal with. With the maximum tenure of nine years, the independence of INEs can be in question. Provision 39 of the proposed code states that the transparency report will include the criteria for assessing the independence of the INEs. More detail is required regarding who will perform any such assessment. To counter suspected agency problems, the Code has to ensure, or at least encourage the provision of more information on how INEs have worked and facilitated the provision of 'better audit quality'. There is an evident risk, given the

long-standing nature of the 'audit expectation gap', that the concerns that have led to the promotion of INE's as a policy solution will be accompanied by the creation of an INE 'expectation gap'

The mandatory introduction of INEs in the governance of audit firms essentially represent a public interested form of internal audit of accounting firms – made more visible through the publication of an informative Transparency report. Implemented properly, such requirements and processes can not only cast meaningful light on how audit is undertaken in a public interested manner but help to enhance the overall public interest contribution made by audit. Done poorly or superficially, we are left with a governance Code in name only and a sense of impression management at a time when so much more is needed. We hope our comments above can help to ensure that a revised governance code for audit firms really does deliver in the public interest.