

**Meeting:** IESBA

**Meeting Location:** AICPA Offices, New York

**Meeting Date:** December 10-12, 2012

## Agenda Item

# 3

### Conflicts of Interest

#### Objective of Agenda Item

1. To consider proposed changes to the exposure draft wording to address comments received, and approve the final standard.

#### Task Force

2. Members:
  - Peter Hughes, Chair, IESBA Member
  - Jim Gaa, IESBA Member
  - Gary Hannaford, IESBA Member
  - Sylvie Soulier, IESBA Technical Advisor

#### Background to the Project

3. On December 20, 2011, the IESBA issued an exposure draft (Agenda Paper 3-C) proposing changes to the Code related to addressing conflicts of interest. The comment period ended on March 31, 2012 and 50 responses have been received.
4. The Task Force met on May 14-15, 2012 and by conference call on May 31, 2012 to review the comments received. The Task Force reviewed the comments and provided the IESBA with a summary of the main comments and their proposed resolution. At its June 2012 meeting, the IESBA discussed the responses to the first five questions in the exposure draft and provided feedback to the Task Force. The CAG representatives discussed the key issues and the IESBA's tentative conclusions at its September 12 meeting. The Task Force has met twice since September 12 on September 12-13 and October 15-16 and has revised the exposure draft wording in the light of the input from the IESBA and CAG representatives and from detailed comments on exposure. The Task Force feedback statement to CAG representatives' comments is attached at Agenda Paper 3-D. The Task Force's detailed analysis of all comments and their proposed resolution of each one is attached at Agenda Paper 3-F.

#### *Structure of Sections 220 and 310*

5. Prior to addressing the specific questions included in the Exposure Draft the Task Force points out that it concurs with the view of four respondents that the order of paragraphs 220.3-220.7 should be revised to make a clearer distinction between the identification, evaluation and management of

conflicts of interests and to make the process more logical. In addition some CAG representatives proposed re-ordering of certain paragraphs. The proposed new order of the paragraphs is reflected in the table below. This table will help IESBA correlate the original ED with the proposed revised wording:

<b><i>Exposure Draft</i></b>	<b><i>Task Force proposal</i></b>
<i>220.1 Description</i>	<i>220.1 Description</i>
<i>220.2 Examples</i>	<i>220.2 Examples</i>
<i>220.3 Reasonable steps</i>	<i>220.3 Third party test</i>
<i>220.4 Third party test</i>	<i>220.4 Need to decline</i>
<i>220.5 Identify and evaluate</i>	<i>220.5 Importance of Confidentiality</i>
<i>220.6 Effective process</i>	<i>220.6 Reasonable steps to Identify</i>
<i>220.7 Evaluation, disclosure, consent, safeguards and documentation.</i>	<i>220.7 Effective process</i>
<i>220.8 When disclosure is not possible</i>	<i>220.8 Evaluation</i>
<i>220.9 Need to decline</i>	<i>220.9 Safeguards</i>
<i>220.10 Importance of Confidentiality</i>	<i>220.10 Disclosure and consent</i>
	<i>220.11 When consent is refused</i>
	<i>220.12 Documentation</i>
	<i>220.13 When disclosure is not possible</i>

6. Section 310 has been conformed to be consistent with the revised structure and wording of Section 220.

## Discussion

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

7. Extant Sections 220 and 310 do not describe a conflict of interest or provide examples of conflicts of interest. The exposure draft includes a description of circumstances that might create a conflict of interest for the professional accountant together with examples of such circumstances. The purpose is to help the professional accountant to identify a potential conflict of interest at a sufficiently early stage to be able to take any actions necessary to comply with the fundamental principles.
8. The exposure draft includes a description of a conflict of interest in paragraph 100.17 and in each opening paragraph of Sections 220 and 310.
9. There was support for the proposed approach from respondents.
10. The Task Force was of the view that the description should show the linkage between the professional service provided by the professional accountant and the conflict between the two parties. It proposed a revised description.

