

IESBA SME/SMP Working Group Report October 2011

Introduction

This report presents the Working Group's findings and recommendations to the Board on how it might address the unique and challenging issues faced by professional accountants in SMEs and SMPs when complying with the IESBA Code.

Background

Small- and medium-sized entities ("SMEs") are an important contributor to the world's economies. SMEs account for the majority of private sector employment and are also a major source of economic growth, innovation and job creation in most if not all countries around the globe. According to the Global Alliance of SMEs¹, SMEs represent more than 98% of all businesses worldwide, play an instrumental role in the socio-economic development of the entire global community and are a major force not only in economic prosperity but also in social stability. As such the health of SMEs, and the small- and medium-sized practices ("SMPs") that in many cases provide them with accounting, assurance and related services, is critical to the public interest. Many SMEs are dominated by an owner-manager, lack a robust control environment, are subject to resource constraints (time, funds, qualified individuals, etc), and have few financial statement users and other stakeholders. SMEs and professional accountants in SMEs often value the advice that their professional accountants in public practice are able to provide them more than an audit or review – where independence is required, it is important to keep this in mind.

In order to better serve the public interest, the IESBA recognizes the importance of understanding the unique and challenging issues encountered by professional accountants in SMEs and professional accountants in public practice, including SMPs, providing services to SMEs when complying with the Code. The Board established the IESBA SME/SMP Working Group to identify and advise it on these issues. For this initiative, SMEs do not include public interest entities. SMEs far outnumber entities characterized within the IESBA Code of Ethics ("the Code") as public interest entities, SMEs are an important part of global markets and providing high quality ethics standards to support SMEs is in the public interest.

Information sources

Each of the Working Group members (listed at the end of this *Preliminary Report*) has experience with SMEs and SMPs. In order to gain additional insights into the challenges faced by professional accountants in SMEs and SMPs, the Working Group:

¹ <http://www.globalsmes.org/html/index.php?func=expo2010&lan=en>

- Reviewed relevant information available from IFAC bodies, including reports and responses to exposure drafts and surveys
- Compared portions of the Code (excluding material dealing with public interest entity auditor independence) with ethics standards in various local jurisdictions
- Participated in the 2011 SMP Forum held in Istanbul, including leadership of a breakout session of over 50 participants from around the world focusing on challenges faced by professional accountants in SMPs and SMEs complying with the Code, and a panel discussion by the Working Group Chair
- Obtained input from and maintained ongoing communication with the SMP Committee and its staff, including a face-to-face meeting of the Working Group Chair and the SMP Committee in March
- Obtained input from national standard-setters from around the world at a face-to-face meeting attended by the Working Group Chair in April
- Obtained input from individuals around the world responding to questions in the SMP Committee's *April 2011 Quick Poll* included in its e-newsletter (reference is made to the results of this poll in the findings set out below)
- Obtained input from a selection of other individuals from various geographic locations and backgrounds

Working Group findings and recommendations

The Working Group's findings and recommendations are set out in the following pages for the Board's consideration.

While these findings and recommendations relate to the application of the Code by professional accountants in SMEs and SMPs, the Board may find them of broader relevance. SMEs and SMPs are not terms used in the Code, and the Working Group did not consider it necessary to define either SMEs or SMPs for any of its recommendations. However, none of the recommendations is intended to apply to public interest entity auditor independence as this is outside the scope of the Working Group's mandate.

1. Knowledge and Understanding of the Code

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. This challenge may be exacerbated by the length and complexity of the Code, particularly when the professional accountant's language is other than English and translation is required.

The length of the Code may also make it difficult to communicate its requirements to external stakeholders, such as SMEs and their owners.

Recommendations

- a) Develop guidance for users to facilitate general learning and the application of the Code to specific circumstances. It is suggested that this guidance be comprised of *IESBA Staff Questions and Answers*, supplemented as appropriate by case studies. When asked in the *April 2011 SMP Quick Poll*, significantly more than half the respondents expressed the view that case studies applying the Code to specific typical scenarios would be helpful. Topics for consideration include:
 - Addressing threats to the fundamental principles that may be elevated for a professional accountant in an SME with a dominant owner-manager and without a robust control environment
 - Responding to suspected illegal acts – accompanying changes to the Code arising from the current project
 - Preparing accounting records and financial statements – addressing matters such as the application of the “routine or mechanical” guidance, the importance of an informed management² and the impact of complex accounting issues
 - Valuation services
 - Tax services
- b) Prepare and publish a synopsis of the Code. It must be clear that the synopsis is not meant to be a complete representation of the Code; it should be brief and condensed in such a manner as to enable an overview of the Code to be described appropriately, potentially very few pages in length. The synopsis could be presented in various formats, including hard copy or electronic form with hyperlinks to the appropriate section of the Code. These various methods of delivery are meant to provide SMPs and SMEs quick and easy access to the relevant information contained in the Code.

² An informed management encompasses characteristics such as understanding of relevant requirements, facts and assumptions, and responsibility for the results.

