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IFAC Small and Medium Practices Advisory Group (SMPAG) Response to the International Ethics Standards Board for Accountants (IESBA) Exposure Draft: *Proposed Revisions to the Definitions of Listed Entity and Public Interest Entity in the Code*

INTRODUCTION

The SMP Advisory Group (SMPAG) is pleased to respond to the IESBA (the Board) on this Exposure Draft (ED). The SMPAG is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small-and medium-sized entities (SMEs). The constituents of the SMPAG are small-and medium-sized practices (SMPs) who provide accounting, assurance, and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMPAG have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies representing 23 countries from all regions of the world.

GENERAL COMMENTS

The SMPAG has been closely following the development of the PIE and Listed Entity project and has welcomed the opportunities to provide input as the IESBA developed the proposals. For example, we provided input through comment letters in March and June 2020, as well as during a specific meeting in November 2020.

It is important for IESBA to ensure that a principles-based approach to standard-setting is maintained. The SMPAG agrees that it would be difficult, if not impossible, to develop a single definition of PIE at a global level that can be consistently applied by all jurisdictions without modification and further refinement at a local level. However, an approach that appears designed to require adaptation is not appropriate. On balance, we believe that the PIE definition in the IESBA Code (the Code) should be narrow (approach 1), rather than broad (approach 2), otherwise the situation arises where PIEs at an international level are not PIEs under local legislation in several parts of the world and it leads to inconsistent practices. The overriding consideration in proposing any PIE-only changes to the IESBA Code has to be whether or not enhanced ethical requirements are needed because of the level of public interaction with a certain type/ classification of entity.

Approach 1 with a short and narrow list of categories which local regulators and authorities may continue to add to (similar to the current definition of PIE in the Code) would provide a base that can be applied consistently throughout the world (as far as possible) and be understood by stakeholders as a consistent approach. Whilst going beyond this may be necessary in a few jurisdictions and for certain cases (i.e., this would be determined in legislation), exclusions of entities or additions by individual firms would be far less appropriate (i.e., going below the base) from a stakeholder's and public interest perspective. In our opinion,

if IESBA presupposes there will be a need to exempt certain entities, they ought not to be included, otherwise it will lead to inconsistent practices internationally and have potential unintended consequences.

For a variety of reasons outlined below, we are particularly concerned about the potential practical impact of the proposals for individual auditors to go beyond the definition of a PIE in national law, with a requirement to consider this and disclose it. We believe there is a risk of inconsistent application, further confusion and misunderstanding in the marketplace, as well as potential unintended consequences.

We believe that achieving consistency between international standard setters is critical. In practice, it is problematic that differences exist between the definitions and expressions used. With the IAASB using the term 'Entities with Significant Public Interest' (ESPI) and the IASB using the term 'Publicly Accountable' it does not augur well for investors, potential investors, and other key stakeholders in obtaining a clear understanding of the objectives of broader corporate reporting, and in particular, financial reporting. We strongly encourage the International Standard Setting Board's to work together to eliminate the differences and harmonize the definitions.

SPECIFIC COMMENTS

We have outlined our responses to each question (*in italics*) in the ED below.

Overarching Objective

1. Do you support the overarching objective set out in proposed paragraphs 400.8 and 400.9 as the objective for defining entities as PIEs for which the audits are subject to additional requirements under the Code?

We generally support the concept of having the overarching objective but are concerned about the relationship between the proposed paragraphs 400.8 and 400.9 and the requirement in R400.14 and how the proposed structure will work in practice. We understand that the requirements in R400.14 are intended to be refined by local jurisdictions using 400.8 and 400.9. However, these factors can be considered very broad, which could lead to challenges and inconsistency upon adoption and implementation.

Also, we have some concerns about the use of the term "financial condition" and how it has been described and used in the revised sections of the Code. The term remains undefined and para. 400.9 refers to *"confidence in financial statements"*, which may create confusion to users of the Code as they try to determine whether these are the same, or different, concepts. The wording in para. 400.8 also states that the section of the Code only applies to *"the audit of financial statements of public interest entities, reflecting significant public interest in the financial condition of these entities"*. This may suggest that the interest stakeholders have in the financial statements is restricted solely to an organization's financial condition.

