



International
Ethics Standards
Board for Accountants

529 Fifth Avenue, 6th Floor, New York, NY 10017
T + 1 (212) 286-9344 F +1 (212) 286-9570
www.ethicsboard.org

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

Agenda Item

D

Review of Part C

Objective of Agenda Item

To seek input from CAG members on a review of Part C of the Code that addresses professional accountants in business.

Background

The IESBA has determined that as part of informing the development of its next Strategy and Work Plan, it should examine whether recent accounting irregularities reveal ethical implications for professional accountants in business (PAIBs) and whether Part C of the Code, which (along with Part A) establishes ethical standards for PAIBs, should be strengthened to provide more guidance and support for PAIBs.

A Working Group¹ was organized to analyze reported accounting irregularities at certain companies and determine whether Part C should be strengthened to better promote ethical behavior by PAIBs. Based on its analysis, the working group would make recommendations about issues that merit the Board's attention in Part C. As part of its effort, the working group undertook a preliminary informal survey of a number of IFAC member bodies whose memberships comprise a large number of PAIBs, including member bodies from both developed and developing nations. The survey attempted to identify the types of ethical issues and problems encountered by the member bodies' PAIBs. The working group also considered whether additional guidance might be provided other than (or in addition to) changes to the Code itself.

The working group reviewed the responses from the preliminary informal survey, and conducted its own analysis of the Code. Based on the survey responses and its own analysis, the working group identified a number of areas where further development of the Code might be considered.

At its June 2012 meeting the IESBA discussed the preliminary recommendations of the Working Group. The IESBA agreed that the review be extended to identify any other related issues that the Board may wish to address in its Strategic Plan for 2014/15. Therefore the Working Group undertook a further survey of stakeholders, mainly member bodies, asking about the importance

¹ Jim Gaa (Chair), Alice McCleary, Lisa Snyder (Technical adviser), Ian Rushby (member of IFAC Professional Accountants in Business Committee), Larry Kean (SME).

of, and the prioritization of, potential issues and asking for further issues to be identified. The results of this survey are being presented to the CAG. The Working Group will also obtain further input from the IFAC Professional Accountants in Business Committee. The working group plans to provide a final report with recommendations to the IESBA at its December meeting.

Matters presented to the IESBA at its June 2012 meeting

In recognition of the competing demands on the IESBA's time and other resources, the preliminary recommendation of the working group was that the IESBA consider two major and interconnected issues in its next Strategy and Work Plan.

1. Responsibilities of PAIBs to Produce Relevant and Faithfully Representative Depictions

According to the Conceptual Framework of the International Accounting Standards Board and the Financial Accounting Standards Board, financial reports should be useful to current and potential investors and creditors. Usefulness requires that information be relevant (capable of making a difference to the users of the information). In addition, information "must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral, and free from error."² International Accounting Standards (IAS1) allows for management to override IFRS in "extremely rare circumstances" when management concludes that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework.

The IESBA Code mentions a PAIB's responsibility to provide representationally faithful information only briefly in two places: indirectly in paragraph 110.1 ("Integrity also implies fair dealing and truthfulness") and in 320.1 ("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.") Related to this responsibility, 320.2 states that financial reports shall be prepared in accordance with applicable financial reporting standards and 320.3 provides guidance on recordkeeping. The IESBA may wish to consider whether the Code could provide more guidance to PAIBs on the meaning of faithful representation.

The Code (including already proposed changes) also addresses a PAIB's responsibility not to be associated with misleading reports. This occurs in a number of different places and contexts: 110.2, 300.10, and 310.2 (which, with all the provisions in the current 310, has been proposed for deletion in the project on Conflicts of Interest). In addition, the Suspected Illegal Acts Task Force and the Board (in the Conflicts of Interest project) have proposed substantive changes to 300.6 and 320.4. It should be noted that in the Conflicts of Interest project, the paragraphs in the current version of Section 310 would be deleted because they do not concern conflicts of interest, and because the issues addressed in them are covered to some degree in other sections of Part C. The Board did not make any judgment about the adequacy of the other sections when it

² <http://www.ifrs.org/NR/rdonlyres/0BD5A2FE-1659-44D1-9074-FE07E4459E6D/0/ConceptualFW2010vb.pdf>

requested that the Conflicts of Interest Task Force work on consequential changes to 320 and 340 (as are contained in the Exposure Draft).

