

**Committee:** IESBA Consultative Advisory Group

**Meeting Location:** Grand Hyatt, New York, United States

**Meeting Date:** March 7, 2011

## Conflicts of Interest

### Objectives of Agenda Item

1. To consider the IESBA's direction on the conflicts of interest project and provide input on preliminary wording for a new provision in the Code.

### Background

At its October 2009 meeting, the IESBA approved a project proposal to develop additional guidance for professional accountants to address conflicts of interest.

At its February 2011 meeting, the IESBA discussed Task Force<sup>1</sup> proposals and provided input on preliminary wording for revisions to Section 310 addressing professional accountants in business and new paragraphs 100.17 and 100.18. The Task Force met after the IESBA's February 2011 meeting to consider the input received from IESBA members and, based on this input, revised the draft wording for Section 220 and 310 and new paragraphs 100.17 and 100.18 (Agenda Paper E-1). The IESBA will consider revised draft wording at its June 2011 meeting, with the view to approving an exposure draft at its October 2011 meeting.

This agenda paper describes the results of the IESBA's deliberations to date and the latest thinking of the Task Force in response to input received from the IESBA's February meeting. Certain positions in this paper are therefore characterized as the views of the Task Force.

### Issues

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

At the February 2011 meeting of the IESBA, the Board generally agreed with the following description of a conflict of interest:

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<sup>1</sup> Michael Niehues (chair), Nina Barakzai, Jim Gaa, Peter Hughes, Bob Rutherford, Sylvie Soulier, and Sandrine Van Bellinghen

*“A conflict of interest arises if, when undertaking a professional activity for a party, a professional accountant has an interest or relationship other than with that party that creates a threat to objectivity and may create threats to compliance with other fundamental principles. Such threats may be created by:*

- Conflicts between the interests of two or more parties for whom the professional accountant undertakes professional activities; or*
- Conflicts between the interests of the professional accountant and the interests of a party for whom the professional accountant undertakes a professional activity.”*

When the Task Force met after the February meeting, concern was expressed with the clarity of the first sentence. On reflection, the Task Force was of the view that the two bullets clearly describe the types of conflicts of interest for which guidance is needed. The Task Force, accordingly, revised the description as below, and will present this to the IESBA at its June 2011 meeting:

*“A professional accountant may be faced with a conflict of interest when undertaking a professional activity. A conflict of interest creates a threat to objectivity and may create threats to other fundamental principles. Such threats may be created by:*

- Conflicts between the interests of two or more parties for whom the professional accountant undertakes professional activities; or*
- Conflicts between the interests of the professional accountant and the interests of a party for whom the professional accountant undertakes a professional activity.*

The description uses a new term “professional activity.” The Code currently uses the term “professional service.” The IESBA believes that term may not resonate with professional accountants in business because it is more commonly used to describe the rendering of services to clients by professional accountants in public practice. The IESBA, therefore, proposes the following two new definitions in the Code:

*Professional Activity: An activity requiring accountancy or related skills undertaken by a professional accountant, including accounting, auditing, taxation, management consulting, and financial management.*

*Professional Services: Professional activities performed for clients.*

The term “professional activity” will be used in Parts A and C of the Code and “professional services” will be used in Part B of the Code.

**Action requested:**

CAG members are asked to provide their views on the description of a conflict of interest.

***Content of New Guidance in Sections 220 & 310***

The new guidance in Sections 220 and 310 will address the following:

- Description of a conflict of interest and examples of conflicts of interest;
- A requirement to identify and evaluate the significance of a conflict of interest;
- A reasonable and informed third party test for use in identifying, evaluating, and managing (i.e., safeguarding) a conflict of interest; and
- Examples of safeguards that can be applied to address threats created by a conflict of interest.

Agenda Paper E-1 contains working drafts of Sections 220 and 310 and new paragraphs 100.17 and 100.18.

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

The Task Force proposes that when identifying, evaluating and managing a conflict of interest, a professional accountant shall take into account whether a reasonable and informed third party would be likely to conclude that compliance with the fundamental principles is compromised. This reasonable and informed third party test is consistent with other parts of the Code. For example, the conceptual framework requires a professional accountant to identify and evaluate threats to compliance with the fundamental principles and apply safeguards to eliminate a threat or reduce it to an *acceptable level*. An acceptable level is defined as:

“A level at which 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 not compromised.”

The reasonable and informed third party test is also embedded in the definition of independence in appearance.

This Task Force proposal is modified somewhat from what was presented to the IESBA in February 2011. At that meeting, the Task Force proposed that at the identification phase, a professional accountant be alert to interests and relationships that a reasonable and informed third party could be likely to conclude would give rise to a conflict of interest. In response to input from the IESBA, the Task Force has reconsidered the position and proposes that the professional accountant be required to take into account the likely views of a reasonable and informed third party throughout the process of identifying, evaluating, and managing/addressing a conflict of interest.

