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Richard George
Chair of International Ethics Standards Board for Accountants

By Email: EDComments@ifac.org

Dear Richard,

Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence - Audit and Review Engagements, and Proposed Section 291, Independence - Other Assurance Engagements

SUMMARY OF MAIN POINTS

- **We fully support efforts to clarify and strengthen the *Code of Ethics for Professional Accountants* (Code) and to change the Code where it can be clearly demonstrated to be in the public interest.**
- **There is little evidence to justify many of the proposals on public interest grounds and there is a strong case for a systematic assessment of the costs and benefits of each proposed requirement.**
- **Many of the proposals fail to adequately reflect the needs of small- and medium-sized entities (SMEs) and small- and medium-sized practices (SMPs).**
- **The timetable through to the effective date is unnecessarily ambitious.**
- **IESBA should seek to proactively persuade regulators of the most appropriate form of regulation based on evidence from rigorous international research.**
- **The proposals fail to achieve their stated objective intent of being principles-based and easy to understand.**
- **Section 290 should apply to audits only while Section 291 should apply to all other assurance engagements.**
- **We agree with a differential approach based on the concept of entities of significant public interest (ESPI) and agree that the precise definition of ESPI should be left to individual jurisdictions.**
- **Consideration should be given to amending the scope of ESPI to exclude certain small entities such as not-for-profits, pension funds, charities, governmental agencies, and, possibly, entities listed on secondary markets or traded over the counter.**
- **There is a need for more clarity and implementation assistance.**

- **The costs associated with mandatory partner rotation - increase in audit failures, increased start-up costs, increase difficulties in timely reporting, loss of "institutional knowledge", opportunity to disguise voluntary rotations, and reduced incentives to improve efficiency and audit quality – appear to far outweigh the benefits.**
- **The costs associated with new restrictions on non-assurance services, especially in respect of tax services, are likely to far outweigh the benefits.**

INTRODUCTION

1. The International Federation of Accountants (IFAC) Small and Medium Practices (SMP) Committee and Developing Nations Committee (DNC) welcome the opportunity to comment on the exposure draft (ED) of the proposed revisions to Section 290 Independence (S290) and the proposed new Section 291 of the IFAC *Code of Ethics for Professional Accountants* (Code) published for comment on December 29, 2006 by the International Ethics Standards Board for Accountants (IESBA).

2. The letter has been formally endorsed by the SMP Committee at its meeting in Tunis on May 3-4, 2007. The letter incorporates many of the comments the SMP Committee made previously, in particular to Geoffrey Hopper's presentation at the SMP Committee meeting in Hong Kong on July 5, 2006, the SMP Committee comment letter of August 8, 2006, and to Jean Rothbarth's presentation at the SMP Committee meeting on October 9, 2006 in Rome.

3. Our committees are wholly supportive of the IESBA in its quest to improve the Code by issuing an ED containing proposals designed to strengthen its independence requirements. This project should help maintain the relevance of its Code, ensure it reflects global best practice and enhance its clarity.

4. The 'Wong Report'[1] identified widespread concern as to the relevancy and appropriateness of international standards of accounting, auditing and ethics to SMEs and SMPs, especially those operating in developing nations and where the profession is in a developmental phase. This concern has continued to increase over the past few years to the point that over-regulation of SMEs, largely the result of imposing one size fits all standards which have been drafted from a large entity and developed country perspective, is considered one of the biggest problems confronting the small business sector. The burden of regulation is such that the viability of SME audits is a threat as indeed is the viability of many SMPs remaining in the assurance market.

5. Our committees look to the IESBA to develop and maintain a high quality Code. We, therefore, welcome initiatives such as this one aimed at improving the Code. IESBA is, rightly, held in high regard as a global standard setter and as such many regulators and member bodies will unquestioningly adopt the revised Code and adhere to the letter rather than follow its spirit. Hence, it is vital that every effort be made to ensure we achieve an optimal outcome.

[1] '*Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs'*, September 2004.

6. The SMP Committee and DNC acknowledge the considerable progress made in enhancing the Code. We are also generally satisfied with the way the IESBA has approached this important project. While more effort could have been made to research how best to serve the public interest in the revision of the Code, the general approach taken has been deliberate, considered and consultative. IESBA has engaged with a broad range of interested parties as part of its consultation exercise. This has gone some way towards ensuring that the eventual standard reflects the combined counsel of all constituents that have an interest in and/or are affected by the proposals. Moreover, there is clear evidence that the IESBA has considered and acted on the feedback.

7. This submission is organized into four parts. First, the basis for this submission is described. Second, general background issues are presented, including the principles underlying the detailed points. Third, the key points of our submission are explained. Finally, the specific comments including detailed responses to the questions posed in the Explanatory Memorandum at the front of the ED are set out in the final section.

BASIS FOR THIS SUBMISSION

8. The views expressed in this letter represent the general views of the SMP Committee and Developing Nations Committee. This response letter is a joint submission of the SMP Committee and Developing Nations Committee. The rationale for this is that consultations with members of these two committees have revealed a high degree of commonality of views.

9. Compiling a single response that wholly satisfies all of the members represented on our committees is impracticable, owing to their diversity. Not surprisingly, the views expressed by members varied, often reflecting a particular national stance. Therefore, when formulating its views the committees have sought to take a global, public interest position. This perspective may not always be consistent with individual national laws, regulations and interests.

10. Collectively our committees boast substantial experience of accounting and audit, especially of SMEs. Their members are drawn from over 30 IFAC member bodies from some 25 countries from all regions of the world are represented on these committees. In addition, we have consulted regional accountancy organizations.

11. We have sought to encourage active and constructive consultation and research aimed at helping the IESBA obtain an optimal outcome. We have also encouraged our constituents to respond to the ED.

GENERAL ISSUES

Public Interest

12. The SMP Committee and the Developing Nations Committee see a considerable public interest angle to the proposals contained in the ED. Strengthening the Code has the potential to enhance the quality of assurance and other services provided by professional accountants, harmonize this quality across national borders, and, in turn, bolster the quality and credibility of financial statements worldwide. Ultimately, the public interest will benefit from more efficient allocation of capital, the effective exercise of business ownership and supervision of management's stewardship, and

even the prevention of fraud. It should also help prevent a recurrence of the financial collapses of recent years, most notably of entities of significant public interest (ESPI).