2. Do you agree with the proposed list of factors set out in paragraph 400.8 for determining the level of public interest in an entity? Accepting that this is a non-exhaustive list, are there key factors which you believe should be added?

As indicated above, we are concerned about how the list of factors set out for determining the level of public interest in an entity interacts with R400.14 and whether these are helpful. If it is retained, we recommend that IESBA clarify that these are possible factors that it may be relevant to consider (rather than "will depend on…", which implies this is always a requirement).

The SMPAG provided observations on some of the specific factors:

- The factor *"Whether the entity is subject to regulatory supervision designed to provide confidence that the entity will meet its financial obligations"* could be misinterpreted, particularly upon translation, so we recommend it is further clarified.
- The factor *"Number and nature of stakeholders including investors, customers, creditors and employees"* may be too broad, such that it will lead to inconsistency and be challenging for entities (especially SMEs) to consider and categorize. This may be a particular issue for jurisdictions that do not modify the IESBA Code at the local level.

Approach to Revising the PIE Definition

3. Do you support the broad approach adopted by the IESBA in developing its proposals for the PIE definition, including:

- *Replacing the extant PIE definition with a list of high-level categories of PIEs?*
- *Refinement of the IESBA definition by the relevant local bodies as part of the adoption and implementation process?*

The SMPAG agrees that it would be difficult, if not impossible, to develop a single definition of PIE at a global level that can be consistently applied by all jurisdictions without modification and further refinement at a local level. However, an approach that appears designed to require adaptation is not appropriate. In our opinion, if IESBA presupposes there will be a need to exempt certain entities, they ought not to be included, otherwise it will lead to inconsistent practices internationally and have potential unintended consequences. Overall, we believe the proposed approach places too much emphasis and expectation on the local bodies to refine the list of PIEs and make modifications.

On balance, we believe that the PIE definition in the IESBA Code (the Code) should rather be too narrow (option 1) than too broad (option 2), otherwise the situation arises where PIEs at an international level are not PIEs under local legislation in several parts of the world and it will lead to inconsistent practices and global fragmentation resulting in confusion.

There are concerns about the need to refine the list of PIEs by excluding entities and the resulting inconsistent practices this will lead to internationally and potential unintended consequences. For example, in a group audit, if the definition of PIE is different between the parent company in country A and subsidiary (component) in country B, it will be difficult in practical application and cause confusion.

If the IESBA continue to move forward then the development of education material (e.g., FAQs) would be particularly helpful.

PIE Definition

4. Do you support the proposals for the new term "publicly traded entity" as set out in subparagraph R400.14(a) and the Glossary, replacing the term "listed entity"? Please provide explanatory comments on the definition and its description in this ED.

We do not support the new term "publicly traded entity" replacing the term "listed entity". We understand some of the rationale was to clarify the extant definition of a "recognized stock exchange" but are concerned this new term is not clearer, is too broad and will scope in more entities. For example, crypto-currency fund traders and OTC desks could be considered "publicly traded entities", which we do not consider would be appropriate or necessary.

We do not believe the IESBA has presented sufficient evidence and considered the cost/benefit of such a change in practice. The SMPAG has previously raised the issue about PIE requirements being disproportionate to small PIEs, as they may not have the governance and oversight structures available in larger PIEs. We recommend the IESBA undertakes an exercise to understand the potential impact from the proposed change, including how the new term is translated into other languages and interpreted.