- c) Publish the Code in a format that facilitates ready access to the sections of the Code relevant to the particular user – for example, the electronic version of the Code might be made available in one folder with separable files so that a professional accountant in an SME or SMP who does not need access to independence matters could ignore Sections 290 and 291. Alternatively, the electronic version might be interactive, with responses to initial questions resulting in a tailored extract of the Code that includes only those components relevant to the particular user.
- d) Liaise with member bodies to identify how this guidance and other tools that the Board may develop can be aligned with training programs to facilitate learning about the Code. Possibilities include short videos introducing the main sections of the Code; while these would not be a substitute for reference to the detailed guidance, they could raise the Code's profile and provide an initial orientation.

2. Safeguards

The safeguards noted in various sections of the Code (see below “Appropriate safeguards available to sole practitioners and smaller SMPs”) appear to be appropriate for most situations, yet the examples, although similar, vary from section to section. This inhibits the ability of a professional accountant in an SME or SMP to apply an intuitive approach to establishing safeguards.

When addressing management responsibilities, the Code acknowledges that risk of self-review and self-interest may be avoided if the firm is satisfied that management is responsible for making significant judgment and decisions, evaluating the results of services and accepting responsibility for the actions to be taken arising from the results of the services. The Code also states that risk can be further reduced when the firm gives the client the opportunity to make judgments and decisions based on an objective and transparent analysis and presentation of the issues. We will refer to this as “informed management”. Informed management is viewed by many as an effective safeguard yet it is not listed in any other Code sections as an appropriate safeguard. Including an informed management as an appropriate safeguard would provide professional accountants in SMPs and other firms providing services to SMEs with an appropriate and effective safeguard for some of the threats identified in the Code.

SMEs typically rely upon their professional accountant to provide advice on a variety of matters in addition to performing an audit or review. This advice enables them to overcome resource constraints and is often valued more than the audit or review. For a professional accountant in an SME, it may enable consultation with another professional accountant and be one of the few safeguards available to the professional accountant in business. An informed management is an important safeguard that contributes to the ability of SMEs to obtain the advice they need while safeguarding independence.

The Working Group has received some anecdotal feedback that, at least in some jurisdictions, professional accountants in SMEs and SMPs believe the Code’s examples of safeguards are being interpreted as all-inclusive and not subject to modification. It has been suggested that this may be more likely in certain jurisdictions that use legislation to mandate the Code. If this is the case, it may inhibit the ability of a professional accountant in an SME or SMP to apply safeguards other than those included in the examples.

The Code’s establishment of the same independence standards for professional accountants performing review engagements as for auditors has been a topic of discussion. The following recommendations do not differentiate between audits and reviews; however, the Working Group realizes that if some or all of the recommendations are not implemented, reconsideration of the independence requirements for review engagements may be warranted.

Recommendations

- a) More clearly include an informed management as an appropriate safeguard when addressing self-review and self-interest threats
- b) Revise the examples of safeguards so they are consistent, where appropriate, from section to section to enable a more intuitive approach to applying safeguards

Typical safeguards include:

- Ensuring that the client has an informed management
- Arranging for services to be performed by an individual who is not a member of the audit team; or

If such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed

- Obtaining advice from an external professional
 - Regular independent internal or external quality reviews of the engagement
- c) Consider whether any action is warranted to clarify that professional judgment is required when applying the Code's guidance on threats and safeguards because, though it is quite comprehensive, the Code may not have identified every threat or every safeguard available in a particular circumstance
 - d) Consider whether there are appropriate safeguards that may reduce to an acceptable level the self review threat associated with a professional accountant performing a material valuation involving a significant degree of subjectivity for an SME audit client. There are differing views as to whether the self-review threat is manageable. Although valuation services are currently prohibited by the Code in these circumstances, some member bodies' standards contemplate the availability of sufficient safeguards. These safeguards generally include involvement of others such as a valuation specialist not on the audit team. A valuation by a valuator who is not a member of the audit firm and does not have existing knowledge of the SME may result in a higher cost to the SME. Resistance to the additional cost may cause some SMEs to avoid engaging a valuator in some situations where the involvement of a professional with valuation expertise is appropriate.
 - e) Consider whether there are appropriate safeguards that may reduce to an acceptable level the advocacy threat associated with a professional accountant acting as an advocate for an SME audit client in the resolution of a material tax matter before a public tribunal or court. Matters that are referred to a public tribunal or court vary by jurisdictions – some

jurisdictions include matters that in other jurisdictions are resolved without having to resort to a public tribunal or court. As a result, the Code considers some matters subject to an unmanageable advocacy threat when referred to a public tribunal or court that in other jurisdictions are considered manageable as they are resolved without going to a public tribunal or court.

