International Ethics Standards Board for Accountants (IESBA)
CONSULTATIVE ADVISORY GROUP (CAG)
Draft Minutes
Held on March 07, 2011 New York, United States

Present:	Richard Fleck (Chair)	Financial Reporting Council
	Marc Pickeur	Basel Committee on Banking Supervision
	Kristian Koktvedgaard	Business Europe
	Federico Diomeda	European Federation of Accountants and Auditors for SMEs
	Marie Lang	European Federation of Accountants and Auditors for SMEs
	Jean-Luc Peyret	European Federation of Financial Executives' Institutes
	Philip Johnson	Fédération des Experts Comptables Européens
	Hilde Blomme	Fédération des Experts Comptables Européens
	Paul Koster	Gulf States Regulatory Authorities
	Obaid Saif Hamad Al Zaabi	Gulf States Regulatory Authorities
	Margie Bastolla	Institute of Internal Auditors
	Nigel James	International Organization of Securities Commissions
	Koichiro Kuramochi	International Organization of Securities Commissions
	Filip Cassel	International Organization of Supreme Audit Institutions
	Gaylen Hansen	National Association of State Boards of Accountancy
	David Morris	North American Financial Executives Institutes
	Dominique Pannier	Organisation for Economic Cooperation and Development
	Martin Baumann	Public Company Accounting Oversight Board[1]
	Ajith Ratnayake	Sri Lanka Accounting and Auditing Standards Monitoring Board
	Simon Bradbury	World Bank
	Linda de Beer	World Federation of Exchanges
	Ken Dakdduk	IESBA Chair
	Robert Franchini	IESBA Member
	Isabelle Sapet	IESBA Member
	Kate Spargo	IESBA Member

[1] The views expressed by Mr. Baumann, here noted in the minutes, represent his own and do not necessarily reflect the views of the PCAOB members or its staff.

	Jan Munro	IESBA Deputy Director
	Michael Hafeman	PIOB
Regrets	Conchita Manabat	Asian Financial Executives Institutes
	Matthew Waldron	CFA Institute
	Elena Lobanova	Graduate School of Financial Management, Russia
	Gerald Edwards	Basel Committee on Banking Supervision
	Georges Couvois	European Federation of Financial Executives' Institutes
	Pat Sucher	International Organization of Securities Commissions

A. Opening Remarks

Mr. Fleck welcomed all participants to the CAG meeting. He welcomed new IOSCO member Nigel James and the new IAASB CAG Chair Linda de Beer. He also welcomed Michael Hafeman representing the Public Interest Oversight Board.

The minutes of the London September 2010 CAG meeting were approved subject to some editorial changes.

B. Report from IESBA Chair

Mr. Dakdduk reported that the IESBA had met twice since the last CAG meeting. The Task Force addressing Conflicts of Interest and Responding to a Suspected Fraud or Illegal Act met directly after the February IESBA meeting. Thus, some of the positions presented in the CAG agenda papers are characterized as Task Force proposals. This approach was taken to provide CAG members with the opportunity to provide input on the most current thinking on both projects.

At the February 2011 meeting, the IESBA approved the Strategy and Work Plan 2011-2012. The plan will be issued after PIOB consideration that due process was followed in its development.

To further its Adoption and Implementation initiative, the IESBA staff issued some material in late 2009. To supplement this material, the IESBA staff issued some Questions and Answers (Q&A) in December 2010. The staff will issue additional Q&As as needed.

At its February 2011 meeting, the IESBA approved the terms of reference of an IESBA SME/SMP Working Group. The Working Group's objective is to identify issues faced by SMEs and SMPs, and particularly SMPs serving SMEs, in complying with the IESBA Code and recommend to the IESBA ways in which the board might address them. The IESBA will receive an interim report on the group's findings at its June 2011 meeting and a final report along with the group's recommendations at its October 2011 meeting.

At its November 2010 meeting, the IESBA discussed a stand-alone document identifying the independence requirements related to public interest entities. The IESBA provided input on changes to be made to the document, which would then be used to benchmark the Code's requirements against the requirements of select jurisdictions. At its February 2011 meeting, the IESBA received an update on the status of the benchmarking exercise. The IESBA will discuss a schedule of differences at its June 2011 meeting with the view to determining the extent to which the IESBA should focus its attention on these differences for possible future revisions to the Code. Mr. Hansen asked whether the results of the benchmarking would be public. Mr. Dakdduk responded that they will be and noted that the results will be discussed at the public portion of the IESBA's meeting in June and October 2011.

Ms. Blomme asked what activities the IESBA would be undertaking to follow the discussion on the EC Green Paper. Mr. Dakdduk stated that the IESBA planned to closely monitor developments and would need to determine how it should become involved in the debate. He noted that any activities of the IESBA would need to be consistent with its status as an independent standard setter. Mr. Fleck commented that while the Green Paper considered matters in the European Union, many of the options, if implemented, would have global consequences. He noted that the IESBA could play a role in shedding light on the global implications of the proposals. Mr. Casel expressed strong support for this suggestion.

