

Review of Part C of the Code— Preparation and Presentation of Information (Section 320)

How the Project Serves the Public Interest

Over half of the world's professional accountants are professional accountants in business (PAIBs) in the traditional sense – being accountants who do not work in public accounting practices. PAIBs are a very diverse constituency, and work as employees or consultants in commerce, industry, financial services, education, and the public and not-for-profit sectors. Many are in a position of strategic or functional leadership, or are otherwise well-placed to collaborate with colleagues in other disciplines to help their organizations toward long-term sustainable success.

All organizations require relevant and reliable information in order to conduct their affairs. In addition, interested external parties (such as investors, suppliers, customers, employees, and government agencies) require relevant and reliable information to assess an organization's situation, in order to ensure accountability to them and for them to make decisions about the organization. In particular, enabling PAIBs to better deal with the issue of inappropriate pressure on them with respect to the preparation and reporting of information, will contribute to the public interest because such pressure may undermine the quality of financial information on which users rely.

It is in the public interest that PAIBs who are responsible for the preparing such information do so honestly, and that the information they present is not false or misleading, or prepared or presented recklessly or negligently. The IESBA intends that Section 320 will provide more specific guidance for PAIBs who present information (a) internally and externally, (b) financial and non-financial in nature, (c) and which might or might not be prepared in accordance with a reporting framework.

1. This paper addresses Section 320 in two parts. Part I addresses the whole of Section 320 except for paragraph 320.6. Paragraph 320.6 is addressed in Part II.

I. Section 320

2. A preliminary revised Section 320 was considered by the Board at its meeting in December 2013. A number of IESBA members expressed various concerns about a proposal to include a requirement that the information be prepared or presented “without bias.” A few IESBA members also questioned the proposed addition of the word “completely” to this requirement, believing that it added little.
3. The Task Force also proposed to require a PAIB not to prepare, alter or present information in a manner that is intended to deceive or mislead; misrepresent the underlying economic performance of the employing organization; or inappropriately influence decisions, or contractual or regulatory outcomes that depend on the reported information. In addition, the Task Force proposed to require the PAIB not to prepare or report information that misrepresents what it purports to represent, notwithstanding that the information is in accordance with the applicable financial reporting framework. IESBA members expressed various concerns with these proposals.
4. The Task Force addressed these matters at its meetings in February and March 2014 and makes the following proposals.

5. Section 320 is re-titled “Presentation of Information” which encompasses preparation and reporting of information.
6. The Task Force had initially proposed to create separate requirements for internal and external information, but because a PAIB may not know whether their work would ultimately be used internally or externally, the Task Force proposes that Section 320 should establish the same requirements for all information, with an additional condition that external information be presented in accordance with an applicable reporting framework. This requirement is intentionally not limited to financial reporting frameworks to recognize the existence of sustainability and similar information that the PAIB may prepare.
7. The Task Force recognizes that there is no objective benchmark to which the PAIB should refer when preparing information that is not subject to a reporting framework, such as budgets or non-GAAP supplementary measures. It proposes a requirement for the PAIB to disclose such relevant information as is necessary to enable those who may rely on such information to form their own judgments.
8. The Task Force proposes to retain the requirement for information to be “complete” because this avoids the omission of relevant information. In addition, the Task Force proposes to include the caveat that the PAIB “have regard to the purpose for which the information is to be used, the context in which it is provided and the audience to whom it is addressed,” which would address the comments from the Board that internal information need not be complete.
9. The Task Force accepts that internal information, such as budgets, may intentionally be biased, for example the use of stretch targets. It therefore proposes to make clear that what the PAIB should not impose is *personal* bias beyond any bias that management may appropriately wish to apply. To make clear why there is no place ethically for personal bias, the Task Force proposes to link the prohibition of personal bias to the fundamental principle of objectivity, which imposes an obligation on all professional accountants not to compromise their professional or business judgment because of *bias*, conflict of interest or the undue influence of others.
10. The Task Force noted that the Structure of the Code Working Group is proposing Scope and Purpose paragraphs at the start of each Section. The Task Force proposals are drafted in the style of the extant Code. The Task Force believes that the purpose of the Section is to influence the behavior of the PAIB in presenting information. Section 320 sets the standard and Section 370 (Pressure) provides guidance to the PAIB as to how to respond to pressure to compromise the standards set in Section 320.

CAG Comments in March 2014

11. CAG representatives considered proposed changes to Section 320 at the March 2014 CAG meeting. There were no comments made in regard to the above proposals.

