



Meeting: IESBA Consultative Advisory Group
Meeting Location: New York
Meeting Date: September 12, 2012

Agenda Item

C

Conflicts of Interest

Objective of Agenda Item

To seek input from CAG members on key issues raised on exposure and issues raised at the IESBA June meeting.

Background to the Project

On December 20, 2011, the IESBA issued an exposure draft (Agenda Paper C-2) proposing changes to the Code related to addressing conflicts of interest. The comment period ended on March 31, 2012 and 50 responses have been received as at September, 2012.

The Task Force¹ met on May 14-15, 2012 and by conference call on May 31, 2012 to review the comments received. The Task Force reviewed the comments and in due course will provide the IESBA with a detailed analysis of all comments and the proposed resolution of each one. At its June 2012 meeting, the IESBA discussed the responses to the first five questions in the exposure draft and provided feedback to the Task Force. The Task Force meets again on September 13.

The majority of responses were related to Section 220. Therefore the Task Force focussed its attention on those matters. In addition the Task Force paid attention to ensuring its proposals for Section 220 would be appropriate for the relevant sections of Part C of the Code. It also considered those individual comments that applied to the relevant sections of Part C of the Code.

Subject to comments from the CAG members, the Task Force anticipates presenting revised wording at the December 2012 IESBA meeting, together with a detailed analysis of all comments received.

Structure of Section 220

Prior to addressing the specific questions included in the Exposure Draft the Task Force wishes to point out that it concurs with the view of four respondents that the order of paragraphs 220.3-220.7 should be revised to make a clearer distinction between the identification, evaluation and management of conflicts of interests and to make the process more logical. The proposed new order of the paragraphs is reflected in the table below. This table will help CAG members correlate the original ED with the proposed revised wording (Agenda Paper C-1):

¹ Peter Hughes (Chair), Jim Gaa, Gary Hannaford, Sylvie Soulier (Technical Advisor)

Exposure Draft	Task Force proposal
<i>220.3 Reasonable steps</i>	<i>220.3 Third party test</i>
<i>220.4 Third party test</i>	<i>220.4 Reasonable steps to Identify</i>
<i>220.5 Identify and evaluate</i>	<i>220.5 Effective process</i>
<i>220.6 Effective process</i>	<i>220.6 Evaluation</i>
<i>220.7 Evaluation, disclosure, consent and safeguards</i>	<i>220.7 Safeguards</i>
	<i>220.8 Disclosure and consent</i>

Discussion

Question 1: Do respondents find the description and examples of conflicts of interest helpful?

Extant Sections 220 and 310 do not describe a conflict of interest or provide examples of conflicts of interest. The exposure draft includes a description of circumstances that might create a conflict of interest for the professional accountant together with examples of such circumstances. The purpose is to help the professional accountant to identify a potential conflict of interest at a sufficiently early stage to be able to take any actions necessary to comply with the fundamental principles. The description developed for this purpose specifically includes conflicts between:

1. The interests of two or more parties for whom the professional accountant undertakes professional activities; and
2. The interests of the professional accountant and the interests of a party for whom the professional accountant undertakes a professional activity.

The exposure draft includes a description of a conflict of interest in paragraph 100.17 and in each opening paragraph of Sections 220 and 310.

The task force considered in May whether respondents found the description and examples helpful.

There was support for the proposed approach from respondents. Six respondents preferred the use of a definition of conflicts of interest rather than a description and examples. However, no respondents provided a proposed definition. Many respondents commented on the examples. The task force agreed to add some examples and to re-order the examples from the less obvious to the obvious.

The task force was of the view that the description should show the linkage between the professional service provided by the professional accountant and the conflict between the two parties and proposed a revised description. There was general support for the revised description from the Board.

The IESBA supported the Task Force's tentative conclusion that the description of a conflict of interest should be redrafted to provide a linkage between the professional activity and the matters

that are in conflict, thus making it clear that a conflict of interest is not created merely because the interests of two clients are in conflict.

