



March 2019

Explanatory Memorandum

Quality Management at the Firm and Engagement Level – Australian Exposure

Issued by the Auditing and Assurance Standards Board



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Important Note and Disclaimer

This Explanatory Memorandum is issued by the AUASB to provide information to auditors and assurance practitioners about the AUASB's exposure in Australia of the IAASB's proposed Quality Management suite of standards.

This Explanatory Memorandum does not establish or extend the requirements under an existing AUASB Standard(s) and is not intended to be a substitute for compliance with the relevant AUASB Standards with which auditors and assurance practitioners are required to comply when conducting an audit or other assurance engagement. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this document or for any errors or omissions in it.

CONTENTS

	<i>Paragraph</i>
Purpose	1-3
Composition of the Exposure Drafts and this Explanatory Memorandum	4-9
What are the key changes?	
Key changes from ASQC 1 <i>Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements</i>	10-12
Key proposals of ASQM 2 <i>Engagement Quality Reviews</i>	13
Key changes from extant ASA 220 <i>Quality Control for an Audit of a Financial Report and Other Historical Financial Information</i>	14-16
Background	
IAASB.....	17-19
AUASB	20-23
The AUASB’s approach	24-29
Outreach Activities	30
Application	31
Website Resources	32

EXPLANATORY MEMORANDUM

Exposure Draft: *Quality Management Standards*

Purpose

1. The International Auditing and Assurance Standards Board (IAASB) have issued three Exposure Drafts for managing quality at the firm and engagement levels:
 - (a) Proposed International Standard on Quality Management 1 (Previously International Standard on Quality Control (ISQC) 1), Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance Engagements or Related Services Engagements ([ED-ISQM 1](#));
 - (b) Proposed International Standard on Quality Management 2, Engagement Quality Reviews ([ED-ISQM 2](#)); and
 - (c) Proposed International Standard on Auditing 220 (Revised), Quality Management for an Audit of Financial Statements ([ED-220](#)).

These EDs replicated and been exposed in Australian format, as explained below.

2. The AUASB is seeking feedback from stakeholders on the Australian EDs to inform us when developing our response to the IAASB, and when considering whether there are any compelling reasons for the proposals to be modified for application in Australia. For further information on the compelling reasons test, refer to the Australian [Principles of Convergence](#).
3. The aim of this Explanatory Memorandum is to provide stakeholders with information about the development of the EDs, the key changes from the extant (where applicable) and links to information that will be helpful when considering the proposed changes. .

Composition of the Exposure Drafts and this Explanatory Memorandum

4. Four exposure drafts have been issued for comment by the AUASB, these exposure drafts are:
 - (a) ED 01/19 Proposed ASQM 1 *Quality Management for Firms that Perform Audits or Reviews of a Financial Report, or Other Assurance or Related Services Engagements*;
 - (b) ED 02/19 Proposed ASQM 2 *Engagement Quality Reviews*;
 - (c) ED 03/19 Proposed ASA 220 *Quality Management for an Audit of a Financial Report and other Historical Financial Information*; and
 - (d) ED 04/19 *Proposed Auditing Standard 2019-X Amendments to Australian Auditing Standards – Conforming amendments*.
5. ED 01/19 proposes amendments to ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements*, including a change in title.
6. ED 02/19 proposes the introduction of a new standard which focuses on *Engagement Quality Reviews*. Engagement quality control requirements which exist in the extant ASQC 1 and ASA 220 will be moved to this new standard.
7. ED 03/19 proposes amendments to ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information*, including a change in title.

8. ED 04/19 proposes conforming amendments, as a result of ED 01/19, ED 02/19 and ED 03/19, to:
- (a) *ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards;*
 - (b) *ASA 210 Agreeing the Terms of Audit Engagements;*
 - (c) *ASA 230 Audit Documentation;*
 - (d) *ASA 250 Consideration of Laws and Regulations in an Audit of a Financial Report;*
 - (e) *ASA 260 Communication With Those Charged with Governance;*
 - (f) *ASA 300 Planning an Audit of a Financial Report;*
 - (g) *ASA 500 Audit Evidence;*
 - (h) *ASA 540 Auditing Accounting Estimates and Related Disclosures;*
 - (i) *ASA 600 Special Considerations-Audits of a Group Financial Report;*
 - (j) *ASA 610 Using the Work of Internal Auditors;*
 - (k) *ASA 620 Using the Work of an Auditor's Expert;*
 - (l) *ASA 700 Forming an Opinion and Reporting on a Financial Report;*
 - (m) *ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report;* and
 - (n) *ASA 720 The Auditor's Responsibilities Relating to Other Information.*
9. Where appropriate, IAASB resources have been referred to throughout ED 01/19, ED 02/19, ED 03/19 and this Explanatory Memorandum. The IAASB resources which accompany the IAASB EDs, listed below, are available on the IAASB website:
- [Overall Explanatory Memorandum](#) for the IAASB's Exposure Drafts for Quality Management at the Firm and Engagement Level, Including Engagement Quality Reviews

