

# Agenda Item 6

**IESBA**

INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS

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**Meeting Location:** InterContinental Eros, Nehru Place, New Delhi

**Meeting Date:** February 6-8, 2011

## Conflicts of Interest

### Objective of Agenda Item

1. To consider the Task Force proposals and to provide input on the proposed draft wording.

### Introduction

The Task Force<sup>1</sup> met on December 8-9, 2010 and January 18-19, 2011 to consider:

- The description of a conflict of interest (COI) as proposed by the Task Force at the November, 2010 meeting of the IESBA;
- The structure of Sections 220 and 310; and,
- The content to be included in Sections 220 and 310.

Please note that attached to this agenda item is Agenda Item 6-A which is a preliminary draft of Paragraphs 100.17 and 100.18 and Section 310. Agenda Item 6-B contains a preliminary framework for Section 220 which is still in the process of being constructed. Within Agenda Item 6-B the text in regular font has been generally agreed to by the Task Force but will be further developed during the Task Force meeting on February 9, 2011 and the text in ***bold italics*** is explanatory language of the intent of the Task Force.

### Discussion

#### Description of a COI

At the November, 2010 meeting of the IESBA, the Task Force presented the following description of a COI:

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

The Task Force also proposed two new definitions for inclusion in the Code for the terms “professional activities<sup>2</sup>” and for “professional services<sup>3</sup>,” which the Board agreed upon.

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

These definitions were proposed based on the Board's prior feedback that the term "professional service" did not seem a meaningful way of referring to the activities performed by professional accountants in business.

*Proposed Changes to the Description of a COI & Location of the Description in the Code*  
During the November, 2010 meeting, the Task Force received feedback from the Board concerning the phrase "other than with that party." The Task Force agreed that there may be confusion as to whom the phrase "other than with that party" may pertain and thus agreed to add explanatory language in order to provide further guidance concerning parties that can be involved in a COI. This language is intended to include the two types of COIs the Board differentiated: (1) conflicts between professional accountants and third parties and (2) situations where the professional accountant is working for two or more parties whose interests compete or conflict. The revised description of a COI and the proposed explanatory language are as follows:

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

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

The Task Force discussed the description of a COI and considered where it should be located in the Code. The description was written to apply to all professional accountants and therefore, would logically fit into Part A of the Code. The Task Force did note two factors while discussing the location of the description:

- The Task Force agreed that users of the Code would benefit from stand-alone descriptions in each section so that the descriptions would be easily located and read; and,
- The structure of Sections 220 and 310 would benefit by beginning each section with the description of a COI which would be further developed to reflect specific examples of relationships that cause conflicts for professional accountants in public practice and professional accountants in business, respectively.

The Task Force thus concluded that the description should be included in all three parts of the Code: a high level description in Part A, and more precise descriptions in Parts B and C.

The general description of a COI is linked to all of the fundamental principles as agreed at the November, 2010 meeting of the IESBA in Singapore. Based on that fact, the Task Force decided that the description's location in Part A should be in Section 100, *Introduction and Fundamental Principles*, as opposed to being located in any of the

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<sup>2</sup> Professional Activities: Activities requiring accountancy or related skills undertaken by a professional accountant including accounting, auditing, taxation, management consulting and financial management.

<sup>3</sup> Professional Services: Professional activities performed for clients.

sections 110 through 150, as these sections are specific to each fundamental principle. The Task Force considered the current sub-sections in Section 100 and noted no natural fit for the description. Therefore, the Task Force proposes that a new subsection be created for COIs and that it be placed before the subsection currently titled “Ethical Conflict Resolution.” Thus, the description of a COI that relates to all professional accountants would be located in paragraph 100.17. Please see agenda item 6-A for the proposed language and for paragraphs 100.17 and 100.18.