***Network Firms***

The Task Force proposes that a professional accountant in public practice be required to evaluate any potential conflicts of interest that the professional accountant has reason to believe are created by network firm interests and relationships.

The term network firm is currently only applicable 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 Task Force recognizes that a conflict of interest may exist or appear to exist because of interests and relationships of network firms. The Task Force is of the view that the “reason to believe” test is appropriate with respect to the evaluation of network firm interests and relationships that create a conflict of interest. The Task Force recognizes this requirement will extend the application of the network firm concepts from Sections 290 and 291 to Section 220. The Task Force feels that this is appropriate in order to satisfy the reasonable and informed third party test and so that known interests or relationships of a network firm that create a conflict are not ignored simply because the firm engaged in the professional activity is not the one with the interest or relationship. The Task Force is of the view that the “reason to believe” threshold is the appropriate threshold. It is consistent with the position taken for independence requirements for other assurance engagements. It also recognizes the legal obstacles (for example, legal confidentiality requirements) that would be associated with a requirement for proactive inquiries to identify possible conflicts of interest across a network.

**Action requested**

CAG members are asked to provide their views on the content of Sections 220 and 310.

***Situations Where Disclosure is Not Possible***

For professional accountants in public practice, the working draft states that it is generally necessary to disclose the conflict and to obtain consent. The Task Force is considering whether there are situations where it is not possible to disclose the conflict because disclosure would breach confidentiality or the timing of the professional service may preclude disclosure.

The Task Force has had some preliminary discussions on this matter. The Task Force has considered the example of a situation where a listed audit client (company A) is issuing a public circular in connection with the proposed hostile takeover of another listed audit client of the firm (company B). Some stock exchange regulations include a requirement for the offeror to include a statement of the benefits expected to accrue from the takeover. This statement is required to be reported on by a reporting accountant. It might be such that in the time available it is only possible for the audit firm to provide this report. Preparation of the report will require the audit firm to have access to the synergy benefits prepared by the directors of company A, which include estimates of potential revenue enhancements and cost savings with respect to company B. The estimates are derived from publicly available sources. The deal is highly confidential and company A has not disclosed its intentions to mount a takeover bid of company B. Accordingly, the audit firm cannot seek the consent of company B to undertake the work.

The Task Force is considering whether the guidance should address such situations and provide that such an engagement could be accepted when it was not possible to obtain consent, and if so, what conditions would need to be met or safeguards applied. For example:

- Institutional mechanisms that were strong enough to demonstrate the engagement team undertaking the reporting accountant assignment did not have access to confidential information gained from the audit of company B, such as might be the case if the two clients were served out of different offices and there was no contact between the engagement teams.
- It was not possible for another firm to perform the reporting accountant function; and
- The firm does not provide any services for company B that directly relate to the possible takeover.

**Action requested**

CAG members are asked to provide their views on situations where disclosure is not possible.

***Current Section 310***

Section 310 of the Code is currently called “Potential Conflicts” and the text deals with undue pressure that a professional accountant in business may face, namely pressure to act in a way that is unlawful or unprofessional. The section does not deal with conflicts of interest as described above. The IESBA has reviewed the Section on a line by line basis to determine whether the guidance provided is already addressed elsewhere in the Code. Appendix A to this agenda paper contains the detailed analysis and support for the IESBA’s conclusion that the text of existing 310 is duplicative of guidance contained elsewhere in the Code and should, therefore, be deleted.

***Conflicts Arising from Compensation tied to Financial Performance***

When conducting preliminary research for this project, the Task Force attempted to obtain real-life examples of conflicts of interest faced by professional accountants in business. The Task Force reached out to member bodies whose memberships comprise a large number of professional accountants in business. Many of the examples provided in response to this request did not relate to conflicts between the interests of two or more parties for whom the accountant was undertaking a professional activity or to conflicts between the interests of the accountant and another party for whom the accountant is undertaking a professional activity. Rather, many of the examples related to undue pressure and ethical dilemmas.

In particular, it was noted that a self-interest threat is created when the compensation of a professional accountant in business is directly related to the results reported in the financial statements and that particular professional accountant is responsible for

financial reporting. There are many complex arrangements designed to incentivize individuals for achieving business success, measured in different ways, including financial performance, share price movements, etc. Typically, these arrangements are applied across teams, albeit often with different percentages applied depending on seniority of individuals. It was noted that these arrangements can result in a significant self-interest threat for the individual, but most importantly because they apply across teams can place significant peer pressure on the professional accountant in business.

