

AUSTRALASIAN COUNCIL OF AUDITORS- GENERAL

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The Chairman
Auditing and Assurance Standards Board
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Dear Chairman,

ED 1/05 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Re-issuance of AUS 402)

Exposure Draft 2/05 Proposed Auditing Standard: The Auditor's Procedures in Response to Assessed Risks (Re-issuance of AUS 406)

Exposure Draft ED 3/05 – Proposed Auditing Standard: Audit Evidence (Re-issuance of AUS 502)

Exposure Draft 4/05 – Proposed Auditing Standard: External Confirmations (Re-issuance of AUS 504)

Exposure Draft ED 5/05 – Proposed Auditing Standard: Existence and Valuation of Inventory (Re-issuance of AUS 506)

Members of the Australasian Council of Auditors-General (ACAG) have been canvassed and submit the attached comments in response to the Exposure Drafts referred to above.

This represents the views of the Australian members of ACAG with the exception of the Auditor-General for South Australia who reserves his right to respond separately to auditing and accounting Exposure Drafts where he deems it appropriate, rather than as a member of ACAG.

Request for Comments

While overall ACAG supports the Proposed Auditing Standards, we have enclosed, as separate attachments for each Exposure Draft, commentary on matters that the AUASB should consider as it finalises these Exposure Drafts.

We have also enclosed an attachment titled “generic matters”. This covers our comments on issues that apply to all five Exposure Drafts.

Thank you for providing the members of ACAG with the opportunity to comment.

Yours faithfully

A handwritten signature in black ink, appearing to read 'M. Blake', with a long horizontal flourish extending to the right.

Mike Blake
Chairperson, ACAG Advisory Committee
14 October 2005

SUBMISSION BY THE AUSTRALIAN MEMBERS (EXCEPT FOR THE AUDITOR-GENERAL FOR SOUTH AUSTRALIA) OF THE AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL ON AUDITING EXPOSURE DRAFTS ED 1/05, 2/05, 3/05, 4/05 AND 5/05

Generic matters – matters raised that were common to each of these five Exposure Drafts

1. ***Substitution of “shall” for “should”.*** We support the substitution of “shall” for “should” in the bold-type text of the proposed standards. We understand that the AUASB has used the word “shall” to eliminate the auditor’s discretion when determining whether to apply certain audit procedures, but we do not consider this to be contentious.
2. ***Implied obligations versus mandatory requirements.*** We agree with the re-drafting of explanatory paragraphs such that any implied obligations are clarified as either mandatory (elevated to black letter) or neutralised.

While we do not object to the inclusion of the word "ordinarily" for the purpose intended, our concern is that when an auditor has not conducted the procedures 'ordinarily' expected of them, they may be increasingly exposed to legal proceedings. The onus may be on the auditor to justify why they elected not to undertake the procedures an auditor would 'ordinarily' perform. If the aim is to differentiate these sections from the mandatory bold type sections, perhaps terms such as “may consider” would be more appropriate for providing a clearer expectation in these areas.

Should the AUASB continue to use the term "ordinarily", we believe the Preamble to the AUASB Standards should clearly identify the extent of any obligations of the auditor in relation to these procedures. For example, are there any obligations when the auditor decides not to undertake procedures "ordinarily" performed (i.e. documentation of reasons for not performing etc)?

3. ***Inclusion of additional explanatory text.*** The inclusion of additional explanatory text throughout the proposed standards improves the guidance provided to auditors and is therefore supported by ACAG members.
4. ***Cross references to other auditing standards.*** In reviewing these exposure drafts, for example ED 2/05, we have assumed that cross references to other auditing standards, which are or may also be subject to exposure, continue to remain valid.
5. ***Application of the proposed Standards.*** Auditing standards issued by the AUASB are issued under the *Corporations Act* 2001 and therefore have the force of law when registered company auditors of entities established under this Act conduct audits. Paragraph 1 of each Exposure Draft makes this clear but goes on in 1(b) to make reference to the proposed Standards’ application to “an audit of a financial report for any other purpose”.

By this we assume the proposed Standards are referring to financial reports prepared for audit under statutes other than the *Corporations Act 2001*. Bearing in mind that the AUASB is a function of the *Corporations Act 2001*, has the AUASB given consideration as to how, and by whom, this requirement will be enforced?

In addition, the AUASB may wish to clarify whether they are referring to:

- (a) Undertaking an audit to form an opinion on the financial report, where the audit is not being undertaken for the purposes of the *Corporations Act 2001*;
or
 - (b) Undertaking the audit of a financial report for a purpose other than expressing an opinion on the financial report.
6. ***Proposal to remove the Public Sector Perspective Appendix.*** While ACAG does not oppose the principle of preparing these standards on the basis of “sector neutrality”, we consider it important to retain the material on “public sector perspective” as a means of identifying the subtle differences that can exist when undertaking audits in the public and private sectors. Therefore, we expect significant information previously discussed in an Appendix on the public sector perspective to be included as additional commentary or guidance material in the body of each standard.
7. ***Operative Date.*** The ‘operative date’ section [para. 3] in each exposure draft does not discuss early adoption. We recommend that the Standards allow for early adoption. In the event that the AUASB decides that early adoption should not be permitted, we recommend that the following paragraph be included:
- “This Auditing Standard shall not be applied to financial reporting periods commencing before 1 July 2006”.*
8. ***Reference to Auditing Standards.*** We support the technique of using “pursuant to/in accordance with” to clarify that material in grey letter guidance directly arises from a mandatory (black letter) requirement. We also support the decision to limit cross-references to Auditing Standards only rather than individual paragraphs within a Standard.