This memorandum explains the significant issues common to the three exposure drafts, including listing the conforming amendments. It also gives details about the proposed effective dates, the rationale behind not including an effective date and the implementation period. This memorandum should be read in conjunction with the explanatory memorandums for each of the three proposed standards.
 - Proposed International Standard on Quality Management 1 – [ISQM 1](#)
 - Draft [Frequently Asked Questions](#) Regarding ISQM 1
 - [Draft Examples](#) on How the Nature and Circumstances of the Firm and the Engagements it Performs Affect Implementation of ISQM 1
 - Proposed International Standard on Quality Management 2 – [ISQM 2](#)
 - Proposed International Standard on Auditing 220 (Revised) – [ISA 220 \(Revised\)](#)

What are the key changes?

Key changes from ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements*

10. The key changes introduced from extant ASQC 1 by the IAASB are:
 - A new proactive risk-based approach to firms' systems of quality management
 - Modernising the standard for an evolving and increasingly complex environment, including addressing the impact of technology, networks, and use of external service providers
 - Increasing firm leadership responsibilities and accountability, and improving firm governance
 - More rigorous monitoring of quality management systems and remediation of deficiencies.
11. For more information on the key changes, refer to the IAASB's Explanatory Memorandum to ISQM 1, contained within the [IAASB ED](#).
12. Alongside the IAASB ED and Explanatory Memorandum the IAASB has released:
 - (a) Draft FAQs

The Draft Frequently Asked Questions prepared by a Task Force of the International Auditing and Assurance Standards Board regarding ISQM 1 Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements, provides further clarity on various matters contained within ED – ISQM 1.
 - (b) Draft Examples

The Draft examples: *How the Nature and Circumstances of the Firm and the Engagements it Performs Affect the Implementation of Proposed ISQM 1 Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, prepared by a Task Force of the International Auditing and Assurance Standards Board is intended to illustrate how ED ISQM 1 can be applied in a scalable manner by firms with varying circumstances.

Key proposals of ASQM 2 *Engagement Quality Reviews*

13. The key changes introduced from extant ASQC 1 and ASA 220 by the IAASB are:
 - Extending the requirement for an engagement quality review to engagements in addition to audits of a financial report
 - Enhancing the eligibility criteria for an individual to be appointed as an engagement quality reviewer
 - Enhancing the requirements and application material regarding the engagement quality reviewer's responsibilities, including nature, timing and extent of the engagement quality review procedures performed; and
 - Consideration of the effect of engagement quality reviews, and other forms of engagement reviews, on the appropriate exercise of professional scepticism by engagement teams.

Key changes from extant ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information*

14. The key changes introduced from extant ASA 220 by the IAASB are:
- Modernising the standard to acknowledge different audit delivery models. Including material outlining that regardless of location of engagement team members, the work of any individual undertaking audit procedures need to be appropriately directed and supervised.
 - Removal of material that allowed engagement team members to rely on the firm's system of quality control, unless information from the firm or other parties suggested otherwise.
 - Strong emphasis on the Engagement Partner's overall responsibility for managing and achieving audit quality. This includes wording throughout the standard that the engagement partner needs to be sufficiently and appropriately involved throughout the engagement to manage and achieve quality. A new stand-back provision has also been included.
 - Material relating to relevant ethical requirements has been strengthened with more focus on the engagement partner's role in dealing with relevant ethical requirements.
 - Inclusion of a new section relating to engagement resources which includes human, technological and intellectual resources, and the engagement partner's responsibility to determine whether the resources assigned are sufficient and appropriate.
15. For more information on the key changes, refer to the IAASB's Explanatory Memorandum to ISA 220, contained within the [IAASB ED](#).

Questions asked by the IAASB and AUASB on Exposure

16. A number of questions have been asked by the IAASB and the AUASB on exposure, which are listed below and in the relevant EDs. Questions on each of the EDs will be used to inform the AUASB when responding to the IAASB on their equivalent ED. Australian specific questions will be used when considering whether to amend the standards when adopted in Australia.