At the June, 2010 meeting of the IESBA, the Task Force presented three preliminary categories of COIs as follows:

1. Professional conflicts;
2. Commercial conflicts; and
3. Other conflicts

After further deliberations, the Task Force agreed that the proposed explanatory language in the two bullet points provide two broad categories of COIs. This decision to have just two broad categories within the description of a COI as explanatory language was based on research of categories of COIs from other documentation and noting that there was much overlap between the various proposed categories. This would mean the description of the COI would be more detailed in the respective paragraphs of 220 and 310. See below for the proposed descriptions:

*220.1 A conflict of interest arises if, when performing a professional service for a client, a professional accountant in public practice or a firm has an interest or relationship other than with that client that creates a threat to objectivity and may create threats to compliance with other fundamental principles. Such threats may be created by:*

- *Conflicts between the interests of two or more clients; or*
- *Conflicts between the interests of the professional accountant in public practice or the firm and the interests of a client.*

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

- *Conflicts between the interests of two or more parties, including an employing organization, a vendor, a customer, a lender, a shareholder or another party, for whom the professional accountant in business undertakes professional activities; or*
- *Conflicts between the interests of the professional accountant in business and the interests of a party, including an employing organization, a vendor, a customer, a lender, a shareholder, or another party, for whom the professional accountant in business undertakes a professional activity.*

**Action requested**

IESBA members are asked to consider the explanatory language added to the description of a COI in the two bullet points and provide feedback.

IESBA members are asked to consider including a high-level description of a COI in Part A of the Code and two more precise descriptions with modified language as it pertains to Sections 310 and 220 of the Code and provide feedback.

**Proposed Structure of Sections 220 and 310**

At the November, 2010 meeting of the IESBA in Singapore, the Task Force reviewed each paragraph of Section 310 and noted that each paragraph was covered in other sections of the Code. Therefore, the Task Force proposed that each paragraph be deleted due to the fact that it merely repeated material elsewhere in the Code and the section as a whole dealt with undue influence as opposed to COIs as described by the Task Force. At the same meeting of the IESBA, the Task Force noted that most of the information in Section 220 was useful concerning COIs for the professional accountant in public practice. However, the Task Force did note that more guidance should be added and that the section should be modified.

The Task Force discussed the nature of the structure of Sections 220 and 310 and agreed that in the interest of consistency, the two sections should be the same in terms of the order in which the content is presented. The Task Force agreed that the content for each section would be presented in the following order:

- Description of a COI;
- Specific examples of COIs;
- Reasonable and informed third party test in identifying a COI;
- Identifying and evaluating the significance of a COI; and
- Management techniques for COIs.

*Description of a COI*

Based on the analysis described above under the heading “Proposed Description of a COI,” the Task Force agreed that Sections 220 and 310 would begin with the description of a COI and that the description in each of the two sections would be modified for professional accountants in public practice and in business, respectively.

*Specific Examples of COIs*

In order to further explain the broad categories of COIs within the description, the Task Force agreed that the next paragraph within the section would provide specific examples of COIs for professional accountants in public practice and in business.

*Reasonable and Informed Third Party Test*

The Task Force recommends that a stand-alone paragraph addressing consideration of a “reasonable and informed third party” should follow the specific examples of COIs for each section. Therefore, the professional accountant should consider the likely view of a reasonable and informed third party early in the process of identifying COIs after having considered the description and examples of COIs.

#### *Identification and Evaluation of a COI*

The Task Force agreed that after requiring the professional accountant to identify the potential COI from a reasonable and informed third party’s perspective, the next part of the section should provide guidance on techniques to identify and evaluate the threats to fundamental principles which the potential COI may create before undertaking a new professional activity or during the course of a current professional activity.

#### *Management Techniques for COIs*

After a professional accountant has identified and evaluated the threats to fundamental principles created by a COI and using the techniques provided in the preceding paragraph, the Task Force agreed that the next part of each section should provide management techniques for dealing with COIs.

#### **Action requested**

IESBA members are asked to consider whether they agree with the Task Force’s overall approach to the structuring of Sections 220 and 310.