Research

13. While we are generally satisfied with the way the IESBA has set about developing the proposals in the ED, we feel that more effort could have been made to more systematically and rigorously research and consult during its development. We need evidence-based solutions to determine the appropriate measures to enhance auditor independence in a cost effective way. Hence, we would have preferred to see a more systematic consultation exercise based on international multi-jurisdictional primary research into how best to serve the public interest through the revision of the Code, and in particular, the wider cost and benefits from a public interest perspective of the various proposals. In the absence of such evidence we are not convinced of the merit of many of the proposals. Some proposals impact our constituents severely and yet there is little if any evidence to justify them.

14. We suggest, therefore, that the IESBA fill this void by undertaking some tests of some of the proposals, especially those that have the most impact on SMP/SME. It is crucial that the research effort be as comprehensive and thorough as possible. We would be happy to assist the IESBA in this effort.

Applicability

15. While we endorse the notion of having one globally applicable Code we recognize the difficulty of deriving provisions suitable for application across a range of engagements and by firms ranging from sole practitioners through to the Big Four. We are concerned, however, that the proposals are geared more towards providing an optimal solution for larger firms and engagements. This focus has resulted in provisions that in some cases result in an impractical and/or disadvantageous cost-benefit outcome for SMEs especially those in developing and emerging nations.

Cost-Benefit

16. As noted above one of the pressing concerns for SMEs is over-regulation. Over-regulation threatens the vitality and growth of the sector and, in turn, fails to serve the public interest. It seems that this over-burdensome regulation stems largely from drafting regulation to suit larger entities, which is subsequently retrofitted to smaller ones. The inevitable result is that the compliance costs exceed the benefits.

17. Cost-benefit from a public interest perspective is the primary rationale underlying our comments. We suggest it be elevated to the overarching constraint or criteria when determining the form and content of all regulation governing the work and behavior of professional accountants such that a requirement is only introduced when the benefits, which we take to be the fulfillment of the information needs of the users of financial statements exceed the costs, that is the cost of preparing, disseminating and providing assurance on the financial statements.

18. Differences in the distribution and size of benefits and costs between entities of significant public interest (ESPI) and other entities, perhaps established through regulatory impact assessments, provides the justification for having differential rules, albeit embodied in the same Code and conforming to the same conceptual

underpinnings. In effect a pragmatic rationale, cost-benefit, rather than a conceptual reason, should form the basis for differential rules. While we recognize that the IESBA has embraced a differential approach, cost-benefit could justify it being applied more widely and consistently throughout Section 290-291 and be used to differentiate, in a few specific instances, rules applying to larger and smaller practices in the same way there is differentiation between ESPI and non-ESPI.

19. Outlined in this submission are a number of suggestions that we believe will result in fair, relevant and understandable guidance that delivers a favorable cost-benefit outcome for the vast majority of engagements.

KEY POINTS

20. This section sets out the key points of this submission. Many of these points are elaborated upon under the next section "Specific Comments". It should be noted that the responses do not cover every conceivable issue but rather concentrate on what we consider to be the most relevant from an SME/SMP perspective.

21. There is considerable merit in many of the proposed revisions and these we welcome. For example, in many areas there is much greater clarity than the original version and this will enhance consistent application. Other proposals are less welcome, but justified on the grounds they stand to significantly improve audit quality. However, there are some proposals which we do not welcome; they carry a high cost, especially for SMEs and SMPs, with minimal corresponding benefit. In this letter we focus on these aspects of the proposals and suggest resolutions.

Main Concern

22. Our main concern is that collectively the proposals risk undermining the viability of many SME assurance engagements and the SMPs that provide them, reduce choice of service provider available to SMEs, and impair the quality of service, while doing little to improve auditor independence or public confidence.

23. For example, the introduction of absolute prohibitions, even in circumstances when acceptable safeguards could be applied, will increase the cost to SMEs of obtaining professional services where these could otherwise be provided most effectively by their auditors. These additional costs do not appear to have been properly considered and there is little evidence they will be offset by enhanced independence and/or public confidence. There are a number of matters that need to be considered when proposing additional prohibitions which require consideration of public policy issues, particularly for SMEs. For example, in SME audits the additional information acquired when providing other services enhances audit quality. In some locations there may be little or no alternative professional service provider to the auditor, so the choice is that either the auditor provides the service or no-one does.

Timetable

24. The SMP Committee notes the IESBA's sense of urgency in wishing to conclude this project, but wonder whether this is necessary. From an SMP perspective there is no crisis of confidence in the profession. A number of surveys spanning several jurisdictions indicate a high level of confidence and trust in the profession while others stress the fact that SMPs are often the business advisors of choice for many

SMEs and that SMEs prefer, and sometimes rely on, an SMP to act as the so called 'one stop shop' for various regulatory and business services. Hence, we see little justification for proceeding according to the ambitious proposed timetable.

25. The timetable is ambitious, especially when one considers the time needed for translation, implementation and education. If the revision to the Code is not approved and publicized in the time anticipated, it is vital that the effective date be deferred sufficiently to accommodate such translation, implementation and education. In addition, we note that it is intended that "firms will have six months after the effective date to complete any ongoing services that were contracted for before the effective date". We believe that six months is insufficient time to allow existing contractual commitments to be fulfilled. We suggest the period is at least twelve months. In the event that the proposals in the ED are largely preserved then there is a case for granting SMPs and SMEs even more time to adapt to the new regime.

Regulators

26. Many of the proposals appear to be driven by the need to be seen to be responsive to concerns expressed by regulators. Regulators, eager to avert high profile audit failures of large listed companies, seem to view independence in appearance as a surrogate for audit quality. Consequently, the threats identified concentrate on independence in appearance with prohibitions and/or safeguards designed accordingly. Unfortunately, these prohibitions and/or safeguards impact most directly and adversely the SME audit and SMP, for whom the same threats either do not apply or do apply but to a lesser extent. The end result is an ED that is more suited to the larger firms and larger clients than SMP/SME. This is despite the fact that there is differentiation of rules in a number of areas between ESPI and other entities.

27. Hence, we feel that there is a strong case for more differentiation throughout S290 both between ESPI and other clients as well as large and small practices if it is to be fair, proportional, practical, and, above all, serves the public interest by improving audit quality and supporting the SME sector. This is explained more fully below.

