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20 February 2015

File Ref: OW/XGF/2-0004
AU/APS/6-0012

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

CONSULTATION PAPER – IMPROVING THE STRUCTURE OF THE CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

Thank you for the opportunity to provide comments on the International Ethics Standards Board for Accountants (IESBA) Consultation Paper – *Improving the Structure of the Code of Ethics for Professional Accountants* (the Consultation Paper).

The primary purpose of our submission is to reiterate our concern that the standard of independence over the provision of assurance engagements in the *Code of Ethics for Professional Accountants* (the Code) is too low. Furthermore we are concerned that the examples in the Code that illustrate the application of the fundamental principle of objectivity, as it applies to independence, are inconsistent with the fundamental principle itself.

We note that the purpose of the Consultation Paper is to seek comments on the proposal to review the presentation of the Code, rather than to address the content (and hence the meaning) of the Code.

Rather than repeat our concerns in full in this letter, we have attached a copy of an earlier submission (dated 3 May 2007) that sets out a number of fundamental issues we have with the Code.

We have also responded to the questions in the Consultation Paper in the Appendix to this letter.

If you have any questions about our submission, please contact me at roy.glass@oag.govt.nz.

Yours sincerely

Roy Glass
Director - Auditing Policy
Office of the Controller and Auditor-General of New Zealand

Appendix - Our Specific Responses to the IESBA Questions in the Consultation Paper

1. *Do you believe that the approach outlined in this Consultation Paper, as reflected in the Illustrative Examples, would be likely to achieve IESBA's objective of making the Code more understandable? If not, why not and what other approaches might be taken?*

   Our comments are confined to the independence aspects of the Code.

   As noted in our covering letter we have significant concerns with the standard of independence required by the Code.

   We also consider the Code is too complicated. As a consequence there is a greater chance for the Code to be misapplied by professional accountants. Complexity is introduced through the identification of various situations (and accompanying guidance to assist in responding to those situations) that may lead to the dissipation of the fundamental principle, when the fundamental principle applies equally to every situation. Specifically, complexity is introduced by having separate independence requirements for:

   - Audits and reviews of financial statements (section 290) and other assurance engagements (section 291);
   - Assurance that is being provided to a specific party, and that party effectively waives the professional accountant's obligation to comply with the independence requirements of the Code; and
   - Public interest entities and other entities.

   Our preference would be to simplify the Code by removing the separate independence requirements and thereby reduce the complexity and the opportunity for misapplication.

2. *Do you believe that the approach outlined in this Consultation Paper, as reflected in the Illustrative Examples would be likely to make the Code more capable of being adopted into laws and regulations, effectively implemented and consistently applied? If not, why not and what other approaches might be taken?*

   We would contend that it is inappropriate to write the Code for the purpose of enabling it to be legally enforceable. The proper application of the fundamental principles requires the professional accountant to exercise professional judgement, at a point in time in the context of a particular situation. Often there is no one 'correct' answer to a situation. Instead the professional accountant will take account of the independence threats, and relevant contextual information, in developing a response that 'on balance' is considered to be appropriate.

   Effective legal enforcement typically relies on there being an obvious response to a situation, whereas it is often the presence of a robust process to develop an appropriate response that is the critical consideration to be taken into account when assessing compliance with the Code.

   In summary, it is our view that the Code does not lend itself to legal enforceability when the proper application of the Code requires the application of professional judgement. The exception to this is when the professional accountant has obviously ignored the requirements of the Code.

3. *Do you have any comments on the suggestions as to the numbering and ordering of the content of the Code (including reversing the order of extant Part B and Part C), as set out in paragraph 20 of the Consultation Paper?*

   We have no comments to make.

4. *Do you believe that issuing the provisions in the Code as separate standards or rebranding the Code, for example as International Standards on Ethics, would achieve benefits such as improving the visibility or enforceability of the Code?*

   We have no comments to make.

5. *Do you believe that the suggestions as to use of language, as reflected in the Illustrative Examples, are helpful? If not, why not?*

   We have no comments to make.