Matter for Consideration

1. Does the Board have any comments on the draft changes to proposed Section 320, other than with respect to paragraph 320.6?

II. Whether Paragraph 320.6 Should Explicitly Address Misleading Information

12. The Task Force paid close attention to the circumstances in which a PAIB may present misleading information in paragraph 320.6 and requests the Board's input on this particular matter.

Background

Relevant Fundamental Principles

13. The fundamental principles of integrity, objectivity and professional behavior under the Code impose important obligations on all professional accountants (PAs). Specifically (emphasis added below):

Integrity

- Paragraph 110.1 of the Code requires all PAs to be *straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.*
- Paragraph 110.2 requires a PA *not to knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:*
 - (a) *Contains a materially false or misleading statement;*
 - (b) *Contains statements or information furnished recklessly; or*
 - (c) *Omits or obscures information required to be included where such omission or obscurity would be misleading.*

It also requires that when a PA becomes aware that the PA has been associated with such information, the PA *take steps to be disassociated from that information.*

Objectivity

- Paragraph 120.1 requires all PAs not to compromise their professional or business judgment because of *bias*, conflict of interest or the undue influence of others.
- Paragraph 120.2 requires a PA not to perform a professional activity or service if a *circumstance or relationship biases* or unduly influences the accountant's professional judgment with respect to that activity or service.

Professional Behavior

- Paragraph 150.1 requires that all PAs comply with relevant laws and regulations and *avoid any action that the PA knows or should know may discredit the profession.* It utilizes the third party test as the criterion for judging whether an action would be likely to adversely affect the reputation of the profession.

Section 320¹ of the Code

14. Extant Section 320 requires that where a PAIB is involved in the preparation and reporting of information, whether for internal or external use, the PAIB prepare or present such information *fairly*,

¹ Section 320, *Preparation and Reporting of Information*

honestly and in accordance with relevant professional standards so that the information will be understood in its context.

15. Extant paragraph 320.4 recognizes that threats to compliance with the fundamental principles are created where a PAIB is pressured (either externally or by the possibility of personal gain) to prepare or report information in a misleading way or to become associated with misleading information through the actions of others. Extant paragraph 320.6 requires the PAIB to evaluate the significance of any threat and apply safeguards when necessary to eliminate the threat or reduce it to an acceptable level.

Issue Definition

16. There are a number of ways in which a PAIB can be associated with misleading information:
 - (a) The information is misleading because it contains errors that were inadvertently introduced during the preparation of the information.
 - (b) Compliance with the applicable financial reporting framework results in a misleading depiction of the entity's financial position, financial performance or cash flows.
 - (c) The PAIB is involved in fraudulent financial reporting through such means as recording fictitious transactions, altering financial records or intentionally misclassifying accounting entries (whether directly or through a subordinate).
 - (d) The PAIB intentionally misuses or abuses the discretion provided under the applicable financial reporting framework with the intention of misrepresenting the entity's economic situation or performance to achieve a specific objective. This may arise even if the information complies with the applicable financial reporting framework. Discretion in this context means the use of judgment either in determining estimates or in selecting a particular accounting treatment among two or more alternatives permitted under the applicable financial reporting framework.
 - (e) The PAIB is involved in structuring real transactions with the intention of misrepresenting the entity's economic situation or performance to achieve a specific objective. The accounting for such transactions may be in full compliance with the applicable financial reporting framework.
17. This paper is not addressing cases (a)-(c). Cases (a) and (b) are outside the scope of Section 320. Case (c) is covered by the other provisions in the proposed revised Section 320.
18. Generally accepted accounting principles (GAAP) recognize that case (b) will be extremely rare. Some applicable financial reporting frameworks such as IFRSs allow for a "true and fair" override in such circumstances to enable management to depart, with appropriate disclosure, from the requirement of a particular financial reporting standard in order to achieve a true and fair view or fair presentation.
19. Case (c) is effectively forbidden by paragraph 150.1 of the Code in that any type of fraud (including fraudulent financial reporting) is an illegal act and paragraph 150.1 imposes the clear obligation on all PAs to comply with laws and regulation.
20. Cases (d) and (e) are implicitly covered under the fundamental principles of integrity, objectivity and professional behavior, and by Section 110.2 in particular. The question is whether the Code should provide explicit guidance to PAIBs when facing such circumstances. The Task Force believes that it should, given:

- Evidence that cases (d) and (e) do arise in practice; and
- The fact that extant Section 320 is silent on them and the main objective of the project is to develop enhanced guidance for PAIBs.