Mr. Koktvedgaard asked whether the IESBA had considered looking at all of the proposals in the Green Paper and mapping them to IESBA projects completed or in progress. Mr. Dakdduk responded that this had not been ruled out, though IESBA’s response to the Green Paper did acknowledge the threats created by certain interests or relationships and indicated how the Code addressed those threats.

Mr. Koktvedgaard asked whether the IESBA planned to conduct a benchmarking exercise for the independence provisions applicable to non-listed entities. Mr. Dakdduk responded that this might be a recommendation from the SME/SMP Working Group.

Mr. Hansen asked Mr. Dakdduk to explain the process used to determine which questions would be addressed in a Q&A paper. Mr. Dakdduk responded that staff collected questions from member bodies, IESBA members, and other individuals. He noted that great care was taken to ensure that the answers clarified existing requirements in the Code and did not create new requirements.

C. Inadvertent Violation

Ms. Spargo, Task Force chair, introduced the topic. She noted that at its November 2010 meeting, the IESBA approved a project proposal to address the inadvertent violation provisions in the Code. The IESBA undertook this project to address concerns expressed by the International Organization of Securities Commissions ("IOSCO"). In its February 2011 meeting, the IESBA discussed Task Force proposals and provided input on preliminary wording for a new provision in the Code. The Task Force plans to present a revised document to the IESBA for approval as an exposure draft at its June 2011 meeting.

Ms. Spargo noted that in developing the proposals the Task Force focused on whether the provisions were in the public interest. The proposal is quite different from the provisions currently contained in the Code, which state that independence is deemed not to be compromised, do not explicitly state that the auditor may need to resign, and do not require the auditor to discuss the matter with those charged with governance.

Need for Provisions

Ms. Spargo stated that the IESBA was of the view that such provisions are in the public interest because if the automatic consequence of any violation is that the firm is not independent, and therefore unable to continue the audit engagement, regardless of the magnitude of the violation and its impact on the firm's ability to maintain its objectivity, the public interest is not well served. Despite firms having policies and procedures in place to maintain independence, violations will occur from time to time. Not all jurisdictions have a regulator that is willing to deal with violations or have a regulatory process for dealing with them. Member bodies also differ in their ability to deal with violations. If a firm believes that it can continue as the client's auditor despite a violation of an independence provision in the Code, the IESBA believes the firm should be required to apply a rigorous and transparent process that will support that conclusion. Including such a process in the Code makes the process authoritative and therefore mandatory if the outcome could be anything other than resignation. This is appropriate, as overcoming the consequences of a violation should involve meeting a very high mandatory hurdle.

The IESBA also believes that provisions for dealing with violations will benefit those charged with governance (e.g., audit committees). Such provisions would provide them with a framework by which to judge the effects of a violation for themselves and determine, independent of the auditor's judgment, whether the actions taken by the auditor are sufficient to support a conclusion that the auditor's objectivity had not been compromised, or that it has and the auditor should resign. This is important if the relevant regulator or member body is consulted by the firm, as they may consider the views of those charged with governance in determining the outcome.

In summary, it is the potential consequences to the company, its investors, and the capital markets of an auditor resigning whenever there is a violation of an independence provision without considering the impact of the violation that raise the public interest argument. There needs to be some guidance on dealing with such situations.

Mr. Hansen noted that in the presentation and also the papers there was a lot of focus on the difficulties a company might face if its auditor had to resign. He questioned whether there should be more focus on the public interest. In some circumstances, the appropriate action might be for the auditor to resign. He noted that in the United States when such issues occur, an auditor would consult with a regulator, such as the relevant state board of accountancy. He noted that he thought guidance for audit committees would be useful.

Mr. Morris expressed the view that the Code should describe actions to be taken when there is a violation but it was important that the guidance be written in such a way that it does not encourage noncompliance – the presumption should be that compliance is mandatory. The drafting of the current Code does sound a little permissive and implies a bit of a "free pass" mentality. He noted that the Code should address the steps to be taken, including discussion with those charged with governance and possibly the regulator. Mr. Fleck noted that one of the challenges with the existing Code is that it does not address responsibility – if responsibility was addressed it would be easier to indicate the actions to be taken to address a violation.

Mr. James stated that he did not see the need for provisions to address an inadvertent violation because each section of the Code has an inbuilt way of dealing with a violation.

Mr. Koktvedgaard stated audit regulators would examine violations when they performed their review of audit firms. It was, therefore, important to link to audit regulators. He also questioned what public communication should take place – for example, should the auditor give a public report on the violation, the steps that were taken after the violation, and why the firm believes that it is still independent? Mr. Baumann noted that communication to the public was an interesting notion as some would like to see a statement in the audit report that the auditor is not independent. There may also be some who would want to see a public disclosure of a violation.