28. Finally, we consider it important that changes to the Code are not simply based on emulating what a minority of large regulators have done. This reactive stance is evidenced by the benchmarking exercise. This inevitably indicates a case for additional restrictions but does not of itself provide evidence of a need for these restrictions in an international code, to maintain public confidence. We feel that the IESBA needs to take a leadership role and, equipped with the appropriate evidence from consultation and research, seek to persuade regulators, what it considers is in the public interest. In this way it should lead, not lag, so that national codes are benchmarked to the IFAC one.

Conceptual Framework

29. We fully support the idea of a principle-based Code which adopts a threats and safeguards approach to determining the appropriate requirements. The Code should be a vehicle for communicating to all interested parties, in a clear and understandable way, that the profession is concerned about ethics and that it has objective, effective and straightforward rules to ensure ethical conduct. Such an approach is inherently

superior to that of a rules-based one which tends to promote a tick-box/checklist compliance with the form of the requirement than the spirit.

30. However, we have serious reservations about whether the proposed S290 adopts a principles-based approach. In many instances the specificity of the circumstances and the attendant requirements are such that the exercise of judgment is effectively eliminated and prescriptive rules supersede principles. For example, there are a number of outright prohibitions, especially for ESPIs, in the application section. For an SMP this often means that there are either no safeguards at all or else safeguards which are not able to be applied. This begs the question how can blanket prohibitions, or situations where there is no practical relief, be reconciled with a principles-based approach?

31. We, therefore, encourage the IESBA to prioritize the redrafting of the entire Code using a similar drafting convention to that used by the IAASB on its Clarity project. The Code should set out a concise set of clearly understandable principles or objectives so that these might be communicated effectively outside the profession. The main body of the Code should clearly differentiate between what the accountant is required to do, ideally kept to a minimum, from non-binding explanatory and application material. We discuss this in more detail below.

Splitting Section 290

32. We have no issues, per se, over the demarcation. There is inherent logic in advocating different approaches depending on the level or existence of assurance provided. However, we feel the demarcation line is inappropriately drawn and suggest that S290 apply to audits only, while S291 applies to all other assurance engagements. We posit various practical reasons for this.

33. First, it reinforces the distinction between an audit and other types of assurance service. Second, in many jurisdictions there is a lack of clarity as to what exactly constitutes a 'review' engagement. In some countries there are clear frameworks that carefully define these but in others various types of assurance engagements could fall within this definition. Redrawing the line as suggested would make this a non-issue. Third, the proposals for S290 would greatly undermine the market for alternative assurance services such as review or any new service that may be developed by member bodies and/or the IAASB.

34. Finally, we note that within S290 there are some requirements relating to audit engagements/clients and others to assurance engagements/clients. This is potentially confusing, a confusion that may be eliminated were S290 only to relate to audit.

35. In sum, we feel that limited forms of assurance should be married with less onerous independence requirements, so as to ensure an appropriate balance of costs and benefits.

Entities of Significant Public Interest

36. We generally support the idea of introducing the notion of an ESPI and differentiating many of the requirements according to whether the client is an ESPI or not. While the threats are similar for all entities, their magnitude varies according to the nature of the client. Differentiation enables some degree of tailoring and devising appropriate

safeguards and prohibitions to address them. We also concur with the IESBA in not providing specific 'bright-line' criteria for determining what constitutes an ESPI. We agree with IESBA that this is best left to national jurisdictions.

37. The rationale for using a differential approach is based on the fundamental differences between ESPI and other entities. While we agree with a differential approach based on ESPI we have various suggestions. First, we note increased use of the public interest/accountability concept to differentiate entities and corresponding requirements in international standards. We would encourage all international standard setters – IESBA, IAASB and IASB[2] – to adopt a common descriptor and supporting criteria for ESPI. There is considerable merit in harmonizing these concepts and their definitions since it should enhance consistency of reporting and assurance treatment for like entities.

38. Second, while we recognize that precise scope definitions are best made at national level so as to ensure compatibility with the local circumstances, we wonder whether the IESBA should make some positive statements as to which entities are *not* ESPI so that regulators can more clearly distinguish ESPI and other entities. This could be achieved by providing some guiding principles for the development of more specific criteria at national level. Central to this is deriving a suitable "public interest" test to be applied when considering requirements. This test could comprise 4 basic criteria: ensure access to practitioners that have the requisite experience and knowledge, and are independent; preserve audit quality; avoid imposing unnecessary costs to the entities and wider society; and facilitate timely and accurate financial reporting.

39. Third, in addition to, or as part of, providing a definition of a non-ESPI, the existing qualitative criteria for determining ESPI could be supplemented with some principle-based quantitative criteria. We interpret the ESPI principle in its broadest sense including the wider economic impact through, for example, the employment supported by the entity and the transaction with customers, rather than just the financial impact on capital market participants. The principle-based quantitative criteria could include a combination of size criteria based on, say, profit, assets and turnover, perhaps related to GDP per capita and/or other developmental indices, as well as employee numbers. Nevertheless, it is important that the Code only includes high level principles and that individual jurisdictions develop the detailed criteria.

40. Such guidance for principle-based quantitative criteria should be designed so as to ensure that larger unlisted entities are captured within the scope of ESPI as well as ensure more consistent application of the public interest/accountability principle from country to country. The guidance could also be used to give certain jurisdictions, in particular, developing and emerging economies with large numbers of smaller listed entities, the flexibility to exclude smaller listed entities with few outside investors from the ESPI net, subject, perhaps, to fulfilling certain conditions, such as obtaining approval to do so from those charged with governance of the entity. One could

[2] In its proposed International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) the IASB is proposing to differentiate on the basis of public accountability, a concept which is presently defined in a similar, but not the same, way as ESPI.

differentiate listed entities on the basis of whether the entity is listed on a secondary or over the counter market rather than using size criteria.

41. Fourth, we suggest the concept of differentiating on the basis of ESPI be applied more widely and consistently throughout so that there is differential treatment across more areas, especially in the provision of many non-assurance services, as explained below. In effect, this would amount to a "think small first" approach with certain basic requirements applicable to all circumstances and the application of additional provisions to ESPI. This should result in a favorable cost-benefit for clients of all sizes.

