

13 October 2005

Ms Merran Kelsall
Chairman, Auditing and Assurance Standards Board
Level 4
530 Collins Street
Melbourne VIC 3000

Dear Merran

Re: Submission on first five auditing exposure drafts

The National Institute of Accountants (NIA) is pleased to respond to the request for comments on the five exposure drafts issued by the Auditing and Assurance Standards Board (AUASB). We believe the work being done by the AUASB has an important public interest role and as such has our unqualified support.

While this submission relates to the five exposure drafts for which the AUASB is seeking the input from the profession, we would like to at the outset set down our philosophical approach to auditing and the role it plays in preserving the public interest. It is necessary to set down the public interest principles that are driving our response to these exposure drafts so the AUASB can understand the lens through which the NIA is viewing its work.

Changes brought about to the structure of the setting of auditing and accounting standards have occurred as a general observation because the community has become more sophisticated in its understanding of the importance of the communication of corporate performance, particularly as it is represented in financial reporting, as well as the verification of the way in which financial performance is reported, which is the domain of those that adhere to the professional discipline we refer to as audit.

This submission supplements and further expands on matters stated in the joint submission forwarded to the AUASB on October 11 by the Auditing Standards Response Group.

We have confined our remarks to matters of principle because we believe the AUASB has done an very good job in trying to fulfil a huge demand within a tight timeframe. We support the two-stage approach the AUASB has taken and are satisfied that the current drafting meets the objectives set down by the AUASB. While we acknowledge that there are some commentators that have concerns about the form of some of the guidance it would be impossible for the AUASB to undertake a broad review of the documents within the time constraints imposed on it by the legislators.

It is appropriate for the AUASB to complete this short-term project before it commences a more detailed review of the auditing standards that should produce standards that are more refined.

Auditors and the public interest

The NIA is a member of the International Federation of Accountants (IFAC) and the organisation subscribes to the public interest philosophy that has been put in place by the board and council of IFAC to ensure that accounting professionals globally act in the community good and seek to take whatever measures possible to create and maintain an environment where there is sufficient community trust in the work being done by the accounting profession. This is a general objective that covers the entirety of the accounting profession and is not limited solely to practitioners that fulfil statutory roles such as auditors or liquidators. The NIA has undertaken to communicate the need to auditors and others to act in the public interest in various releases and articles over the past 12 months. We will continue to do so as a means of ensuring our members understand that each of them has a fundamental obligation to serve the public interest as both members of our organisation and members of the professional community that is generally known as the accounting profession.

Members of the NIA are expected to adhere to a public interest ethic as they pursue their role as accounting professionals. Each member is bound by the NIA's own ethical pronouncements that are consistent with the IFAC code of ethics. There is also an overriding obligation on the part of members of the professional body to behave in the public interest, which involves but is not limited to members ensuring they use their best endeavours to avoid participating in activities that constitute a breach of laws or general business ethics.

It should also be noted that the ashes of Enron are still smouldering in the accounting profession's backyard. The behavioural issues that existed in the American scene over the past decade need to be reflected upon because while there are differences between the American and Australian markets the core fact is that accountants were involved inside and outside the corporation, whether in a senior management role, an accounting or compliance role, internal audit role and external audit. We must recognise it is in our own self-interest bodies to have the public interest or community good at the heart of our activities in all respects because we have members that are involved in various aspects of the running or monitoring or auditing businesses of all sizes.

The accounting profession, particularly the professional accounting bodies that are charged with the task of ensuring professionals comply with codes of ethics and other professional requirements, must acknowledge as a whole that the expectations of the community have changed over the period of time that a greater number of people have become direct or indirect shareholders in listed entities. The NIA acknowledges that the market place has changed in its dynamics and as such the profession must be conscientious enough to ensure that there is a clear and unambiguous demonstration on its part that it not only pursues the rhetoric of public interest but that its entire behaviour embodies and is seen to embody a public spiritedness.