The Code addresses this issue through Sections 320 and 340 (the complete text of which is contained in Appendix B). Paragraph 320.1 requires a professional accountant in business to prepare or present information “fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.” Paragraph 340.1 explicitly recognizes the threat created when the professional accountant “holds, directly or indirectly, share options in the employing organization, the value of which could be directly affected by decisions made by the professional accountant in business.”

The Task Force recognizes that while the issue is addressed in Sections 320 and 340, it is addressed somewhat briefly. The IESBA favors providing additional guidance to address this matter. The Task Force will consider this issue at its next meeting to determine what additional guidance can be contained in the Code, including, for example, whether the revised section 310 should be cross-referenced to Sections 320 and 340.

**Action requested**

CAG members are asked to provide their views on conflicts arising from compensation linked to financial performance.

**Material Presented**

Agenda Paper E	This Agenda Paper
Agenda Paper E-1	Preliminary Draft Wording

## Appendix A

Paragraph 310.1		
Sentence	Where it's covered in the Code	Recommended Disposition
Sentence 1: "A professional accountant in business shall comply with the fundamental principles"	Par. 100.5, Sentence 1: "A professional accountant shall comply with the following fundamental principles:" – the fundamental principles are then listed.	Delete the sentence from Section 310.1
Sentence 2: "There may be times, however, when a professional accountant's responsibilities to an employing organization and professional obligations to comply with the fundamental principles conflict."	See "Note 1"	Delete the sentence from Section 310.1
Sentence 3: "A professional accountant in business is expected to support the legitimate ethical obligations established by the employer and the rules and procedures drawn up in support of those objectives."	Par. 300.4: "A professional accountant in business has a responsibility to further the legitimate aims of the accountant's employing organization. This Code does not seek to hinder a professional accountant in business from properly fulfilling that responsibility, but addresses circumstances in which compliance with the fundamental principles may be compromised."	Delete the sentence from Section 310.1
Sentence 4: "Nevertheless, where a relationship or circumstance creates a threat to compliance with the fundamental principles, a professional accountant in business shall apply the conceptual framework approach described in Section 100 to determine a response to the threat."	Par. 100.6: "The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles...Therefore, this Code establishes a conceptual framework that requires a professional accountant to identify, evaluate, and address threats to compliance with the fundamental principles."	Delete the sentence from Section 310.1

Note 1: The Task Force considered the second sentence of the paragraph to identify situations where a professional accountant's duty to the employing organization would be in conflict with the accountant's obligation to comply with the fundamental principles. The Task Force considered the example of aggressive earnings management – whether, for example, the accountant's duty to the employing organization to maximize shareholder return could conflict with the obligation to comply with the fundamental principles. The Task Force is of the view that aggressive earnings management could reach the point where it is contrary to professional standards. The Task Force also looked to Section 320 of the Code, which states that a professional accountant in business "shall present such information fairly, honestly and in accordance with relevant professional standards." The Task Force, therefore, believes that the second sentence can be deleted

because it is already addressed in the Code. Although it may be useful additional guidance for a professional accountant if retained, the Task Force is in favor of deleting the language to avoid unnecessary repetition.

Paragraph 310.2		
	Where it's Covered in the Code	Recommended Disposition
"As a consequence of responsibilities to an employing organization, a professional accountant in business may be under pressure to act or behave in ways that could create threats to compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization. A professional accountant in business may face pressure to:	General description of pressure	Delete sentence
Bullet point 1 & 2: "Act in contrary to law or regulation. Act in contrary to technical professional standards."	Section 130, Due Professional Care and Section 150, Professional Behavior	Delete the first two bullet points from paragraph 310.2
Bullet point 3: "Facilitate unethical or illegal earnings management strategies."	Par. 320.4: "Threats to compliance with the fundamental principles, for example, self-interest or intimidation threats to objectivity or professional competence and due care, are created where a professional accountant in business is pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others."	Delete the third bullet point from paragraph 310.2
Bullet point 4 and 5: "Lie to others, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular: <ul style="list-style-type: none"> <li>The auditors of the employing organization; or</li> <li>Regulators</li> </ul> Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example: <ul style="list-style-type: none"> <li>The financial statements;</li> <li>Tax compliance;</li> <li>Legal compliance; or</li> <li>Reports required by securities regulators."</li></ul>	Section 110, Integrity "The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships  "A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information <ul style="list-style-type: none"> <li>Contains a materially false or misleading statement</li> <li>Contains statements or information furnished recklessly; or</li> <li>Omits or obscures information required to be included where such omission or obscurity would be misleading."</li></ul>	Delete the fourth and fifth bullet point from paragraph 310.2



