Meral KAGITCI,
The Bucharest University of Economic Studies
Oana Gabriela SPIRIDON,
Universite Paris 1 Pantheon-Sorbonne

THE CONFLICT OF INTEREST AND THE INFLUENCE ON THE FINACIAL STATEMENTS OF A COMPANY

Theoretical article

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Abstract

The financial crisis revealed serious imperfections in the integrity of the financial system, exposing major cases of fraud and conflict of interest. This integrity deficitis a cause for concern,given the roles of the information in the decision making process and on the financial-market. Further more, the European audit system has been questioned following the fact that the quality of audits has been criticised by the investors. These events have revealed the failure of the auditing system to deliver true independent assurance, being based in many cases by a certain degree of conflict of interests.

1. Introduction

A conflict of interest is a set of events which generate a risk that an actor's or organization's professional judgment or behaviour regarding an essential interest will be unduly influenced by a secondary interest.

Companies rely most of the time on the advice of experts. Sometimes, these experts face conflicts of interest between their own self-interest and their professional obligation to provide good and reliable advice. For example, when undertaking a professional activity, an auditor or a professional accountant maybe faced with a conflict of interest that can create a threat to objectivity and may generate threats to the other fundamental principles which underlie his profession.

In the first part of this article we talk about conflict of interest in general, and about the main categories of conflict of interest. Subsequently, we comment on the link between the accounting profession and the conflict of interest as well as the rules implemented in order to avoid this situation. We conclude this article with the concerns related to services provided by Big Four companies.

2. Theoretical background

2.1. The concept of conflict of interest

The term"conflict of interest"is not evident but is an usage or term of art. For the professional accountants, the term groups together a range of scenarios in which the professional reasoning of the individual in question risks being biased. The profession doesn't use explicit definitions of conflicts of interest, but instead illustrates in their codes a variety of situations that fallunder the heading"conflict of interest"and that must either be avoided or managed in detailed ways. For exemple, the *American Institute of Certified Public Accountants's Code of professional conduct* includes a definition of one of the terms used in its conflict of interest rules, such as "immediate family"but not "conflict of interest". The term of conflict of interest is not specifically used, instead, various risks to independence and objectivity, including the risk posed by certain financial interests are being used.

A conflict of intereste merge from the nature of a fiduciary relationship. Those in a fiduciary relationship must avoid wherever possible placing them selves in a position in which they will be tempted to prefer their own interests or the interests of someone other than the person with whom they have the fiduciary relationship. A conflict of interest therefore arises when an individual or entity proposes to exploit an opportunity for themselves ratherthan for the benefit of the person or entity to whom they own that fiduciary duty.

Conflict of interest prevents the provider or representative from rendering an unbiased and fair financial service to a client, or from acting in the interest of that client, including but not limited to a financial interest, an ownership interest, any relationship with a third party.

Financial interest means any cash, cash equivalent, service, advantage, sponsorship, other incentive or valuable consideration, other than an ownership interest, training, that is not exclusively available to a selected group of providers or representatives, on products and legal matters relating to those products, general financial and industry information, specialised technological systems of a third party necessary for the rendering of a financial service. The third party means a product supplier, a distribution channel and any person associatedwith product supplier, any person associated who provides a financial interest.

2.2. The difference between the related parties transactions and the conflicts of interest.

First, a related party transaction does not lead necessarily to conflicts of interest, but in many cases depending on the actual transactions to be performed, related parties transactions are likely to lead in certain cases to conflicts of interest. However, in case of conflict of interest there is an additional condition to be met - the conflicting interests, that would prohibit a person, that could be a related party, from performing a transaction. On the other hand conflicts of interests do not limit to related parties.

The conflict of interest concept is less precisely regulated than related party. It is likely to coverany type of situation and relationship that may result in conflicting interests.

2.3. Different types of conflicts of interest

The main categories of conflicts of interests regulated by company law and securities regulations are the following:

Conflicts of interest arising in a company: the most common conflict of interests at corporate level emerge between the interests of one member of the corporate bodies and the interests of the company it self. The member of a corporate body could be a director, shareholder, a legal representative.