MATTERS SPECIFIC TO EACH EXPOSURE DRAFT

Exposure Draft 1/05 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement (Re-Issuance of AUS 402)

Subject to the issues raised in the attachment titled 'generic matters', we support this proposed standard as drafted.

Exposure Draft 2/05 Proposed Auditing Standard: The Auditor's Procedures in Response to Assessed Risks (Re-issuance of AUS 406)

The implementation of the proposed Standard makes clear the auditor's obligations when developing procedures in response to assessed risks. We support this. We also support the AUASB's decision to make mandatory certain implied obligations. In particular, we agree with the elevation of the seven paragraphs as detailed within pages 5-6 of the exposure draft. The paragraphs were previously implied obligations within AUS 406 and have now been re-stated as specific mandatory requirements.

Paragraph 67

The Attachment to ED 2/05 '*Table of Proposed Changes from AUS 406*' states that the wording of paragraph 67 shall be amended. However, only some aspects of the sentence were reflected in the exposure draft.

The exposure draft currently reads: "...*the auditor is required to design and perform substantive procedures...*", whereas the attachment states that the sentence should read: "...*the auditor shall design and perform tests of control...*".

Firstly, should the sentence state that the auditor **is required to** or the auditor **shall** design? If it should be "shall" as the Attachment indicates, we recommend that the paragraph be elevated to a mandatory requirement and thus black-lettered. If the current wording is correct, then the Attachment should be amended to reflect the wording in paragraph 67.

Secondly, paragraph 67 is situated under the heading, '*Substantive Procedures*'. However, the abovementioned Attachment states that the auditor shall design and perform **tests of controls**, when in fact they should perform **substantive tests**. Thus, we recommend that the Attachment be amended to reflect the performing of substantive tests rather than tests of controls.

However, prior to considering these suggested changes, the AUASB should firstly ensure that the reference included in this paragraph is actually correct.

Paragraph 99

We recommend that the wording in the first bullet point contained within paragraph 99 be amended. That is, to replace the word "its" with "it" in order for the sentence to read as follows:

Significance of the potential misstatement in the assertion and the likelihood of **it** having a material effect, individually or aggregated with other potential misstatements, on the financial report.

*Exposure Draft ED 3/05 – Proposed Auditing Standard: Audit Evidence
(Re-issuance of AUS 502)*

Paragraph 13

We do not support the insertion of the word ‘ordinarily’ in paragraph 13, as we believe this guidance should be mandatory. Reliability is required by black letter paragraph 5, ‘The auditor shall obtain sufficient appropriate audit evidence...’ where ‘appropriateness’ is defined as being relevant and reliable (paragraph 10).

Paragraph 15

There appears to be an implied obligation in the first sentence in paragraph 15 as it is almost a duplication of black letter paragraph 14. The treatment of this implied obligation should be reconsidered.

There appears to be an implied obligation in the second sentence in paragraph 15. We believe the sentence should be reworded to emphasise/clarify the example and remove the implied obligation within the example:

‘For example, in auditing revenue by applying standard prices to records of sales volume, the accuracy of the price information and the completeness and accuracy of the sales volume data are important.’

Paragraph 30

Consideration should be given to amending paragraph 30 to read as follows:

“When the information is in electronic form, the auditor may carry out some audit procedures described below through CAATs”.

***Exposure Draft 4/05 – Proposed Auditing Standard: External Confirmations
(Re-issuance of AUS 504)***

We believe the guidance in the first sentence of paragraph 41 should be made mandatory. The proposed Standard does not include an explicit obligation to consider/investigate the causes and frequency of exceptions. As paragraph 41 states, exceptions may indicate misstatements, which may have a material effect on the financial report.

Exposure Draft ED 5/05 – Proposed Auditing Standard: Existence and Valuation of Inventory (Re-issuance of AUS 506)

Paragraph 19

We agree with the proposed elevation of former paragraph 11 (AUS 506) that contained an implied obligation. However, we are of the opinion that paragraph 19 is in need of some additional guidance to address matters including:

- When it is appropriate to use estimates of inventory (including examples such as coal stockpiles as provided in ISA 501.010 and in current AUS 506);
- Procedures the auditor can use to test the reasonableness of the estimates; and
- Reference to AUS 516 ‘Audit of Accounting Estimates’ to provide a general understanding of what is meant by the audit of accounting estimates. (Inventory related accounting estimates would fall within AUS 516).

Paragraph 29

In paragraph 29, we consider the word ‘method’ is better understood than using the word ‘bases’. The word ‘method’ is consistent with the wording used in the AASB 1019 ‘Inventory’ (paragraph 10.1A).

Existing paragraph 23

We do not support the deletion of paragraph 23(b)(c) & (f) of the current AUS 506. These points provide useful guidance in relation to the existence of inventory.

Sequence of paragraphs and removal of subheadings

The sequence of information in paragraphs 10 to 28 seems illogical. For example, the section on “Attendance at Physical Inventory Counting” commences and ends with requirements and guidance when attending physical inventory counting. However, in between (paragraphs 13-16) are requirements and guidance when an auditor is unable to attend the count. For this example, we recommend that paragraphs 13-16 be placed after paragraph 18.

We also recommend that sub-headings contained within the existing AUS 506 should be retained so that the exposure draft is more readable and the content is appropriately structured.

For example, by removing the subheading ‘Inventory Under the Control of a Third Party’ prior to paragraph 28 it suggests that the following grey paragraphs support black letter paragraph 27 when in fact they cover two separate matters. Therefore removing the subheading reduces clarity and distorts the flow of the Standard.

Paragraph 26 and 27

We believe guidance is required for the black letter requirement within paragraph 27. As paragraph 26 discusses the use of a perpetual inventory system versus a physical

inventory count, resolution of this concern could be to simply swap paragraphs 26 and 27.