



*European Federation of Accountants and Auditors for SMEs*

International Ethics Standards Board for Accountants (IESBA)  
529 Fifth Avenue, 6th Floor  
New York, NY 10017 USA  
Attn. IESBA Technical Director  
Brussels, 15 December 2012

Dear Sir

### **Comment on IESBA Exposure Draft – Responding to a Suspected Illegal Act**

The European Federation of Accountants and Auditors for SMEs (“EFAA”) represents accountants and auditors providing professional services primarily to small and medium-sized entities (“SMEs”) both within the European Union and Europe as a whole. Constituents are mainly small practitioners (“SMPs”), including a significant number of sole practitioners. EFAA’s members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs.

EFAA appreciates the opportunity to comment on the IESBA Exposure Draft (“ED”) – Responding to a Suspected Illegal Act.

#### **General comments**

##### *Project objective*

The ED proposes significant changes to sections 225 and 360 of the IESBA Code of Ethics (“the Code”) with little explanation as to why these changes are warranted. Whilst an Impact Assessment has been provided we believe that there would be value in IESBA clearly explaining why changes in the Code were warranted in this regard and to this degree. That is to say, what problem is this ED addressing?

As a general point it seems that this ED addresses much larger issues than those normally encountered by SMEs or SMPs. We say this because:

- the ED and its accompanying Impact Assessment and Press Release are very much focussed on the concept of the Public Interest and the consequences of non disclosure being harmful to individuals and society;
- the IESBA SME / SMP WG has already reported (preliminary report of June 2011) on the specific challenges of the Code in respect of SMEs and SMPs. Within the report it was noted that “resource constraints, including lack of time, funds and qualified individuals available to provide direction and advice, often inhibit the ability of professional accountants in SMEs and SMPs to develop a knowledge and understanding of the Code”;
- the escalation procedures in the Code are more appropriate to medium-sized and larger accounting firms because in a small or sole practice there is very little or no opportunity to escalate;
- the proposed changes to the Code could add significant and disproportionate requirements to SMEs and SMPs; and
- we believe that the ED has failed to consider the special relationship of the SMP as the trusted adviser of the SME. Through this relationship the SMP may well have day to day contact and therefore very detailed knowledge of the SME. This would place the SMP in a position that the much larger firms and networks will not likely face and could possibly place a disproportionate burden on the SMP professional accountant.



*European Federation of Accountants and Auditors for SMEs*

We have further concerns about the ED where it requires the professional accountant to use his judgement in terms of what is required when information comes to light that was not “acquired as a result of professional and business relationships”. In which circumstances would this be the case? The ED states that “a professional accountant’s rights and responsibilities with respect to disclosing such acts (personal misconduct) would be the same as for any other member of society. We have difficulty in agreeing with this sentiment, as we believe that the professional accountant when acting in that capacity should always act with integrity and exercise professional behaviour.

Lastly, we do not believe that confidentiality can be restricted to certain pieces of information. We do not think that the fact that information comes through one channel, not another, should cause a professional accountant to act in a different manner.

#### *General approach and drafting*

In general we are of the opinion that this ED would have benefited from being drafted in a “think small first” or building block approach. This is because the vast majority of services provided by professional accountants in practice are non-audit services provided to companies that do not require by law or do not voluntarily commission an audit.

In this regard, an SMP reader of the Code providing non-audit services to an SME client has to read the entire section to understand what they must do. If a “think small first” or building block approach had been used an SMP would have been able to read their appropriate section first.

We also believe that such an approach could offer a practical solution to combatting what are general Code issues with respect to complexity and length. These issues have already been brought to the attention of IESBA through the report of the IESBA SME/SMP Working Group.

On a further note, it may be that a flow chart that encapsulated the required steps would be worthy of further consideration.

#### *Definitions*

The ED is built on the premise that any reporting of a suspected illegal act would ultimately arise if it were deemed to be in the “public interest”. We are not aware of the existence of a widely accepted definition of the term “public interest” and therefore we anticipate that there will be a significant difference in how the “public interest” is ultimately determined and in how this standard is therefore applied in practice. In our opinion this is a fundamental issue.

We are concerned about what would constitute a “suspected illegal act” and as a result we are of the opinion that the term should be clearly defined. This is because the ED requires the practitioner to make a determination of whether the act could ultimately be found to be illegal in a court of law. As the Code requires the professional accountant to exercise competence it rightly deters the accountant from attempting such a determination without commensurate legal skills, which few accountants possess. For example, tax avoidance is not illegal yet tax evasion is. The final determination of whether an act was evasion or avoidance can often only be made after a complicated and lengthy legal process. As it is not clear in the ED what constitutes a “suspected illegal act” it is not clear in the aforementioned example what a professional accountant should do.



