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The International Ethics Standards Board for Accountants
545 Fifth Avenue, 14th Floor
New York, 10017
United States of America

Dear Members of the International Ethics Standards Board for Accountants

EXPOSURE DRAFT – PROPOSED REVISIONS PERTAINING TO SAFEGUARDS IN THE CODE – PHASE 1

Thank you for the opportunity to provide comments on the International Ethics Standards Board for Accountants (IESBA) Exposure Draft – *Proposed Revisions Pertaining to Safeguards in the Code – Phase 1* (the Exposure Draft).

Appendix 1 to our submission responds to the questions listed in the Explanatory Memorandum dated December 2015.

We are pleased that the IESBA has taken the opportunity to re-examine the application of safeguards, which is a fundamental aspect to the proper application of the *Code of Ethics for Professional Accountants* (the Code). In addition to our responses to the questions in the Explanatory Memorandum, we would like to raise some additional matters for your consideration.

We have long held the view that adhering to the fundamental principles in the Code is absolutely essential if professional accountants are to carry out, and are seen to carry out, their public interest obligations. Previous submissions that we have made have focused on the topic of auditor independence. In those submissions, we have encouraged the IESBA to require a higher standard to be met when auditors apply the 'independence in appearance' test. Because the 'independence in appearance' test is essentially the same as the 'reasonable and informed third party' test that is being promulgated in the Exposure Draft, we have a particular interest in the way this test is described and how it might be applied in practice.

The additional matters we raise for your attention are as follows:

Should the same 'Acceptable Level' be applied to all of the Fundamental Principles in the Code?

The Code requires professional accountants to comply with the following fundamental principles:

- Integrity;
- Objectivity;
- Competence and Due Care;
- Confidentiality; and
- Professional Behaviour.

Our focus has been on objectivity, with a particular emphasis on the independence of the auditor. However, in reflecting on all of the fundamental principles, it is clear to us that the same 'acceptable level' or standard should be applied to all of the fundamental principles.

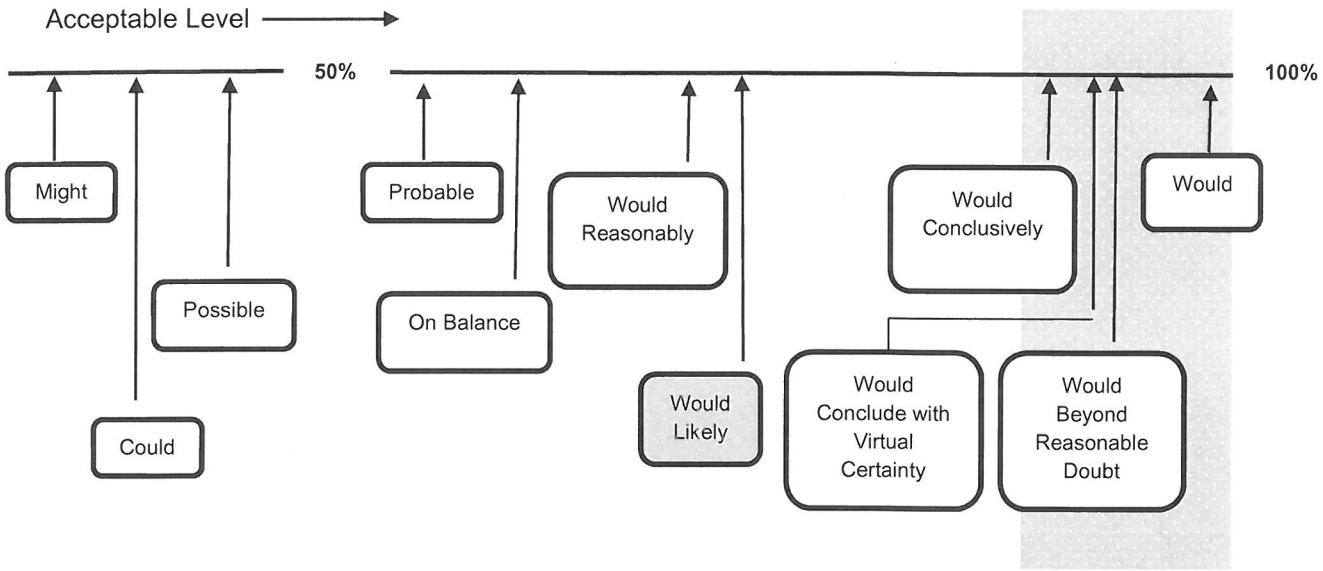
Because professional accountants are acting in the public interest, in our view there is no doubt that the 'acceptable level' should be set at a high level. Our view is based on the importance of professional accountants' public interest obligations, which requires having the trust of those parties who rely on professional accountants' work and opinions.