42. Finally, we are concerned that the ESPI concept risks embracing many smaller not-for-profit entities and burdening them with unnecessary compliance costs. Non-governmental organizations (NGOs) as a large group of not-for-profit entities can be regarded as being of significant public interest, though this is more in terms of ensuring accountability to the general public than accountability to financial stakeholders. Many NGOs, especially smaller ones and/or those in developing nations, are run on extremely low overheads either by necessity in order to survive and/or by design so as to maximize public benefits. These organizations will face great difficulty paying for the increased cost of services likely to result from the proposed new rules. A more difficult environment for NGOs is clearly not in the public interest. Hence, size criteria could exempt smaller NGOs from the ESPI net. Alternatively, not-for-profit entities could be explicitly excluded from the definition. Similar arguments could be employed to exempt small charities, small pension funds and small government organizations from the ESPI.

Independence of Appearance and in Mind

43. While we accept that the auditor should be independent of mind on *all* audits, we do not believe the auditor always needs to be independent in appearance. Rather the 'specific facts and circumstances' surrounding a particular engagement have to be considered. Large listed entities typically have a large number of shareholders, most, if not all, of whom are not able to get a clear picture of the role and independence, or otherwise, of the auditor on a specific engagement. This contrasts with SMEs, including smaller listed entities, where the shareholders, fewer in number and often more closely connected to the company, often have direct access to the auditor so as to establish their independence for example, during the annual general meeting.

44. Consequently, for ESPI with a large, diverse and 'remote' shareholder base there is a need for greater safeguards to ensure independence in appearance than in a SME where there is more transparency. In addition, in the case of SMEs and SMPs, the identification of threats is more effectively done in a more direct way without recourse to formal reporting systems. The business environment and threats differ in nature and relative importance, so the safeguards need to be tailored to fit.

Independence and Audit Quality

45. The SMP Committee notes that independence and audit quality sometimes conflict. A good knowledge and understanding of the business is the key to an auditor executing a high quality audit. Concerns have been expressed in recent months that partner

rotation requirements in certain countries, for example the UK, may inadvertently have a negative impact on audit quality, particularly in specialized sectors, because key audit partners are removed without always having someone of sufficient experience of the industry to replace them. This problem may well be exacerbated in the context of SMP/SME and developing nations. Hence, we suggest that where there is doubt as to the ultimate impact on audit quality, it is better to avoid prescriptive rules.

Clarity

46. We recognize the significant effort made to ensure the text is unambiguous, easy to translate and likely to result in consistent implementation. However, we feel more can be done and suggest that the IESBA look to the IAASB Clarity project for ideas on how to improve clarity both in terms of structure and language. Indeed, we suggest that the entire Code would benefit from redrafting in accordance with the Clarity drafting conventions. For example, clearly distinguish requirements, especially for outright prohibitions, from application material/guidance and link the two with cross referencing. This structure would lend itself to a web-based version of the Code with hyper-links built into the text taking readers to the relevant sections.

47. While full scale redrafting of the entire Code may not be possible in the near future, we would encourage a certain degree of redrafting of S290-291 prior to its publication. First, we suggest the presentation and structure make it clear what the prohibitions are, especially outright ones and those relating to material matters. For example, by using bold text. Second, we suggest some restructuring so as to clearly distinguish what requirements apply to ESPI and what apply to other entities. In this way practitioners can readily see what requirements apply to their ESPI clients and what relate to other clients. Again, this could be achieved through the combination of bold text and/or sectioning off material that relates to ESPI. Third, tables could be used in some cases to summarize the requirements for a particular sub-section so that practitioners could see at a glance what was required. A good candidate would be taxation services. See **Table 1** for a sample draft illustration.

Table 1: Summary of Restrictions for Taxation Services

	Type of Audit Client	
Category of Tax Service	**Entities of <u>no</u> significant public interest**	**Entities of significant public interest**
Tax return preparation ***(Sec. 290.176)***	→ no general threat to independence	
Preparation of tax calculations to be used as the basis for the accounting entries in the financial statements ***(Sec. 290.177 – 290.178)***	→ self review threat → application of safeguards	→ <u>prohibition</u>, if material to the financial statements
Tax planning and other tax advisory services ***(Sec. 290.179 – 290.182)***	→ self review threat → no general threat by advisory services where the advice is supported by tax authority, by established practice or has a basis in tax law → application of safeguards if threat is not clearly insignificant → <u>prohibition</u>, if • Effectiveness of the advice depends on a particular accounting treatment • There is reasonable doubt as to the appropriateness of the treatment The outcome of the advice will have a material impact on the financial statements	
Assistance in the resolution of tax disputes ***(Sec. 290.183 – 290.185)***	→ advocacy threat if tax authorities have rejected the client's arguments on a particular issue and referred the matter to a tribunal or court → application of safeguards if the threat is not clearly insignificant → <u>prohibition</u>, if taxation services involve acting as an advocate before a public tribunal or court and the amounts involved are material to the financial statements → no preclusion from having a continuing advisory role in relation to the matter being heard before a public tribunal or court	

48. Finally, we note that in respect of ESPI a number of approaches seem to be taken for different parts of S290 including outright prohibition, prohibition if material, prohibition if material and subjective, and the same provisions as for other entities. This raises many questions including whether there should be a general or category-by-category approach and whether there should be differential approaches to different sizes and types of client. We suggest consideration be given to weighing up the case

for different approaches against the implications this has for understandability and clarity to the end user. A more consistent approach, while having some theoretical flaws, may ultimately deliver larger benefits.

Implementation Guidance

49. We are concerned that many SMPs will have difficulty understanding and hence effectively and consistently implementing the provisions of S290-291. We would, therefore, encourage the IESBA, with our assistance, to develop non-authoritative explanatory guidance to assist with its implementation.

50. Guidance would ideally be directed primarily at SMPs and SMP networks - large firms and networks have sufficient in-house resources to develop guidance of their own which they will no doubt do. Such guidance would be particularly useful and our committees would gladly lend their support to its development. Guidance should be written in non-jargon plain English so as to ensure it can be easily understood and consistently applied. The use of illustrations, such as case study scenarios, would be especially welcome.