Paragraph 320.1 requires information to be presented “fairly, honestly and in accordance with relevant professional standards so that the information will be understood in its context.” Thus, a PAIB has a responsibility to prepare financial statements in accordance with GAAP and use professional judgment in determining that the information will be understood in the context in which it is presented. However, circumstances may exist where GAAP allows a presentation that does not reflect the economics of the transaction and may thus be misleading. As noted above, IFRS allows a management override and other frameworks may also allow a management override. The language in 320.1 could be interpreted as establishing a second test; that is, that the information is presented “fairly” and “honestly.” The Code does not expand on the meaning of fairly and honestly in this context. It may be helpful for PAIBs to understand whether the Code intends for a second test to apply and if so how it should be applied. The working group's preliminary recommendation is that the Board clarify the intent of the requirement that information be presented fairly and honestly. Specifically, it would clarify whether PAIBs are required to do something more than present information in accordance with relevant professional standards if application of a standard would result in a portrayal of, for example, financial position and results

Some earnings management is illegal, but most is by design legal (i.e., not in violation of GAAP), and the ethical status of legal earnings management is controversial. For example, an academic survey of 400 executives³ indicates that almost all businesses undertake earnings management (and often do so for short term gain to the detriment of potentially greater long term gain) , but do so without violating GAAP, laws, or regulations. and without regard to whether the information is fair and honest in the circumstances.

Earnings management is an important challenge to faithful representation, but the current code makes no reference to it. It has both positive and negative connotations and ranges from acceptable to unacceptable. There are many definitions of earnings management. They are variants of each other, in that there is a focus on it as a form of strategic behavior. For example, earnings or balance sheet numbers may be presented, in order to produce a predetermined result, such as earnings that meet analysts' forecasts, produce a bonus for management, or allow the payment of dividends. Many of the definitions also build in the idea that earnings management can be unethical, rather than defining it in a way that is ethically neutral, to allow for the possibility that earnings management may be ethically acceptable in some circumstances and not acceptable in other circumstances.

Some examples of earnings management, such as arrangements to accelerate or to delay the recognition of expenses or losses, or to move material liabilities off balance sheet, are in accordance with GAAP. Regulators or third parties may consider the accounts to be misleading even though the financial statements are in accordance with GAAP. A PAIB in this case is faced with the dilemma that the financial statements may be seen to be misleading even though they do

³ The published version of this paper is behind the copyright wall of a major academic journal. The working paper version is available at:
http://faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W73_The_economic_implications.pdf

not violate applicable financial reporting standards. The Code could provide guidance on how PAIBs should respond to such situations.

The Code does not provide guidance on distinguishing acceptable and improper earnings management. Because the credibility of financial reporting is central to investor protection, the working group recommends that the Board provide guidance on earnings management, especially as this term is included in the paragraph 300.6 (Responding to a Suspected Illegal Act). This would also be contained in Section 320, building on 320.1-320.3, and Section 300, amended to address the ethical issue. Further detailed guidance could be provided in relation to recommended revisions to Sections 320 and 340 (below).

2. Pressure by Superiors and Others to Engage in Unethical or Illegal Acts

Section 360, currently under consideration by the IESBA, focuses on suspected illegal acts. Except for a proposed change to paragraph 300.6, the proposed guidance does not address how a PAIB should deal with the unethical acts of others, and does not deal with pressures to engage in illegal or unethical acts. The preliminary survey of member bodies conducted by the working group revealed that the most common inquiry they receive from PAIBs concerns pressure to engage in unethical or illegal acts. Currently, guidance on this matter is contained in Sections 310 (the current version, which is being deleted in the revision of Section 310), 320.5-320.8, and 340. The working group recommends that this guidance be consolidated and developed further in Section 340. In addition, it believes that pressures on PAIBs may come from superiors who are also PAIBs, and that the Code should address the responsibilities of superior PAIBs towards others in the context of illegal and unethical acts.

