

**Basis for Conclusions**  
**Prepared by the Staff of the IESBA**  
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*International Ethics Standards Board for  
Accountants*

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# Changes to the Code of Ethics for Professional Accountants Addressing Conflicts of Interest

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This document was prepared by the Staff of the International Ethics Standards Board for Accountants (IESBA).

The IESBA is an independent standard-setting board that develops and issues high-quality ethical standards and other pronouncements for professional accountants worldwide. Through its activities, the IESBA develops the *Code of Ethics for Professional Accountants*, which establishes ethical requirements for professional accountants.

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, including auditor independence requirements, through the development of a robust, internationally appropriate code of ethics.

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## **BASIS FOR CONCLUSIONS: CHANGES TO THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS ADDRESSING CONFLICTS OF INTEREST**

This Basis for Conclusions has been prepared by staff of the International Ethics Standards Board for Accountants (IESBA). It relates to, but does not form part of, the changes to the *Code of Ethics for Professional Accountants* (the Code) addressing conflicts of interest. These changes were approved by the IESBA in December 2012 with the affirmative votes of 16 out of 16 IESBA members present.

### **Background**

1. The Code contains two sections that address conflicts of interest, Section 220 for Professional Accountants in Public Practice and Section 310 for Professional Accountants in Business. Failure to identify and address conflicts of interest on a timely basis may result, for example, in an accountant having to withdraw from an arrangement at a point in time where the affected parties have insufficient time to effect an orderly transition to an alternative service provider. In October 2009, the IESBA approved a project proposal to provide additional guidance for all professional accountants in identifying and addressing conflicts of interest. The purpose of the project was to examine Sections 220 and 310 and revise them to provide more comprehensive guidance in identifying, evaluating and managing conflicts of interest.
2. The IESBA published its proposals in an exposure draft (ED) in December 2011. The comment period for the ED closed on March 31, 2012. Fifty comment letters were received from various respondents, including regulators and oversight bodies, national standard setters, IFAC member bodies, other professional organizations, and firms. This Basis for Conclusions explains the more significant issues raised by respondents to the ED, and how the IESBA has addressed them.
3. The IESBA has also discussed this project with its Consultative Advisory Group (CAG) on four separate occasions, including: at the project commencement stage; prior to the issuance of the ED; and prior to the finalization of the standard.

### **Description of a Conflict of Interest**

4. The ED included a description of circumstances that might create a conflict of interest for the professional accountant together with examples of such circumstances. The description developed for this purpose specifically included conflicts between: the interests of two or more parties for whom the professional accountant undertakes a professional activity; and the interests of the professional accountant and the interests of a party for whom the professional accountant undertakes a professional activity. The ED included a description of a conflict of interest in paragraph 100.17 and in each opening paragraph of Sections 220 and 310, which relate to Professional Accountants in Public Practice and Professional Accountants in Business respectively.
5. Many respondents either explicitly or implicitly supported the proposed description and examples, although numerous changes to the examples were suggested. Several respondents stated that they would prefer a definition to a description. A few respondents were of the view that there should be a different standard for assurance engagements and suggested that, in relation to conflicts of interest which relate to assurance engagements, threats to independence and threats to objectivity are subtly different, and may not clearly be addressed in the proposed description.

A respondent was of the view that the description addresses circumstances that might give rise to a conflict of interest, but it was not clear how the conflict of interest might be created, and there was no reference to the parties being in conflict.