Mr. Fleck stated that he was conscious of the challenges that arise if a regulator will not give clearance on a minor violation. In such circumstances the only way to address a minor violation is to have an open dialogue between the firm and the audit committee.

Mr. Baumann stated that there should probably be an expectation that significant matters would be communicated to a regulator.

Inadvertent

Ms. Spargo stated that the IESBA had concluded that the cause of the violation, be it unintentional, intentional, unknowing, or reckless was less significant than the potential impact on the company and those consequently affected – the investors and potential investors. It is the violation that gives rise to the potential impairment of independence, regardless of its nature. Accordingly, the IESBA believes that the term "inadvertent" should be dropped. Whether the action creating the violation was inadvertent or not does not alter the fact that the firm needs to evaluate the implications of the violation and take appropriate action. Resignation from the audit can be a disproportionate outcome irrespective of whether the violation was inadvertent or not. The disproportionate outcome also can be of the same magnitude whether the violation was inadvertent or not.

Mr. Baumann stated that he agreed that action would need to be taken irrespective of the cause of the violation – a violation is a violation.

Types of Possible Violation

Ms. Spargo noted that the IESBA is of the view that the provisions should address any violation of an independence requirement because what was relevant was the consequence of the violation as opposed to the interest or relationship that caused the violation. For example, if the consequence of the violation is that the audit client is required to find a replacement auditor to complete the audit, it would not matter whether the violation was created by the holding of a prohibited financial interest or the provision of a non-assurance service. The impact of the violation and, therefore, the actions to be taken to address the violation may differ, but both types of violations need to be addressed.

Actions to be Taken

Ms. Spargo reported that the Task Force recommendation was that if a violation is identified and the firm believes its objectivity has not been compromised as a result:

- The firm shall determine whether corrective measures can be applied that will resolve the situation;
- The firm shall evaluate whether the corrective measures will resolve the situation such that the firm can continue the audit engagement;
- Except as noted below, all violations shall be discussed with those charged with governance. The matters to be discussed shall include:
    - The nature and significance of the violation;
    - Any corrective measures taken or proposed;
    - The rationale as to whether, in the firm's professional judgment, the corrective measures resolve the situation such that the firm can continue the audit engagement;
    - A description of the firm's relevant policies and procedures designed to provide it with reasonable assurance that independence is maintained; and
    - An explanation of why, despite the policies and procedures, the violation occurred, and the steps taken or proposed to address any identified weakness in those policies and procedures; and
- The firm shall obtain the agreement of those charged with governance that the corrective measures, including any additional measures required by those charged with governance, resolve the situation such that the firm can continue the audit engagement.

The Task Force recognized that those charged with governance may have determined that the firm need not communicate some violations, such as those that are trivial and inconsequential and do not affect the firm's ability to continue the audit engagement. However, the firm would be required to determine whether a matter should be communicated despite the determination of those charged with governance that it need not be. In addition, if the violation involves a financial interest held by an immediate family member of a partner or employee of the firm, disclosure would not be necessary provided certain conditions are met.

The IESBA CAG discussed the Task Force recommendation and, while broadly agreeing with the actions to be taken, provided the following direction to the Task Force:

- All violations should be disclosed to those charged with governance irrespective of magnitude or who committed the violation;
- It was not clear what was meant by "resolve the situation";
- The drafting should not imply that all violations could be rectified such that the audit could continue. It may be useful to make it clear that in some cases resignation may be necessary; and
- The drafting should not convey the impression that the aim is to continue the audit at all costs and it may be preferable for the drafting to expressly state that resignation would be necessary unless certain conditions could be met.

Ms. Blomme stated that she agreed with the framework proposed but noted it might be useful to be clearer about the conditions that need to be in place such as prompt correction and application of necessary safeguards. Ms. Spargo responded that the Task Force would carefully consider the wording.

Mr. Morris noted that it might be useful to split the guidance to separately address the actions to be taken to determine whether the firm can continue as auditor and the actions to be taken regarding the individual who caused the violation. Ms. Spargo indicated that the Task Force would consider this.

Mr. James indicated that IOSCO would want to consider whether, if every violation was not going to be discussed, there should be a distinction between whether the violation was inadvertent or not.

Mr. Kuramochi stated in thinking about the significance of a violation it was important to consider the aggregate effect of any violations. Several insignificant violations could be indicative of a more significant underlying problem that needed to be addressed.

Ms. de Beer expressed the view that if there were to be a *de minimis* test, where reporting was not necessary, it would be important that the wording clearly convey the fact that the threshold is at a very low level. Mr. Fleck indicated that in setting the threshold it would be important to consider the relationship between the violation and the effectiveness of the firm's systems of control.