Is the proposed 'acceptable level' appropriate?

To act in the public interest, professional accountants must apply a very high standard (or 'acceptable level') when assessing if they comply with the fundamental principles. For example, the auditor gives the capital markets credibility by providing assurance as to the reliability of audited information. In turn this provides investors, and potential investors, with a sound basis for making investment decisions. It has been argued that the standards that auditors must apply to themselves in assessing their ability to carry out audits is similar to the standards that the judiciary must apply in deciding whether they can sit in judgement on a case without bias.[1]

In our opinion, the 'acceptable level' that is proposed in the Exposure Draft when applying the 'reasonable and informed third party' test is too low. The Exposure Draft asks the auditor to place themselves in the shoes of a 'reasonable and informed third party' and to assess if a reasonable and informed third party 'would likely' conclude that the fundamental principles have been complied with.

We admit that any 'acceptable level' test will always be subject to ambiguity, but we would argue that a more demanding 'acceptable level' is needed, given the trust that a professional accountant must assume when acting in the public interest. Although we don't have a strong view on the wording that should be used in setting the 'acceptable level', there are a number of more appropriate alternatives that could be used. We have attempted to describe the alternatives in the following diagram.



In our opinion, the 'acceptable level' should be in the range of 'Would Conclusively', 'Would Conclude with Virtual Certainty', 'Would Beyond Reasonable Doubt' and 'Would'. Our argument for supporting a more rigorous 'acceptable level' test is also based on the fact that all information needed to apply the test is known to the professional accountant. There is no risk that conclusions are based on incomplete or unreliable information.

[1] See the extract from the April 2003 Report of the HIH Royal Commission in Australia on the Audit Function in Appendix 2 to this submission. The specific recommendation that auditors should apply a 'freedom from bias' test similar to that used by the judiciary is highlighted on page 14 in Appendix 2 to this submission.

Is the process for assessing the 'Acceptable Level' when applying the 'Reasonable and Informed Third Party' test appropriate?

In applying the 'reasonable and informed third party' test, the professional accountant is placed in the almost impossible position of being asked to be judge, jury and executioner in their own trial. The stakes are high because the professional accountant is required to act in the public interest.

If we apply the rules used by the judiciary in deciding if there is bias, then any cause for doubt will disqualify them from sitting in judgement of a case. Such decisions are made on the grounds of 'appearance' as much as they are on 'fact'.

Critical to the application of the 'reasonable and informed third party' test is whether the information that is known and used by the professional accountant is available to those who are reliant on the professional accountant's work and conclusions. While the standard continues to allow the professional accountant to be the judge in their own court, it seems entirely reasonable that all of the information the professional accountant has used in making their decision is disclosed publicly.

Professional accountants continue to attract criticism when undisclosed circumstances are subsequently discovered. This usually occurs after deficiencies have been found in the work or actions of a professional accountant. If professional accountants are acting in the public interest then there is no reason for them not to fully disclose all of the facts they have used in making their decisions when applying the 'reasonable and informed third party' test.

There is an added dimension that applies to commercial firms of professional accountants in applying the 'reasonable and informed third party' test and that relates to the provision of other services, over and above the firm's public interest activities. This is a complication not faced by the judiciary in making their decision as to whether they can sit in judgement of a case. The profit motive of commercial firms of professional accountants does not sit comfortably with firms' public interest obligations, particularly in the eyes of those who rely on the work and conclusions of the professional accountant. This fact raises questions about the credibility of the 'reasonable and informed third party' test when it is exercised in the context of commercial pressures.