### **IESBA Decisions**

6. The IESBA had initially considered whether to include a definition of a conflict of interest in the Code. However, it had been unable to identify a definition that was sufficiently broad to encompass the diverse activities of both professional accountants in public practice and in business, but that was sufficiently precise to avoid capturing situations that were not conflicts of interest. The IESBA therefore proposed a description with examples, in preference to a definition, to make the guidance relevant in the specific context of the Code and to provide help to professional accountants. The IESBA noted that no respondent had provided a suitable definition and reaffirmed its view that a description with examples is preferable to a definition.
7. The IESBA, however, was persuaded that the proposed description could be enhanced to provide a clearer linkage between the subject of a professional service and the existence of a conflicting interest or relationship. This in turn would help provide a better context for the later discussion of how conflicts of interest are to be identified and the factors by which they are to be evaluated. The list of example situations in which a conflict may arise was amended based on the feedback. The revised description is set out in paragraph 100.17.
8. Objectivity and independence are closely connected. A conflict of interest creates a threat to objectivity. Objectivity is a fundamental principle which applies to all professional activities and is essentially a state of mind. Independence is necessary to enable a professional accountant in public practice undertaking an assurance engagement to express an objective conclusion. The independence requirements of the Code set a standard that helps demonstrate compliance with the fundamental principle of objectivity, in fact and in appearance, so far as concerns interests and relationships with the audit client.
9. Therefore the IESBA added the following cross reference in paragraph 220.1 as a reminder that the Code's independence requirements apply to the conduct of assurance engagements: *"When the professional service is an assurance service, compliance with the fundamental principle of objectivity also requires being independent of assurance clients in accordance with Sections 290 or 291 as appropriate."*

### **Reasonable and Informed Third Party Test**

10. The proposed revision to Section 220 in the ED required the professional accountant to take into account whether a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, that compliance with the fundamental principles is compromised. This would be required both when identifying and evaluating conflicts of interest and when implementing safeguards to address them.
11. Many respondents expressed either complete or general agreement with the reasonable and informed third party test and the IESBA concluded that no significant change need be made to the draft wording. However, some respondents pointed out that the wording of the third party test was not consistent with that used elsewhere in the Code. The IESBA therefore aligned the wording accordingly.

12. Several respondents, while expressing agreement, noted that the reasonable and informed third party test is subjective and a matter of judgment, and cultural differences may result in inconsistent application of the test. The IESBA has noted that this matter could be addressed in a future project.

### **Evaluation of Conflicts of Interest across Network Firms**

13. The ED proposed that potential conflicts of interest within a network of firms should be evaluated when the professional accountant has *reason to believe* that a conflict of interest may exist due to interests or relationships of another firm. The “reason to believe” test requires the professional accountant to consider the facts available to the professional accountant at the time. The proposal recognized that the extent of client information exchanged will vary between different networks depending on legal and contractual constraints. It would, therefore, have been disproportionate to require a firm, before accepting a new engagement, to undertake a search across the network to identify any interests or relationships that might create a conflict of interest regardless of whether the firm has reason to believe that a conflict exists.
14. Many respondents expressed either complete or general agreement with the “reason to believe” threshold for network firms.
15. Those respondents who considered that the “reason to believe” test should be strengthened proposed the following alternatives:
  - A reasonable and informed third party test as an alternative.
  - Strengthening the test by adding “having made enquiries as appropriate” or similar wording.
  - A similar test in order to gather evidence.
  - A “knows or could reasonably be expected to know” test.
16. Some CAG representatives suggested that the “reason to believe” test should be aligned to Section 290 rather than Section 291. Paragraph 290.13 requires that the firm shall be independent of the audit clients of other firms in the network. Paragraph 291.3 uses the “reason to believe” threshold to identify relationships or circumstances that are relevant to the evaluation of a firm’s independence in respect of non-audit assurance engagements.

### **IESBA Decisions**

17. While the IESBA recognized the need to consider actual or potential conflicts that may arise across a network, it also recognized that creating a requirement for proactive inquiries to identify possible conflicts of interest across a network may be hindered by data protection and other constraints, such as legal obstacles relating to confidentiality. These constraints complicate the identification and evaluation of potential conflicts across different jurisdictions. They also make it impractical for smaller networks with relatively informal arrangements for co-operation to undertake such tasks.
18. The term network firm is currently only used in Sections 290 and 291 of the Code. In the case of audit and review engagements, Section 290 generally imposes the same obligations on a network firm as the firm. In the case of other assurance engagements, Section 291 requires an evaluation of any threats that the firm has reason to believe are created by network firm interests and relationships. The proposal extends the application of the “network firm” concept to Section 220 to require evaluation of conflicts of interest that the firm has reason to believe may exist or might arise due to interests and relationships of a network firm. This is consistent with the position taken for

independence requirements for non-audit assurance engagements in Section 291. The Board believes this is the appropriate standard.