Mr. Pannier stated that a *de minimis* threshold would provide a pragmatic approach. He expressed support for the direction of the proposal noting that it was important that violations were dealt with in an appropriate manner.

Mr. Johnson noted that the discussion was similar to the debate regarding reporting of internal control weaknesses. It is a difficult issue to know where to establish a threshold because of the concern that small issues might be indicative of a larger more systemic problem. He noted that there will be some audit committee chairs who will want every violation reported and others that only want to see any matter of significance.

Mr. Pickeur said that in addition to knowing how the violation occurred it was important to know how it was detected. In this regard the firm should disclose to the audit committee how it monitors independence.

Mr. Johnson noted that there is a requirement under auditing standards for auditors to state that they are independent. In Europe there is also a requirement to have a public document regarding independence and quality control.

Mr. Koktvedgaard stated that if the notion of inadvertent is to be dropped, there should not be a *de minimis* threshold. A threshold would also disincentivize firms from having robust systems of quality control.

Mr. Hansen stated that he thought audit committees would likely want to hear about all violations. He agreed with Mr. Pickeur that it was important to disclose how the matter was detected and how independence is monitored.

Ms. Spargo noted that in practice audit committees may initially request that all matters be disclosed and then, after some experience, require only matters above a certain threshold.

Mr. Hansen asked how the Code would deal with a violation that was not the result of a lack of knowledge – for example, an individual just disregarded the requirements. Ms. Spargo noted that there would be two actions. The first action would involve determining whether resignation is necessary or the audit can continue. The second action would involve actions to be taken regarding the individual who created the violation. Mr. Fleck agreed, noting that the mindset of the individual was relevant in determining how the matter should be reported. The significance of the violation will also be affected by whether it is inadvertent or not.

Mr. Baumann noted that the approach seemed to place a lot of reliance on the audit committees, which can vary in strength from company to company and jurisdiction to jurisdiction.

Mr. Hansen noted that the drafting seemed to imply that all violations could be resolved such that the firm could continue with the audit. Mr. Fleck noted that the Task Force had this under advisement from the IESBA and that, at a minimum, it would seem that the language should be neutral.

Mr. Koster noted that it would be useful for the audit committee to also have some guidance on how to address such a matter. Mr. Dakdduk agreed that this might be useful. He noted that while the Code does not provide guidance for Audit Committees the IESBA could consider issuing a brochure that considered the issue from the perspective of an audit committee. Mr. Pickeur agreed that some audit committees are stronger than others but questioned whether the IESBA was the body to issue a document providing assistance to audit committees. Mr. Kuramochi noted that the discussion on providing some guidance for audit committees seemed to be changing the possible direction of the project and, as such, the time line for the project might need to be expanded.

Mr. Kuramochi noted that some feel that there is no need for such provisions in the Code and that regulators in some jurisdictions are addressing this. Mr. Fleck noted that the Code would not change this but it would provide guidance for situations where regulators were not addressing the matter.

Need for Provisions to Address other Parts of the Code

Ms. Spargo noted that the IESBA is of the view that the provisions should apply only to the independence requirements of the Code. A distinguishing feature of the independence provisions is the consequences of the violation – if an independence requirement is violated and the firm cannot issue an opinion, there is a potential for harm to, for example, third parties who are planning certain activities upon receiving the audited financial statements and may be working within tight time constraints. If the impact of the violation was trivial or inconsequential, the consequences of a firm resignation would thus be disproportionate to the violation. In the case of the other provisions in the Code, there are not the same consequences to the public

Ms. de Beer noted that if a violation was a violation, it seemed to be contradictory to limit the provisions to only independence. Mr. Dakdduk noted that the distinguishing feature was the protection of the public interest and the possible disproportionate consequences if the auditor has to resign. Ms. Blomme stated that the IESBA's rationale needed to be clearer than expressed in the agenda material.

Other

Mr. Koktvedgaard noted that there should be a question in the exposure draft about disclosure of independence violations at a firm level. While disclosure on an engagement by engagement basis was important it would also be interesting to know the overall level of violations at the firm level. Mr. Fleck stated that he did not think this was something that should be addressed by the Code, rather it was an issue for those who regulate audit firms. An audit regulator can request the firm to provide a register of every violation, which would then be available for inspection.

Mr. Kuramochi stated that the project seemed to be on a fast track. He noted that this would be the last CAG meeting before the IESBA planned to approve the exposure draft. In light of the controversial nature of the project, he noted that some people may want to extend the timing of the project. Mr. Dakdduk stated that the reason for the accelerated timetable was that the matter had been raised some time ago when the IESBA was finalizing the drafting conventions project and, given the concerns, the IESBA felt that it was appropriate to address the issue quickly. He indicated that he would be pleased to discuss the project with the IOSCO Auditing Subcommittee, either in person or by conference call. Mr. Fleck noted that it was good to see a project progressing at a quick pace. He noted that, if CAG members wished, there could be the opportunity for a conference call before the June IESBA meeting. In addition, CAG member organizations would have the opportunity to comment on the exposure draft.