If a higher 'acceptable level' is required (and we would strongly argue that this is necessary), any doubt over the ability of a professional accountant to satisfy the 'reasonable and informed third party' test would result in them either disqualifying themselves from accepting the public interest engagement, or removing the threat to the fundamental principle.

If, under a higher 'acceptable level' regime, it is determined that a threat exists but there is doubt over whether the threat compromises a fundamental principle, it may be appropriate for a firm to introduce an 'independent process' to decide on the application of the 'reasonable and informed third party' test. Without detailing how such a process might operate it may, for example, consist of a panel of several individuals who are sufficiently independent as to have credibility in the eyes of those who will place reliance on the professional accountant's work and opinions.

Does the Internal Separation Safeguard satisfy the 'Reasonable and Informed Third Party' test?

Based on our arguments under the previous heading, we would strongly suggest that the traditional internal separation safeguard (for example, where different partners and engagement teams with separate reporting lines within the same firm provide non-assurance services) does not satisfy the 'reasonable and informed third party' test.

If you have any questions about our submission, please contact Roy Glass (roy.glass@oag.govt.nz) or me.

Yours sincerely

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Appendix 1 - Our Responses to the IESBA Questions in the Exposure Draft

Proposed Revisions to the Conceptual Framework

1. *Do respondents support the Board's proposed revisions to the extant Code pertaining to the conceptual framework, including the proposed requirements and application material related to:*

   (a) *Identifying threats;*

   Yes.

   (b) *Evaluating threats;*

   No. As discussed in our covering letter we consider the 'acceptable level' is too low.

   (c) *Addressing threats;*

   No. If the 'acceptable level' is higher (as we believe it should be) then the approach to addressing threats will need to change.

   (d) *Re-evaluating threats; and*

   We agree that threats need to be re-evaluated as new circumstances arise.

   (e) *The overall assessment*

   We consider the requirement in paragraph R120.9 should be supported by application guidance that indicates when the overall assessment should be carried out. We would presume the overall assessment should be carried out:

   - Before any work is commenced; and
   - When new information becomes available or when new circumstances arise that indicate a threat to the fundamental principles.

Proposed Revised Descriptions of "Reasonable and Informed Third Party" and "Acceptable Level"

2. *Do respondents support the proposed revisions aimed at clarifying the concepts of (a) "reasonable and informed third party;" and (b) "acceptable level" in the Code. If not, why not?*

   We support the change that expresses the 'acceptable level' in the positive, rather than the negative. The expression in the negative causes confusion under the existing Code.

   However, we consider further improvements are required so that there is greater transparency over the application of the 'reasonable and informed third party' test, and in requiring the 'acceptable level' to be at a higher standard. Our suggestions on both of these matters (in our covering letter) reflect our view that greater transparency and a higher standard is needed if professional accountants are to properly meet their public interest responsibilities.

Proposed Revised Description of Safeguards

3. *Do respondents support the proposed description of "safeguards?" If not, why not?*

The definition of safeguards, as defined in paragraph 120.7.A2 appears to be reasonable. However, the availability of safeguards will be significantly reduced under a higher 'acceptable level' regime.

4. *Do respondents agree with the IESBA's conclusions that "safeguards created by the profession or legislation," "safeguards in the work environment," and "safeguards implemented by the entity" in the extant Code:*

(a) Do not meet the proposed description of safeguards in this ED?

Yes.

(b) Are better characterized as "conditions, policies and procedures that affect the professional accountant's identification and potentially the evaluation of threats as discussed in paragraphs 26–28 of this Explanatory Memorandum?"

Yes.

Proposals for Professional Accountants in Public Practice

5. *Do respondents agree with the IESBA's approach to the revisions in proposed Section 300 for professional accountants in public practice? If not, why not and what suggestions for an alternative approach do respondents have that they believe would be more appropriate?*

In addition to the pervasive matters identified in our covering letter, we have several comments to make on the revisions to proposed Section 300.