The Explanatory Memorandum notes that firms will incur costs when revising their policies and procedures to ensure all their clients are correctly classified as either PIEs or non-PIEs, and additional costs in implementing new proposed requirements for firms to determine if additional entities should be treated as PIEs. SMPs are likely to be most affected by the decisions reached in this project. We have previously encouraged the IESBA to undertake a formal impact assessment, especially on the SMP market. As indicated in the project proposal (Agenda Item 3-A for the IESBA December 2019 meeting), the costs and benefits will be an important consideration as the IESBA and IAASB evaluate options and this documentation is necessary so that stakeholders fully understand the choices and trade-offs made, including the practical impact of any potential changes. The IESBA should weigh up whether all the requirements applicable to entities covered by a future definition are justified/ necessary for them before finalizing a term and definition.

We are concerned that an unintended consequence of moving more entities under the PIE umbrella with the need to apply more stringent independence requirements – mainly to address perceptions rather than factual independence issues – could be a perception that the other independence requirements are less important.

As outlined earlier, there are strong views that the international standard setters – IESBA, IAASB and IASB should all have a common definition. We note the initial coordination between the IAASB and IESBA and the IAASB proposal to take a case-by-case approach to review the use of "listed entity" in the IAASB standards. In practice, it is problematic that differences exist between the definitions and expressions used and we strongly encourage the International Standard Setting Board's to work together to eliminate the differences and harmonize the definitions, where appropriate. We are concerned that should the IAASB retain the use of listed entity (which may be appropriate) this will lead to more confusion with the Code and less harmonization, which is the opposite of the project's intention. In addition, the term listed entity remains in the Code (e.g., 400.14 A1), so consideration may be needed on whether a definition in the glossary is still required.

We note the Glossary defines a publicly traded entity as "*An entity that issues financial instruments that are transferrable and publicly traded".* We understand that the term "financial instruments" is intended to be broadly applied covering shares, stock or debt, securities, equity, or debt instruments etc. and it may be helpful to include such detail and clarity to reduce potential confusion. There are also instances where the titles (e.g., shares, debentures) are transferable but not necessarily traded on a recognized market and the entity (and its auditors) may be unaware. We understand the Board has discussed this issue and it may only apply to certain jurisdictions, but further work may be required to understand the implications in practice and an exclusion may be needed if the IESBA proceed with the proposed definition.

5. Do you agree with the proposals for the remaining PIE categories set out in subparagraphs R400.14 (b) to (f)?

In general, we agree with the proposals for the PIE categories set out in subparagraphs R400.14 (b), (c), (e) and (f).

We are concerned that category (d) *"An entity whose function is to provide post-employment benefits"* is too broad and does not reference directly "the public", which is in the other categories. It may therefore capture entities that do not interact with the public directly and so ought not to be included i.e., it is too broad where members of the public are not making decisions about whether to be a member of the plan or not, and are not using the financial statements in their decision making.

In addition, we are concerned that the broader definition is going to create more confusion in jurisdictions which currently have more narrow definitions of PIE (e.g., the European Union and US) and the practical implications and lack of clarity to what should be followed. We note R400.15 but are also concerned that the language "…shall have regard to law or regulation..." implies a choice. As we have commented previously on various occasions and most recently in our response to the IESBA's NAS project, we believe it is important for IESBA to clearly specify the entities to which the specific provisions of the Code shall apply, otherwise some jurisdictions may include entities in their PIE definitions for which the IESBA provisions would be inappropriate or impractical.

6. Please provide your views on whether, bearing in mind the overarching objective, entities raising funds through less conventional forms of capital raising such as an initial coin offering (ICO) should be captured as a further PIE category in the IESBA Code. Please provide your views on how these could be defined for the purposes of the Code recognizing that local bodies would be expected to further refine the definition as appropriate.

In our opinion, the IESBA should maintain its principles-based approach, so the definition should not be too detailed. There is also a risk that specifically naming emerging forms of capital raising will cause the standard to be rapidly outdated due to the fast pace of technology developments. For example, whereas there has previously been a use of initial coin offerings (ICOs) for fundraising, this has more recently given rise to Security Token Offerings (STOs) and Decentralized Finance (DeFi) products.

As such, it should not be the method of raising funds that is the defining criteria, but rather whether the funds are raised from the public i.e., whether it meets the definition of publicly traded or not. The public has an expectation that an entity's financial reporting will be of the highest quality for relevant and appropriate decision making. Moreover, how an item is accounted for in the financial statements should not necessarily be a determinant of whether an entity is a PIE.