Paragraphs 220.1 and 2 marked up, as presented to June IESBA:

220.1 A professional accountant in public practice may be faced with a conflict of interest when performing a professional service². A conflict of interest creates a threat to objectivity and may create threats to other fundamental principles. Such threats may be created ~~by~~when:

- ~~Conflicts~~ The professional accountant provides professional services with respect to a particular matter for~~between the interests of two or more clients whose interests with respect to that matter are in conflict;~~ or
- ~~Conflicts between~~ The interests of the professional accountant with respect to a particular matter and the interests of the client for whom the professional accountant provides professional services with respect to that same matter are in conflict.

A professional accountant shall not allow a conflict of interest to compromise professional or business judgment.

220.2 Examples of situations in which conflicts of interests may arise include:

- Recommending a client to invest in a business in which a family member of the professional accountant in public practice has a financial interest;
- Providing services to both a vendor and a purchaser in relation to the same transaction;
- Acting as a liquidator of a company which is a debtor of an audit client of the liquidator's firm;
- Advising a client on its competitive position while having an interest in the same market segment;
- ~~Representing~~ Advising two clients at the same time who are trying to acquire the same company;
- Preparing valuations of assets for different two parties in~~who are in an~~ adversarial proceedings~~position with respect to the assets;~~
- Performing litigation services for the plaintiff in connection with a lawsuit filed against a client of the professional accountant's firm;
- Representing two clients who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership;
- ~~Advising two shareholders in dispute over the distribution of assets on the dissolution of the company;~~
- Advising a client on the purchase of an a product or service information system while having a license-royalty or commission agreement with a one of the potential software-vendors.

² **Revised Definition:** Professional Services: Professional activities performed for clients.

Action Requested

CAG members are asked whether they agree that the description of a conflict of interest should be revised to provide a clearer linkage between the subject of a professional service and the existence of a conflicting interest or relationship.

Question 2: Do respondents find the reasonable and informed third party standard appropriate?

Respondents were generally supportive of the application of the reasonable and informed third party test.

The proposed revision to Section 220 requires the professional accountant to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude 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. In the IESBA's view it is appropriate for the professional accountant to consider how a conflict of interest would be viewed by a third party. Additionally, this is consistent with the application of the conceptual framework and the determination of whether threats to compliance with the fundamental principles are at an acceptable level.

The task force considered the responses to the reasonable and informed third party standard and noted that 36 out of 41 respondents agreed with the proposal. Some respondents suggested that the third party test is subjective and a matter of judgment. The task force proposes to emphasize that the professional accountant needs to exercise professional judgment. The Board cautioned that references to professional judgment should be consistent with references in other parts of the Code.

The task force is of the view that the reasonable and informed third party standard should conform to 100.2 (c) in that "compliance with the fundamental principles is not compromised". This was generally supported by the Board.

There was support from the Board to the use of the reasonable and informed third party standard.

Action Requested

CAG members are asked whether they agree with the Task Force proposal to add a reference to professional judgement and for the test to conclude that compliance is not compromised.

Question 3: Do respondents find the "reason to believe" threshold for network firms in evaluating conflicts of interest helpful?

The IESBA considered what standard should apply with respect to potential conflicts of interest that might be created by the interests and relationships that a firm that is a member of a network of firms, has with a client. The IESBA considered the following points and is of the view 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 exists because of other interests or relationships that another firm in the network has with a client. The “reason to believe” test requires the professional accountant to consider the facts available to the professional accountant at that time. The proposal recognizes that the extent of client information exchanged will vary between different networks depending on legal and contractual constraints. It would, therefore, be 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. When evaluating whether the professional accountant has reason to believe that a conflict of interest may exist or be created due to interests and relationships of a network firm, the proposal requires the accountant to take into account factors such as the nature of the professional services provided, the clients served, and the geographic locations of all relevant parties.

Respondents were generally supportive of the basis on which threats arising from network firm interests and relationships are addressed in the exposure draft.