We have up to this point only addressed the general public interest duty of the accounting professional. The external auditor has a special duty and one that demands the strictest observance of audit standards and standards of independence. External auditors of listed entities in particular have a special trust placed in them by the stakeholders of entities to ensure a company's financial position and financial performance are fairly presented in accordance with the accounting framework and the requirements of the Corporations Act. This has escalated in importance in the eyes of the community following the various corporate governance failures and the accounting profession must factor in this heightened interest in the way in which auditors work as a result. We have a new process for audit standard setting where the accounting profession is only one of several players rather than it being the custodian of the process as has been the case in the past. This is clearly a sign the community expects to have some level of input in the way in which the behavioural standards of auditors are shaped by an auditing standard setter. It is a sign of the change in the community's mindset and expectations that first began when accounting standards were given legal backing.

The NIA sees the present process being undertaken by the AUASB as being one part of a broader co-regulatory environment. This co-regulatory environment captures the monitoring and discipline being undertaken by the professional accounting bodies, investigations and inspections of corporations and accounting firms conducting as required by the corporate regulator, the monitoring engaged in by the Financial Reporting Council (FRC) and the constant vigilance provided by the Federal Parliament, State and Territory parliaments and their various Committees.

Auditing standards and ethics

We would like to take the opportunity to reiterate our support for the AUASB's actions surrounding the maintenance of the reference to ethical pronouncements in the revised auditing standards. The NIA as an organisation expects its members to apply both the ethical pronouncements and the auditing standards when they undertake to fulfil the obligations of external audit. It was inconceivable to us that the auditing standards could ever contemplate the deletion of ethical requirements from the standards themselves because of the importance of ensuring that the linkage between audit procedures and ethical standards is maintained.

Our concern on this matter was also amplified when we reflected on the damage that could be done to the audit standard setting regime if the standards that previously referred to ethical pronouncements dropped the reference to those same standards when they were being reviewed by a statutory board. The process would never have been served well with an outcome that resulted in auditing standards dropping a reference to ethics. Such an outcome would have led to the system of the setting of auditing standards, which has effectively just come under the oversight of the FRC, being criticised for producing standards that would have been seen as being less than adequate. That would have been counterproductive for the AUASB, the FRC, the professional accounting bodies and the professional firms that are involved in the provision of external audit services.

An additional concern for the NIA was the need for the Australian market to have its audit standards as closely aligned with the standards issued by the IFAC. We did not understand how anybody could entertain the removal of such an integral component of the international auditing standards in an environment where these matters

Change management

We must acknowledge at this point that we understand the nervousness of some of our colleagues whenever changes occur with audit regulation. This is reflected in concerns dealing with the potential for auditors' liability to increase also a concern that certain provisions may be interpreted in different ways by regulators and others under a legally backed framework. It is clear that these issues have been at the forefront of the minds of some commentators. We consider that the fears expressed by accounting professionals regarding the impact of the change in status are largely a question of change management for the AUASB, the professional accounting bodies and others interested in ensuring the standards are properly implemented under a new regime. It is not in our view necessary for the AUASB to divert from its present course of issuing the exposure drafts in the manner it has determined just because accounting professionals may be concerned about the impact of the changes in the audit regulation regime.

The NIA is preparing itself to publish online a series of technical releases dealing with the change in status of auditing standards so that members may become more aware of the work of the AUASB and the intended program for the issuance of these exposure drafts as auditing standards. We intend to have a technical release about the audit standard setting due process published online by the end of this month in order to ensure our members develop a better understanding of the timelines that we are all required to observe.

The standards: 'black' and 'grey letter'

The NIA is concerned that some constituents are focusing inappropriately on the interpretation of mandatory requirements (bold text) and guidance paragraphs (unbolded text). We consider this to be outside the principles-based approach that is generally taken to the reading of professional standards and accounting pronouncements.

Any analysis of the standards that focuses on a demarcation between mandatory requirements and guidance will lead to the standards being misread. An interpretation by counsel that gives primacy to the mandatory requirements in the absence of consideration of the contents of the guidance contained in the unbolded paragraphs could be described as being overly aggressive. While the bolded paragraphs state that an auditor 'shall' do something the paragraphs of the standard that follow provide additional detail regarding the expectations of the standard setter, the developer of the legislative instrument. It is difficult to see how a reasonable regulator, reasonable lawyer or for that matter a reasonable auditor could do anything other than read the mandatory requirements in conjunction with the guidance.