Overall

1. Do you support the approach and rationale for the proposed implementation period of approximately 18 months after the approval of the three standards by the Public Interest Oversight Board? If not, what is an appropriate implementation period?
2. In order to support implementation of the standards in accordance with the IAASB's proposed effective date, what implementation materials would be most helpful, in particular for SMPs?

ED 01/19 – Proposed ASQM 1

3. Does ED ASQM 1 substantively enhance firms' management of engagement quality, and at the same time improve the scalability of the standard? In particular:
 - (a) Do you support the new quality management approach? If not, what specific attributes of this approach do you not support and why?
 - (b) In your view, will the proposals generate benefits for engagement quality as intended, including supporting the appropriate exercise of professional scepticism at the

- engagement level? If not, what further actions should the IAASB take to improve the standard?
- (c) Are the requirements and application material of proposed ED ASQM 1 scalable such that they can be applied by firms of varying size, complexity and circumstances? If not, what further actions should the IAASB take to improve the scalability of the standard?
4. Are there any aspects of the standard that may create challenges for implementation? If so, are there particular enhancements to the standard or support materials that would assist in addressing these challenges?
5. Is the application material in ED ASQM 1 helpful in supporting a consistent understanding of the requirements? Are there areas where additional examples or explanations would be helpful or where the application material could be reduced?
6. Do you support the eight components and the structure of ED ASQM 1?
7. Do you support the objective of the standard, which includes the objective of the system of quality management? Furthermore, do you agree with how the standard explains the firm's role relating to the public interest and is it clear how achieving the objective of the standard relates to the firm's public interest role?
8. Do you believe that application of a risk assessment process will drive firms to establish appropriate quality objectives, quality risks and responses, such that the objective of the standard is achieved? In particular:
- (a) Do you agree that the firm's risk assessment process should be applied to the other components of the system of quality management?
- (b) Do you support the approach for establishing quality objectives? In particular:
- (i) Are the required quality objectives appropriate?
- (ii) Is it clear that the firm is expected to establish additional quality objectives beyond those required by the standard in certain circumstances?
- (c) Do you support the process for the identification and assessment of quality risks?
- (d) Do you support the approach that requires the firm to design and implement responses to address the assessed quality risks? In particular:
- (i) Do you believe that this approach will result in a firm designing and implementing responses that are tailored to and appropriately address the assessed quality risks?
- (ii) Is it clear that in all circumstances the firm is expected to design and implement responses in addition to those required by the standard?
9. Do the revisions to the standard appropriately address firm governance and the responsibilities of firm leadership? If not, what further enhancements are needed?
10. With respect to matters regarding relevant ethical requirements:

- (a) Should ED ASQM 1 require firms to assign responsibility for relevant ethical requirements to an individual in the firm? If so, should the firm also be required to assign responsibility for compliance with independence requirements to an individual?
 - (b) Does the standard appropriately address the responsibilities of the firm regarding the independence of other firms or persons within the network?
11. Has ED ASQM 1 been appropriately modernised to address the use of technology by firms in the system of quality management?
12. Do the requirements for communication with external parties promote the exchange of valuable and insightful information about the firm's system of quality management with the firm's stakeholders? In particular, will the proposals encourage firms to communicate, via a transparency report or otherwise, when it is appropriate to do so?
13. Do you agree with the proposals addressing the scope of engagements that should be subject to an engagement quality review? In your view, will the requirements result in the proper identification of engagements to be subject to an engagement quality review?
14. In your view, will the proposals for monitoring and remediation improve the robustness of firms' monitoring and remediation? In particular:
- (a) Will the proposals improve firms' monitoring of the system of quality management as a whole and promote more proactive and effective monitoring activities, including encouraging the development of innovative monitoring techniques?
 - (b) Do you agree with the IAASB's conclusion to retain the requirement for the inspection of completed engagements for each engagement partner on a cyclical basis, with enhancements to improve the flexibility of the requirement and the focus on other types of reviews?
 - (c) Is the framework for evaluating findings and identifying deficiencies clear and do you support the definition of deficiencies?
 - (d) Do you agree with the new requirement for the firm to investigate the root cause of deficiencies? In particular:
 - (i) Is the nature, timing and extent of the procedures to investigate the root cause sufficiently flexible?
 - (ii) Is the manner in which ED ASQM 1 addresses positive findings, including addressing the root cause of positive findings, appropriate?
 - (e) Are there any challenges that may arise in fulfilling the requirement for the individual assigned ultimate responsibility and accountability for the system of quality management to evaluate at least annually whether the system of quality management provides reasonable assurance that the objectives of the system have been achieved?
15. Do you support the proposals addressing networks? Will the proposals appropriately address the issue of firms placing undue reliance on network requirements or network services?
16. Do you support the proposals addressing service providers?