51. Guidance could take many forms. First, it could help with the practical application of the new network firm definition in respect of S290-291 by SMP networks. Second, it could assist with the implementation in the area of the preparation of accounting records and financial statements and management responsibilities. Finally, it could conceivably outline appropriate strategies for SMPs to adopt to ensure compliance with S290, including timely partner recruitment, collaboration with other practices and joining networks. This would help them adjust to the new requirements.

SPECIFIC COMMENTS

Mandatory Partner Rotation

52. We note that throughout S290 additional prohibitions have been added for the audit of an ESPI. In many cases this will often result in the exclusion of SMPs from performing the audit of ESPI. We suggest modifying the mandatory partner rotation requirement and/or the definition of ESPI for various reasons.

53. First, the mandatory partner rotation combined with the expanded definition of key audit partners will for many SMPs and SMP networks amount to firm rotation. Such firms will lose ESPI audit clients while larger firms will retain such clients by way of rotating audit partners. Over time many SMPs will be driven from the ESPI audit market and ESPI will slowly concentrate in the hands of larger firms. Large firms seem to have concluded that firm rotation is generally inappropriate because of the potential damage to audit quality resulting from new auditors being unfamiliar with the client. SMPs will, therefore, ask: if large firms see firm rotation as unacceptable on grounds of excessive cost, then why is it effectively being mandated for us? Moreover, many SMPs will question why they have to bear the brunt of the adverse impact of the revisions, revisions which have been prompted by regulators intent on averting a repeat of the high profile audit failures of recent years?

54. Second, the proposals could be viewed as discriminatory, anti-competitive and even a restraint of trade matter from the standpoint of both the auditor and the client**.** In countries with large numbers of smaller listed entities typically the partner rotation

requirement will have a particularly serious impact on SMPs, forcing many SMPs to relinquish ESPI audit clients to larger firms. This will simultaneously exacerbate the concentration of the audit market and effect as a barrier to market entry for SMPs. If rotation is seen as the appropriate safeguard, and we think in most cases it is not, then in the interests of fairness firm rather than partner rotation should be employed.

55. Third, rotation will restrict the choice of auditors open to ESPI. There are considerable benefits to be had when an ESPI is faced with a choice of auditors. This choice is limited in certain circumstances, such as developing nations and remote and/or sparsely populated areas. The proposals stand to restrict this choice still further and could conceivably result in an ESPI having a no access to an auditor.

56. Fourth, from the perspective of an external stakeholder, partner rotation within a firm is not visible since they do not get to see or know the individual auditor(s) undertaking the audit. This then begs the question: how does partner rotation within a large firm improve independence of appearance?

57. Fifth, the foregoing implies a high cost to SMPs and some ESPI with little, if any, corresponding benefit in terms of enhanced audit quality. Indeed, firm rotation will likely impair audit quality in the period immediately following firm rotation since new auditors, with limited knowledge and understanding of the client, are more prone to making mistakes. In addition, new auditors will likely be charging more since they are intent on recovering the costs of getting a proper understanding of their new client. Consequently, in the short-term rotation may well enhance independence but at the cost of a more expensive and lower quality audit.

58. Sixth, the costs associated with regulatory requirements need to be proportional to the threats in order for a favorable public interest outcome. Blanket mandatory rotation represents a draconian requirement to address what, in most situations, will likely amount to a modest threat. In the case of an SMP auditing a small listed entity the balance between public interest issues (auditor independence/audit quality/competition) is not the same as with a large firm auditing a large listed entity. Hence, partner rotation is not always an appropriate way of ensuring auditor independence for listed entities. In a large audit firm one could argue partner rotation is an acceptable safeguard since it imposes limited costs on the firm while yielding significantly more comfort for the general public. But in an SMP rotation may not be proportional as it may preclude the SMP from the audit and deny the client choice.

59. Seventh, while rotation may enhance independence of appearance, it does not necessarily follow that it will improve independence of mind. Moreover, in the case of smaller listed entities independence of appearance is less relevant since there are few, if any, truly external investors. We believe there is a fundamental difference between large and small listed entities such as those trading on secondary markets or over the counter. Larger listed companies exhibit a clear separation between investors and the company, and hence increased demand and need for independence of appearance. Meanwhile with smaller listed entities the investors are much closer to the company and generally more involved. Investors are more likely individuals with some connection with the company.

60. Finally, if the investors vote to have an SMP undertake the audit in the full knowledge that the key audit partner has not been rotated then it would seem their consent means that rotation is a non-issue.

61. These reasons suggest that the public interest case for blanket mandatory rotation of key partners for audits of ESPI, as defined in the ED, is not proven and/or inequitable. In many cases the wider costs of rotation – in terms of lower audit quality, higher audit costs, lack of choice, etc – may outweigh the benefits. We suggest that IESBA consider a combination of one or more of the following: modifying the ESPI definition as suggested above; providing for the use of alternative safeguards; and retaining the existing SMP exemption.

62. We strongly recommend that the IESBA consider alternative safeguards to address the familiarity threat with respect to audits of non-listed entities of significant public interest. In particular, we suggest that where the key audit partner has been involved with the engagement for an extended period of time, the potential threat to the firm's independence should be discussed with those charged with governance of the entity. During this discussion, the firm and client should consider the appropriateness of implementing additional safeguards to eliminate or reduce the threat to an acceptable level. Such safeguards might include:

- An additional professional accountant who was not a member of the assurance team, including accountants from outside the firm, to do a pre-issuance review of the work done by the senior personnel or otherwise advise as necessary; or
- An enhanced quality review of the engagements that focuses on the overall quality of the audit and, in particular, the independence and competence of the key personnel on the audit engagement teams.

63. We also believe, contrary to the IESBA, that external review by a regulator is an appropriate safeguard in certain cases. While we accept such a review is conducted ex-post, these reviews, just like historical financial statements, have confirmatory as well as predictive value.

Cooling-Off

64. We have similar reservations to those outlined above for partner rotation. We are especially concerned that the proposed restrictions may prevent small not-for-profit entities from getting access to the advice of experienced people at reasonable cost. We strongly encourage the IESBA to consider safeguards for non-listed entities of significant public interest, other than a cooling-off requirement.