*European Federation of Accountants and Auditors for SMEs*

### **Request for Specific Comments**

Our comments on specific matters are set out below.

- 1. Do respondents agree that if a professional accountant identifies a suspected illegal act, and the accountant is unable to dispel the suspicion, the accountant should be required to discuss the matter with the appropriate level of management and then escalate the matter to the extent the response is not appropriate? If not, why not and what action should be taken?**

We have already raised concerns about the definition of a “suspected illegal act”. It would be unreasonable for the professional accountant to have to discuss the suspected illegal act with management or those charged with governance (“TCWG”) without being certain of the subject matter and this may also require that the accountant takes legal advice or has at least discussed this with its regulatory body or professional institute in the first instance. Taking action to dispel the suspicion could prove difficult in practice and some guidance on this may be appropriate. There may also be instances where the professional accountant can neither confirm nor dispel the suspicion. The ED does not address this particular circumstance.

We have further concerns about the materiality of such actions. Whilst accepting that all illegal acts should have consequences we feel that this could place undue burden on SMPs because of their special relationship outlined above. Larger practices and networks are more likely to have audit clients where their only responsibility is to form an opinion on whether the accounts give a true and fair view. In doing so they necessarily plan their work with audit materiality in mind and it is possible that they would be likely to find fewer suspected illegal acts. This would mean that the professional accountant in a smaller practice which, for example, provides bookkeeping and daily accounting services could be placed in a situation in which he is held to a higher standard as he is more likely to become aware of such issues which may be very small but nevertheless could be judged ultimately to have been likely to be deemed illegal.

We are also of the opinion that this determination could require significant time and effort for SMPs which is disproportionate to that which would be required within much larger firms or networks which may well have in house legal and technical staff and certainly have access to additional resources to which staff can turn to for a second opinion.

What we can say is that we do agree that some escalation of the matter is warranted and we would agree that “if a professional accountant identifies a suspected illegal act, and the accountant is unable to dispel the suspicion, the accountant should be required to discuss the matter with the appropriate level of management”.



*European Federation of Accountants and Auditors for SMEs*

**2. Do respondents agree that if the matter has not been appropriately addressed by the entity, a professional accountant should at least have a right to override confidentiality and disclose certain illegal acts to an appropriate authority?**

Firstly we assume that the question is in fact addressing suspected illegal acts as illegal acts would have been determined by a court of law and would therefore already be in the public domain.

We reiterate the point made above about the skills required of a professional accountant. It may be beyond the ordinary competence of a professional accountant to determine whether a matter has been appropriately addressed by the entity and indeed to determine whether disclosure is in the public interest. That said, we agree with the principle that a professional accountant should at least have a right to override confidentiality subject to existing national requirements and guidance already included in the Code.

**3. Do respondents agree that the threshold for reporting to an appropriate authority should be when the suspected illegal act is of such consequence that disclosure would be in the public interest? If not, why not and what should be the appropriate threshold?**

In our opinion the issue is potentially more complicated than that outlined. Our earlier comments addressed the difficulties inherent in the definition of the “public interest”. A clear definition is necessary for the professional accountant to be able to conclude that a threshold has been exceeded.

For instance, the issue may involve one that rests within a small “not for profit” organisation. The matter in question may not involve large sums of money but could be of particular interest to certain sections of the local community and therefore would be of public interest. That said, in the scenario outlined this would not necessarily fall into the current view of what the public interest is or when it is best served. We think that this will always be a grey area unless a definition of the public interest is clear and widely accepted. It may also be the case that a matter on its own is not in the public interest but because of other similar “matters” raised or because of a general feeling of unease in certain sections of business or the community, the accountant concludes that this issue should be brought to the attention of others.

Whilst we believe that this lack of clarity will result in different practical applications of the Code we are sympathetic to IESBA’s attempt to determine a threshold given the complexity of the issue. Asking professional accountants to use their judgment therefore seems sensible in this regard.



*European Federation of Accountants and Auditors for SMEs*

#### **Matters specific to professional accountants in public practice (Section 225 of the Code)**

- 4. Do respondents agree that the standard for a professional accountant in public practice providing services to an audit client should differ from the standard for a professional accountant in public practice providing services to a client that is not an audit client? If not, why not?**

We do not believe that the standard should differ as in our mind the only difference in respect of the fundamental ethical principles should surround the issue of independence and we do not believe that this is of importance in the sphere of “illegal acts”.