Paragraph 300.2 A3	At a conceptual level, we have some difficulty in distinguishing between the entity in para 300.2 A3 (a) and the entity in para 300.2 A3 (b). In our view, the threat will be the same if we accept that assurance is a public interest activity.
Paragraphs 300.2 A4, A5 and A6	Evaluating the threats identified in these paragraphs, in the context of the reasonable and informed third party test presents particular challenges. We have discussed the application of this test in our covering letter, and have suggested that the 'acceptable level' as it is currently expressed in the Exposure Draft is too low.
Paragraph 300.2 A9	In our view, a number of these safeguards do not satisfy the reasonable and informed third party test. The reasons for our view are set out in our covering letter.

Request for General Comments

8. *In addition to the request for specific comments above, the IESBA is also seeking comments on the matters set out below:*

   (a) *Small and Medium Practices (SMPs) – The IESBA invites comments regarding the impact of the proposed changes for SMPs.*

   New Zealand is a small country with a population of less than 5 million people. New Zealand is dominated by SMPs, and our responses to the questions raised by the IESBA reflect a SMP perspective.

   (b) *Developing Nations—Recognizing that many developing nations have adopted or are in the process of adopting the Code, the IESBA invites respondents from these nations to comment on the proposals, and in particular, on any foreseeable difficulties in applying them in their environment.*

   Developing nations face difficulties in applying the requirements of the Code when both auditing and financial reporting expertise is in short supply.

   (c) *Translations—Recognizing that many respondents may intend to translate the final pronouncement for adoption in their environments, the IESBA welcomes comment on potential translation issues respondents may note in reviewing the proposals.*

   We have no comments to make on potential translation issues.

Appendix 2: Extract from the April 2003 Report of the HIH Royal Commission in Australia on the Audit Function[2]

7.2 The audit function

It is the responsibility of the directors of a company to produce accounts that are in accordance with the requirements of the *Corporations Act 2001*. The financial reports prepared by the directors must be in accordance with accounting standards (s. 296) and must present a true and fair view of the financial position and performance of the company (s. 297).

The financial reporting system is underpinned in the case of public and large private companies by a requirement that their accounts be audited by a registered auditor. A company has to obtain from its auditor a report to shareholders on whether its financial report is in accordance with those requirements of the Corporations Act.

While the auditor's services are normally procured by a company's board or management, the appointment of the auditor is a matter for the annual general meeting.[30] Once appointed the auditor holds office until death, removal or resignation from office.[31] An auditor can be removed by resolution of the company in general meeting[32]or can resign as auditor of the company with the consent of ASIC.[33]

As a practical matter great store is placed by directors, as well as by shareholders, creditors and others with an interest in the financial position of a company, in the fact that its accounts have been audited. The fact remains however that a company's financial report is the responsibility of the directors by whom it is signed and presented.

The point of an audit is to provide independent assurance of the integrity of the way in which the company has reported. It follows that shareholders in particular have an interest in the proper functioning of the audit process as it provides them with comfort in making investment decisions. This element of assurance is of course also relevant to the directors themselves, so far as they rely on management in the preparation of the accounts as well as to others with an interest.

Recent high-profile corporate collapses, including that of HIH, have given rise to public concerns about the efficacy of the audit function, as well as about other aspects of the financial reporting system. These concerns in turn have led to a series of reports and proposals for changes in this area.

In September 2002 the Commonwealth Government issued a chapter of its Corporate Law Economic Reform Program entitled 'Corporate disclosure— Strengthening the Financial Reporting Framework'. CLERP 9, as it is known, set out a series of reform proposals with a view to achieving further improvement in audit regulation and the wider corporate disclosure framework. An earlier report to the Minister for Financial Services and Regulation entitled 'Independence of Australian Company Auditors. Review of Current Australian Requirements and Proposals for Reform' by Professor Ian Ramsay in October 2001 was followed by Report 391 of the Joint Standing Committee on Public Accounts and Audit 'Review of Independent Auditing by Registered Company Auditors' in August 2002.