Case (d): Misuse or Abuse of Discretion Under the Applicable Financial Reporting Framework

Academic Research

21. Substantial academic research over the past 30 years supports the inference of the existence of misuse or abuse of discretion under the applicable financial reporting framework to misrepresent an entity's economic situation or performance. One particularly relevant study² has been recently published. It surveyed CFOs of public and private companies about their views regarding the quality of financial statement information, including misrepresentation. Of the 169 public company CFOs,³ 168 believe that companies "use discretion within GAAP to misrepresent the economic performance of the business" is common. Specifically, they believe that in any given period about 20% of firms use discretion within GAAP to misrepresent the economic performance of the business, and that on average, the magnitude is about 10% of EPS.
22. While the point estimates of the frequency and amount of misrepresentation are subject to uncertainty, this study is particularly relevant because it reports directly the beliefs of public company officers who are responsible for financial reporting and who are in a position to have informed opinions about financial reporting practices. In addition, it does not depend on indirect evidence to infer intentions to misrepresent. Also, since it focuses on external audited financial statements, it indicates that complying with an applicable financial reporting framework and having an unmodified audit opinion are not guarantees that the financial statements do not contain misrepresentations.
23. A common example of misuse or abuse of discretion under the applicable financial reporting framework leading to misrepresentation is "big bath" accounting. This involves recognizing a loss that is larger than management believes is justified by the facts of the situation, but which does not violate a relevant financial reporting standard. By overstating the loss in one period, the company creates a "cookie-jar" reserve that can be used flexibly to overstate income in subsequent periods. This technique can be used in many situations, including after the appointment of a new CEO (especially in a time of financial distress) or at the time of a merger or an acquisition.

The Auditing Literature

24. The existence of misuse or abuse of discretion under the applicable financial reporting framework is well acknowledged in auditing standards. The Task Force referred to the auditing standards to help it in providing guidance to PAIBs. (The fact that auditing standards deal with this case does not mean that the situation is limited only to circumstances where the entity is audited. This situation exists whether or not an entity is audited.) In particular the auditing standards include the following:

² Dichev, Ilia D. and Graham, John R. and Harvey, Campbell R. and Rajgopal, Shivaram, Earnings Quality: Evidence from the Field (May 7, 2013). Available at SSRN: <http://ssrn.com/abstract=2103384>

³ The survey includes companies quoted on US stock markets.

- International Standard on Auditing (ISA) 540⁴ requires the auditor to review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. ISA 540 defines management bias as “a lack of neutrality by management in the preparation of information.” It also explains the following:
 - “A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or *intentional management bias* (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate.
 - A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. *Where, however, there is intention to mislead, management bias is fraudulent in nature.*” [Emphasis added.]
- In addition, paragraph A125 of ISA 540 gives the following examples of indicators of possible management bias with respect to accounting estimates:
 - Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
 - Use of an entity’s own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
 - Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
 - Selection of a point estimate that may indicate a pattern of optimism or pessimism.
- Paragraph 32 of ISA 240⁵ requires the auditor to review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. It also requires that in performing this review, the auditor evaluate whether the judgments and decisions made by management in making the accounting estimates, even if they are individually reasonable, indicate a possible bias on the part of the management that may represent a risk of material misstatement due to fraud. If so, it requires the auditor to reevaluate the accounting estimates taken as a whole.

⁴ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

⁵ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

- ISA 240 also explains the following:

“A45. The preparation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and to monitor the reasonableness of such estimates on an ongoing basis. *Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates.* This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability.” [Emphasis added.]

Case (e): Transaction-Based Misrepresentation

25. Misrepresentation may also occur by making real decisions about an entity’s activities or about the structure of specific transactions. For example, a legal transaction may be structured and completed for the purpose of temporarily removing liabilities from the entity’s balance sheet at the balance sheet date. This was the case with Enron’s use of special purpose vehicles.
26. If the intention behind such actions is to misrepresent the entity’s economic situation or performance, there is a question as to whether this would be in compliance with the fundamental ethical principles, notwithstanding that the accounting for the transactions would be in compliance with the applicable financial reporting framework. Indeed, if a PAIB is associated with such a transaction by helping to create it, the PAIB would be associated with the deception and therefore be in breach of paragraph 110.2 of the Code. Whether the PAIB who does the actual accounting is also responsible would depend on the facts of the specific case.