Mr. Fleck stated that he would like to provide the CAG with an opportunity to comment on the next draft before it went to the IESBA for approval as an exposure draft. He noted that he would work with Mr. Dakdduk and Ms. Munro to see how this could be achieved.

Ms. Spargo thanked CAG members for their comments and indicated that they would be carefully considered by the Task Force when it next met in April.

D. Responding to Suspected Fraud or Illegal Acts

Mr. Franchini, Task Force chair, introduced the topic. At its November 2010 meeting, the IESBA approved a project proposal to provide ethical guidance for professional accountants when encountering a suspected fraud or illegal act. Confidentiality is one of the fundamental principles with which the professional accountant is required to comply While the Code recognizes that a professional accountant may have a professional duty or right to disclose confidential information, it does not provide examples or guidance to the accountant on how to respond in such situations. The objective of this project is to determine what guidance can be provided.

At its February 2011 meeting, the IESBA discussed Task Force proposals and provided input on the proposed direction. The Task Force met after the IESBA meeting to consider the input received. The IESBA will consider draft wording for two new sections addressing this matter at its June 2011 meeting, with the view to approving an exposure draft at its October 2011 meeting.

Nature of Items to be Addressed

The project proposal calls for a consideration of the nature of the items to be addressed and indicates that the Task Force should be mindful of *ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* and *ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements.* The project proposal also calls for the Task Force to consider whether the scope of the project should be wider and address, for example, personal misconduct and matters that are "unethical or improper."

The Task Force has considered this matter and is of the view that the definitions of fraud and illegal acts in ISA 240 and 250 are appropriate starting points. The Task Force is also of the view that because "a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest," the sections should provide guidance on suspected fraud, illegal acts, and unethical or improper acts – but the actions to be taken will differ depending upon the nature of the act.

Process for Responding

The Task Force recognizes that the accountant will likely encounter a "suspected" matter – that is, the determination of whether a fraud or other illegal act exists is a matter that would be decided by a court. The Task Force is of the view that if the accountant has a reasonable level of suspicion, he or she should take action. A reasonable level of suspicion is a concept that has some foundation in law.

In considering how the professional accountant should respond to a matter, the Task Force developed the following sequential approach for disclosing within the client or employing organization before considering whether the matter should be disclosed to a regulator or other outside authority:

- A professional accountant in public practice discloses the matter as follows:
    - To client management at an appropriate level.
    - If client management's response is not appropriate, to a higher level of management or to those charged with governance as appropriate.
- A professional accountant in business discloses the matter as follows:
    - Within the reporting lines of the organization, to a superior.
    - If the matter is not satisfactorily addressed, to a higher level of authority within the organization, such as those charged with governance, or to the entity's external auditor.

The following factors would be considered in determining whether the matter has been satisfactorily addressed.

- Whether the matter was appropriately investigated;
- Whether appropriate available remedial action has been taken to address the matter;
- Whether steps have been taken to reduce the risk of recurrence, for example, additional controls or training; and
- Whether the entity has disclosed the matter to an appropriate authority, or intends to do so within a reasonable period of time.

Actions to be Taken after Disclosing within the Organization

If a client or employing organization does not satisfactorily address a matter, it may call into question the professional accountant's ability to comply with the fundamental principles– for example, if it does not take appropriate steps to prevent a recurrence of the matter. If the matter has not been appropriately addressed, the professional accountant should determine the appropriate course of action, including whether to resign from the client or employing organization.

Paragraphs 210.1-201.5 address client acceptance. The Task Force plans to develop some additional guidance to address client continuance - situations where a matter is identified with an existing client.

In considering whether to disclose a matter outside the client or employing organization, if disclosure has not already been made, the Task Force is of the view that a professional accountant should be required to disclose suspected fraud or other illegal acts that have a direct or indirect effect on the financial reporting or are otherwise within the professional accountant's area of expertise if such disclosure has not been made and disclosure would be in the public interest. The Task Force is of the view that such a requirement would be consistent with public expectations and consistent with the profession's acceptance of a responsibility to act in the public interest.

With respect to other frauds or illegal acts unrelated to financial reporting or that are not within the professional accountant's area of expertise, the Task Force is of the view that there should not be a requirement under the Code to disclose such matters as the professional accountant's position is similar to that of any other provider of professional services or employee. The Task Force believes that a requirement to disclose such matters would not be appropriate; the professional accountant may only have a reasonable level of suspicion about a matter which is outside his or her level of expertise. The accountant should, however, have the right to disclose such a matter if he or she believes that it is in the public interest.