Role of Local Bodies

7. Do you support proposed paragraph 400.15 A1 which explains the high-level nature of the list of PIE categories and the role of the relevant local bodies?

We recognize that the role of local bodies is critical in determining what applies in specific jurisdictions but are concerned with the consequences in jurisdictions where local bodies (for a variety of reasons) will not, or cannot, refine the list. It is not clear how many this could be, but it should be acknowledged by the Board. We would also encourage the Board to explain, in such situations, on what entities firms and individual professional accountants should apply the enhanced independence requirements in the Code as a consequence of the approach.

We have some concerns with paragraph 400.15 A1, which links directly to, and is dependent on, paragraph 400.14 A1. Both paragraphs have the potential to create confusion, in particular the sentences *"However, if law or regulation designates entities as "public interest entities" for reasons unrelated to the objective set out in paragraph 400.9, that designation does not mean that such entities are public interest entities for the purposes of the Code."* and *"Similarly, the Code provides for such bodies to exclude entities that would otherwise be regarded as falling within one of the broad categories in paragraph R400.14 for reasons relating to, for example, size or particular organizational structure."*

As outlined above, if IESBA presupposes there will be a need to exempt certain entities, they ought not to be included and the Code should remain silent on exclusions. Regulatory authorities have the option to make their own determinations, for their own jurisdictions, for what entities are defined as PIEs and also to attach other requirements to this that may have nothing to do with the IESBA Code and can already revise the definition provided in the Code. In our view, it undermines the Code to establish such clear avenues by which those adopting the Code can choose to ignore its contents. It may also signal another undermining of one of the foundation cornerstones of the development of the Code by introducing the concept that "while this is what we expect, we note that you can choose to ignore it", rather than being clear "this is what is expected".

In addition, an unintended consequence may be that some jurisdictions are, in effect, "coerced by peer pressure" into extending the definition at a national level, which will likely lead to inconsistent practices internationally. We understand that in part the proposals seek to address regulators' proposals that IESBA needs to give a "clear steer" to legislators and regulators globally as to what PIEs should constitute in their jurisdiction. Whilst as a supposition this is possibly valid, we are not convinced it is IESBA's role and the "use" of auditors in this role is a significant concern (see response to question 9 below).

8. Please provide any feedback to the IESBA's proposed outreach and education support to relevant local bodies. In particular, what content and perspectives do you believe would be helpful from outreach and education perspectives?

As outlined above, our preference is for narrower (clearer) definitions and guidance to be included in the Code. However, we believe that there will be a need for material to support relevant local bodies, so agree with the plans to release non-authoritative guidance and organize webinars and targeted stakeholder outreach to help adoption and implementation. In addition, whilst we do not support the proposed changes to the role of firms (see response below), case studies/ scenarios would be particularly useful to demonstrate how firms determine if an entity should be treated as a PIE.

Role of Firms

9. Do you support the proposal to introduce a requirement for firms to determine if any additional entities should be treated as PIEs?

The SMPAG does not support the proposal to introduce a requirement for firms to determine if any additional entities should be treated as PIEs.

We are extremely concerned about the potential practical impact of the proposals for an auditor to go beyond the definition of a PIE in national law. Firms should be free to apply additional requirements to an audit of any entity, not just a public interest entity, if relevant risk assessments warrant such additions. However, to make it a requirement that a firm *"shall determine whether to treat additional entities, or certain categories of entities, as public interest entities"* (R400.16), rather than being encouraged, seems unnecessary and excessive. In our view, there would need to be robust data and evidence on what is the issue/ problem with the extant encouragement and therefore the need to change, which has not been presented in the EM.