6. *Do you consider it is necessary to clarify responsibility in the Code? If so, do you consider that the illustrative approach to responsibility is an appropriate means to enhance the usability and enforceability of the Code? If not, what other approach would you recommend?*

   Refer to our comments in response to question 2.

7. *Do you find the examples of responsible individuals illustrated in paragraph 33 useful?*

   Refer to our comments in response to question 2.

8. *Do you have any comments on the suggestions for an electronic version of the Code, including which aspects might be particularly helpful in practice?*

   The Code requires a professional accountant to exercise their professional judgement on the appropriate application of a fundamental principle.

   Enabling the Code to be adapted to particular situations is an implied acknowledgement of the complexity of the Code. As noted in our response to question 1, it is our opinion that the Code should be simplified.

   Furthermore, a facility that would enable the Code to be adapted to particular situations may encourage an approach to resolving situations that 'unless a matter is expressly prohibited, it is permitted'. The Code specifically requires professional accountants not to take this approach.

9. *Do you have any comments on the indicative timeline described in Section VIII of this Paper?*

We have no comments to make.

10. *Do you have any other comments on the matters set out in the Consultation Paper?*

Our primary concerns are set out in our covering letter, and are expanded in our earlier submission on the Code dated 3 May 2007 (copy attached).

3 May 2007 File Ref: PS32-0001

Senior Technical Manager
International Ethics Standards Board for Accountants
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017
USA

Dear Sir/Madam

1 PROPOSED REVISED SECTION 290 OF THE CODE OF ETHICS AND PROPOSED NEW SECTION 291 OF THE CODE OF ETHICS (ISSUED DECEMBER 2006)

Thank you for providing the opportunity to comment on the proposed revision of Section 290 of the Code of Ethics and the new Section 291 of the Code of Ethics issued in December 2006 (the Exposure Draft).

Our submission is presented in 3 parts – as follows:

- Overall comments on the application of the approach to independence;
- Specific responses to the questions in the Explanatory Memorandum (in Attachment 1); and
- Detailed comments on the Exposure Draft (in Attachment 2).

Overall comments on the application of the approach to independence

We accept and support the conceptual framework underlying the approach to identify, evaluate and address threats to independence. In particular, we agree with the comment in paragraph 100.5 of the Code of Ethics which states:

"A conceptual framework that requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore in the public interest."

We strongly agree, as stated in paragraph 100.4 (b) of the Code of Ethics, that objectivity is a fundamental principle and that:

"A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments."

However, we are also of the view that independence is so fundamental to the accountancy profession that it deserves recognition as a fundamental principle in its own right – rather than being subsumed into the fundamental principle of objectivity.

Paragraphs 290.3 and 291.3 of the Exposure Draft provide the link back to the fundamental principle of objectivity by stating that it is in the public interest and, therefore, required by this Code of Ethics that members of audit and assurance teams, firms and network firms be independent of audit and assurance clients.

The conceptual approach is weakened by the application guidance

Whilst we support the conceptual framework to independence, we consider that the application of the conceptual framework fails to ensure that auditors and the providers of assurance engagements are both independent and seen to be independent. In our opinion the existing guidance in Section 290 of the Code of Ethics does not establish sufficiently high standards of independence. The changes proposed in the Exposure Draft introduce some minor improvements but fail to tackle what we regard as core independence considerations. We have significant concerns about two fundamental aspects underlying the conceptual approach being:

- the definition and application of "independence in appearance"; and
- the application of safeguards.

Both of these matters are discussed under the respective headings below.

In addition, we have a number of significant concerns of a conceptual nature on the proposals in the Exposure Draft relating to:

- the failure to recognise that threats to independence can arise through events unrelated to relationships with, or interests in, the audit or assurance client;
- a trend towards a rules oriented approach;
- the proposal to provide separate guidance on other assurance engagements in new Section 291; and
- the proposal to provide further independence requirements to differentiate entities of significant public interest from other entities.

These matters are also discussed under the respective headings below.

Definition and application of "independence in appearance"

We are concerned that the definition of "independence in appearance" does not establish a sufficiently high standard for this important dimension of independence.