Conflicts of interest emerging between specialised companies acting on the regulated markets and their clients: generally, brokerage companies are required to give priority to their clients interests and abstain from satisfying their own interests first, to the disservice of the clients interests.

Conflicts of interests between members of certain professions providing services to specialised Services Providers: the most common case is that of auditors, censors. There maybe a wide array of conflicting interests.

Conflicts of interest regulated under specific regulations: generally, with certain companies, conflicts of interest are regulated more specifically.

3. Accounting profession and conflict of interest

As the number of human cooperation in business is enormous, it follows that professional accountants will be faced with conflicts of interest and ethical dilemmas that they have to deal with. The conflict of interest in the accounting profession emerge from various sources. Ethical dilemmas emerge when the accountant has to consider two or more seem like incompatible ethical obligations. For example: he may be asked by a manager to cover certain matters that would have an adverse impact on the financial accounts of an organisation, there by testing the accountant's loyalty to his manager on the one hand, and his responsibilities as a professional accountant on the other.

Professional accountants in business are often involved in the preparation and reporting of information that may be either made public or used by others inside or outside the employing organisation. Such information may include financial or management information, for exemple, financial statements, the management letter of representation provided to the auditors during the audit of the entity's financial statements. The information must be prepared or presented fairly, honestly and in accordance with relevant professional standards such as IAS 1 "Presentation of financial statements" and must not be the subject of conflict of interest.

According to the International Federation of Accountants, a professional accountant in business shall take reasonable steps to maintain information for which the professional accountant in business is responsible in a manner that describes clearly the true nature of business transactions, assets or liabilities, classifies and records information in a timely and proper manner and represents the facts accurately and completely in all material respects.

The IFAC Code offers a frame work through which ethical dilemmas such as conflict of interest, may bead dressed. When faced with ethical struggle, the decision-taker shouldconsider the fact of the situation, the ethical principles involved, related fundamental principles, the alternative courses of action, consequences of each alternative course of action.

4. Big Four companies - a conflict of interest between auditing and consulting?

A tension between auditing and consulting was identified and criticised before the Enron scandal, but it was only after the collapse of Enron and WorldComthat practices and codes of conduct changed to address it. Enron was considered the evidence which indicatesthat the profession had reached a stage where commercial interests simply over-whelmed allegiance to professional integrity. A set of rules issued by the Securities and Exchange Commission were implemented in US in order to avoid ethical problems. Auditors were barred from providing most non-audit services to firms they audit. In other countries, however, the rules are less strict.

For exemple, in Great Britain, firms can perform internal audit for a company while also performing its traditional external audit. Some academics argue that doing an internal audit makes an auditor more knowledgeable about a client, and therefore a better external auditor. In the same time, the Institute of Internal Auditors, a global industry body, disagrees, saying that this situation has the potential to cause serious conflicts of interest. This situation concerns mostly Big Four companies which, even if they have policies and procedures in place to support audit quality, they still encounter conflict of interest problems.

In order to ensure independence, the audit of companies must be carried out by accountants and accountancy firms who provide no other financial services to the company, are not investors in or directors of the company and are free of any appearance suggesting to a reasonable person a loss of objectivity. An audit is supposed to bea cold-eyed outsider's look at a company's finance. For an auditor to provide its client with accounting advice or reviews of internal controls involves a closeness that can cause, for exemple, biased financial statements.

5. Conclusion

The issue of the conflict of interest in the private sector carries a high degree of importance. Decisions taken by management will indubitably reflect on the company's performance and ultimately will underpin the shareholders' wealth. Taking business decisions under a strong conflict of interest will ultimately lead to unfair or biased results.Therefore, a conflict of interest can cause serious repercussions.

It is obvious that favour one's interests over general interests has both moral and economic consequences. It generates financial losses for the company in favour of those who have not comply with the rules: financial costs, loss of investors'confidence.

The financial crisis revealed, among others, the influence of conflict of interest over acompany's activity. Big Four companies were spotted due to their related activities. The European Commission implemented a set of rules intended to avoid conflict of interest as well as detailed guidance in order to mitigate the threats linked to independence principles, similar to other international normes.

The end goal of these rules are to ensure a true and unbiased view of the financial statements.

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