#### **Examples of COIs and Potential Revision of Section 320**

At the November, 2010 meeting of the IESBA, the Task Force presented some examples of COIs for professional accountants in business for possible inclusion in Section 310 of the Code. The Task Force also sent requests to members of the Board for examples of COIs for professional accountants in business. Most of the responses received dealt with undue influence rather than COIs as described by the Task Force. In light of the number of responses dealing with undue influence, the Task Force discussed whether the Code needed further guidance on issues of ethical behaviour. The issue of ethical behaviour for professional accountants in business engaged in the provision of financial information is addressed in Section 320, *Preparation and reporting of information*, of the extant Code. However, based on the concern expressed by members of the Board and examples provided by IFAC member bodies, Section 320 may need to be examined to determine if the guidance provided can be enhanced. While this Task Force is not currently charged with addressing Section 320 and the topic of undue influence, the Task Force would like the Board’s input on the possibility of the Task Force examining the section and making recommendations for changes to the respective section.

**Action requested**

IESBA members are asked to consider whether the Task Force should examine Section 320 to determine if further guidance is needed in terms of undue influence.

**Reasonable and Informed Third Party Test**

At the June, 2010 meeting of the IESBA, the Task Force noted that the description of a COI would not include a reasonable and informed third party test due to the fact that a COI is either present or it is not, regardless of the perception. The Task Force proposed that the reasonable and informed third party test would be included within the guidance as to how to manage COIs in each section of the Code. As discussed above, the Task Force now recommends that the reasonable and informed third party test should be located in a stand-alone paragraph and should follow the specific examples in each of sections 210 and 320. This reflects the Task Force's view that the professional accountant, acting in the public interest, should take into account the likely view of a reasonable and informed third party early in the process of identifying COIs in order to ensure that potential COIs are captured before proceeding to determine what steps should be taken to manage COIs. A stand-alone paragraph also stresses the importance of such considerations in each section in response to the Board's feedback from previous meetings. The Task Force also deliberated on whether or not each section should include the reasonable and informed third party test in the "management techniques" paragraph. The Task Force concluded that it is already mandatory in the Code that any safeguards applied must be done so that the threat is eliminated or reduced to an acceptable level taking into account the views of a reasonable and informed third party. Therefore, the Task Force agreed not to include the reasonable and informed third party test when discussing COI management techniques.

The proposed language for 310 would read as follows:

*310.3 A professional accountant in business shall be alert to all interests and relationships 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, might give rise to a conflict of interest.*

**Action requested**

IESBA members are asked to consider whether they agree with the Task Force's view that the reasonable and informed third party test should be addressed in a stand-alone paragraph.

## **Identification & Evaluation of COIs**

The Task Force discussed the requirements for professional accountants in business and public practice in terms of the process to identify and evaluate potential COIs. While a large accounting firm may have the resources and the need to collect and store data that may identify potential conflicts in a sophisticated database, a professional accountant in business or a sole practitioner or a small firm may not have such a need due to the limited number of relationships that may cause a COI. It would appear unreasonable to expect a professional accountant in business to gather information from every possible relationship and to retain such data for the purposes of evaluating a potential conflict. For instance, the professional accountant in business should not be expected to research the investments of siblings or attempt to identify every employee of other companies in which their employer may do business with and track all of the information in any type of database. Also, a sole practitioner or a small firm may be able to identify COIs without the use of electronic databases. Therefore, the Task Force agreed that in identifying and evaluating COIs, Section 310 would not require a formal process of gathering and storing information, but rather, require that the professional accountant in business maintain a level of alertness in understanding certain relationships and interests and evaluate the significance of such relationships and interests. See Agenda Item 6-A for the preliminary drafted text. Section 220, in consideration of sole practitioners and smaller firms, also would not create any new requirements in terms of the collection and storage of information, but rather include a requirement that the firm take “reasonable steps to identify” potential COIs. The Task Force is currently considering factors to provide as guidance in the Code for professional accountants in public practice and firms to consider that would represent “reasonable steps” in identifying potential COIs depending on the particular circumstances.