We note that the definition of "independence in appearance" in the Exposure Draft has been amended to read:

"The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's or a member of the audit team's integrity, objectivity or professional scepticism has been compromised."

Despite the changes, we are concerned that the definition is not sufficiently robust to ensure that independence in appearance is adequately considered.

The inclusion of the highly subjective term *"so significant"* does not establish a sufficiently high or rigorous threshold to ensure that independence in appearance is maintained. Those applying the *"so significant"* test are required to discount all facts or circumstances unless they meet a level of significance that exceeds "normal" significance. This interpretation can be taken from the term *"so significant"*. It is our opinion, apart from the subjectivity in applying the *"so significant"* test, that this test will mean that many significant facts or circumstances will be eliminated and hence not considered as impacting on independence in appearance.

The definition also requires that a reasonable and informed third party *"would be likely to conclude"* that integrity, objectivity or professional scepticism has been compromised. The *"would be likely to conclude"* test is a relatively low standard in that the facts and circumstances must be persuasive before those applying the test would conclude independence in appearance had been impaired. In our opinion, the *"would be likely to conclude"* test does not establish a sufficiently high standard to ensure appropriate consideration is given to independence in appearance.

We agree in principle that the "appearance of independence" needs to be assessed from the perspective of a reasonable and informed third party. In the case of some of the specific examples considered in the Exposure Draft and the safeguards outlined in paragraphs 200.10 to 200.15 of the Code of Ethics, the informed third party would not have access to information about the safeguards which had led a firm to conclude independence in appearance had been not been impaired. To properly reflect the "appearance" dimension, we believe the focus should be on a third party informed with publicly available information.

The question of audit independence was considered in an April 2003 report of a Royal Commission in Australia following the collapse of HIH, a large Australian based insurance company. The report challenges the definition of independence in appearance and recommends that the standard to be met is whether a reasonable and informed third party might conclude that the auditor might be impaired. In our opinion, this is a more appropriate standard and we would, therefore, commend the IESBA to take account of the findings in the report. A copy of the section of the report that discusses the audit function is included as Attachment 3.

The application of safeguards

We have a concern that some of the safeguards included in paragraphs 200.10 to 200.15 of the Code of Ethics may assist in mitigating threats to "independence of mind", but do little to mitigate threats to "independence in appearance". An often suggested safeguard is to use personnel not associated with the assurance engagement to provide non-assurance services to an assurance client. This "Chinese walls" safeguard would not enable an informed third party to conclude that independence had not been impaired as they would not have knowledge of all relevant information - hence the "appearance

of independence" test would not be satisfied. In any event, the informed third party is unlikely to be persuaded that "Chinese walls" do achieve the desired level of independence given the tendency to focus on the firm as a whole.

We believe that the Code of Ethics would be more effective in its role of balancing the public interest and self-regulatory responsibilities of the profession with the interests of its members if it were to presume that any threats to independence should require the firm and the members of the assurance team to either eliminate the threat to independence or resign from the assurance engagement. If this approach is taken, the fundamental issue of preserving independence is given full prominence. The emphasis on safeguards, in our view, tends to encourage behaviour to circumvent or attempt to minimise any threats to independence. Such behaviour is inappropriate and should not be encouraged.

Furthermore, it appears that predominance has been given to the "state of mind" rather than the "appearance of independence" in the practical examples in Sections 290 and 291 of the Exposure Draft. For example, the examples in paragraphs 290.170 (valuation services) and 290.177 (preparation of tax calculations for financial reporting) of the Exposure Draft indicate that the provision of such services may be acceptable if performed by professionals who are not members of the audit team. This safeguard does not address the threat to "independence in appearance".

Failure to recognise that threats to independence can arise through events unrelated to relationships with, or interests in, the audit or assurance client

We would observe that the examples are limited to relationships or interests between the audit or assurance client and the firm and its personnel. Threats to independence can also arise when, for example, the firm engages with an entity that is unrelated to the audit or assurance client when that entity is contemplating entering into a significant transaction with the audit or assurance client. A typical example is when an audit client is disposing of a significant business unit. A member of the network firm may be asked to act for an entity that is contemplating purchasing the business unit. If such an engagement is entered into, the network firm will be conflicted because of its requirement to audit the vendor entity on one hand and of its obligation to maximise the economic benefits to the purchasing entity on the other hand. In our opinion, this is a situation that threatens independence in appearance to the extent that no safeguards could mitigate the threat.