Should the Code Explicitly Address Both Cases (d) and (e)?

27. The Task Force reflected on whether it would be appropriate for the Code to address cases (d) and (e) explicitly. The Task Force recognizes that misrepresentation of these kinds exists, and believes the Code should provide enhanced guidance addressing these cases for the following reasons:
 - While the fundamental principles cover both cases, they only do so implicitly. Importantly, while case (e) misrepresentations involving a PAIB violate paragraphs 110.1 and 110.2, the extant Section 320 does not appear to cover it as the Section presently only deals with the preparation and reporting of information, not the structuring of real transactions with a view to misrepresenting the entity’s economic situation or performance.
 - In addition to specific requirements, a code of ethics should contain guidance about how a PA should recognize and deal with issues. For example, such guidance may concern a PAIB’s intentions or objectives. Such statements do not provide clear and unambiguous “bright lines” for them (or others) to use in making judgments about their actions. Since a PAIB’s intentions are not directly observable to others, they can only be inferred from a PAIB’s behavior. Even though intentions and purposes are not observable, they are enforceable, even legally enforceable, in some cases. The Task Force recognizes that a PAIB who is intent on committing fraud will ignore the law, let alone guidance in the PAIB’s code of ethics. Nevertheless, just as laws exist despite the fact that they may be violated, the Task Force believes the Code should provide robust guidance to PAIBs when facing the

circumstances described in cases (d) and (e), in order to help them recognize and deal with such situations.

- Pressure to violate the fundamental principles is dealt with in the proposed Section 370. In the context of paragraphs 370.2 and 370.6 of Agenda Paper 3-E, an explicit statement about this issue in Section 320 may help PAIBs deal with pressure to misrepresent economic performance, by providing a clear statement of their responsibilities.
28. Subject to the views of the CAG and the Board, the Task Force will consider how such guidance may be drafted as part of this project.

CAG Representative Comments in March 2014

29. CAG Representatives considered proposed changes to Section 320 at its meeting in March 2014. Because of the timing of the meeting it was not possible for the Task Force to consider the CAG comments. The Representatives' views and the discussion are summarized below:
- A Representative did not doubt that the issue exists but thought it is a financial reporting or auditing issue, rather than a matter for the Code. Mr. Gaa did not agree with the Representative's views and emphasized that the issue in Section 320 is for the preparer.
 - Mr. Siong referred the CAG to ISA 540.A10 which states that where there is an intention to mislead, management bias may be fraudulent in nature.
 - Mr. Gaa replied that ISAs are written for auditors and that fraud is a legal concept. For this reason, it is important to be careful in applying ISAs to the presentation of information. He noted that ISA 240 does not address misleading information that is not fraudulent.
 - A Representative supported enhanced guidance for PAIBs where it makes sense as the issue starts in companies.
 - A Representative similarly supported enhanced guidance for PAIBs but questioned whether it is possible to mislead while complying with the financial reporting framework.
 - Mr. Gaa replied that it is possible to mislead without violating accounting standards.
 - A Representative noted that he could not think of an example of misleading information that does not breach existing rules or regulations.
 - Mr. Gaa replied that big bath accounting would be an example, and that while some instances are fraudulent, they are not necessarily so. Fraudulent reporting may involve the techniques in categories (d) and (e), but the scope of Section 320 is non-fraudulent information; fraudulent information is covered by paragraph 150.1.
 - A Representative encouraged strengthening the Code for PAIBs as this is the start of the financial reporting supply chain. However, the Representative believes that the academic study that cited the misstating income by around 10% would constitute fraud. The Representative felt that the circumstances described in the academic study are not what this project should be addressing.
 - Mr. Gaa replied that the CFOs surveyed were not addressing their own company's practices and were asked specifically about manipulation that does not violate a financial reporting framework.

- A Representative suggested that it may be helpful to look for any motivations to misstate information that are omitted from paragraph 320.11.
- Mr. Gaa replied that the task force would do so, because it might reveal a gap in the current standards in Part C.

Matters for Consideration

1. What are IESBA members' views as to whether the Code should incorporate enhanced guidance to help PAIBs better understand their responsibilities relating to the fundamental principles when facing the circumstances in cases (d) and (e) above?
2. What practical guidance in Part C could be given to PAIBs to help them better understand paragraph 110.1 and 110.2 of the Code.
3. What practical challenges might IESBA Members foresee in attempting to address cases (d) and (e) in the Code?