### **Action Requested**

IESBA members are asked whether they agree with the Task Force’s views concerning the different requirements of professional accountants in business and public practice, respectively in identifying and evaluating COIs.

## **Management Techniques for COIs**

Section 220 of the extant Code describes safeguards in paragraph 220.3, stating that “application of one of the following safeguards is generally necessary:

- a) Notifying the client of the firm’s business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or
- b) Notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict and obtaining their consent to so act; or
- c) Notifying the client that the professional accountant in public practice does not act exclusively for any one client in the provision of proposed services (for example, in a particular market sector or with respect to a specific service) and obtaining their consent to so act.”

The Task Force agreed that these are all examples of “disclosure and consent” with three different situations applied to the same safeguard. Therefore, the Task Force agreed that the language be deleted and the “disclosure/consent” safeguard be addressed along with other potential COI management techniques. The Task Force also agreed that when providing management techniques for COIs, the Code would use language such as “one of the following management techniques may serve as an appropriate safeguard,” as opposed to making any one safeguard a requirement. For example, the Task Force agreed not to make disclosure and/or consent a requirement, but rather expand on the current guidance. The decision was based on the deliberations of the Task Force and research of guidance of other member bodies.

The Task Force is considering management techniques of COIs for each section for professional accountants in business and in public practice which will differ based on the nature of the professional activities they undertake and take into account the different resources typically available to professional accountants in public practice (and in particular firms) compared with professional accountants in business.

**Action requested**

IESBA members are asked to consider the Task Force’s assessment that there should not be any one safeguard that is mandatory.

**Network Firms**

During the discussion of identifying and evaluating COIs for professional accountants in public practice, the Task Force deliberated the application to network firms. The Task Force considered the following:

- Data protection and other constraints may complicate the identifying and evaluating of potential COIs within network firms, in particular across different jurisdictions; and
- Paragraph 291.3 creates a standard for evaluating threats to independence when the firm has “reason to believe” that threats are created from a network firm’s interests or relationships.

Based on this analysis, the Task Force agreed that network firms should be addressed in a stand-alone statement under the identification and evaluation discussion in Section 220 stating that threats to the fundamental principles should be evaluated when a firm has reason to believe that there may be a conflict of interest due to an interest or relationship with another network firm.

**Action requested**

IESBA members are asked to consider whether they agree with the Task Force’s view that the Code should state that the identification process in section 220 shall take into account interests and relationships of network firms that the firm has “reason to believe” may be relevant.

### **Inclusion of the Term “Firm” in Section 220**

While drafting language for Section 220 of the Code, the Task Force analyzed whether the paragraphs should address “professional accountants in public practice”, or “professional accountants in public practice and the firm.” The Code currently defines a professional accountant in public practice as:

“A professional accountant, irrespective of functional classification (for example, audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.”

The term “professional accountant in public practice” therefore already includes the “firm.” The Task Force is still debating whether, when discussing COIs, it is necessary for emphasis to state “professional accountants in public practice and the firm,” so that the guidance is not narrowly interpreted by readers to apply solely to interests and relationships of individual professional accountants such that conflicts arising in firms are not taken into account.

#### **Action requested**

The Board is asked to consider whether Section 220 should include the terms “professional accountant in public practice and the firm,” or whether, the firm itself is sufficiently covered by the definition.

#### **Material Presented**

Agenda Paper 6	This Agenda Paper
Agenda Paper 6-A	Preliminary drafts of paragraphs 100.17 and 100.18 and Section 310
Agenda Paper 6-B	Preliminary structure of Section 220

#### **Action Requested**

1. IESBA members are asked to consider the questions raised in the paper and provide high level feedback concerning Agenda Papers 6A and 6B.