My inquiry into the failure of HIH necessarily dealt with HIH's audit process and the role of its auditor. Drawing on that experience as well as other developments I turn to policy questions relevant to the audit function.

7.2.1 Auditor independence

Auditor independence is a critical element going to the credibility and reliability of an auditor's reports.[34] Audited financial statements play a key role promoting the efficiency of capital markets and the independent auditor constitutes the principal external check on the integrity of financial statements.[35] The Ramsay report recognised the following four functions of an independent audit in relation to capital market efficiency[36]:

- adding value to financial statements

[2] The full report was available on-line at www.hihroyal com.gov.au/ This website no longer appears to be active.

- adding value to the capital markets by enhancing the credibility of financial statements
- enhancing the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements
- assisting to lower the cost of capital to those using audited financial statements by reducing information risk.

In addition to the above functions noted in the Ramsay report, an independent audit contributes to capital market efficiency by enhancing the consistency and comparability of reported financial information in Australia.

It is widely accepted that the auditor must be, and be seen to be, free of any interest which is incompatible with objectivity.[37] There must be public confidence in the auditor for an audit to fulfil its functions.

The responsibility of auditors to maintain independence in the carrying out of their function was stated by the US Supreme Court:

> The independent public accountant performing this special function owes allegiance to the corporation's creditors and stockholders, as well as the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[38]

In the absence of a competently and independently performed audit, there is increased risk to the efficiency of capital markets. There is a danger that the audit report will lure users into a false sense of security that there has been an independent scrutiny of the financial report when there has not.

While auditors perform a statutory function, the work is generally carried out by private professional services firms. Although it is the shareholders to whom the audit report is addressed, and it is the shareholders who usually appoint and remove the auditor, it is management who have the day-to-day interaction with the auditor. The processes of appointment and removal of an auditor will generally follow the recommendations of management.

CLERP 9 noted these factors may lead to apparent conflicts for auditors:

- the audit function has a significant public interest element, yet auditors are paid by the entity they are overseeing (management)
- there is a personal relationship between auditor and client
- audit partners, managers and staff may have career and financial incentives to comply with audit client wishes on the presentation of financial reports
- lower level audit staff may have career and financial incentives to acquiesce in audit partner wishes
- audit staff may see themselves more as business consultants
- audit firms rely on non-audit services for their revenue and profit growth
- corporate clients may view audit as a dead compliance cost and want to capitalise on the knowledge of audit firm professionals.[39]

CLERP 9 stated that the difficulties which arise from these matters are that:

- only company management has direct fee payment, contract and personal contact relationships with the auditor
- other incentives such as regulatory penalties, professional rules, the protection of auditor reputation, and personal career development may in some cases not be as strong as those relationships
- this can lead to market perceptions of auditors acting for profit rather than the public interest.[40]

Regulation of audit independence

The current regulation of audit independence derives from:

- the Corporations Act 2001
- professional standards and guidance issued by the professional accounting bodies.

The relevant requirements of the Corporations Act are concerned with such matters as indebtedness and employment relationships between a company and its auditor.[41] These provisions are directed to specific indicia of independence.

The standards and guidance issued by the professional accounting bodies are more comprehensive. The enforcement of these requirements is generally undertaken by the professional bodies themselves.

Reform proposals

Various definitions and tests of audit independence have been proposed in the current round of reform proposals including by the Ramsay report and the JSCPAA report.

Paragraph 10 of Professional Statement F1 'Professional Independence' issued by the Institute of Chartered Accountants and CPA Australia states:

> In determining whether a member in public practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of the relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, *could conclude* that the member has placed himself or herself in a position where his or her objectivity *would or could be impaired*. [emphasis added]

In contrast, the definition of independence contained in paragraph 14 of Professional Statement F1 is:

> (a) *Independence* of mind—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and
>
> (b) *Independence* in appearance—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, *would reasonably conclude* a *firm's*, or a member of the *firm's*, integrity, objectivity or professional scepticism *had been compromised*. [emphasis added]

The two definitions contained within Professional Statement F1 are inconsistent. It can be seen that the definition in paragraph 14 contains a test that requires a higher standard of certainty as to the compromise of independence than does the test in paragraph 10.