Paragraph 310.3		
	Where it's covered in the Code	Recommended Disposition
<p>"The significance of any threats arising from such pressures, such as intimidation threats, shall be evaluated and safeguards applied when necessary to eliminate them or reduce them to an acceptable level. Examples of such safeguards include:</p> <ul style="list-style-type: none"> <li>• Obtaining advice, where appropriate, from within the employing organization, an independent professional advisor or a relevant professional body.</li> <li>• Using a formal dispute resolution process within the employing organization.</li> <li>• Seeking legal advice."</li> </ul>	<p>Overall, the safeguards approach to any threat is thoroughly covered in Section 100 of the Code. Specifically, paragraphs 100.17 through 100.22 deal with ethical dilemmas and such threats and specifically mentions to seek legal advice or consulting those charged with governance of an organization. Finally, paragraph 100.22 states that a professional accountant shall consider removing him or herself from the engagement team or organization if a conflict cannot be resolved. It should also be noted that "intimidation threats" as mentioned in paragraph 310.3 is also addressed in paragraph 320.4.</p>	<p>Delete paragraph 310.3 from the Code.</p>

## **Appendix B**

### **SECTION 320**

#### ***Preparation and Reporting of Information***

- 320.1 Professional accountants in business are often involved in the preparation and reporting of information that may either be made public or used by others inside or outside the employing organization. Such information may include financial or management information, for example, forecasts and budgets, financial statements, management's discussion and analysis, and the management letter of representation provided to the auditors during the audit of the entity's financial statements. A professional accountant in business shall prepare or present such information fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.
- 320.2 A professional accountant in business who has responsibility for the preparation or approval of the general purpose financial statements of an employing organization shall be satisfied that those financial statements are presented in accordance with the applicable financial reporting standards.
- 320.3 A professional accountant in business shall take reasonable steps to maintain information for which the professional accountant in business is responsible in a manner that:
- (a) Describes clearly the true nature of business transactions, assets, or liabilities;
  - (b) Classifies and records information in a timely and proper manner; and
  - (c) Represents the facts accurately and completely in all material respects.
- 320.4 Threats to compliance with the fundamental principles, for example, self-interest or intimidation threats to objectivity or professional competence and due care, are created where a professional accountant in business is pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.
- 320.5 The significance of such threats will depend on factors such as the source of the pressure and the degree to which the information is, or may be, misleading. The significance of the threats shall be evaluated and safeguards applied when necessary to eliminate them or reduce them to an acceptable level. Such safeguards include consultation with superiors within the employing organization, the audit committee or those charged with governance of the organization, or with a relevant professional body.
- 320.6 Where it is not possible to reduce the threat to an acceptable level, a professional accountant in business shall refuse to be or remain associated with information the professional accountant determines is misleading. A professional accountant in business may have been unknowingly associated with misleading information. Upon becoming aware of this, the professional

accountant in business shall take steps to be disassociated from that information. In determining whether there is a requirement to report, the professional accountant in business may consider obtaining legal advice. In addition, the professional accountant may consider whether to resign.

## **SECTION 340**

### **Financial Interests**

340.1 Professional accountants in business may have financial interests, or may know of financial interests of immediate or close family members, that, in certain circumstances, may create threats to compliance with the fundamental principles. For example, self-interest threats to objectivity or confidentiality may be created through the existence of the motive and opportunity to manipulate price sensitive information in order to gain financially. Examples of circumstances that may create self-interest threats include situations where the professional accountant in business or an immediate or close family member:

- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest could be directly affected by decisions made by the professional accountant in business;
- Is eligible for a profit related bonus and the value of that bonus could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization, the value of which could be directly affected by decisions made by the professional accountant in business;
- Holds, directly or indirectly, share options in the employing organization which are, or will soon be, eligible for conversion; or
- May qualify for share options in the employing organization or performance related bonuses if certain targets are achieved.

340.2 The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. In evaluating the significance of any threat, and, when necessary, determining the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, a professional accountant in business shall evaluate the nature of the financial interest. This includes evaluating the significance of the financial interest and determining whether it is direct or indirect. What constitutes a significant or valuable stake in an organization will vary from individual to individual, depending on personal circumstances. Examples of such safeguards include:

- Policies and procedures for a committee independent of management to determine the level or form of remuneration of senior management.

- Disclosure of all relevant interests, and of any plans to trade in relevant shares to those charged with the governance of the employing organization, in accordance with any internal policies.
- Consultation, where appropriate, with superiors within the employing organization.
- Consultation, where appropriate, with those charged with the governance of the employing organization or relevant professional bodies.
- Internal and external audit procedures.
- Up-to-date education on ethical issues and on the legal restrictions and other regulations around potential insider trading.

340.3 A professional accountant in business shall neither manipulate information nor use confidential information for personal gain.