There is no common definition of the public interest. The Task Force recognizes that the determination of whether a matter is in the public interest will ultimately be a matter of the professional judgment of the individual making the determination. In considering what guidance can be given, the Task Force is of the view that whether a matter is in the public interest will ultimately depend upon whether it affects the rights, health, or finances of the public at large. This would involve a consideration of matters such as:

- The significance to the entity's financial reporting;
- The extent to which external parties are likely to be affected; and
- The likelihood of recurrence.

The Task Force is considering whether a requirement to disclose could be disproportionately onerous in certain circumstances. For example, where the professional accountant may be subject to threats of physical harm or where there is an absence of a regulatory authority to receive such disclosure or there is a regulatory authority but it has a history of not acting on such information or acting in a selective manner. The Task Force also recognizes that a requirement to disclose can be particularly onerous for a professional accountant in business. Accordingly, the Task Force is considering whether a professional accountant in business should be obligated to disclose only if the following pre-requisites are present:

- Disclosure is not contrary to laws and regulations;
- A whistle-blowing protection scheme is in place that affords both anonymity and protection from liability; and
- There is an appropriate authority to receive the disclosure and there is a judicial process that can be trusted.

Mr. Fleck noted the decision of whether it was in the public interest to disclose a matter would always ultimately be up to the professional judgment of the accountant. Mr. Franchini agreed, noting that it might be useful for the guidance to explicitly recognize this fact.

Mr. Pannier stated that the sequential nature of the guidance seemed to be a practical approach.

Mr. Peyret stated that the guidance could be seen as the conscience clause in the Code. He noted that an employee’s first duty is to the employer but if there is a problem the employee is on his own. He noted that the option for the professional accountant in business to disclose to the auditor was a sensible approach. There would be an extra complexity in international groups because what might be acceptable in one jurisdiction would be unacceptable in another jurisdiction.

Ms. Bastolla noted the nature of the response would depend not only on the nature of the matter but also the role of the professional accountant.

Mr. Pickeur noted that it was a very difficult subject. The Committee of European Banking Supervisors noted in its response to the EC Green Paper:

> “In CEBS’ members experience, external auditors seem to be reluctant to breach their duty of confidentiality towards their clients, despite the fact that a disclosure in good faith to a competent authority shall not constitute a breach of their duty of confidentiality according to article 53.2 of Directive 2006/48/EC.”

Mr. Johnson said that the split between the professional accountant in practice and business is fundamental. It was important that professional accountants in business also have an obligation to report, as this might result in more timely reporting.

Mr. Bradbury stated that he was somewhat nervous about the proposed expansion to address improper or unethical matters. While it was possible to define a fraud or illegal act, there was considerably more subjectivity associated with determining whether something was improper or unethical.

Mr. Koktvedgaard stated that he was not sure whether it would be possible to define an unethical matter. He noted that if a company stated in its annual report that it did not use child labor and the auditor was aware that child labor was used, auditing standards would require the auditor to disclose this information. Mr. Fleck noted that there was no guidance for the auditor if there was no statement in the annual report.

Mr. Pannier stated that the Task Force might find it helpful to look at the United Nations legislation addressing breaches of sanctions. Mr. Franchini indicated that the Task Force would look at the legislation.

Mr. Casel noted that there are differing interpretations of what is and what is not ethical. He noted that it would be important to ensure that the drafting did not result in a requirement that was circular. With this proviso, he stated that he was generally supportive of the approach proposed.

Mr. Franchini noted that the Code addresses unethical behavior. For example paragraph 210.2 states that client dishonesty or questionable financial reporting practices could threaten compliance with the fundamental principles.

Mr. Hansen stated that whether a matter was within the expertise of the professional accountant could be interpreted quite broadly. Mr. Franchini agreed that there was judgment involved.

Ms. Lang noted that although additional guidance could be given, the determination of whether reporting was in the public interest was up to the professional judgment of the individual accountant. She noted that this will be particularly difficult for accountants in SMPs and SMEs.

Mr. Franchini indicated that the Task Force would give thought to whether additional guidance could be given to whether a matter was within the expertise of the accountant.

Ms. Lang noted that a professional accountant in a very small business may be unable to go to management and the business may not have an auditor. Mr. Franchini noted that in some circumstances, the professional accountant may need to disclose outside of the organization because there was no one within the organization.

Mr. Baumann suggested that the guidance state that the professional accountant might disclose to in-house legal counsel

Mr. Fleck noted that the pre-requisites that the Task Force was considering would probably exist in only a few jurisdictions. He recognized that some would be of the view that there needed to be some recognition of personal exposure if the accountant reports externally. Mr. Pickeur noted that even with the provisions in the Directive, which provide protection, there is no reporting by auditors because confidentiality is put ahead of public interest.