In our view the Exposure Draft should be enhanced to alert the professional accountant that threats to independence may arise from circumstances and events that do not directly flow from relationships with, or interests in, the audit or assurance client.

Trend towards a rules oriented approach

We are concerned that, when developing the Exposure Draft, insufficient recognition has been given to the intent expressed in paragraph 100.5 of the Code of Ethics that it is in the public interest that a

professional accountant should identify, evaluate and address threats to compliance with the fundamental principles, rather than merely comply with a set of specific rules which may be arbitrary.

The guidance in the Exposure Draft is both voluminous and very detailed and there is a significant risk that this material may become a set of specific rules that may be inappropriately applied by professional accountants - without a proper appreciation of the fundamental principles. It is our opinion that the conceptual framework that is used to make judgements on independence matters is not sufficiently robust (for instance, in assessing threats to "independence in appearance" and in the application of safeguards) to ensure appropriate and consistent standards of independence are maintained. If the key matters that influence the application of the conceptual framework were clearer and unambiguous we believe that there would be less need for lengthy guidance material. This is because most facts and circumstances would be readily addressed by reference to matters of principle.

Provision of separate guidance on other assurance engagements in new section 291

Following on from our comments above on the possible trend towards a rules oriented approach, we are of the opinion that the provision of separate guidance on other assurance engagements is unnecessary. This is because it is not possible to anticipate every fact or circumstance that may threaten independence and the better approach to remove or mitigate threats to independence is by reference to principles. The principles do not vary with the nature of the engagement and, for this reason, it is preferable that the guidance on independence is contained within one section of the Code of Ethics.

We are also of the opinion that the split between audit and review (in Section 290) and other assurance engagements (in Section 291) is quite arbitrary. As a consequence there is a risk that the lesser guidance material in Section 291 may be inappropriately applied. For example, Section 290 is limited to audits and reviews of historical financial information. If an auditor is requested to examine and report on prospective financial information to be included in a prospectus document they would likely refer to the guidance material in Section 291 when considering independence matters. In this instance it is our opinion that reference to Section 291 would be inappropriate and it is the guidance material in Section 290 that should be referred to.

Provision of further independence requirements to differentiate entities of significant public interest from other entities

We agree that it is appropriate to extend the key audit partner rotation provisions to entities of significant public interest. We also agree that engagement quality control review should be extended to entities of significant public interest. Both of these measures are legitimate quality control responses to audits of entities of significant public interest and are quite different in nature to the changes proposed in the Exposure Draft.

The proposed changes in the Exposure Draft tend to relate to the provision of non-assurance services to audit clients such as valuation services, taxation services and IT systems services. Conceptually, given the nature of non-assurance services, it is very difficult to explain why it is possible to provide one level of service to an entity of significant public interest and another level of service to an other entity and assert that consistent standards of independence have been maintained. It is our opinion that the guidance in the Exposure Draft should apply equally to all audits – unless additional quality control measures are required for entities of significant public interest.

The opportunity to provide comment is appreciated and I trust you will find our comments useful.

Yours sincerely

Kevin Brady

ATTACHMENT 1: SPECIFIC RESPONSES TO THE QUESTIONS IN THE EXPLANATORY MEMORANDUM

1. *Is it appropriate to extend all of the listed entity provisions to entities of significant public interest?*

   We agree that it is appropriate to extend the key audit partner rotation provisions to entities of significant public interest. We also agree that engagement quality control review should be extended to entities of significant public interest. These are quality control measures and can be readily distinguished from the new differential independence provisions that are proposed in the Exposure Draft.

   We consider that it is inappropriate, as a matter of principle, for the Exposure Draft to establish different independence provisions – particularly in respect of the provision of non-assurance services to audit clients. Instead, we would prefer that the Exposure Draft emphasise that the standards of independence apply equally to all audits.