17. With respect to national standard setters and regulators, will the change in title to “ASQM” create significant difficulties in adopting the standard at a jurisdictional level?

ED 02/19 – Proposed ASQM 2

18. Do you support a separate standard for engagement quality reviews? In particular, do you agree that ED ASQM 1 should deal with the engagements for which an engagement quality review is to be performed, and ED ASQM 2 should deal with the remaining aspects of engagement quality reviews?
19. Are the linkages between the requirements for engagement quality reviews in ED ASQM 1 and ED ASQM 2 clear?
20. Do you support the change from “engagement quality control review/reviewer” to “engagement quality review/reviewer?” Will there be any adverse consequences of changing the terminology in respondents’ jurisdictions?
21. Do you support the requirements for eligibility to be appointed as an engagement quality reviewer or an assistant to the engagement quality reviewer as described in paragraphs 16 and 17, respectively, of ED ASQM 2?
- (a) What are your views on the need for the guidance in proposed ASQM 2 regarding a “cooling off” period for that individual before being able to act as the engagement quality reviewer?
- (b) If you support such guidance, do you agree that it should be located in proposed ASQM 2 as opposed to the APESB Code?
22. Do you agree with the requirements relating to the nature, timing and extent of the engagement quality reviewer’s procedures? Are the responsibilities of the engagement quality reviewer appropriate given the revised responsibilities of the engagement partner in proposed ASA 220 (Revised)?
23. Do you agree that the engagement quality reviewer’s evaluation of the engagement team’s significant judgments includes evaluating the engagement team’s exercise of professional scepticism? Do you believe that ED ASQM 2 should further address the exercise of professional scepticism by the engagement quality reviewer? If so, what suggestions do you have in that regard?
24. Do you agree with the enhanced documentation requirements?
25. Are the requirements for engagement quality reviews in ED ASQM 2 scalable for firms of varying size and complexity? If not, what else can be done to improve scalability?

ED 03/19 – Proposed ASA 220

26. Do you support the focus on the sufficient and appropriate involvement of the engagement partner (see particularly paragraphs 11–13 and 37 of ED 03/19), as part of taking overall responsibility for managing quality on the engagement? Does the proposed ASA appropriately reflect the role of other senior members of the engagement team, including other partners?

27. Does ED 03/19 have appropriate linkages with the ASQM 1 and ASQM 2? Does you support the requirements to follow the firm's policies and procedures and the material referring to when the engagement partner may depend on the firm's policies or procedures?
28. Do you support the material on the appropriate exercise of professional scepticism in managing quality at the engagement level? (See paragraph 7 and A27–A29 of ED 03/19)
29. Does ED 03/19 deal adequately with the modern auditing environment, including the use of different audit delivery models and technology?
30. Do you support the revised requirements and guidance on direction, supervision and review? (See paragraphs 27–31 and A68–A80 of ED 03/19)
31. Does ED 03/19, together with the overarching documentation requirements in ASA 230, include sufficient requirements and guidance on documentation?
32. Is ED 03/19 appropriately scalable to engagements of different sizes and complexity, including through the focus on the nature and circumstances of the engagement in the requirements?

Australian Specific Questions

33. Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
34. Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
35. Whether there are any principles and practices considered appropriate in maintaining or improving audit quality in Australia that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?
36. What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the requirements of this proposed standard? If significant costs are expected, the AUASB would like to understand:
 - a. Where those costs are likely to occur;
 - b. The estimated extent of costs, in percentage terms (relative to audit fees); and
 - c. Whether expected costs outweigh the benefits to the users of audit services?
37. Are there any other significant public interest matters that constituents wish to raise?

Background

IAASB

17. The project to revise ISQC 1 and ISA 220 was initiated by the IAASB in December 2016. The need to revise the standards was based on findings from the post-implementation review of the suite of ISAs, post the clarity project.
18. A key finding from the post-implementation review was that additional guidance was needed to demonstrate how ISQC 1 and ISA 220 could be applied proportionately by small and medium sized practitioners (SMPs) and that various aspects of the standards could be made more robust.
19. A strategic objective of the IAASB is to ensure the International Standards on Auditing (ISAs) continue to form the basis for high quality, valuable and relevant audits conducted worldwide by responding on a timely basis to issues noted in practice and emerging developments.