11. The June IESBA supported the Task Force's conclusion that the description of a conflict of interest should be redrafted to provide a linkage between the professional activity and the matters that are in conflict, thus making it clear that a conflict of interest is not created merely because the interests of two clients are in conflict.
12. There was general support for the revised description from the CAG representatives at its September meeting.
13. Since the IESBA June meeting the Task Force addressed comments made by the IESBA in June and the CAG in September.
14. CAG representatives and some respondents raised the question of the connection between Conflicts of Interest and Independence in Sections 290 and 291.
15. The Task Force carefully considered the relationship between Conflicts of Interest and Independence comments and is of the view that because of the apparent uncertainty, a reference to the need to comply with Sections 290 and 291 when performing an audit or other assurance engagement should be included in the revised proposal.
16. The Task Force has added the sentence: "When the professional service is an assurance service the professional accountant in public practice shall also comply with the independence requirements of Sections 290 and 291 as appropriate." to paragraph 220.1 to emphasize.
17. The Task Force also:
  - Changed "in respect of" to "related to" in the description to recognize that although there should be a linkage between the conflicting interest and the subject of a professional service in order to create a conflict of interest, it is recognized that the relationship may not necessarily be a direct one where the professional service is in respect of the conflicting interest, but may merely be related to that interest.
  - Considered the need for further examples and added to and deleted from the list. In particular an example has been added of a conflict involving an assurance engagement in response to CAG comments.
  - Reviewed the examples to ensure they are consistent with the revised description in particular as to whether there is sufficient connection between the conflicting interests in each case and re-classified them to align with the two types of conflicts.
  - Agreed the description need not include a specific reference to relationships as the description captures relationships and the inclusions would over-complicate the description.

**Matter for IESBA Consideration**

The IESBA is asked to confirm its support for the additional sentence linking Section 220 to Independence and the changes to the description and the examples.

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

18. The ED requires the professional accountant to take into account whether a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at the time, would be likely to conclude that compliance with the fundamental principles

is compromised. This would be required both when identifying and evaluating conflicts of interest and when implementing safeguards to address them. In the IESBA's view it is appropriate for the professional accountant to consider how a conflict of interest would be viewed by a third party. Additionally, this is consistent with the application of the conceptual framework and the determination of whether threats to compliance with the fundamental principles are at an acceptable level.

19. Respondents were generally supportive of the application of the reasonable and informed third party test. The Task Force considered the responses to the reasonable and informed third party standard and noted that 36 out of 41 respondents agreed with the proposal. Some respondents suggested that the third party test is subjective and a matter of judgment.
20. There was support from the IESBA in June to the use of the reasonable and informed third party standard.
21. The CAG representatives raised no objections to the third party test.
22. Since the June IESBA meeting the Task Force aligned the third party test to the construct in 100.7 as recommended by the IESBA in June.
23. The Task Force noted that a number of respondents had stated that the third party test was subjective. It noted that this matter was not specific to Sections 220 and 310 and that reference to it was to be addressed in a Staff Q&A but that a question on the third party test had been withdrawn. The Task Force does not however believe that the subjectivity of this test creates a significant flaw in the conflict of interest guidance because application of the test necessarily requires professional judgment.

**Matter for IESBA Consideration**

The IESBA is asked to note the comments from respondents on the need for guidance on the subjective nature of the third party test in the Code.

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

24. The ED considered what threshold should apply with respect to potential conflicts of interest that might be created by the interests and relationships that a firm, that is a member of a network of firms, has with a client. The exposure draft proposes that potential conflicts of interest within a network of firms should be evaluated when the professional accountant has reason to believe that a conflict of interest exists because of interests or relationships that another firm in the network has with a client. The "reason to believe" threshold requires the professional accountant to consider the facts available to the professional accountant at the time.
25. The Task Force considered the responses to the reason to believe threshold and noted that 31 out of 42 respondents agreed with the proposal.
26. The IESBA agreed in June with the general approach proposed by the Task Force for a "knows or has reason to believe" threshold.