   We have also raised our concerns with the differential independence proposals in the Exposure Draft in the covering letter.

2. *Is it appropriate to eliminate the flexibility for small firms to apply alternative safeguards to partner rotation?*

   Yes.

3. *Is the revised guidance related to the provision of non-audit services appropriate?*

   We have concerns with both the existing guidance and the revised guidance related to the provision of non-audit services. Refer to our comments in the covering letter and Attachment 2.

4. *Do you agree that the benefits of the proposals are proportionate to the costs and therefore the proposals strike the appropriate balance between the differing perspectives of stakeholders?*

   We have assumed that the reference to benefits is primarily with regard to the fact that the providers of assurance engagements can also provide certain non-assurance services to clients in certain circumstances. Implicitly non-assurance work provides benefits to the client but at the same time potentially threatens the independence of the assurance provider in the eyes of the users of assurance reports. We therefore question whether those benefits typically accrue to the users of assurance reports.

   The concerns that we have raised in this submission support our view that the balance to be struck between the differing stakeholders is not appropriate. We have some fundamental concerns with the application of the conceptual approach. This has translated into guidance that does not establish appropriate standards of independence – particularly with respect to "independence in appearance".

5. *Have considerations regarding the audit of small entities been appropriately dealt with in the proposed revisions to the Code?*

   In our opinion a consistent approach should be applied to all audit clients, irrespective of whether the client is large or small or whether the client is an entity of significant public interest or otherwise.

   We have expressed concern over the proposals in the Exposure Draft to extend differential provisions to entities of significant public interest in our response to question 1 above. Management of small audit clients may benefit from the ability of firms to conduct more extensive non-assurance services provided for in the Exposure Draft. However the more liberal provisions, that apply to clients who are not entities of significant public interest, do

increase the threat to independence from the perspective of users of assurance reports of small entities – particularly in respect of the appearance of independence.

6. *Are there any foreseeable difficulties in applying the proposed provisions in a developing nation environment?*

From our experience with some of the smaller nations in the South Pacific region the Exposure Draft will present significant application challenges.

Family ties are pervasive within many of the government and commercial institutions in smaller South Pacific nations and it is likely that the requirements of the Exposure Draft will present challenges to auditors and their firms.

ATTACHMENT 2: DETAILED COMMENTS ON THE EXPOSURE DRAFT

In addition to the matters raised in the covering letter and in Attachment 1 we have a number of detailed comments on the Exposure Draft as set out below.

Paragraph	Comment
290.30	In the circumstances outlined in this paragraph it is our opinion that the threat to independence cannot be mitigated by safeguards and that the only option open to the auditor is to not accept the audit engagement.
290.105	The condition that the client is material to the entity seems irrelevant as the threat to independence arises because of the existence of a financial interest in an entity that has a controlling interest in the audit client. This creates an unacceptable threat to independence in appearance.
290.106	If the firm's retirement benefit plan has a direct or material indirect financial interest in an audit client the only options would appear to be either remove the financial interest or withdraw from the audit. To permit the continuance of any financial interest creates an unacceptable threat to independence in appearance.
290.109	In our opinion the following wording in the first sentence should be removed "who provide non-audit services to the audit client, except those whose involvement is clearly insignificant". The inclusion of this wording creates an unacceptable threat to independence in appearance.
290.111	We do not consider that disposing of a sufficient amount of the interest so that the remaining interest is no longer material is an appropriate response to this situation. This creates an unacceptable threat to independence in appearance. In our view all of the interest should be disposed of.
290.112	We do not consider the mitigations proposed in this paragraph are sufficient to reduce the threat to independence in appearance to an acceptable level.
290.114	Refer to our comments relating to paragraph 290.111.
290.117	We consider the first sentence should be expanded to include the underlined wording as follows: "If a loan to a firm <u>from an audit client that is a bank or a similar institution</u> is made under normal ..." We also consider that the presence of such a loan creates an unacceptable threat to independence in appearance.
290.119	We would regard an immaterial loan or guarantee to an audit client in this situation as creating an unacceptable threat to independence in appearance.
290.120	This situation ignores independence in appearance. Accordingly we would regard an immaterial loan or guarantee from an audit client in this situation as creating an unacceptable threat to independence in appearance.
290.121 to 290.123	These paragraphs do not consider the independence implications of other partners and managerial employees having a close business relationship with an audit client. Such relationships need to be assessed to address threats to independence in appearance. We also question whether the presence of immaterial financial interests is acceptable when considering threats to independence in appearance.