We are concerned the proposal means that firms will be in a position of "second guessing" what legislators, the Code and local bodies have determined to be PIEs. There are practical challenges in determining which audit clients ought to be treated as PIEs, which may desire to be treated as PIEs, or are so treated by chance of circumstance. It places undue pressure and focus on decisions by audit firms that arguably, are decisions for others in the community to make. For example, the argument provided for not including entities that may be in the process of enabling their financial instruments to be publicly traded is that auditors will know which of their clients fit this and thus should be "added" by the auditor. In some jurisdictions this is addressed by law instead of being at the auditor's discretion, and we do not see that this could not be addressed the Code. In our view, a clear criteria would be superior in terms of its ability to achieve this. It will also potentially be more difficult for SMPs generally not serving the PIE audit markets, and if a determination is needed to be made (and documented) on each engagement, it will cause unnecessary cost for SMPs.

We are concerned that it will open the door to audit firm shopping, to disagreements between auditors and regulators and to a potential notion that audit firms are being used to "correct" definitions determined by legislators or regulars. There could also be jurisdictions where it may be socially or culturally "unpalatable" for the accountancy profession to seek to go beyond the law voluntarily.

In addition, firms making decisions about whether client entities should be treated as PIEs increases their risks, which will have an impact on firms' professional indemnity insurance policies, potentially increasing premiums in the market.

Finally, the decision made must be respected and regulatory hindsight avoided. For example, it raises a question about what could happen if an SMP makes what is considered by a regulator, or court, at a future point in time, to be an incorrect assessment about the entity's PIE status.

10. Please provide any comments to the proposed list of factors for consideration by firms in paragraph 400.16 A1.

Please see our response to question 9.

Transparency Requirement for Firms

11. Do you support the proposal for firms to disclose if they treated an audit client as a PIE?

We do not support the proposal for firms to disclose if they treated an audit client as a PIE and are concerned about the implications and potential unintended consequences. As outlined above, we do not agree with the proposed requirement for firms to determine whether to treat additional entities, or certain categories of entities, as public interest entities.

We are concerned that such disclosure may not be properly understood or interpreted by users. In particular given the differences in implications between various jurisdictions. For example, questions arise over whether it is just for the provisions of the IESBA Code, or for the additional individual jurisdictional PIE requirements.

There is also a risk that it may add to the expectation gap in auditing, which should be recognized by IESBA. Further misunderstanding and confusion could occur, especially if the disclosure is that the entity is treated as a PIE, despite that entity being excluded from legal/regulatory PIE definitions in a particular jurisdiction. Disclosing such information may also require disclosing what it means i.e., the firm would need to also explain why they chose a particular entity to be considered a PIE from their perspective and describe what ways the audit undertaken differed from an audit of a non-PIE. Greater confusion in the market will ensue where firms offer different explanations and descriptions of why they have treated client entities as PIEs, and it could also be perceived as an attempt to be a "gold seal of approval" for an audit firm or an audit client.

In our view, taking all of this into account means that what might, on the face of it, seem to be a very simple disclosure becomes very detailed and complex. As a result, it raises multiple questions about the value of the disclosure from a cost-benefit perspective.

12. Please share any views on possible mechanisms (including whether the auditor's report is an appropriate mechanism) to achieve such disclosure, including the advantages and disadvantages of each. Also see question 15(c) below.

Recognizing the comments made in answering question 11, and were the IESBA and IAASB to pursue this issue further, the auditor's report does seem to be the most appropriate place for such a disclosure – as further details and explanations beyond just declaring that an entity is being treated as a PIE, would be required. In addition, as the decision about treating an entity as a PIE is, in such cases, being made solely by the auditor, then the auditor's report is the only communication that is owned by the auditor. The disclosure would need to be in that communication; it could not be in the entity's own communications.

However, we believe it essential that IESBA coordinate fully with the IAASB, as this would also be a matter for the IAASB's consideration as the auditor's report is in their remit.

Other Matters

13. For the purposes of this project, do you support the IESBA's conclusions not to:

(a) Review extant paragraph R400.20 with respect to extending the definition of "audit client" for listed entities to all PIEs and to review the issue through a separate future workstream?

(b) Propose any amendments to Part 4B of the Code?