27. Some CAG representatives suggested that the reason to believe test is not strong enough and compared it with the network test in the Independence sections 290. The Task Force agreed to reconsider the matter.
28. The Task Force distinguished between the reason to believe test in Section 220 and in Sections 290 and 291. Section 290 applies to interests and relationships between the firm (including, its network firms) and its audit or review client that might affect the independence of the firm in performing the audit or review. The scope of section 291 is equivalent to section 290 but with respect to assurance engagements other than audit and review. (In the case of section 291 the restrictions apply beyond the firm performing the engagement to network firms only when the firm performing the engagement has reason to believe that interests and relationships of network firms are relevant to evaluating the independence of the performing firm.) Section 220, however, applies more broadly to *any* interests and relationships that might represent a conflict of interest when performing any service for any client of a professional accountant in public practice (for example, relationships with other parties who have a conflicting interest with the client), i.e., not limited to interests and relationships with the audit/assurance client itself. Therefore the scope of section 220, on the one hand, and sections 290 and 291 on the other are not comparable.
29. In order to avoid any uncertainty, however, a cross reference to sections 290 and 291 has been added in 220 to clarify that those sections also apply when evaluating independence for the purposes of audit and other assurance engagements.
30. The Task Force performed a detailed analysis of those respondents who did not support the reason to believe test.
- Three respondents (ICPAS, CICA, SAICA) proposed a reasonable and informed third party test as an alternative.
  - Three respondents (KPMG, EYG, CARB) proposed the test be strengthened by an additional test e.g. having made enquiries as appropriate.
  - IRBA proposed a similar test in order to gather evidence.
  - Two respondents (CPAB, NZAuSB) proposed a “reasonably be expected to know” test.
  - One respondent (DTT) proposed the test be replaced with “knows”.
31. In the revised proposal, paragraph 220.7 has been modified, as proposed by certain respondents, to strengthen the reason to believe test as follows:
- Linking it more clearly to the identification process for networks;
  - Adding “knows” to “has reason to believe”; and
  - Adding “having made enquiries as appropriate”.

#### **Matter for IESBA Consideration**

The IESBA is asked to consider whether it agrees with the Task Force that the reason to believe test in 220, as strengthened, is appropriate.

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

32. The exposure draft expands on the guidance in the extant Code regarding the nature of safeguards that may be available to manage conflicts of interest within firms. The IESBA believes that it is generally necessary to disclose the nature of the conflict to the client and all known relevant parties and to obtain written consent from the client and such parties before performing the professional service. Implicit in providing consent is that the consenting parties believe the firm can carry out the activity in compliance with the fundamental principles in the Code, particularly objectivity.
33. The exposure draft recognizes that in certain circumstances the consent obtained from any relevant party may be implied by the party's conduct in keeping with common commercial practice. The exposure draft also encourages the professional accountant to document such consent when it is obtained verbally or implied by the party's conduct.
34. The Task Force noted majority support for the proposal but that there were a number of specific comments regarding a lack of clarity in some terms used in the guidance e.g. "generally necessary" and some suggested a need to split out disclosure and consent. Some respondents questioned whether consent itself is a safeguard and the Task Force agreed not to describe it as such.
35. The IESBA requested the Task Force consider:
  - Whether more guidance can be provided on implied consent, including an example. It was noted that consent is normally general or explicit. A suggested example of implied consent was where a party asks the professional accountant to analyze financial information on all parties in a multi-party dispute and where the instruction itself provides evidence of consent to any perceived conflict.
  - Whether there are particular issues in relying on consent where the conflict of interest arises from an interest of the professional accountant, given that self-interest should not be allowed to influence a professional accountant's judgment and there may be few safeguards available in such a situation.
  - If it is necessary to disclose and obtain consent if safeguards have already reduced the threats to an acceptable level.
36. CAG representatives commented on documentation in Section 220 and some suggested that clearer disclosure and documentation requirements are appropriate.
37. Since the June IESBA meeting, the Task Force has subdivided disclosure and consent into: general disclosure and general consent with an example; specific disclosure and explicit consent; and implied consent with a description.
38. Further, the Task Force has considered the CAG comments on documentation requirements, and is of the view that documentation is a decision for the professional accountant that does not change the facts as to whether the existence of a conflict of interest compromises the professional accountant's objectivity or compliance with the other fundamental principles. The revised proposal, however, requires the professional accountant to determine whether the significance of the conflict is such that specific disclosure and explicit consent is necessary. Where such disclosure is made, the disclosure of the circumstances of the particular conflict together with any planned safeguards, together with the client's written consent (or otherwise), provides documentation of the matter. The revised proposal encourages documentation when disclosure is verbal or consent is verbal or

implied. The Task Force does not believe that it is appropriate for the Code to mandate documentation for the reasons stated above.