In CLERP 9 the Commonwealth Government put forward a proposal to amend the Corporations Actto include a general statement of principle requiring the independence of auditors:[42]

> The general statement of principle will also establish a general standard of independence that an auditor is not independent with respect to an audit client if the auditor *is not*, or a reasonable person with full knowledge of all relevant facts and circumstances *would conclude* that the auditor *is not*, *capable* of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent all relevant circumstances should be considered, including all relationships between the auditor and audit client. [emphasis added][43]

CLERP 9 further proposed that the law be amended to require the auditor to make an annual declaration, addressed to the board of directors, that the auditor has maintained independence in accordance with the Corporations Act and the rules of the professional accounting bodies.[44]

Difficulties with CLERP 9 proposals

In my opinion, there are certain difficulties inherent in the standard of independence proposed in CLERP 9. The proposed standard of independence requires the independence of 'the auditor'. It will be important to clarify in the Corporations Act that the requirement of audit independence applies equally to both individual auditors and their firm (if any). Since both the individual auditor and the firm sign the audit report[45], it follows that both should be required to be, and be seen to be, independent. There may be some circumstances where one is independent, but the other is not. For example, I have discussed in Chapter 21 the change of the HIH audit engagement partner in 1999. Despite my conclusion that the circumstances surrounding that change gave rise to the perception that Andersen was not independent, I drew no such conclusion in relation to the new engagement partner's actual independence as a result of his appointment.

The proposed standard of independence in CLERP 9 imposes a high standard of certainty of the lack of independence by requiring that a reasonable person *would conclude* that the auditor is not independent. That test appears to require a higher degree of satisfaction than is required in civil proceedings. In my opinion, the high standard adopted in the CLERP 9 proposals does not pay sufficient regard to the importance of auditors being seen to be exercising impartial and objective judgment. For reasons that are discussed below, I consider that the importance of audit independence is such that the test should be stated in terms of *might* rather than *would*. Neither CLERP 9, the Ramsay report nor SEC Rule 210-01 (upon which the proposed definition is based) provide any explanation for or discussion of the high standard of the proposed definition. I am proposing an alternative standard of audit independence which deals with the difficulties I perceive in the CLERP 9 proposals.

Matters for an audit independence standard

In framing an alternative standard of audit independence, there is a particular need to consider: the difficulty of identifying any actual breach of independence; the manner in which the auditor undertakes his or her task; the interaction between the company, users of the financial reports and regulatory bodies; and the relationship an auditor has with management.

Inadequate independence on the part of an auditor will usually be difficult to discern. Suspicions might be excited but definite conclusions could be drawn only in extreme circumstances. Rarely would an auditor deliberately or even consciously compromise their independence. More often, as was the case with HIH, the auditor will deny that their independence was in any way compromised, even where an objective consideration might point to the opposite conclusion. Rarely will there be unequivocal evidence that conclusively establishes for example a connection between influence exerted by management upon the auditor and the provision by the auditor of an unqualified audit opinion. The existence of such a connection from a range of surrounding circumstances can usually only be inferred.

The difficulties associated with identifying a compromise of audit independence are inherent in the nature of the audit process. Most of the decisions of an auditor are made behind closed doors, either internally within the audit firm or in conjunction with management. In the case of HIH only selected matters were taken to the audit committee because Andersen and HIH management often resolved issues before the audit committee meetings. Users of the financial statements are not aware of the reasons for the auditor's decisions nor the extent to which the auditor has relied on management representations. Nor are users of the financial statements aware of any pressure which might have been exerted on the auditor by management, such as obtaining an opinion from another audit firm on a technical issue which supports management's view that a judgmental or controversial item accords with accounting standards. Such an initiative by management may leave the auditor feeling constrained to accept that opinion and put aside his or her own opinion on the issue as being merely a difference of professional judgment.