19. The IESBA agreed that including the “reason to believe” test for identifying conflicts of interest across a network as a bullet point in the paragraph dealing with conflict identification within the firm did not give it sufficient prominence. The IESBA decided it should become a separate paragraph to increase its prominence and to distinguish the threshold from conflict identification within a firm. (See paragraph 220.8.)

## **Disclosure, Consent and Safeguards**

20. The ED proposed that it is generally necessary to disclose the nature of a conflict to the client and all known relevant parties and to obtain written consent from the client and such parties before performing the professional service. Implicit in obtaining consent is that the consenting parties believe the firm can carry out the activity in compliance with the fundamental principles in the Code, particularly objectivity.
21. Many respondents expressed either complete or general agreement with the guidance concerning safeguards to manage conflicts of interest and obtaining and documenting consent. Although generally supportive, several respondents suggested that the guidance was insufficiently clear and some suggested that disclosure and consent should be treated separately. Several respondents stated that the concept of “implied consent” was unclear.
22. A few respondents questioned whether consent itself is a safeguard because while disclosure and consent ensure that the interests of the other relevant parties are safeguarded, they do not mitigate any threats to the fundamental principles which arise from the conflict of interest. Such consent was also described as merely a “waiver”. However if consent is not a safeguard, this would prevent a sophisticated client from providing consent to a professional accountant where there was a conflict of interest and other safeguards are not available.
23. Some respondents challenged the statement that it is only “generally necessary” to disclose a conflict. Some stated that disclosure should always be required and some stated that it was difficult to see when disclosing the nature of the conflict and gaining written consent should not be required. Some respondents stated that the requirements with respect to consent should be strengthened because, as drafted, the professional accountant was permitted to rely on implied consents or verbal consents from clients or other parties and this would be compounded if documentation were not a requirement.

## **IESBA Decisions**

24. In order to clarify the nature and process of disclosure and consent, the IESBA redrafted the relevant paragraph. The need for, and examples of, safeguards were extracted and included in a separate paragraph.
25. The IESBA took the view that consent is not a safeguard but did not wish to prevent a sophisticated client from providing consent if the professional accountant is able to conclude that the threat is already at an acceptable level and it would not, therefore, be necessary to obtain consent. Therefore, wording was introduced to clarify that consent is generally necessary “when safeguards are required to reduce the threat to an acceptable level.”

26. The IESBA agreed that paragraph 220.11 could be more clearly drafted to assist the professional accountant in understanding the different ways in which disclosure may be made and the related forms of consent. It therefore subdivided disclosure and consent into: general disclosure and general consent with an example; specific disclosure and explicit consent; and implied consent with a description.
27. The IESBA does not agree that disclosure is always necessary in a global Code because there are many diverse situations making it impractical to mandate disclosure and consent in all cases. However, the intention is that the professional accountant should not avoid disclosure and consent when it is appropriate. An additional provision has been inserted requiring the professional accountant to determine when specific disclosure and explicit consent are necessary and recognizing that it is a matter of professional judgment when specific disclosure and explicit consent are appropriate (see paragraph 220.11).

## **Documentation**

28. The ED proposed that if the consent is obtained verbally or is implied by the party's conduct, the professional accountant is encouraged to document such consent.
29. Several respondents were of the view that rather than encouraging the documentation of verbal or implied consent, there should be a requirement to do so. Their rationale was that in case of a future dispute, particularly an adversarial conflict situation, the professional accountant might well face the challenge of having to defend allegations that the fundamental principles were compromised by continuing to provide the professional services, albeit after obtaining the client's verbal or implied consent.