Mr. Baumann noted that he did not agree that a protection scheme that affords both anonymity and protection from liability was an appropriate pre-requisite. Mr. Johnson agreed noting that the pre-requisites would encourage accountants not to report matters.

Mr. Kuramochi noted that the factors that were to be considered in determining whether disclosure was in the public interest did not seem to be the right factors. For example, the first factor, significance to financial reporting, would seem to indicate that if two entities (one large and one small) engaged in the same level of money laundering, the matter would have to be disclosed outside of the smaller entity because of the significance to financial reporting but disclosure would not be necessary for the larger entity. This did not seem right because what was important was the significance vis a vis the public interest. With respect to the third criteria of likelihood of recurrence, this could be interpreted as meaning that no disclosure was necessary if there was an assurance from management that there would be no repetition of the illegal act. Mr. Franchini indicated that the Task Force would consider these matters.

Mr. Kuramochi expressed the view that he appreciated the IESBA undertaking this very difficult project.

E. Conflicts of Interest

Ms. Munro introduced the topic. She noted that the Project Proposal was approved by the IESBA in October of 2009, that the Task Force met during 2010 and 2011 and that at the February, 2011 meeting in New Delhi, the IESBA reviewed a draft of Section 310. Ms. Munro also noted that the Task Force met in New Delhi immediately after the Board meeting and, thus, some of the positions she was presenting represented the views of the Task Force and they had not yet been presented to the IESBA. Ms. Munro noted the following issues to be presented to the CAG:

- Description of a conflict of interest (COI);
- Reasonable third party test;
- Network firms and conflict of interest;
- Situations where disclosure is not possible;
- Compensation tied to performance; and
- Review of drafting.

Description of a COI

Ms. Munro presented the description of a COI as presented to the Board at the February, 2011 meeting in India and noted that the two bullet points below the first sentence capture the types of conflicts of interest that the Task Force is addressing in Sections 220 and 310. She noted that Section 310 of the extant Code deals with undue pressure, which is a conflict, but not a conflict of interest as described in the project.

Ms. Munro stated that the proposed description of a COI uses the term “professional activity,” which will be a new definition for the Code. The IESBA feels the term “professional service” did not resonate with the duties of a professional accountant in business. Therefore, two new definitions are proposed. The term “professional activity” is proposed to be used in Parts A and C of the Code (as the term is applicable to all professional accountants) and “professional service” is to be used in Part B of the Code (as the term is applicable to serving clients). Ms. Munro asked for comments and questions from the CAG concerning the description of a COI, and the two newly proposed definitions. There were no comments or questions.

Reasonable and Informed Third Party

Ms. Munro stated that the reasonable and informed third party test is embedded throughout the Code because the framework requires threats to be eliminated or reduced 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. However, the Task Force concluded that the reasonable and informed third party should be explicitly stated within the guidance for conflicts of interest due to the importance of the test and that it should stress the notion that the professional accountant must remain objective when facing a COI.

Ms. Munro asked for comments and questions from the CAG concerning the reasonable and informed third party test. Mr. Fleck commented that it was important that the guidance emphasize the need to remain objective.

Network Firms

Ms. Munro informed the CAG that in the extant Code, network firms are currently only mentioned in Sections 290 (*Independence – Audit and Review Engagements*) and 291 (*Independence – Other Assurance Engagements*). Section 290 of the Code generally imposes the same obligations on a network firm as the firm in terms of compliance with the independence rules. 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. Ms. Munro stated that this "reason to believe" threshold used in Section 291 could be viewed as a "lighter touch" than that of 290. The Task Force concluded that the "reason to believe" threshold is appropriate for network firms when identifying conflicts of interest for the following reasons:

- The expectation of having a system to check for potential conflicts of interest among some networks that do not communicate much may be unreasonable in the view of a reasonable third party;
- There may be legal obstacles that prevent network firms from disclosing certain information due to confidentiality rules; and,
- There may be networks that only perform non-assurance services, and therefore guidance that makes a systematic approach to identifying conflicts of interest mandatory may seem unreasonable.

Mr. Fleck noted that one might expect a test for potential conflicts of interest to be performed before undertaking a new professional activity. Mr. Baumann inquired as to the extent that "reason to believe" actually extends. Mr. Baumann provided the following example: a firm that is part of a network obtains an audit client. The audit client provides consultative services around the world. Some of the firms within the network are located in other countries and provide the same services as the audit client. Would this set of circumstances fall under the "reason to believe" threshold, thus forcing the professional accountant to investigate any potential conflict of interest that may exist within the network?