The IESBA considered what threshold should apply with respect to potential conflicts of interest that might be created by the interests and relationships that a firm, that is a member of a network of firms, has with a client. The exposure draft proposes 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 exists because of interests or relationships that another firm in the network has with a client. The “reason to believe” threshold requires the professional accountant to consider the facts available to the professional accountant at that time.

The task force considered the responses to the reason to believe threshold and noted that 31 out of 42 respondents agreed with the proposal.

It was noted that:

- Six respondents suggested that the threshold should be strengthened to a “reasonably be expected to know threshold”
- Two respondents suggested that the threshold was too strong

One respondent noted that the reference to the “reason to believe” threshold should be made more prominent and the task force is of the view that the threshold should be treated as a separate paragraph and “knows or” be added to “has reason to believe” but otherwise proposes to retain the threshold as proposed in the exposure draft.

The board agreed with the general approach proposed by the task force for a “knows or has reason to believe” threshold.

Action Requested

CAG members are asked whether they agree with the Task Force's recommendation that no significant changes need be made to the Exposure Draft wording with respect to this matter.

Question 4: Do respondents find the guidance concerning safeguards to manage conflicts of interest and obtaining and documenting consent, as set out in paragraph 220.7, appropriate?

The exposure draft expands on the guidance in the extant Code regarding the nature of safeguards that may be available to manage conflicts of interest within firms. The IESBA believes that it is generally necessary to disclose the nature of the 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 providing 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.

The exposure draft recognizes that in certain circumstances the consent obtained from any relevant party may be implied by the party's conduct in keeping with common commercial practice. The exposure draft also encourages the professional accountant to document such consent when it is obtained verbally or implied by the party's conduct.

The task force noted majority support for the proposal but that there were a number of specific comments regarding a lack of clarity in some terms used in the guidance e.g. "generally necessary" and some suggested a need to split out disclosure and consent. Some respondents questioned whether consent itself is a safeguard and the task force agreed not to describe it as such.

The task force reached a tentative conclusion that the guidance on managing conflicts of interest, and obtaining and documenting consent, could be clarified by addressing disclosure and consent separately and providing additional guidance on the types of consent - general, explicit, and implied. Specifically the task force proposed that the following changes could increase the clarity of the paragraph:

- subdivide disclosure into "specific" and "general"
- analyze consent into verbal, written and implied
- place examples of safeguards in a separate paragraph

The task force does not propose to strengthen the encouragement to document consent in the generality of cases. However, the task force does propose to require documentation when consent is not to be obtained in the circumstances described in paragraph 220.9 (see question 5 below).

The IESBA considered the task force proposals and requested the task force consider:

- if more guidance can be provided on implied consent, including an example. It was noted that implied consent in fact occurs very rarely in practice and that consent is normally general or explicit/specific. A suggested example of implied consent was where a party asks the professional accountant to analyze financial information on all parties in a multi-

- party dispute and where the instruction itself provides evidence of consent to any perceived conflict.
- whether there are particular issues in relying on consent where the conflict of interest arises from an interest or relationship of the professional accountant themselves, given that self-interest should not be allowed to influence a professional accountant's judgment and there may be few safeguards available in such a situation. The last sentence of 220.1 states "*A professional accountant shall not allow a conflict of interest to compromise professional or business judgment.*"
 - if it is necessary to disclose and obtain consent if safeguards have already reduced the threats to an acceptable level.

Action Requested

CAG members are asked whether they agree with:

- separating disclosure and consent
- analyzing consent into general, explicit and implied
- including a new "shall" statement requiring the professional accountant to determine whether the significance of the threat is such that specific disclosure and consent are necessary.

Question 5: Do respondents concur with the three conditions set out in paragraph 220.8 required to be met before a professional accountant can proceed to accept or continue with an engagement when a conflict of interest exists but consent cannot be obtained because it would in itself breach confidentiality? Are the examples within paragraph 220.8 helpful?

Respondents were supportive of proposals to deal with situations when consent cannot be obtained because it would breach confidentiality.

The exposure draft recognizes 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 exposure draft provides 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.

