

# Agenda Item 3

**IESBA**

INTERNATIONAL ETHICS STANDARDS BOARD FOR ACCOUNTANTS

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**Meeting Location:** Sofitel Victoria, Warsaw, Poland

**Meeting Date:** June 15-17, 2011

## Conflicts of Interest

### Objective of Agenda Item

1. To consider the revised description of a conflict of interest (COI).
2. To consider the proposed draft Sections 220 and 310.
3. To consider proposed changes to Sections 320 and 340.
4. To consider draft impact analysis.

### Introduction

The Task Force<sup>1</sup> met on February 9, 2011 and April 5-6, 2011 and conducted conference calls on April 21 and May 6, 2011 to consider:

- The description of a COI;
- The wording of proposed Sections 220 and 310 and paragraphs 100.17 and 100.18;
- Feedback from the IESBA's February 2011 meeting; and
- The draft impact analysis of Section 310.

### Description of a COI

At the February 2011 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, 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.”*

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

At the February 2011 meeting of the IESBA, there was a discussion concerning whether there should be a definition of a COI in the Definitions section of the Code. The majority of the Board believed this was either inappropriate or unnecessary. At its meeting on 9 February the Task Force considered the comments made at the Board meeting and noted:

- The Task Force has not developed a *definition*, but rather a *description* of circumstances that give rise to a COI; and,
- Terms set out in the Definitions are generally used throughout the Code whereas the Task Force is proposing that use of the phrase Conflicts of Interest is confined to Section 220 and 310 which deal specifically with Conflicts of Interest.

Accordingly the Task Force considers that it would not be appropriate to include an entry for Conflicts of Interest in the Definitions section of the Code.

*Proposed Changes to the Description of a COI*

Based on feedback from the previous Board meeting, the Task Force reconsidered the wording of the description of a COI. Specifically, concern had been expressed over the phrase “other than with that party.” Therefore, the Task Force re-examined the description and noted the following:

- No questions had been raised by the Board concerning the intent and clarity of the two bullet points following the first sentence of the description;
- The two bullet points clearly state the two categories of COIs that Sections 220 and 310 address and provide a clear introduction to the subject matter of Sections 220 and 310.

Based on that analysis the Task Force agreed to remove the first sentence and add two introductory sentences which include the notion that a COI begins with the undertaking of a professional activity as discussed in previous meetings and links a COI into the fundamental principles. The Task Force’s revised proposal is set out below:

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

- *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.*

**Action requested:**

The Board is asked to provide feedback on the newly proposed description of a COI.

## **Draft Sections 220 and 310 and Paragraphs 100.17 and 100.18**

The Task Force analyzed and modified the proposed drafts of Section 220 (Agenda Paper 3-A), Section 310 and paragraphs 100.17 and 100.18 (Agenda Paper 3-B).

### *Reasonable and Informed Third Party Test*

At the February 2011 meeting of the IESBA, the Task Force proposed that at the identification phase, a professional accountant shall be alert to interests and relationships that a reasonable and informed third party would be likely to conclude would give rise to a conflict of interest. In response to input from the Board, the Task Force has reconsidered the position and proposes the professional accountant be required to take into account the likely views of a reasonable and informed third party throughout the process of identifying, evaluating, and managing/addressing a COI. A stand-alone paragraph also stresses the importance of such considerations in response to the Board's feedback from previous meetings. See below for the proposed language:

*220.4 When identifying and evaluating the interests and relationships that might give rise to a conflict of interest and implementing safeguards, where necessary, the professional accountant in public practice, including the firm, shall take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude that compliance with the fundamental principles is not compromised.*

### **Action requested:**

IESBA members are asked to consider paragraph 220.4 as redrafted by the Task Force and provide feedback.

### *Network Firms*

At the February 2011 meeting of the IESBA, the Task Force proposed that a stand-alone paragraph be included in Section 220 stating that the threats to the fundamental principles should be evaluated when a firm has reason to believe that there may be a COI due to an interest or relationship with another network firm. The Task Force deliberated the feedback from the Board and concluded that this should be addressed as a bullet point in paragraph 220.5 which deals with the identification of COIs, thus not addressing the matter in a stand-alone paragraph. The Task Force did conclude that the threshold for identifying COIs within a network firm should remain as a “reason to believe” test for the following reasons:

- The exchange of client information may vary between different networks depending on legal and contractual provisions. Exchange of such information may also depend on how a network is structured or governed. While some networks may exchange client information to the maximum extent permitted by local laws and client consent, others may not. Therefore, the Task Force concluded it