3. Appropriate safeguards available to sole practitioners and smaller SMPs

The Code provides many examples of safeguards available to professional accountants when managing threats. However, many of these safeguards are not readily available to sole practitioners or SMPs with only one audit/review partner. Many SMEs obtain audit or review engagement from a sole practitioner or a small SMP and cost, geographic location or other factors may limit the alternatives available to these SMEs. There are typically few users of the audit or review reports on SMEs issued by sole practitioners or SMPs with only one audit/review partner.

Recommendation

Develop guidance for sole practitioners and SMPs with only one audit/review partner to facilitate the identification of appropriate safeguards. This guidance may initially be provided in *IESBA Staff Questions and Answers* and later incorporated in the Code. Topics for consideration include:

- Long association of senior personnel with an audit client (paragraph 290.150)
- Preparing accounting records and financial statements (paragraph 290.171)
- Valuation services (paragraph 290.176)
- Tax calculations for the purpose of preparing accounting entries (paragraph 290.184)
- Tax planning and other tax advisory services (paragraph 290.189)
- Assistance in the resolution of tax disputes (paragraph 290.192)
- Fees – relative size (paragraph 290.220 - .221)

Sole practitioners and SMPs with only one audit/review partner, and the member bodies to which they belong, may expand the available safeguards by establishing relationships with other professional accountants. For circumstances when the examples provided remain unavailable, the Board should consider the acceptability of other safeguards. One possibility for the Board's consideration is an informed management combined with exposure to recurring internal or external inspection - this safeguard may, for example, be limited to lower risk engagements of sole practitioners and SMPs with only one audit/review partner, and may require communication to the client and the individuals responsible for the internal or external monitoring.

4. Network Firm

Many SMPs develop relationships with correspondents either in their own jurisdiction or abroad. Many sole practitioners join together to share office space, administrative staff and even partner in performing reciprocal internal quality reviews. In some circumstances, these relationships may constitute an “alliance” but not a network. There is concern regarding the application of the definition of a “network” as defined in the Code, and the related independence requirements.

Recommendation

Develop guidance for users on the Code’s definition of a network firm particularly as it relates to formal or informal associations developed by and between SMPs. It is suggested that this guidance be included in *IESBA Staff Questions and Answers*.

5. Future expansion of the Code

Many view the Code as long, but much of the Code is focused on the independence of the professional accountant providing (or in a firm providing) audit, review or other assurance services. Many professional accountants in SMPs provide non-assurance services. The Code provides only general guidance related to non-assurance services.

A question in the *April 2011 SMP Quick Poll* asked respondents to consider expansion of the Code to deal more specifically with non-assurance services (the poll asked specifically about tax, wealth management and advisory) – of the 440 responses:

- 37.3% identified tax services as their first choice for more specific coverage in the Code
- 26.1% identified advisory services as their first choice for more specific coverage
- 9.1% identified wealth management as their first choice for more specific coverage
- 27.5% responded that no further guidance is required

Recommendation

When developing future workplans, while being mindful of the overall length of the Code, consider dealing more specifically with non-assurance services, particularly tax services. For example, guidance on tax services might include matters such as association with tax positions that have low probability of surviving challenge.

6. Ongoing consideration of SMEs and SMPs in the standard-setting process

The objective of the IESBA is to serve the public interest by setting high-quality ethical standards for professional accountants and by facilitating the convergence of international and national ethical standards, thereby enhancing the quality and consistency of services provided by professional accountants throughout the world and strengthening public confidence in the global accounting profession. It is appropriate to consider SMEs and SMPs when addressing this objective.

Many SMPs perform audits of entities other than public interest entities and need guidance in navigating the Code. In addition, SMPs provide services to SMEs that are not traditional audit services. These services include, but are not limited to, providing business and management advice, assistance with the preparation of accounting records and financial statements, valuation and tax services, to name a few. In April 2010, the SMP Committee issued an information paper titled, *The Role of Small and Medium Practices in Providing Business Support to Small- and Medium-Sized Enterprise*, which provides the following commentary on the relationship of the SMP to the SME.

“In general, all the interviewees regarded SMPs as the main providers of advice and support for SMEs: a “port of first call” or a “general practitioner” for the SME and there were many advantages of being an SMP in relation to the SME market. SMPs were regarded as being part of a traditional system of providing services on a local, face-to-face basis; having a knowledge-base of the industry and particular needs of SMPs; and possessing the experience of dealing with SMEs, including the fact that they are small enterprises and can therefore often empathize with their client.”

Recommendations

- a) Establish processes to ensure that the particular circumstances of SMEs and SMPs are considered in all projects and deliberations
- b) Each year, seek qualified IESBA nominations that will enable the Board to maintain sufficient SME/SMP experience to facilitate appropriate consideration of their circumstances in the standard-setting process
- c) Continue to maintain close cooperation with IFAC’s SMP Committee and extend cooperation to the PAIB Committee in relation to professional accountants in business working in SMEs
- d) Consider maintaining an SME/SMP working group to obtain ongoing advice
- e) Consider discussing with CAG the importance of continued appropriate SME/SMP representation

WORKING GROUP MEMBERS

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