Paragraph	Comment
290.136	We question why the twelve month period should not also apply to an audit client that is not an entity of significant public interest.
290.138	We consider that the activities of the loaned staff should be supervised by a member of management in accordance with the criteria specified in paragraph 290.160. This reduces the risk of the staff member (and the firm by association) from making any significant judgement or decision on behalf of management.
290.144 and 290.145	We consider that the situations set out in these paragraphs threaten independence in appearance and the guidance should be reassessed with this in mind.
290.147	We agree with the proposed amendment that would prevent a key audit partner, rotating off an audit after a pre-defined period, from participating in the audit until a further period of time, normally two years, has elapsed. The amendment, however, does allow a former key audit partner to continue to be involved with the audit client in other ways – such as in the provision of non-assurance engagements. In our opinion, the familiarity risk will only be removed if the key audit partner rotating off the audit has no association with the audit client *in any capacity* during the two-year "cooling off" period. Consideration should therefore be given to extending the proposed revision to require a former key audit partner to have no association with the *audit client* during the "cooling off" period.
290.159	We do not consider the example of executing an insignificant transaction that has been authorised by management is appropriate – as it does not adequately take account of the threat to independence in appearance.
290.160	We consider this is an important enhancement.
290.165	We do not consider that the examples provided under the first four bullet points are services that should be performed for audit clients. Under the fifth bullet point the word "preparing" should be replaced by the word "compiling". We are also of the view that compiling financial statements should only be carried out in emergency situations as provided for in paragraph 290.168.
290.167	We disagree that such services should be permitted as it does not adequately take account of the threat to independence in appearance.

Paragraph	Comment
290.169 to 290.173	The Exposure Draft recognises that the conduct of valuation services creates a self-review threat – however, it also acknowledges that valuation services may be provided in certain circumstances. In our view, valuations of material matters should not be undertaken in any instance, irrespective of whether the audit client is an entity of significant public interest. Paragraph 290.171 states that valuation services that have a material effect on the financial statements and which involve a significant degree of subjectivity, impair independence to such an extent that either the valuation services should not be provided or that the firm should withdraw from the audit engagement. What this paragraph could permit is valuation services on material matters that do not involve a significant degree of subjectivity. This possibility also appears to be envisaged in paragraph 290.172. In our view, such an outcome is unacceptable and the Exposure Draft should be amended accordingly. There is a further matter to consider in the provision of valuation services to audit clients in that the client will not generally be competent to form a view on the reasonableness of the valuation. In fact, the audit client will typically have acknowledged this in seeking an expert to provide a valuation for them. In this situation the auditor must also take account of the guidance in paragraph 290.160 which requires a member of management with a sufficient level of understanding of the service, and an ability to evaluate the results, to be designated to make all significant judgements and decisions connected with the services, and to accept responsibility for the actions to be taken arising from the results of the service. The guidance in paragraph 290.160 therefore needs to be reflected in the guidance on valuation services.
290.174 to 290.185	We have concerns that the guidance in respect of taxation services is too permissive and ignores the threat to independence in appearance. An argument supporting the preparation of tax returns by auditors for audit clients is that tax returns are prepared on the basis of established tax law and are subsequently approved by the taxation authority. In our opinion this argument is flawed in that the application of tax law is often subject to interpretation and the application of professional judgement and that tax returns are rarely approved by the taxation authority before the completion of the audit. As noted previously, in respect of valuation services, it is unlikely that the audit client will be competent to form a view on the reasonableness of the taxation services provided. In fact, the audit client will typically have acknowledged this in seeking an expert to provide the taxation services for them. In this situation the auditor must also take account of the guidance in paragraph 290.160 which requires a member of management with a sufficient level of understanding of the service, and an ability to evaluate the results, to be designated to make all significant judgements and decisions connected with the services, and to accept responsibility for the actions to be taken arising from the results of the service. The guidance in paragraph 290.160 therefore needs to be reflected in the guidance on taxation services.
290.186 to 290.191	The guidance on internal audit services will be subject to the overriding guidance in paragraph 290.160 – which effectively elaborates on the existing guidance in paragraph 290.190(b).