- unreasonable to require a network firm to inquire within its network if it has no positive knowledge concerning a client relationship with other network firms (e.g. through participation in a global engagement, or through public knowledge of another network firm having a certain client relationship);
- If firms within a network are required to perform research in terms of relationships that could cause a COI, there is a risk that the firm may not be in compliance with the fundamental principle of confidentiality; and,
  - In Section 291, “Independence – Other Assurance Engagements,” specifically paragraph 291.3 states that “...any threats that the firm has reason to believe are created by a network firm’s interests and relationships be evaluated.” The Task Force concluded that threats arising from potential COIs should similarly be evaluated by the firm when there is a reason to believe one exists on the basis that the threshold for COIs for network firms should not be set at a higher level than that of the independence rules for non-audit assurance services.

**Action requested:**

IESBA members are asked to provide feedback on the Task Force’s conclusion concerning the “reason to believe” threshold concerning potential COIs within network firms.

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

At the February 2011 meeting of the IESBA, the Task Force requested feedback from the Board concerning the use of the phrase “professional accountant in public practice” or “professional in public practice and the firm.” The term “professional accountant in public practice,” by definition, includes the firm. It was suggested by the Board that the Task Force consider the phrase “including the firm.” The Task Force concluded that within each paragraph of Section 220, when the term “professional accountant in public practice” is used for the first time, the phrase “including the firm” will be added. Throughout the rest of the respective paragraph, only the phrase “professional accountant in public practice” will be used. Using the phrase “including the firm” is included for emphasis so that when considering COIs, the guidance is not narrowly interpreted by readers to apply solely to interests and relationships of individual professional accountants.

**Action requested:**

IESBA members are asked to provide feedback on the Task Force’s conclusion concerning adding the phrase “including the firm” to “professional accountant” each time “professional accountant” is used for the first time in each paragraph of Section 220.

*Situations Where Disclosure of a COI May Not Be Possible*

For professional accountants in public practice, the draft of Section 220, specifically paragraph 220.7, states that disclosure of a COI is generally necessary. The Task Force considered situations where the disclosure of a COI may not be possible because disclosure may breach confidentiality or the timing of the professional service may preclude disclosure. The Task Force considered the example of a situation where a listed client (company A) is issuing a public circular in connection with the proposed hostile takeover of another listed audit client of the firm (company B). Some stock regulations include a requirement for the offeror to include a statement of the benefits expected to accrue from the takeover. This statement is required to be reported on by a reporting accountant. It might be such that in the time available it is only possible for the audit firm to provide this report. Preparation of the report will require the audit firm to have access to the synergy benefits prepared by the directors of company A, which include estimates of potential revenue enhancements and cost savings with respect to company B. The estimates are derived from publicly available sources. The deal is highly confidential and company A has not disclosed its intentions to mount a takeover bid of company B. Accordingly, the audit firm cannot seek the consent of company B to undertake the work.

In such an example, the Task Force noted that if separate teams are auditing company A and company B and confidentiality has not been breached, while there may be a perceived COI, if the firm can proceed while remaining objective, in particular because the firm is not providing services to both parties which specifically relate to the adverse relationship between them, then there is no true COI. That being said, the Task Force decided that the real issue to address is not situations in which a COI cannot be disclosed to the affected parties, but situations where a perceived COI may actually be a matter of protecting confidentiality. The proposed guidance can be seen below:

*220.8 A professional accountant in public practice may be requested to undertake a professional engagement for a client in circumstances where the professional accountant, including the firm, has confidential information that might be relevant to the engagement which has been obtained in the course of providing another professional service to another client (including a former client). Particular care is needed where the clients' interests are opposed in the subject of the new engagement and disclosure of the confidential information held by the firm to the engagement team undertaking the new engagement could prejudice the interests of the other client. Such a situation might arise, for example, in the following circumstances:*

- Where the professional accountant is requested to perform a transaction-related service for a client in connection with a takeover of another client of the firm, in particular where the takeover may become hostile;*
- Where the professional accountant is requested to perform a forensic investigation for a client and the firm has confidential information obtained through having performed another professional service for one of the parties who would be the subject of the investigation.*

*In these circumstances, disclosure to both clients would normally be a necessary safeguard before accepting the new engagement, for example where the professional accountant is to perform services to both clients which are relevant to the subject of the adverse interests between the clients.*