The task force considered the responses to the provisions when disclosure would itself be a breach of confidentiality and noted that 36 of 45 respondents agreed with the proposal. The task force proposed that

- the wording should explicitly recognize that the situation is “exceptional”
- the third condition above should be strengthened to require that inability to perform the service would produce a disproportionate outcome for the client or other relevant third parties
- documentation should be required.

The IESBA requested the task force to consider:

- clarifying that the provision would not apply where implied or general consent has already been obtained. The provision would only apply if it has been decided that explicit consent is necessary, and is impossible to obtain without breaching confidentiality,

Action requested

CAG members are asked to provide comments on the Task Force’s proposals.

The Task Force did not identify, at its May 2012 meeting, any points of principle arising from responses to Questions 6, 7 and 8.

Respondents were supportive of the proposed requirements for professional accountants in business.

Other matters raised by respondents

The Task Force considered the issues raised by IOSCO in their letter regarding the importance of the public interest when considering conflicts of interest and the relationship between conflicts of interest and auditor independence.

IOSCO noted that the proposal did not include reference to the public interest. This view is stated in the following extract from the letter:

“The notion of a “conflict of interest” seems to implicitly suggest that there may be various identifiable interests at play during the performance of services by a professional accountant. In our view, the overarching and most important interest is the public interest. We are concerned that the proposed revisions and more broadly, the Code of Ethics, may not sufficiently and explicitly guide the accountant to use the public interest as a benchmark for his/her behavior.

We note many instances in the Code where reference is made to the professional accountant’s general responsibility to use the public interest as a benchmark. We also noted, however, that the Fundamental Principles within paragraph 100.5 of the Code do not explicitly mention the accountant’s responsibility to act in the public interest. We believe that acting in the public interest would entail that the auditor functions in a manner that is consistent with and/or contributes above all other interests to the efficient and effective functioning of the securities markets, including providing the relevant information to the users/investors on a timely basis. As we believe the public interest is the overarching and most important interest, we think it should be made clear

within the Code that the interest of the profession or clients should never trump or come at the expense of the public interest. We believe this should be a principle explicitly set out in Paragraph 100.5 of the Code. A general principle of this nature could then be detailed in some further provisions. We would for instance suggest that the auditor be required to avoid creating new conflicts of interest, and also that he would be required, when dealing with conflicting interests, to give most weight to the public interest.”

The IOSCO letter expresses the view that the public interest should be a principle explicitly set out in paragraph 100.5 of the Code, which could then be detailed in further provisions. The Task Force notes that acting in the public interest is an overarching provision in paragraph 100.1 of the Code and is of the view that a detailed consideration of this matter falls outside the remit of this project.

The IOSCO letter states there seems to be no guidance on how to deal with situations where the public interest conflicts with other interests. The Task Force is of the view that the purpose of the guidance in Section 220 is to provide guidance to the professional accountant in dealing with conflicts of interest as described paragraph 220.1 and that the public interest is addressed by the identification and evaluation of potential conflicts of interest, including in particular the application of the reasonable and informed third party test set out in paragraph 220.4.

The IOSCO letter suggests that the Board look more deeply into the relationship between conflicts of interest and auditor independence, although it recognizes this may take some time. As a first step they suggest that paragraph 220.5 should cross refer to the Independence section of the Code. The Task Force is of the view that Section 220 applies to all Professional Accountants in Practice whereas Section 290 only applies to accountants providing audit and review services and therefore a cross reference would not be appropriate.

The IESBA noted that the IFAC Board had approved a policy position paper setting out guidance on the public interest. The IESBA also noted that in its response to the exposure draft addressing Conflicts of Interest, IOSCO had encouraged the IESBA to consider the concept of the public interest as outlined in the Code and whether it should be a fundamental principle. The IESBA agreed that it would consider both of these matters at its December 2012 meeting.

Action requested

CAG members are asked to consider and comment on the Board’s proposed disposition of the IOSCO’s response.

Material Presented

Agenda Item C	This Agenda Paper
Agenda Item C-1	Section 220 proposed revised wording
Agenda Item C-2	Exposure Draft

Action Requested

CAG members are asked to consider the questions raised in this paper.