In our view, it is not clear that there is a need to review extant R400.20 at this time, as the term listed entity is used in the ISAs and the current wording provides an important link back to the ISAs.

Paragraph 79 of the explanatory memorandum explaining the rationale for not making changes to Part 4B of the Code may require further clarity. It seems to imply that an assurance engagement for an entity considered a PIE for audit purposes will not necessarily be an assurance engagement for a PIE and vice versa.

Paragraph 900.13 of the extant code states *"Independence standards for audit and review engagements are set out in Part 4A* - Independence for *Audit and Review Engagements. If a firm performs both an assurance engagement and an audit or review engagement for the same client, the requirements in Part 4A continue to apply to the firm, a network firm and the audit or review team members."* Therefore, if an entity is a PIE for audit purposes, the firm is obliged to maintain the same independence requirements for any assurance engagements it performs. It could thus also be assumed that the opposite is true.

The explanatory memorandum seems to imply that if, for example, there is an assurance engagement being performed that is "of significant public interest" it may not be considered a PIE even if that assurance engagement is somehow related to the financial condition of the entity. This may need to be clarified and the logic in para. 79 revisited before a perspective can be made on whether amendments to Part 4B of the Code are required.

14. Do you support the proposed effective date of December 15, 2024?

As IESBA will be aware, in response to NAS ED and Fees ED, the SMPAG outlined our view that in light of the significant impact the definition of PIEs will have, both projects should have been deferred pending the outcome of this ED.

It is difficult to have a position on the proposed effective date until it is clear what the requirements will entail following the Board's analysis of all the responses to the ED. It will be impacted by how broad the final PIE definition will be and how many entities are captured. This information is necessary to understand what will be involved in practice to consider when a reasonable effective date should be.

In addition, as outlined in our response to question 4, we believe the IESBA should undertake a formal impact assessment of the proposals. The cost/ benefit assessment is an important consideration for understanding the practical impact of any potential changes.

Matters for IAASB consideration

15. To assist the IAASB in its deliberations, please provide your views on the following:

(a) Do you support the overarching objective set out in proposed paragraphs 400.8 and 400.9 for use by both the IESBA and IAASB in establishing differential requirements for certain entities (i.e., to introduce requirements that apply only to audits of financial statements of these entities)? Please also provide your views on how this might be approached in relation to the ISAs and ISQMs.

We believe that achieving consistency between IAASB and IESBA standards is critical. The extent of any impact on requirements within standards developed by the IAASB will also need to be clear and exposed for comment if the change in terminology proposed is intended to allow the two Boards to match their terminology where appropriate. Ideally, where the same concepts and matters are addressed, there should be no differences between the standards, but this does need to be considered on a case-by-case basis.

We also suggest coordination between the IESBA and IAASB project on the audits of less complex entities.

(b) The proposed case-by-case approach for determining whether differential requirements already established within the IAASB Standards should be applied only to listed entities or might be more broadly applied to other categories of PIEs.

Please see our response to 15 (a) above. In addition, when developing new or revised pronouncements both the IAASB and IESBA will need to consider on a case-by-case basis the impact of the PIE provisions as there may be instances it is not warranted for all the entities captured in any new proposals.

(c) Considering IESBA's proposals relating to transparency as addressed by questions 11 and 12 above, and the further work to be undertaken as part of the IAASB's Auditor Reporting PIR, do you believe it would be appropriate to disclose within the auditor's report that the firm has treated an entity as a PIE? If so, how might this be approached in the auditor's report?

As outlined in our responses to questions 11 and 12 above, we are concerned about the risk of adding to the expectation gap in auditing and whether such disclosure will cause further misunderstanding and confusion in the marketplace. The lack of consistency by different jurisdictions because of the broad approach may also lead to unintended consequences.

CONCLUDING COMMENTS

We hope the IESBA finds this letter helpful in informing the Board's deliberations on the proposed revisions to the definitions of listed entity and public interest entity in the Code. Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

Monica Foerster
Chair, IFAC SMP Advisory Group