65. For example, the Code could require that, when a key audit partner becomes employed by an ESPI, the partner must completely disassociate with the firm and the following safeguards be implemented: the ongoing audit engagement partner should consider the need to modify the engagement procedures to adjust for the risk that audit effectiveness could be impaired by the former partner's prior knowledge of the audit plan; the firm should assess whether existing audit engagement team members have the appropriate experience and standing to effectively deal with the former partner and their work, when that person will have significant interaction with the audit engagement team; and the subsequent audit engagement should be reviewed to

determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former partner, when the person joins the client in as a director, officer or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements within one year of disassociating from the firm, and has significant interaction with the audit engagement team.

Provision of Non-Assurance Services – General

66. We firmly believe in the basic principle that an auditor should not review their own work and that this principle should apply irrespective of the size of the audit client or practice undertaking the audit. We also recognize that this is already bedded into the existing Code and that the ED largely simply clarifies this. Nevertheless, it is also important to recognize that the provision of non-assurance services by the auditor is appropriate in some circumstances.

67. Many SMEs lack the appropriate in-house expertise and so rely more heavily on practitioners for help than larger entities. Many SMPs, especially those operating in jurisdictions where there is a statutory audit requirement for all companies regardless of size, typically provide a comprehensive range of assurance and other services to the same client. Often the SMP *helps* a particular SME client prepare the underlying books of account from the source documents, maintain proper accounting records, draw up the financial statements, compute taxes payable, and file the tax return while also providing tax advice, auditing the financial statements and providing general business advice. Restrictions on SMPs offering non-assurance services to SME audit clients can significantly increase the costs of doing business and make it less likely they will purchase services that will be of real benefit to them and their stakeholders.

68. SMEs often prefer to have many of these services provided by a known and trusted entity/person. They see great value in having a close business relationship with a practitioner who develops a deep understanding of their business. The relationship is one that is mutually beneficial and serves the public interest by making for a vibrant SME sector. We believe some aspects of the proposals, while well intended, threaten this relationship while offering little enhancement to independence.

69. In particular, we have significant concerns regarding the provision of tax services. The introduction of additional absolute prohibitions, even in situations where acceptable safeguards could be applied, does not seem justified in terms of enhanced independence. Moreover, these prohibitions will hinder the ability of businesses to secure necessary professional services in a cost effective manner. There are a number of matters that need to be considered when proposing additional prohibitions, particularly for SMEs. For example, cost and management time is often greater when non-audit services are obtained from a provider other than the auditor. In addition, in audits of SMEs, the additional information acquired when providing other services enhances audit quality.

Provision of Taxation Services – General

70. We agree that the provision of taxation services by auditors could create threats to independence and that accordingly these need to be assessed and necessary

safeguards applied, or the service prohibited. The existing Code simply states in one section (290.180) that the provision of tax services to financial statement audit clients is generally not seen to create threats to independence. The ED, however, marks a significant shift in the IESBA's attitude towards the provision of such services. It proposes stringent and detailed regulation of the provision of tax services by a firm to an audit client.

71. We believe that the proposed provisions are far more detailed than necessary and in many cases presume the existence of threats which cannot be mitigated by safeguards. It introduces a number of absolute prohibitions that exceed those applied in many other cases and for which there is no evidence of a public interest need. Indeed, from the perspective of the users of professional tax services, the inevitable additional costs of sourcing tax assistance, combined with issues of reduced choice and audit quality, suggest that these additional restrictions will work against the public interest.

72. As well as adversely impacting SMPs and their clients, this implies a move towards a rules-based approach in this area and, consequently, deviates from the IESBA's stated intent to adopt a principles-based approach. Furthermore, with the exception of the preparation of tax calculations, no distinction is drawn between the provision of tax services to ESPI clients and others. This lack of distinction is especially detrimental to SMPs since many SMPs will not be in a position to apply the safeguards as outlined in Section 290.181.

73. The end result of applying the new provisions will be that many SMPs will be excluded from providing such services to their clients, forcing their clients to look elsewhere for tax services and/or to move all their audit and non-assurance work to a larger firm that can apply the safeguards. This is potentially discriminatory, will likely increase business costs and risks impairing the quality of both the audit and tax work. Similar arguments can be extended to other non-assurance services, for instance, some IT systems services and litigation support and legal services.

74. If the IESBA is determined that the proposed structure of a detailed analysis is to be retained, we have two general comments: first, we suggest extending the public interest entity differential approach from the present few isolated cases to most, if not all, taxation services and other non-assurance services; and second, we suggest consideration be given to extending the use of the materiality concept across more taxation services, such as tax advice, and other non-assurance services. In the next section we set out a number of specific comments.

Provision of Taxation Services – Specific

75. According to the last sentence of Section 290.176, the provision of tax return preparation services does not generally threaten the firm's independence as long as management takes responsibility for the returns including any significant judgments made. To our assessment there is obviously no reason to keep the word "generally" in this sentence.

76. We do not believe that the prohibition in 290.178 on material tax calculations by auditors for their ESPI clients is necessary or justifiable in the public interest. At the

very most the prohibition should only apply to material *and* subjective calculations, as we believe the extent of the threat is otherwise not significant.

77. It does not seem appropriate to apply the same treatment to services such as advising the client on how to structure its affairs in a tax efficient manner (tax planning) on the one hand and the application of a new tax law or regulation on the other. It is unclear how the latter could impair the auditor's independence. On the contrary, one could argue that the provider of tax services should be obliged to make the audit client aware of a new tax law or regulation for example, if there is a deadline for a tax exemption or a tax relief. Hence, we suggest clarifying that advising the client on new tax legislation is clearly a duty for a tax advisor and that this could constitute a safeguard. This would help to remove the implication that could be read into Section 290.179 that the services mentioned are a potential threat.

78. Section 290.180 states that a self-review threat may be created where the advice will affect matters to be reflected in the financial statements and that the significance of any threat will partly depend on "the level of tax expertise of the client's employees". It should be clarified to what extent this level of tax expertise represents a relevant factor for the assessment of the self-review threat.

79. Section 290.181 refers to three possible safeguards which are presented as examples as denoted by "might include." In many countries SMEs obtain tax assistance from sole practitioners. However, of the three examples mentioned the only possibility for such practitioners is the last one, obtaining advice on the service from an external tax professional. This is likely to increase the cost to the client. Indeed for this sector of the profession it might render the provision of tax services to audit clients unviable causing the client to have to seek another source. We suggest including additional safeguards, such as obtaining pre-clearance or advice from the tax authorities and extending periodic quality control reviews to include tax services.