39. The Task Force also considered whether the conflict of interest arising from self interest threat might mean that the engagement must necessarily be declined. The Task Force did not believe that this would invariably be the case and that the general guidance is still appropriate, in particular the need to evaluate the extent of the connection between the self-interest and the service to be provided. The Task Force noted that self-interest threats would likely be less significant if they did not directly involve the professional accountant performing the service but other professionals within a firm. The ultimate test, as stated in Paragraph 220.1 is that the professional accountant shall not allow a conflict of interest to compromise professional or business judgment.
40. The Task Force considered whether it is necessary to disclose and obtain consent if safeguards have already reduced the threats to an acceptable level. The Task Force believes that it would generally be appropriate to disclose the nature of the conflict and the safeguards to be applied notwithstanding that the application of these safeguards would, in the professional accountant's judgment, reduce the threat to an acceptable level.

#### **Matter for IESBA Consideration**

The IESBA is asked to consider whether it agrees with the Task Force proposals that:

- The revised disclosure and consent wording is sufficiently clear;
- It is sufficient for the proposed wording to "encourage" documentation;
- Conflicts involving self interest are adequately covered by the proposed wording; and
- The proposed wording is clear that it is generally necessary to disclose and obtain consent if safeguards have reduced the threats to an acceptable level.

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

41. The exposure draft recognizes that in certain circumstances the professional accountant will not be able to obtain consent because requesting consent would in itself result in a breach of confidentiality.
42. The exposure draft provides that the firm shall only accept an engagement in such circumstances if certain conditions are met. These conditions are:
  - The firm does not act in an advocacy role for one client which is adversarial to the interests of another client;
  - Specific mechanisms are in place to prevent disclosure of confidential information between the engagement teams serving the two clients; and
  - The firm is satisfied that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would conclude that it is appropriate for the firm to accept the engagement in the particular circumstances.

43. Respondents were supportive of proposals to deal with situations when consent cannot be obtained because it would breach confidentiality.
44. CAG representatives made no comments on this matter.
45. In response to comments from IESBA in June the Task Force concluded that:
- The provision should clarify that it would not apply where implied or general consent has already been obtained by adding “making specific disclosure for the purpose of obtaining explicit consent” to 220.13.
  - It is appropriate to strengthen the third condition to the extent of requiring there to be a disproportionate outcome in the event that the work cannot proceed.

**Matter for IESBA Consideration**

The IESBA is asked to consider if it concurs with the Task Force's proposed changes to 220.13.

*Question 6: Do respondents agree with the general requirement to identify, evaluate and manage conflicts of interests as set out in proposed Section 310 of the Code?*

Category	Generally Agreed	Other Changes	Disagreed
IFAC Member Body	20	2	1
Firms	7	1	0
Regulators and Public Authorities	1	1	0
Other Professional Organizations	5	0	0
Others	1	0	0
<b>Total</b>	<b>34</b>	<b>4</b>	<b>1</b>

*NB Some respondents did not comment on all questions.*

46. The Task Force did not present any proposals in regard to Section 310 to the June IESBA.
47. CAG representatives made no comments on this matter although relevant changes proposed by the CAG in relation to 220 flow through to 310.
48. The Task Force made conforming changes to Section 310 (Agenda Paper 3A) to reflect changes made to Section 220, in particular the definition and examples and responded to comments made by respondents.

**Matter for IESBA Consideration**

The IESBA is asked to consider if it concurs with the Task Force's proposed changes to Section 310.