The working group is of the view that Section 340 is too narrowly described. First, although many PAIBs are involved in work that may indirectly feed into the group financial statements and other reports, not all are directly involved with financial statements of companies in which they have a financial interest and can influence the preparation of those financial statements. For example, many PAIBs will work at a subsidiary level or with management accounts, and not in financial reporting in divisional or head offices. Second, the working group is of the view that pressure to improperly influence earnings results is as likely to be the result of the corporate culture, bullying and threats of job loss as personal financial gain (which is addressed in Section 340). Third, the motivations created by intimidation threats are in Section 320. The Task Force believes that the positive motivations in Section 340 could be expanded beyond financial interests and that these are closely linked to the pressure to act inappropriately in Section 320. Combining these threats under one heading may make the Code clearer.

In addition to providing guidance to subordinate PAIBs in responding to inappropriate pressure, the Code could include guidance for those PAIBs who may exert the pressure. Paragraph 300.5 refers to the importance of encouraging an ethics-based culture, but there is no other guidance requiring a senior PAIB not to inappropriately pressure subordinates.

Part C currently focuses on the pressure on subordinates to commit illegal or unethical acts, but could also address the fact that a PAIB may be both a superior (exerting pressure on subordinates) and a subordinate on whom pressure is being exerted. An accounting irregularity

may be accomplished with the knowing or unknowing support of a subordinate, who may be pressured to act in accordance with the instructions of the superior. Guidance similar to the escalation process in proposed Section 360 (Responding to a Suspected Illegal Act) may help the PAIB in dealing with unethical acts. In addition, guidance to PAIBs who have subordinates (whether they are PAIBs or not) may be helpful in dealing with the issue of pressure to commit illegal and unethical acts.

Board comments on the working group proposals

A number of Board members expressed support for the recommendations proposed by the Working Group and believed the document prepared by the Working Group reflected a good understanding of the practicalities and realities of issues faced by PAIBs. Certain members, however, believed that the project should be expanded to revise the entire Part C rather than just specified areas within Part C. One member suggested that Part C should also provide guidance on “financial management” issues, such as decision making in financial support roles (e.g., where finance personnel construct decisions in such a way as to justify the decisions of senior management).

Some members expressed caution with respect to addressing the issue of “earnings management,” specifically as to when earnings management would be considered improper or unethical if the reporting of the transaction is not illegal nor contrary to GAAP. It was further noted that the Working Group should be careful not to develop a framework that would be inconsistent with that of the IASB. Overall, the Board was supportive of developing guidance addressing the behavior of the PAIB when faced with improper earnings management but believed that such guidance should not address whether specific types of earnings management would be considered improper.

The IESBA considered whether there were any other issues that should be considered by the Working Group. One Board member recommended that Part C should include guidance specific to professional accountants in government. It was noted that while the pressures facing such accountants are probably similar to other PAIBs, the remedies available could be different. It was noted that the Working Group may also wish to seek the views of the International Organisation of Supreme Audit Institutions (INTOSAI) in this regard. Another member recommended that additional guidance should be included to address how PAIBs could ethically use the skills and experience gained when changing employment without disclosing confidential information of the prior employer as well as guidance on accepting employment with a new employer. Other possible issues noted by Board members included dealing with aggressive valuation estimates and alternative accounting treatments, especially when such accounting treatments could impact the PAIB’s bonus or other compensation.

It was recommended that the Working Group conduct further outreach with PAIBs and other stakeholders to determine what additional guidance should be addressed in Part C.

Stakeholder survey

The Working Group conducted a survey of 23 relevant stakeholders and by August 29 had received 11 responses. It was recognized that responses may be limited because of the short time period available and the time of year in which it was conducted. However, it is believed that the results give a good indication of the views of member bodies with significant numbers of PAIBs. The survey listed those issues the Working Group believed would be most important to stakeholders, but also asked for additional issues.