In addition, the form of the audit certificate is largely standard and does not provide any reasoned analysis of the basis for the opinion expressed. Adopting the words of Brooking J in the *Phosphate Co-operative Co of Australia Ltd. v Shears (No.3)* case (which considered the independence of a report required to be prepared by an independent expert) '[t]he calm, reflective air of the report in no way suggests its long period of gestation or the travail which accompanied its birth'.

The users of the financial statements are not privy to the information that is received by the auditor or the process by which the auditor exercises skill and judgment to reach conclusions on that information. The company, users of the financial reports and regulatory bodies place significant reliance upon the

integrity of auditors. Auditors have an obligation to ensure that they are, and are seen to be, maintaining high standards of honesty and probity, acting in the interests of the shareholders of the company to whom they are reporting and exercising independence of mind to ensure that financial reports provide a true and fair view of the financial position and performance of the company.

Absent independence, shareholders, creditors and other users of the financial statements can have no assurance or comfort as to the truth or fairness of the financial report of the economic entity with which they deal. Such assurance adds value to capital market efficiency because it enhances the credibility of financial statements. It is in those circumstances that the *perception* that an auditor is independent takes on greater importance.

The primary purpose of the audit is to provide an independent and objective review of the company's financial statements. Corporate resources are expended on an audit for that purpose. An independent and objective audit, conducted with an appropriate degree of professional scepticism, is required. Management, in particular senior management, might have a natural interest in presenting the results of the company in the most favourable light and having the auditors sign off on that form of presentation. That interest of management can give rise to tension in the performance of an independent and objective review. In these circumstances, if the auditor is under pressure to conform with management's expectations, the rationale for the expenditure of corporate resources upon audit may be undermined. Where personal relationships between the auditor and management undermine professional independence and objectivity in any way, good corporate governance is imperilled.

In light of the above, it is critical that the auditor should be seen to be exercising impartial and objective judgment in addition to the actual exercise of that impartial and objective judgment. Any standard of audit independence must reflect this requirement.

Further, the difficulties referred to in discerning any actual lack of independence, coupled with a reluctance on the part of auditors to confront their own lack of independence, supports the introduction of an objective standard of independence. The CLERP 9 proposals acknowledge the need for such an objective standard.

Other models for dealing with conflict

The issue of audit independence does not normally arise in the course of litigation. Where an audit is undertaken incompetently it is often said that a lack of independence adds nothing to what is otherwise a complete cause of action based upon a breach of duty. Where an audit is not undertaken incompetently, a lack of independence will not cause any loss of itself.

There are many situations where the law imposes obligations upon people who face conflicts between their interests and their duties. In determining what I consider to be an appropriate standard of audit independence I have had regard to certain of those situations, namely the imposition of fiduciary obligations, the independence of directors, requirements in respect of related party transactions, and disqualification of members of the judiciary on the grounds of bias or apprehended bias, which are discussed below.

Fiduciary obligations
The primary elements of a fiduciary relationship are that:

- the fiduciary has undertaken to act in the interests of another
- that undertaking gives to the fiduciary the power to affect the interests of the other party
- the person to whom the fiduciary duty is owed is vulnerable to the fiduciary's abuse of his or her position.[46]

The vulnerability of one party to the other party with power or discretion was emphasised by Dawson J in *Hospital Products Ltd v United States Surgical Corp:*

> There is, however, the notion underlying all the cases of fiduciary obligation that inherent in the nature of the relationship itself is a position of disadvantage or vulnerability on the part of one of the parties which causes him to place reliance on the other and requires the protection of equity acting upon the conscience of that other.[47]

Vulnerable in this context does not mean intrinsic weakness but rather disadvantage due to the superior knowledge or power of the trusted party.[48] A fiduciary relationship exists where one party is in a position of reliance upon the other because of the nature of the relationship.[49]

It has been said that there are three purposes of the law of fiduciary obligations, namely:

- the maintenance of high standards of honesty and propriety by those who are under a duty to act in the interests of others
- the confiscation of gains arising from the abuse of a relationship of trust
- the protection of one person's reasonable expectations that the other will act in her or his interests, and not in pursuance of a contrary self-interest or conflicting duty.[50]

The fiduciary has a duty to account to the person to whom the fiduciary obligation is owed for any benefit or gain:

- which has been obtained or received in circumstances where a conflict or significant possibility of conflict existed between the fiduciary's duty and their personal interest in the pursuit or possible receipt of such a benefit or gain
- which was obtained or received by use or by reason of the fiduciary's position or by reason of opportunity or knowledge resulting from the position.[51]

As Lord Herschell stated in *Bray v Ford*[52] in relation to the conflict between duty and interest:

> It is an inflexible rule of a Court of Equity that a person in a fiduciary position is not, unless expressly otherwise provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is founded upon principles of morality. I regard it rather as based on the consideration that human nature being what it is, there is a danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect.

Several tests have been proposed to determine whether a fiduciary has a conflict of interest, including whether there is a 'real sensible possibility of conflict'[53], or a 'significant possibility of conflict' between duty and interest.[54]

Directors
In addition to the fiduciary obligations of a director discussed above, directors also have a statutory obligation to avoid conflicts of interest and duty.

Related Parties
Chapter 2E of the Corporations Act requires that transactions between a public company and any related party[55] that give a financial benefit to the related party on other than arm's length terms be approved by the company's shareholders. The purpose of the chapter is to protect the interests of a public company's shareholders as a whole, by requiring shareholder approval for giving financial benefits to related parties that could endanger those interests.[56]

In order for shareholders to make an informed decision about the related party transaction, the company is required to distribute an explanatory statement which sets out certain specified information.[57]

Judicial bias

The test laid down by the High Court to determine whether a judge is disqualified by reason of the appearance of bias is whether a fair-minded lay observer might reasonably apprehend that the judge might not bring an impartial and unprejudiced mind to the resolution of the question the judge is required to decide.[58]

The majority of the High Court stated:

> That test has been adopted, in preference to a differently expressed test that has been applied in England, for the reason that it gives due recognition to the fundamental principle that justice must both be done, and be seen to be done. It is based upon the need for public confidence in the administration of justice. 'If fair-minded people reasonably apprehend or suspect that the tribunal has prejudged the case, they cannot have confidence in the decision.' The hypothetical reasonable observer of the judge's conduct is postulated in order to emphasise that the test is objective, is founded in the need for public confidence in the judiciary, and is not based purely upon the assessment of some judges of the capacity or performance of their colleagues.[59]

The parties to the litigation in question can waive an objection on the ground of bias, even where it is a question of the public apprehension of bias.[60]

ASX Corporate Governance Council—Test for independent directors

By way of comparison, the ASX Corporate Governance Council has defined an independent director as one who is independent of management and free from any business or other relationship that could materially interfere with, or could reasonably be perceived to materially interfere with, the director's ability to act in the best interests of the company.

Proposed standard of audit independence

I have concluded that a general standard of independence for auditors should be adapted from the test laid down to determine whether a judge is disqualified by reason of the appearance of bias. While judges and auditors perform different functions there is a common element. Both functions involve an exercise of judgment which results in the public expression of an important opinion which is capable of affecting society widely.

Just as the requirement that a judge be seen to be free from bias is based on a need for public confidence in the administration of justice[61], the requirement that an auditor be seen to be independent is based on a need for public confidence in the credibility and reliability of reported financial information.[62]

Recommendation 9

I recommend that all standards of independence of auditors in Australia, including those contained in legislation and professional standards such as Professional Statement F1, be consistent with the standard of independence defined as follows:

- An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor's exercise of objective and impartial judgment on all matters arising out of the auditor's engagement.

- A reference to an auditor includes both an individual auditor and an audit firm. In determining whether an auditor or an audit firm is independent, all relevant circumstances should be considered, including all pre-existing relationships between the auditor, the audit firm and the audit client, including its management and directors.