*However, disclosure to one party in these circumstances would frequently breach a duty of confidentiality to the other party. In the specific circumstance where the potential conflict that arises is solely with respect to a duty of confidentiality, the professional accountant may be able to accept the new engagement without disclosure to the other party if, in the professional accountant's judgment, weighing all the specific facts and circumstances, a reasonable and informed third party would nevertheless conclude that it is reasonable for the professional accountant to accept the engagement. Such may be the case where the inability of the professional accountant to perform the new service might compromise the ability of one client to pursue a legitimate commercial interest against another client (or former client) of the firm, for example because it is not practicable in the time available to make arrangements for another firm to undertake the engagement. In such circumstances, as a minimum, the professional accountant in public practice shall ensure that institutional mechanisms are in place to eliminate the risk of a breach of confidentiality, including the risk that the confidential information of one party could be used to the detriment of the other party.*

As noted above, this paragraph does not relate to a true COI. Accordingly there is an argument that the issue should not be addressed in Section 220 as it is not strictly speaking an example of a COI. However, on balance the Task Force believed it should be addressed in Section 220, as this situation is frequently perceived as being a COI (and indeed has been examined as such in courts of law in different parts of the world) and therefore, users of the Code may refer to Section 220 for guidance concerning this type of situation.

**Action requested:**

IESBA members are asked to provide feedback on the proposed paragraph 220.8, including whether the situation described is appropriate for inclusion in Section 220.

**Undue Influence and Situations Where a Professional Accountant's Compensation is Tied to Financial Reporting**

At the February 2011 meeting of the IESBA, the Board charged the Task Force with expanding the scope of the project to consider whether more guidance is needed concerning a situation in which a professional accountant in business's compensation is dependent on financial information on which the professional accountant is responsible for reporting. The Task Force reviewed Sections 320, "Preparation and Financial Reporting," and 340, "Financial Interests," and concluded that the sections appropriately

addressed this situation. The Task Force also concluded that while this situation might be viewed by some as a COI, it is not a COI within the meaning of Section 310 as per the description of a COI drafted by the Task Force. Therefore, the Task Force noted that if a professional accountant seeks guidance for such conflicts under 310, it would be beneficial to have a cross reference to Sections 320 and 340 of the Code. The proposed cross reference is as follows:

*310.8 A professional accountant in business may encounter other conflicts with fundamental principles which may occur when preparing or reporting financial information due to undue pressure from others within the employing organization or due to financial, business or personal relationships that close or immediate family members of the professional accountant may have with the employing organization. For guidance on managing such conflicts, see Sections 320 and 340 of the Code.*

The Task Force also noted that professional accountants in business may search for the topics of undue pressure and compensation linked with reporting by scanning the table of contents of the Code and therefore proposes the following change of titles of Sections 320 and 340 as follows:

*Section 320 – Preparation and Reporting of Information and Undue Pressure*

*Section 340 – Compensation and Incentives Linked to Financial Reporting and Decision Making*

These proposed titles would make it easier for professional accountants in business find guidance on these topics. See Agenda Paper 3-C for Sections 320 and 340 in their entirety with the newly proposed titles.

**Action requested:**

IESBA members are asked to provide feedback on the cross reference in Section 310 to Sections 320 and 340.

IESBA members are asked to provide feedback on the proposed new titles for Sections 320 and 340.

**Impact Analysis**

The Task Force began a preliminary draft of an impact analysis table. A pro-forma table can be viewed below and a sample of the impact analysis on the deletion of the current text of Section 310 can be seen in Agenda Paper 3-D.

Current Standard	Proposed Change	Impact	Party Impacted	Direction & Magnitude	Duration of Impact
This column contains the current standard in the Code.	This column contains the proposed changes to that standard.	This column describes the impact, for example, it explains if the change clarifies the Code, streamlines the Code, enhances compliance with the Code, etc. This column also describes such impact in terms of the standing from the extant Code. The impact is to be described on all parties impacted.	This column lists the parties impacted only.	This column measures the impact in terms of “high,” “moderate,” or “low” impact, and describes any new requirements of the parties impacted.	This column describes the length of time in which the impact will be applicable. For the purposes of this Task Force, all should be “continuing.” Therefore, the Task Force will remove this column when exposing the explanatory memo, however, will keep this column in the agenda for a “place holder” for future Task Force projects.

**Action Requested:**

IESBA members are asked to provide feedback on the proposed draft impact analysis.

**Material Presented**

Agenda Paper 3– This agenda paper

Agenda Paper 3-A – Proposed Section 220

Agenda Paper 3-B – Proposed paragraphs 100.17-18 and Proposed Section 220

Agenda Paper 3-C – Sections 320 and 340 with proposed new titles

Agenda Paper 3-D – Impact analysis