The surveys were sent to the Ethics contacts in member bodies, who were asked to consult relevant PAIB committees or boards as far as possible. The results therefore reflect the member bodies' understanding of the needs of PAIBs. In some cases the results may be based on surveys of PAIBs by the member body.

A number of further issues were identified by the Working Group for inclusion in the survey:

Facilitation payments and bribes (Inducements offered and received)

Section 350 (Inducements) covers both receipts and offers of items of value by PAIBs. These may include gifts, hospitality, preferential treatment etc. Irregularities relating to illegitimate payments appear to be a growing problem, according to a recent survey of professional accountants in business, and as reported in the world press. Section 350 could be reviewed to consider whether the Code appropriately recognizes the diversity of practices in different cultures.

Specific Guidance Relevant to Professional Accountants in the Public Sector

The IFAC definition of a PAIB is: "A professional accountant employed or engaged in an executive or non-executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities." Recent events have raised the issue of the quality of financial information in the public sector, and pressure on professional accountants in the public sector to manipulate financial information.

Additional guidance could be added to Part C to reflect the particular threats and safeguards applicable in the public sector.

Conflicting Business Partner vs. Controller roles

The traditional role of the PAIB as controller requires skepticism and objectivity in questioning and challenging others within the employing organization. In recent years, PAIBs have been encouraged to be a "business partner" and to be part of the team which creates shareholder value. These roles overlap, and may be in conflict to some degree; they thus may provide a challenge for the PAIB who is required to be both an advocate and a skeptic. As an example, a former DG of the European Commission, Jules Muir, stated:

"Over the last 10 years, many CFOs have carved out such a broad function for themselves that, in my view, they are combining responsibilities that are incompatible with the fundamentals of checks and balances. Many CFOs nowadays are not only responsible for the proper functioning of the controls and for the integrity of the numbers, but they are also major game-makers in their

financial management function. You run into a conflict of interest if you combine an obvious management function with the controlling and accounting for it, in particular when the job is strongly bonus-driven.

Therefore, I would strongly favor splitting the CFO role into an officer in charge of 'bean-making' and an officer in charge of 'bean-counting,' in particular for organizations that have financial management as a stand-alone profit center, such as banks and insurance companies, but also others."

The IESBA could consider whether this may be a public interest issue and provide guidance on suitable safeguards to reduce the threat to an acceptable level.

Independence Requirements for Professional Accountants who are not in Public Practice who Perform Assurance Engagements

Sections 290 and 291 of the Code address independence requirements for assurance engagements. The sections apply to professional accountants in public practice. The Code could consider whether guidance is needed on the independence requirements that should apply to other professional accountants who perform assurance engagements, such as accountants in government and internal auditors.

Advocacy threats to fundamental principles

The Code recognizes that a PAIB has a responsibility to further the legitimate aims of the employer. However advocacy may create a threat to the fundamental principles if a PAIB promotes an employer's position to the point where objectivity is compromised. The fundamental principle of Integrity requires information should not omit or obscure information where such omission or obscurity would be misleading.

Further guidance could be useful on how these principles apply to commercial negotiations, in presenting forecasts and projections, and agreeing budgets where tactics, positioning and motivational factors may come into play. Many skills applied by PAIBs, e.g. used in commercial negotiation, produce tension with the fundamental principle of objectivity.

Applicability of Part C to Professional Accountants in Public Practice

Paragraphs 100.3 and 100.12 state that "professional accountants in public practice may also find Part C relevant to their particular circumstances". Therefore, they may be bound by the requirements of Part C as well as Parts A and B. An example of this relevance is that professional accountants in public practice may be inappropriately pressured by superiors to compromise audit quality by working within unrealistic time budgets. This is not addressed in Part B, but is addressed in Part C.