## **IESBA Decisions**

30. The IESBA concluded that on balance "encouraging" the documentation of verbal disclosure and verbal or implied consent was supported by the majority of respondents. The reasons cited by respondents for requiring the documentation of implied or verbal consent were for the protection of the professional accountant. The IESBA took the view that documentation is a decision for the professional accountant that does not change the facts as to whether or not the existence of a conflict of interest compromises the professional accountant's objectivity or compliance with the other fundamental principles. The provision encouraging documentation was included as a separate paragraph to increase its prominence. (See paragraph 220.13.)
31. The revised wording requires the professional accountant to determine whether the significance of the conflict is such that specific disclosure and explicit consent is necessary. Where such disclosure is made, the circumstances of the particular conflict together with any planned safeguards, followed by the client's written consent (or otherwise), would, in principle, lead to documentation of the matter. Documentation is encouraged in the remaining circumstances, specifically where disclosure is verbal or consent is verbal or implied.

## **When Obtaining Consent Would be a Breach of Confidentiality**

32. The ED proposed that in certain circumstances the professional accountant will not be able to obtain consent because requesting consent would in itself result in a breach of confidentiality. The ED provided that the firm shall only accept an engagement in such circumstances if certain conditions are met. These conditions are:

- The firm does not act in an advocacy role for one client which is adversarial to the interests of another client;
  - Specific mechanisms are in place to prevent disclosure of confidential information between the engagement teams serving the two clients; and
  - The firm is satisfied that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would conclude that it is appropriate for the firm to accept the engagement in the particular circumstances.
33. Some respondents did not agree with the proposal to accept an engagement without consent where the request would result in a breach of confidentiality. They stated that the firm should decline the engagement. The IESBA noted that the majority of respondents did support an exception where consent cannot be obtained without breaching confidentiality. A respondent who did not agree with the proposal accepted that where appointing new advisers could produce a disproportionate and damaging adverse situation for that client, the exception should be subject to a reasonable and informed third party considering that acting would be appropriate, having regard to disproportionate adverse consequences to the client of declining the engagement.
34. Some respondents noted that the proposal encouraged documenting consent where consent is verbal or implied but that there is no reference to documentation when obtaining consent would be a breach of confidentiality.

#### **IESBA Decisions**

35. The IESBA clarified that the exception would not apply where implied or general consent had already been obtained, by adding that the paragraph applied when making specific disclosure for the purpose of obtaining explicit consent. It also agreed with the respondent that suggested strengthening the conditions by adding that there should be a disproportionate adverse outcome for the clients or other relevant parties in the event that the work cannot proceed because of the inability to obtain consent. (See paragraph 220.14.)
36. The IESBA agreed that documentation is necessary when a professional accountant accepts an engagement without consent where the request would result in a breach of confidentiality and added a requirement to this effect. (See paragraph 220.14.)

#### **Professional Accountants in Business**

37. Section 310 of the proposed ED addressed circumstances in which conflicts of interest might arise when Professional Accountants in Business perform professional activities that compromise compliance with objectivity and the other fundamental principles. It required the Professional Accountant in Business to take steps to identify, evaluate, and manage those situations. In the IESBA's view, the approach to be taken by a professional accountant in public practice and a professional accountant in business should be broadly similar and the ED was drafted accordingly.
38. Section 310 of the proposed ED specifically required the Professional Accountant in Business to be alert to (as opposed to a Professional Accountant in Public Practice who should take reasonable steps to identify) all interests and relationships that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances available to the professional accountant at that time, might compromise compliance with the fundamental principles.



39. A number of respondents stated that the third party test is subjective and a matter of judgment and cultural differences may result in inconsistent application of the test. The IESBA has noted that this matter could be addressed in a future project.
40. Most respondents were supportive of the proposed Section 310, including the reasonable and informed third party test.

#### **IESBA Decisions**

41. The IESBA made conforming changes to Section 310 to reflect relevant changes made to Section 220, in particular the description of a conflict of interest and related examples.

#### **Conforming changes to Sections 320 and 340**

42. The ED proposed some conforming changes to Section 320, *Preparation and Reporting of Information*, and Section 340, *Financial Interests*, of the Code to improve the alignment between those sections and Sections 220 and 310.
43. All respondents but one were supportive of the conforming changes to Sections 320 and 340. The dissenting opinion was that they are not conforming changes, have little to do with conflicts of interest and are only editorial changes.

#### **IESBA Decisions**

44. The IESBA made a number of editorial changes in regard to suggestions by respondents.

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