What is clear is that the roles and responsibilities may be different and the requirements must thus accommodate such differences. As previously mentioned, an SMP involved in the day to day business of its SME client may well come across very small matters that he judges to be suspected illegal acts. The auditor, on the other hand, will be looking for material issues.

To that end we believe there would be merit in including similar wording in the section entitled “Professional accountant Providing Services to a non-audit Client” in respect of the ability for the practitioner to consult legal advice to that included within paragraphs 225.22 and 225.8.

- 5. Do respondents agree that an auditor should be required to override confidentiality and disclose certain suspected illegal acts to an appropriate authority if the entity has not made adequate disclosure within a reasonable period of time after being advised to do so? If not, why not and what action should be taken?**

Notwithstanding our concerns surrounding the definition of the public interest it seems appropriate that this would be a consideration that the auditor should make. Again we would suggest that this be a matter for professional judgement and not an obligation necessarily.

- 6. Do respondents agree that a professional accountant providing professional services to an audit client of the firm or a network firm should have the same obligation as an auditor? If not, why not and what action should be taken?**

As previously stated we believe that all professional accountants should have the same responsibilities and we are unclear as to why being part of a network that includes the auditor would either increase or decrease the obligations in this regard.

- 7. Do respondents agree that the suspected illegal acts to be disclosed referred to in question 5 should be those that affect the client’s financial reporting, and acts the subject matter of which falls within the expertise of the professional accountant? If not, why not and which suspected illegal acts should be disclosed?**

We believe that the issue is more complicated than that outlined. The determining factors are likely to be pertinent to the task in hand. Different engagements have different requirements. An auditor would necessarily look to auditing standards to determine his responsibilities. A professional accountant undertaking a taxation engagement may have specific tax requirements. Is it sensible to restrict this to financial reporting? On the other hand if the matter does not affect the clients financial reporting is it



*European Federation of Accountants and Auditors for SMEs*

reasonable for the accountant to ignore this? The Professional accountant needs to know when the matter would fall within the scope and when it would not. Perhaps the clearer solution would be to have all suspected illegal acts addressed.

- 8. Do respondents agree that a professional accountant providing professional services to a client that is not an audit client of the firm or a network firm who is unable to escalate the matter within the client should be required to disclose the suspected illegal act to the entity's external auditor, if any? If not, why not and what action should be taken?**

No. We do not believe that there should be a requirement in this regard. This decision is a matter of professional judgment that cannot be passed on to another professional accountant. There should be provision in the Code to allow the professional accountant in this circumstance to take legal advice and the Code should be amended as outlined in our response to question 4. It may be that after legal Counsel has been sought the professional accountant then believes that the auditor needs to be informed because it is now matter of public interest. This right should be allowed.

- 9. Do respondents agree that a professional accountant providing professional services to a client that is not an audit client of the firm or a network firm should have a right to override confidentiality and disclose certain illegal acts to an appropriate authority and be expected to exercise this right? If not, why not and what action should be taken?**

We believe that there should be a right but we do not agree that they be expected to exercise that right which we think is a matter for their professional judgment.

- 10. Do respondents agree that the suspected illegal acts to be disclosed referred to in question 9 should be those acts that relate to the subject matter of the professional services being provided by the professional accountant? If not, why not and which suspected illegal acts should be disclosed?**

As we have already stated in our response to question 7 it would be appropriate for the professional accountant to judge for himself the action that should be taken if he suspects an illegal act has taken place. If we use the test of the reasonable informed party it would seem unprofessional for the accountant to be able to excuse himself from taking any action because of the type of services that were being supplied.

#### **Matters specific to professional accountants in business (Section 360 of the Code)**

- 11. Do respondents agree that a professional accountant in business who is unable to escalate the matter within the client or who has doubts about the integrity of management should be required to disclose the suspected illegal act to the entity's external auditor, if any? If not, why not and what action should be taken?**

Whilst accepting the objective of the ED we have some reservations as to how this would work practically.

There may well be an issue as to why the matter could not be escalated further. Thereafter we would be interested in understanding from IESBA the purposes of informing the auditor. This would require the professional accountant in business to trust the auditor to do something appropriate and there may be instances where this level of trust is not in existence.



*European Federation of Accountants and Auditors for SMEs*

**12. Do respondents agree that a professional accountant in business should have a right to override confidentiality and disclose certain illegal acts to an appropriate authority and be expected to exercise this right? If not, why not and what action should be taken?**

No we do not agree for the reasons outlined above.

**13. Do respondents agree that the suspected illegal acts to be disclosed referred to in question 12 above should be acts that affect the employing organization's financial reporting, and acts the subject matter of which falls within the expertise of the professional accountant? If not, why not and which suspected illegal acts should be disclosed?**

It would be appropriate for the professional accountant to judge for himself the action that should be taken if he suspects an illegal act has taken place.