80. In Section 290.183 regarding assistance in the resolution of tax disputes it remains unclear if, and to what extent, the first bullet-point (whether the firm has provided the advice that is the subject of the tax dispute) and the fifth bullet-point (the role management plays in the resolution of the dispute) are overlapping. In our opinion, the latter bullet-point could be waived.

81. Sections 290.184 and 290.185 prohibit the audit firm from acting as an advocate for the client in the resolution of a tax matter in certain circumstances. While threats need to be considered, the degree of threat will vary. We question whether the advocacy threat is so significant that no safeguard could eliminate or reduce the threat to an acceptable level in particular, in cases where the taxation service is provided to an entity other than ESPI. We suggest, therefore, that at the very least the Code should distinguish between merely representing a client position and the audit firm defending its own opinion, where it has already opined on a certain treatment. In this latter case, there is no advocacy threat to a future opinion and so there should be no prohibition. Indeed, it is hard to justify denying the client access in a decisive phase of tax assessment to the very expert who best knows the circumstances of case.

Preparing Accounting Records and Financial Statements

82. We agree in principle with the requirements in this section. The ED largely clarifies what is or is not permitted and we concur with the proposed new text. However, we are of the view that more detailed implementation guidance is required to ensure proper compliance with the provisions (see above). The guidance needs to help professional accountants determine how to support the SME client as they go about preparing their accounting records and financial statements, while ensuring that the client's management assumes full responsibility for the statements being audited.

Valuation Services

83. We do not believe that there is any evidence to support a need for the tightening of the requirements in the area of valuation services. Accordingly, we do not support the change in requirements for ESPIs such that material valuations are prohibited even if they are not subjective in nature. The self review threat arises as a result of the auditor having to audit his or her own work but if there is no significant element of judgment included in that work then the extent of the threat is modest.

IT Systems Services

84. We note that the scope of this type of service has been changed from covering "design and implementation" circumstances to a wider set of circumstances covering "design or implementation.". We see no justification for the absolute prohibition in Section 290.197 on the provision of such services for ESPI audits. We suggest that the safeguards discussed in Section 290.195 for audit clients that are not ESPIs should still be possible to apply to all audits on the basis that it may be possible to reduce the threats to an acceptable level.

Multi-disciplinary Practices

85. The Code does not appear to recognize and accommodate the incidence of multi-disciplinary practices. For example, in many countries SMPs are often partnerships of lawyers and accountants. These types of practices stand to particularly severely affected by the revisions relating to non-assurance services. We suggest, therefore, that some consideration be given to these types of practices so that the Code does not undermine their existence and viability.

Compensation and Evaluation Policies

86. While we appreciate the potential threats to independence when a partner is compensated based on their success in selling non-assurance services to an audit client, we believe such a requirement can result in significant costs to SMPs that outweigh the benefits of such a provision. SMPs by definition have a relatively small number of partners, available to serve each client, such that they may not have personnel, other than the partner in charge of the SME's audit with sufficient expertise to provide non-assurance services to that client.

87. Hence, we suggest that the IESBA provide an exemption and allow for the use of alternative safeguards for small firms. In particular, where the size of the firm cause such compensation policies to be impractical, we suggest the firm consider the need for the following safeguards: having an additional professional accountant who was not a member of the audit team review the work; removing such partners from the

audit team; or disclosing to those charged with governance, the total amount of client fees broken down by audit and non-assurance services.

Safeguards

88. In most cases we note a list of 2-4 safeguards is presented. In most cases these are linked with 'or' but in a few rare cases, such as Section 290.138, they are linked with 'and', and on others, such as Sections 290.113, 290.146 and 290.181, the first two bullets are linked with nothing. We wonder whether it is appropriate to use 'or' throughout S290-291. In certain cases where the safeguard is not an absolute, it might be more appropriate to say: "Such safeguards might include a combination of one or more of the following:" We also note the use of (a), (b) etc. in place of bullets in some cases, such as Section 290.223.

Experts Definition

89. We are concerned that including "experts" within the definition of "engagement team" will cause problems in practice, especially for SMPs. Recourse to experts in assurance engagements and thus within firms and networks is increasing, not least as a result of the new risk-based approach required by ISAs 315 and 330. In practice, external experts cannot be compelled to subject themselves to the requirements of ISQC 1 and ISA 220 nor the requirements of the Code. Firms that attempt to require compliance with these on a contractual basis will likely find experts unwilling to take on assignments. This would present acute problems in fields where experts are relatively rare. Potentially, this could lead the larger firms to employ experts as part of the firm's personnel, which in turn would exacerbate the difficulties facing smaller firms seeking specific expertise, leading to further concentration of the audit market towards larger firms and networks.

90. We do not agree that experts that are neither employees of the firm nor "perform the engagement" necessarily need to be subject to such stringent independence requirements, since their expertise is provided to the auditor to enable the auditor to perform the engagement in a sufficiently objective manner for the purposes of the engagement: that is, the auditor's scrutiny of an expert's objectivity and work (as required by ISA 620) functions as an adequate safeguard should there be any independence issues. Such experts are not generally performing the engagement to any significant degree, that is, in an audit of financial statements, for example, they do not generally plan the audit, perform risk assessment, design further audit procedures and draw conclusions from an evaluation of evidence to the extent that they influence the outcome of the assurance engagement. Indeed, the expert does not carry responsibility for the audit rather this responsibility rests solely with the auditor.

91. We suggest, therefore, the definition of engagement team is amended to read something like: "All partners and staff of the firm and any individuals contracted by the firm that performs the assurance engagement." This definition would also benefit from brief guidance on what 'performing an assurance engagement' encompasses.

Application of the New Network Definition

92. While IESBA is not seeking comment on the definition, we are concerned at the lack of implementation guidance on how it ought to be applied in practice, especially by

SMP networks. We fear that SMPs will be under the mistaken impression that their 'arrangement' with other practices firms falls within the new network firm definition when in fact, it does not. We suggest, therefore, assisting SMPs in their assessment as to whether a network exists by providing implementation guidance on how to apply the criteria for determining the existence of a network in particular, that pertaining to 'all facts and circumstances available'.