An example of this is undue pressure on junior auditors to perform tasks within a predefined time allowance. It appears that this kind of situation falls under the category of undue pressure by superiors discussed above, and that Part B does not address this issue. The Board could

examine provide guidance about the applicability of Part C to professional accountants in public practice.

Part C could be revised to clarify the relevance of Part C to professional accountants in public practice.

The results of the survey are summarized below.

The Priority rankings and Importance scores are averages of the responses.

Priority	Issue	Importance Rated on a scale of : 1 (high) to 6 (low)
1	<i>Responsibility to produce truthful information and reports</i>	1.64
1	<i>Pressure from superiors to engage in unethical or illegal acts</i>	1.36
1	<i>Requirement to disassociate from misleading information</i>	1.73
4	<i>Facilitation payments and bribes (Inducements offered and received)</i>	2.36
4	<i>Specific guidance relevant to professional accountants in the public sector</i>	3.50
4	<i>Conflicting Business Partner vs. Controller roles</i>	3.82
4	<i>Independence requirements for professional accountants who are not in public practice who perform assurance engagements</i>	4.20
8	<i>Advocacy threats to fundamental principles</i>	3.91
8	<i>Applicability of Part C to professional accountants in public practice</i>	4.50

Respondents were also asked to provide additional issues to those listed in the questionnaire. The following are the issues added by respondents:

- Need for case studies to illustrate points**
- Internal auditors (objectivity rather than independence)**
- Conflict resolution process
- Security of information
- Accountability and consequences of unethical behavior

- Whistle blowing/speaking up – protection of individuals
- Structured approach to decision making
- Fair valuations of assets and liabilities in accordance with IFRS
- The impact of remuneration structures such as bonuses, shares and share options on the behavior of PAIBs
- Applicability of Part C to professional accountants working in the not-for-profit/charity sector, either as employees or volunteers
- Work pressure
- Wanting to provide a positive image of the own organization towards outsiders
- **Difficulties in addressing ethical issues in the organization****
- Application of Part C to those in specialist roles.

NOTE: Additional issues marked “**” were included in the respondent’s top 5 priorities.

Preliminary comments on the survey results

The priorities attributed to the issues have been grouped into three rankings (1, 4 and 8) because the average priorities were not significantly different from each other within each of the three groupings.

The three issues ranked 1st, were ranked 1, 2 or 3 by almost all respondents and one respondent suggested that they be grouped together. This reflects the view of the working group and confirms the proposal to the IESBA in June.

The four issues ranked 4th were generally ranked 2, 3, 4 or 5 by respondents, indicating they would like to see these matters addressed. Professional Accountants working in the public sector are defined as PAIBs within the Code. It is believed that PAIBs working in the private sector far outnumber those in the public sector and the high priority given to this issue suggests that stakeholders perceive a particular importance in such matters. The working group will wish to understand what these issues may be. The importance given to independence requirements for internal auditors was ranked 5th by three stakeholders and 1st by one, thus giving a high average, although only one respondent rated it highly.

The two issues with the lowest priority included the applicability of Part C to professional accountants in practice. This matter is unlikely to be rated highly or important by members in business as it does not impact them, but the working group may wish to assess the broader importance of the issue.

Three respondents gave priorities to issues that were not provided in the survey and therefore they do not appear in the table but they will be carefully considered by the working group. These three issues are listed underneath the table and are:

- **Need for case studies to illustrate points****
- **Internal auditors (objectivity rather than independence)****
- **Difficulties in addressing ethical issues in the organization****

Conclusion

The Working Group will consider the matters discussed by the IESBA at its June 2012 meeting, the results of the stakeholder survey results, the comments of the CAG members and the PAIB Committee members in making a recommendation to the IESBA December meeting as to issues that the Board may wish to address in its Strategic Plan for 2014/15.

Action requested

CAG members are asked to comment on the the matters discussed by the IESBA at its June 2012 meeting and the results of the stakeholder survey, in particular the prioritization and importance of issues, and whether any other issues should be considered.

Material Presented

Agenda Item D	This Agenda Paper
---------------	-------------------

Action Requested

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