AUASB

20. The AUASB has a strategic objective to develop, issue and maintain high quality Australian Auditing Standards. The AUASB takes input received from Australian stakeholders into account when preparing its submissions to the IAASB. The AUASB makes formal submissions on EDs issued by the IAASB to contribute to the setting of international auditing and assurance standards.
21. In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so. The AUASB's principles of convergence with the ISAs and harmonisation with the New Zealand auditing standards can be found on the AUASB's website:
http://www.auasb.gov.au/admin/file/content102/c3/Aug14_IAASB-NZAuASB_Principles_of_Convergence_and_Harmonisation.pdf
22. Compelling reasons fall broadly into two categories: legal and regulatory; and principles and practices considered appropriate in maintaining or improving audit quality in Australia. Compelling reasons are further guided by the AUASB's policy of harmonisation with the standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB).
23. The AUASB will adopt the Quality Management Standards into the Australian Auditing Standards that are made under section 336 of the *Corporations Act 2001*. Prior to implementation, the AUASB is required to consult with stakeholders and accordingly now issues Exposure Draft ED 01/19, ED 02/19, ED 03/19 and ED 04/19 for public exposure and comment. All comments received from stakeholders are considered by the AUASB when providing comments to the IAASB and prior to finalisation of the proposed revised standard.

The AUASB's approach

Exposure Draft Protocols

24. The AUASB has developed ED 01/19, ED 02/19, ED 03/19 and ED 04/19 based on the relevant IAASB equivalents, as noted earlier. The AUASB has Australianised the IAASB Exposure Drafts so that they appear like an Australian Standard which includes terminology changes to comply with requirements relating primarily to legislative instruments. Such changes are mechanical in nature and do not change the meaning from the equivalent ISA.
25. Within the body of each ED, paragraphs that will be considered for modification (addition, deletion or amendment) in-line with the AUASB's Compelling Reasons test have been identified with either of the follow Modification Statements:

- (a) Where the AUASB considers an existing modification to the extant standard may still be relevant the modification statement will be:

Aus The AUASB will deliberate whether a modification in the extant ASQC 1/ASA 220 made to reflect principles and practices considered appropriate in Australia may still applicable to the below paragraph. See Table 1 for more information; or

Aus The AUASB will deliberate whether a modification in the extant ASQC 1/ASA 220 made to reflect Australian laws and regulations may still applicable to the below paragraph. See Table 1 for more information;

- (b) Where the ATG considers there may be a new modification required to comply with the AUASB's Compelling Reasons test the modification statement will be:

Aus The AUASB will deliberate whether a modification may be required to the below paragraph to reflect principles and practices considered appropriate in Australia. See Table 2 for more information. or

Aus The AUASB will deliberate whether a modification may be required to the below paragraph to reflect Australian laws and regulations. See Table 2 for more information.

26. To support each of the Modification Statements, an attachment has been prepared and will be issued alongside each ED and will include two tables.
- (a) Table 1 – Australian modification to the extant QM Standards and whether they may be applicable to the ED; and
- (b) Table 2 – Possible modifications to the ED identified by the ATG or AUASB. These are not drawn from existing modifications to the extant ASQC 1 and ASA 220.
27. The purpose of the tables will be to provide more information to stakeholders about why each of the Modification Statements have been included. Under the Conformity with International Standards section in each ED a Table of Amendments has been included which will indicate which paragraphs are being considered for modification and a short rationale on why they are proposed for amendment.

General

28. ED 01/19, ED 02/19, ED 03/19 and ED 04/18 will be open to stakeholders for a **70 day comment period** closing on 25 May 2019. This is to allow stakeholders time to respond to the AUASB on the EDs, and for the AUASB to conduct further outreach and to collate all feedback into our submission to the IAASB due on 1 July 2019.
29. At the completion of the exposure period, the AUASB will consider stakeholders' submissions:
- (a) to inform us when developing our response to the IAASB on their ED; and
- (b) where the AUASB determines that a compelling reason exist, to inform us as to whether modifications may be required when we are adopting the final standard.

Outreach Activities

30. In addition to the public exposure process, during April and May 2019 the AUASB will be conducting roundtable consultative meetings and a webinar on the suite of Quality Management EDs. Announcement about dates and locations will be announced shortly after the EDs are issued by the AUASB.

Application

31. At this stage, no effective date for the standards has been proposed by the IAASB. Instead the standards have been exposed with the statement “*the standards will be effective 18 months after the final approval by the Public Interest Oversight Board (PIOB)*”. Typically the PIOB approves the standards one quarter after the approval of the standards by the IAASB.

Website Resources

32. The AUASB welcomes stakeholders’ input to the development of Australian Auditing Standards and regards both supportive and critical comments as essential to a balanced review of the proposed standards. Stakeholders are encouraged to access the websites of the [AUASB](#) and the [IAASB](#) to obtain further information.

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