Mr. Fleck noted that the situation would fall under a COI under the second bullet point of the Task Force's description if the audit client did in fact compete with another firm within the network. Mr. Dakdduk stated that in his view the potential for possible competition between a network firm and an audit client would not fall under the "reason to believe threshold," and there would need to be more evidence of a potential COI. However, Mr. Fleck stated that the potential that the audit client and the network firm may compete may cause a COI. Mr. Fleck noted that the nature of the issue is the range in terms of types of relationships between firms within a network and how closely the firms work together. Mr. Baumann stated that firms may represent that they are one global organization as a network, yet, they would not be required to investigate potential conflicts of interest with clients despite this tightly-managed image of “one global organization,” unless there is a reason to believe that a COI may exist. Mr. Johnson noted that a problem may be created if you have small networks that are loosely associated that are forced to investigate potential conflicts of interest, and agreed with the Task Force’s approach. Mr. Hansen agreed by stating that the “reason to believe threshold” may be elusive in that it is much stronger than the attitude of the firm “keeping their eyes open” for potential conflicts of interest.

Situations where Disclosure May Not Be Possible

Ms. Munro stated that the draft of the current guidance for Section 220 states that disclosure is “generally necessary.” However, the Task Force is currently considering situations where a professional accountant may not be able to disclose a COI, yet, implement certain safeguards such as institutional mechanisms, and continue to perform the services creating the COI. Ms. Munro stated that the process of addressing these types of situations is preliminary and may include situations such as hostile takeovers or instances where no other firm may be able to perform the professional service. Neither Mr. Fleck nor Mr. Johnson found the argument acceptable that disclosure may not be acceptable because another firm may not be able to perform the specific professional services.

Mr. Fleck noted that in hostile takeover situations, the professional accountant must follow the law, which may include the continuation of the performance of the professional service due to confidentiality laws. Mr. Fleck stated that for further guidance the Task Force may wish to look at the UK Law Society requirements addressing conflicts of interest.

Mr. Johnson noted that written consent is important when dealing with conflicts of interest and that if this situation is to be addressed, specific acceptable safeguards should be explicitly stated.

Compensation Tied to Performance

Ms. Munro stated that the Task Force requested examples of conflicts of interest for professional accountants in business from Board members and member bodies. The Task Force received examples of conflicts, but not conflicts of interest as described by the Task Force. Ms. Munro stated that the Board expanded the mandate of the Task Force to explore conflicts where the professional accountant in business has compensation that is tied to the financial performance of the employer and areas dealing with undue influence. The Task Force believes that the areas have been addressed in the Code in Sections 320 and 340, however, the Task Force has agreed to review the sections to determine if more guidance is needed. Mr. Morris expressed the view that it would be useful if the Code could emphasize this important issue.

Ms. Munro concluded her presentation. Mr. Fleck stated that he was anticipating that the content proposed by the Task Force will be driven by the approach taken by the Task

Force thus far in dealing with the types of conflicts of interest as described in the two bullet points of the description.

F. PIOB

Mr. Fleck invited Mr. Hafeman, representing the Public Interest Oversight Board (PIOB), to make some comments. Mr. Hafeman congratulated the CAG on a good meeting, which produced advice that would seem to be very useful to the IESBA.

Regarding independence violations, Mr. Hafeman noted that it has been proposed that the persons charged with governance be relied on to help protect the public interest by discussing violations with the auditor. However, as one CAG member pointed out, not all audit committees would warrant such reliance. Accordingly, Mr. Hafeman would agree with those who suggested that minimum requirements for reporting to the audit committee, and transparency more broadly, should be considered.

Both in this context and when discussing the project on responding to suspected fraud or illegal acts, the need for an understanding of the meaning of "public interest" was evident. Mr. Hafeman related the key points recently agreed by the PIOB:

- The PIOB believes that accountancy services are in the public interest if they create net benefit for the public.
- The public refers to the people as a whole. It is not limited to those who have retained an accountant or are making use of a set of accounts. With respect to a particular accountancy service, it is perhaps useful to focus on the segment of the public that is directly or indirectly affected by such a service—in other words, the stakeholders.
- The concept of benefit to the public generally involves a measure of public welfare that is multidimensional and includes aspects such as financial, political, social, and environmental welfare. However, accountancy services have the most direct effect on financial welfare, because accounts usually focus on financial information.
- The PIOB believes that the accountancy profession can best benefit the public by providing account-related information in which the public has confidence. This information will be most helpful if it is relevant to the users and is trusted by them as a faithful representation of the performance of the reported activities.

Mr. Hafeman reported on the changes in composition of the PIOB: retirements of Stavros Thomadakis, Antoine Bracchi, David Brown, and Fayez Choudhury; and appointments of Eddy Wymeersch (chair), C. Bhave, Charles McDonough, and Robert Ward.

Mr. Fleck thanked Mr. Hafeman for his remarks.

H. Close of Meeting

Mr. Fleck thanked all members for their attendance and closed the meeting.

Future Meetings:

- September 14, 2011 (Prague, Czech Republic)