#### **Other**

**14. Do respondents agree that in exceptional circumstances a professional accountant should not be required, or expected to exercise the right, to disclose certain illegal acts to an appropriate authority? If not, why not and what action should be taken?**

We agree that in exceptional circumstances as outlined in sections 225.14, 225.22 and 360.10 a professional accountant should not be obliged to disclose.

**15. If respondents agree that in exceptional circumstances a professional accountant should not be required, or expected to exercise the right, to disclose certain illegal acts to an appropriate authority, are the exceptional circumstances as described in the proposal appropriate? If not, how should the exceptional circumstances be described?**

Yes they are appropriate.

**16. Do respondents agree with the documentation requirements? If not, why not and what documentation should be required?**

It seems reasonable to document the decision whilst accepting that it is possible that any documentation of this sort may also lead potentially to the threats that have been outlined in 225.14, 225.20 and 360.10.

That said, we are unsure as to IESBA's intention in this regard and hence to what purpose documenting the decision is? Is this to record the issue or to improve the ethical decision making process in question? We say this because the example given in the Explanatory Memorandum under "Documentation" states that IESBA is of the view that documentation requirements may be met by having a policy or procedure in place to address such (encountering a large number of immaterial suspected illegal acts) issues. This suggests to us that IESBA may see documentation of the act being replaced by a policy or a procedure. It would be of value to clarify the intention in this regard along with the use of the word "immaterial" when the ED has already proposed that materiality has little relevance in this regard.



European Federation of Accountants and Auditors for SMEs

**17. Do respondents agree with the proposed changes to the existing sections of the Code? If not, why not and what changes should be made?**

To the extent that these changes are in fact being made to make the provisions of the Code consistent we agree.

That said, it appears that the changes proposed to section 210.5 go further than simply to conform to the revisions under this ED. In its extant form it was a clear and concise paragraph as follows:

***Extant 210.5***

***A professional accountant in public practice shall periodically review whether to continue with a recurring client engagement.***

It has been changed to the following:

***Revised 210.5***

***Potential threats to compliance with the fundamental principles may have been created after acceptance that would have caused the professional accountant to decline the engagement had that information been available earlier. A professional accountant in public practice shall, therefore, periodically review whether to continue with a recurring client engagement. For example, a threat to compliance with the fundamental principles may be created by a client's unethical behavior such as improper earnings management or balance sheet valuations. If a professional accountant in public practice identifies a threat to compliance with the fundamental principles, the accountant shall evaluate the significance of the threats and apply safeguards when necessary to eliminate the threat or reduce it to an acceptable level. Where it is not possible to reduce the threat to an acceptable level, the professional accountant in public practice shall terminate the client relationship.***

This newly worded paragraph goes further than a conforming amendment and we are concerned about the introduction of this paragraph as it requires the Professional Accountant to consider unethical behavior such as improper earnings management or balance sheet valuations but does not clarify matters in this regard. Instead it has the effect of making such required determinations even more complicated to understand and therefore less likely to be implemented in the manner that IESBA intended.

**18. Do respondents agree with the impact analysis as presented? Are there any other stakeholders, or other impacts on stakeholders, that should be considered and addressed by the IESBA?**

Whilst we welcome the introduction of the Impact Assessment it seems clear to us that the presumption has been made that the public interest will be better protected because the provisions of the Code have been redrafted.

We would argue that the public interest would only be better served if the provisions of the Code were more widely applied. IESBA itself recognises (in its Proposed Strategy and Work Plan 2010 – 2012) that work is still required in the areas of “Adoption and Implementation Guidance” and “Convergence”. EFAA fully supports the work performed to date and recognises the importance of on-going work to address these matters. Therefore, whilst accepting the importance of what the proposed changes hope to achieve it is difficult for one to conclude that the drafting amendments will result in better protection of the public interest. This would





*European Federation of Accountants and Auditors for SMEs*

result from a more widespread application of the Code itself together with increased appreciation of the Code and its value outside of the profession.

Finally, we would note that the Impact Assessment has been prepared without differentiating between types of professional accountant. We have already stated that there could be a significant burden placed on SMEs and SMPs. The costs of the new proposals outlined in the ED may well outweigh the resulting benefits in terms of serving the public interest in the SME / SMP sphere. This issue has not been dealt with in the Impact Assessment.

I trust that the above is clear but should you have any questions on our comments, please do not hesitate to contact me.

Yours faithfully,

Federico Diomeda  
Chief Executive Officer