Request for Specific Comments

93. The questions in the Explanatory Memorandum to the ED are largely answered in the text above but, for the sake of clarity, certain key points are re-iterated below.

94. **Question 1 - Is it appropriate to extend all of the listed entity provisions to entities of significant public interest? If not, why not, and which specific provisions should not be extended? Is it appropriate that, depending on the facts and circumstances, regulated financial institutions would normally be entities of significant public interest and pension funds, government-agencies, government-owned entities and not-for-profit entities may be entities of significant public interest?**

95. **Response 1 –** We generally support the extension of the ESPI definition to include financial institutions but are concerned that smaller entities, especially not-for-profits, governmental organizations and pension funds, may be unduly burdened. For this reason, we welcome the addition of size criteria to the guidelines for determining whether an entity is ESPI or not. See paragraphs 36-42 above for more details.

96. **Question 2 – Is it appropriate to eliminate the flexibility for small firms to apply alternative safeguards to partner rotation? If such flexibility is appropriate, what alternative safeguards will eliminate the familiarity threat or reduce it to an acceptable level?**

97. **Response 2 -** We are very concerned that a blanket prohibition in respect of ESPI will, in many instances, result in an adverse cost-benefit outcome and so fail to serve the public interest. For this reason, we outline various suggestions above, including alternative safeguards and the retention of some form of small practice exemption.

98. **Question 3 – Is the revised guidance related to the provision of non-audit services appropriate?**

99. **Response 3 –** While we are satisfied with most of the provisions some, in particular those relating to ESPI and taxation services, give us cause for concern. We also support the development of more detailed implementation guidance in the area of preparation of accounting records and financial statements.

100. **Question 4 – The primary objective of the strengthening of the independence provisions of the Code is to enhance both the perceived and actual objectivity of those performing assurance engagements, thereby audit quality. Implementation of the new provisions will likely entail some additional costs to stakeholders, which are particularly difficult to measure in the context of a global standard. The IESBA is, however, of the view that the benefits of the proposals are proportionate to the costs and therefore the proposals strike the right balance between the differing perspectives of stakeholders. Do you agree?**

101. **Response 3 –** We broadly agree and understand the merit of the IESBA's efforts to clarify and strengthen the Code, as well as ensure its consistent application. We do, however, disagree in some specific cases, most notably the definition of ESPI, the extended definition of key audit partners, partner rotation and taxation services. In many of these cases we suspect the result is a disadvantageous cost-benefit outcome. There is a need for evidence to support some of the more controversial changes.

Special Considerations on Application in Audit of Small Entities

102. **Respondents are asked to comment on whether, in their opinion, considerations regarding the audit of small entities have been dealt with appropriately in the proposed revisions to the Code. Reasons should be provided, as well as suggestions for alternative or additional guidance.**

103. Please refer to above.

Developing Nations

104. **The IESBA welcomes comments on any foreseeable difficulties in applying the proposed revisions in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.**

105. Much of the foregoing applies to developing nations and for that reason, the letter is a joint submission of the SMP Committee and DNC. It is, however, worth making some additional specific points with regard to the application of the Code in developing and, to an extent, transition economy countries. These points are not so much ones of principle, that question whether or not the proposals contained in the ED ought to be made, but rather points of practical application that stress the difficulties likely to be faced in ensuring compliance in developing countries.

106. First, many developing countries share strong traditions of kinship and brotherhood and these can have a direct and material influence on what is perceived to be the "right" and the "wrong" ways in which to seek to exert influence. In extreme cases, this could lead to almost total ignorance to the fact that a situation, viewed through the eyes of, say, a western European country, was one in which some ethical boundary had been crossed. If people don't see that they are doing wrong, then they will not even feel any need to consider their behavior from an ethical perspective.

107. Secondly, given these cultural differences, and the associated sensitivities, we feel that it is important in a developing nations' context, to review proposals like those in this ED to ensure that they are not likely to be perceived as an attempt to inject "foreign" values into a country. We appreciate that there are difficulties on both sides. On the one hand we must never tolerate behavior that is unacceptable simply because it is a cultural tradition. On the other hand, we must always have regard to the cultural differences that do exist, and allow, therefore, for some flexibility in interpretation and application. It may be that these concerns are more theoretical than practical in most situations, but we believe they are worth noting. We would also stress that we are not trying to imply some form of "politically correct" review, but rather that standards setters are asked to remind themselves from time to time of the scope of their pronouncements.

108. Thirdly, many developing nations are small, agrarian and sparsely populated, and consequently, there are fewer opportunities in the marketplace to support, for example, the rotation of auditors that may be both possible and desirable in larger, more developed countries. This can make it more difficult in practice to apply ethical standards, often in the very countries where they might be of most benefit.

109. Finally, documents like the proposed ED are typically highly technical and so difficult to read and to interpret. In most developed western countries there is now a well established tradition of technocrats who have experience and expertise in reading and interpreting technical pronouncements as well as offering guidance and advice on how they should be applied so as to ease the task of implementation. The same depth of technical human capital does not exist in many developing countries and, therefore, a key element of the institutional infrastructure necessary to ensure the effective implementation of the Code is missing or incomplete. Similarly, where it is necessary to seek judicial interpretation of the provisions of pronouncements like the Code, this will prove much more difficult to do in developing than in developed countries. The absence of professional bodies for accountants and auditors in many developing countries is also an issue in this context, an issue that the DNC is acutely aware of.

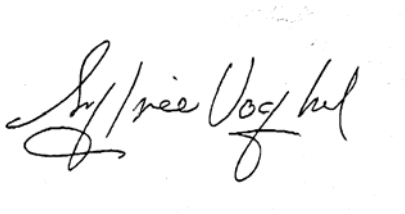
CONCLUDING COMMENTS

110. We are highly supportive of this IESBA project. We hope this letter helps the IESBA in its pursuit of an optimal solution. We have also encouraged member bodies to contribute to the debate and research from an SMP/SME perspective.

111. The success of this project will rest on widespread adoption and consistent implementation. We are committed to helping the IESBA in whatever way it can to ensure these objectives are met.

Please do not hesitate to contact me should you wish to discuss any of the matters raised in this submission.

Sincerely,



Sylvie Voghel,
Chair, SMP Committee

Ignatius Sehoole
Chair, Developing Nations Committee