*Question 7: Do respondents find the reasonable and informed third party test appropriate?*

Category	Generally Agreed	Other Changes	Disagreed
IFAC Member Body	20	1	1
Firms	8	0	0
Regulators and Public Authorities	1	0	0
Other Professional Organizations	3	1	1
Others	1	0	0
<b>Total</b>	<b>33</b>	<b>2</b>	<b>2</b>

*NB Some respondents did not comment on all questions.*

49. The third party test in Section 310 relates to the identification and evaluation of a conflict in paragraph 310.3.
50. The Task Force did not present any proposals in regard to the third party test in Section 310 to the June IESBA.
51. CAG representatives made no comments on this matter although relevant changes proposed by the CAG in relation to 220 flow through to 310.
52. Almost all respondents supported the third party test for Section 310. Of those that disagreed one found it unhelpful and the other suggested replacing it with the opinion of an "independent and qualified third party".
53. The Task Force noted that a number of respondents had stated that the third party test was subjective. It noted that this matter was not specific to Sections 220 and 310 and that reference to it was to be addressed in a Staff Q&A but that a question on the third party test had been withdrawn.
54. The Task Force made conforming changes to 310.3 to reflect changes made to Section 220.

**Matter for IESBA Consideration**

The IESBA is asked to consider if it concurs with the Task Force's proposed changes to Paragraph 310.3.

*Question 8: Do respondents find the conforming changes proposed for Sections 320 and 340 useful? Are they appropriate and adequate?*

Category	Generally Agreed	Other Changes	Disagreed
IFAC Member Body	22	0	0
Firms	6	0	1
Regulators and Public Authorities	1	0	0
Other Professional Organizations	5	0	0
Others	1	0	0
<b>Total</b>	<b>35</b>	<b>0</b>	<b>1</b>

*NB Some respondents did not comment on all questions.*

55. In proposing revisions to Section 310 to address conflicts of interest, the IESBA recognizes that professional accountants in business may encounter other threats to compliance with the fundamental principles. Certain ethical conflicts might arise, such as undue pressure and self-interest threats, when preparing financial information.
56. The IESBA notes that these types of ethical conflicts are addressed in Sections 320, Preparation and Reporting of Information, and 340, Financial Interests, of the Code. The IESBA has made some conforming changes to these sections to improve the alignment between those sections and Sections 220 and 310.
57. The Task Force did not present any proposals in regard to the third party test in Section 310 to the June IESBA meeting.
58. CAG representatives made no comments on these matters.
59. All respondents except one supported the conforming changes. The dissenting opinion was that they are not conforming changes, have little to do with conflicts of interest and are only editorial changes.
60. The Task Force made a number of editorial changes in regard to suggestions by respondents.

**Matter for IESBA Consideration**

The IESBA is asked to consider if it concurs with the Task Force's proposed changes to Sections 320 and 340.

*Question 9: Do respondents agree with the impact analysis as presented? Are there any other stakeholders, or other impacts on stakeholders, that should be considered and addressed by the IESBA?*

61. Detailed comments on the impact analysis will be considered together with other examples of impact analysis by the IESBA in a future meeting. A number of respondents questioned the usefulness of the impact analysis given its high level nature and whether the length of the impact analysis was appropriate.

**Matter for IESBA Consideration**

The IESBA is asked if it concurs that an analysis of the impact analysis should be undertaken as part of a wider consideration of impact analyses of other pilot projects.

*Other Matters Raised by Respondents*

62. The Task Force considered carefully the issues raised by IOSCO in their letter regarding the importance of the public interest when considering conflicts of interest and the relationship between conflicts of interest and auditor independence.
63. The IESBA noted that the IFAC Board had approved a policy position paper setting out guidance on the public interest. The IESBA also noted that in its response to the exposure draft addressing Conflicts of Interest, IOSCO had encouraged the IESBA to consider the concept of the public interest as outlined in the Code and whether it should be a fundamental principle. The IESBA

agreed at its June meeting that it would consider both of these matters at its December 2012 meeting.

**Materials Presented**

Agenda Paper 3-A	Sections 100 and 220 marked up for changes since June IESBA and 310, 320, 340 since ED
Agenda Paper 3-B	Sections 100, 220, 310, 320, 340 Clean
Agenda Paper 3-C	Original ED
Agenda Paper 3-D	Report back on CAG representatives' comments in September 2012
Agenda Paper 3-E	Sections 100, 220, 310, 320, 340 marked up for all changes since ED
Agenda Paper 3-F	Detailed analysis and disposition of responses to ED