Paragraph	Comment
290.192 to 290.197	The guidance on IT systems services will be subject to the overriding guidance in paragraph 290.160 – and should be amended accordingly. Paragraph 290.193 makes reference to IT systems that do not form a significant part of the accounting records or financial statements. We consider the words "a significant" should be removed as it introduces an unacceptable level of subjectivity and does not take account of the threat to independence in appearance. We do not consider implementation of "off-the-shelf" accounting or financial information software (as set out in paragraph 290.193) is appropriate for the reason that it does not take account of the threat to independence in appearance. Paragraph 290.197 should be amended to remove the subjectivity around the references to "...a significant part of the accounting systems or generate information that is significant to the clients financial statements...". This can be achieved by removing the words "a significant" and replacing the words "is significant to" with "will be included in". The amendments also remove the possibility of threats to independence in appearance.
290.198 to 290.200	The guidance on litigation support services will be subject to the overriding guidance in paragraph 290.160 – and should be amended accordingly. In our opinion the guidance does not adequately consider threats to independence in appearance in respect of such engagements.
290.201 to 290.205	The guidance on legal services will be subject to the overriding guidance in paragraph 290.160 – and should be amended accordingly. The provision of legal services to an audit client is fundamentally in conflict with the role of the auditor. This is because the individual providing the legal services is ethically bound to act in the interests of the client. For this reason the provision of legal services should not be permitted. We note that paragraph 290.202 states that the provision of legal services to support an audit client in the execution of a transaction may create self-review threats but may be acceptable if the threat is clearly insignificant and safeguards are applied. In our opinion, it is inappropriate for the firm, network firm or a member of the audit or assurance team to support a client in the execution of a transaction. We consider that this situation creates an unacceptable threat to independence in appearance.
290.206 and 290.207	We do not consider it is appropriate for the firm to be associated with the process of recruiting senior management. In our opinion this situation creates an unacceptable threat to independence in appearance.
290.208 to 290.212	The guidance on corporate finance services will be subject to the overriding guidance in paragraph 290.160 – and should be amended accordingly. Our view on the extent to which assignments involving corporate finance and similar activities should be conducted, is that the firm should only be involved in advising the audit or assurance client on matters of process. The Exposure Draft currently permits certain activities to be performed for an audit or assurance client (such as assistance in development of corporate strategies – paragraph 290.208) that result in an unacceptably high self-review threat. Such activities should therefore be prohibited. In our opinion the guidance does not adequately consider threats to independence in appearance in respect of such engagements.

Paragraph	Comment
290.500 to 290.514	These paragraphs include guidance on restricted use reports. In our opinion the guidance in these paragraphs lacks clarity and is confusing. Furthermore, the risks of a professional accountant agreeing to a restricted use report engagement have not been identified – particularly when the professional accountant is not independent. We note that paragraph 17(b)(v) of the International Framework for Assurance Engagements requires the practitioner to be satisfied that there is a rational purpose for the engagement. Similar guidance should also be included with the guidance on restricted use reports.

We have not provided detailed comments in respect of Section 291 in the Exposure Draft as we are of the opinion that the provision of separate guidance on other assurance engagements is unnecessary. The reasons for our opinion are set out in our covering letter above.

ATTACHMENT 3: EXTRACT FROM THE APRIL 2003 REPORT OF THE HIH ROYAL COMMISSION IN AUSTRALIA ON THE AUDIT FUNCTION[1]

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

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[1] The full report can be accessed on www.hihroyalcom.gov.au/

- 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.