For example, paragraph 5 of the proposed AUS 402 states an auditor 'shall obtain an understanding of the entity ...'. Paragraphs 6 through to 9 describe in some detail how such an understanding is to be obtained. This section of the exposure draft sets down in a broad way the expectations of the standard setter of auditors. Nothing has come to our attention that would appear to warrant great concern in relation to this section of that particular exposure draft. The same is true for other parts of the proposed AUS 402. There are several examples where the mandatory requirements paragraph is followed by guidance paragraphs afterwards that tie what appears to be a strong, unambiguous requirement in bold to the application of professional judgment. There is probably a need for further thought in areas where the contents of the guidance modify the mandatory requirements. This leads us to question whether there is merit considering the approach of the International Accounting Standards Board in giving equal weight to mandatory and guidance paragraphs so that the distinction between the two is removed and documents are read as a whole.

A further question worth pondering for the AUASB and other stakeholders of the audit standard setting process is whether the courts would ignore the guidance that is present in the auditing standard if they were making a decision on whether an auditor had acted reasonably in the circumstances? One perspective on this debate is the document would need to be taken as a whole in determining what constituted a reasonable course of action for an auditor within a given fact pattern presented before a judge. If the guidance had no purpose and its existence within the document was pointless then all the AUASB would have to do is delete it. We have to assume that the guidance contained in the main body of the standard that appears in guidance is an integral part of the auditing standard and, *prima facie*, must be taken into account when interpreting the standard as a whole. An approach that only takes account of the mandatory requirements in interpreting the standard when the 'black' and 'grey' paragraphs build on and complement each other would be unfortunate. It is our view that any action against any auditor or auditors for breach of auditing standards would be determined on the basis of the fact pattern before a regulator. Disputation over the way in which mandatory and guidance paragraphs are to be read will become purely academic in such circumstances as an auditor is required to make all of the queries and do all of the testing that is possible to come up with an opinion. Auditors that do insufficient work are not only in breach of the auditing standards. It should be remembered that they are also in breach of the codes of ethics and other professional requirements of a relevant professional body in such a circumstance, which would include being in breach of the auditors' obligation to act in the public interest as stated in our ethical standards.

Preamble and provision of clarity on authority of paragraphs

Any preamble should contain a clear statement on how the mandatory requirements and guidance paragraphs should be read. We would prefer that it be noted in the preamble that the guidance provides a greater explanation of the obligations that sit in the mandatory requirements.

An alternate approach is for the AUASB to issue its standards on the understanding that all paragraphs are to be read as having equal authority. That would eliminate the demarcation between bold and normal type that exists in these circumstances.

‘Should’ and ‘shall’

The NIA has no significant concerns with the editorial changes from ‘should’ to ‘shall’. We note, however, the concerns of other commentators about the way in which legal counsel may interpret phrases that have undergone such change.

There has been a call on the part of some commentators that the audit board should replicate the wording in accounting standards. We are satisfied that the approach the board is taking aligns with the accounting standard setting model in this country.

Use of the term ‘ordinarily’

We would like to note that we are aware healthy debate exists about the use of the term ‘ordinarily’ in the standards. On the one side is the argument that approves of the use of the term ‘ordinarily’ as a way of specifying that auditors normally do something in an audit but they may not have to meet that hurdle in the standard if it is inappropriate in the circumstances of a particular engagement. The other view is that the use of ‘ordinarily’ may create an incentive for auditors to be lax and not do all they should in a particular engagement.

We have no great concern about the use of the term provided the meaning is adequately spelt out in a brief glossary such as the one found in the draft preamble the AUASB kindly provided on its web site for those attending the special meeting held late in September.

It may be appropriate, however, for the AUASB to review each additional instance of ‘ordinarily’ prior to the issuance of the standard to ensure that the use of the word achieves the AUASB’s intent. Each additional instance of ‘ordinarily’ may be considered a departure from the IFAC standard. A review of the use of this term in the revised standards prior to their being issued as legislative instruments should bear this in mind.

We will continue to monitor the progress of the AUASB’s work. Should you or the AUASB staff have any questions or comments about the contents of our submission please feel free to contact me directly on either 03 8665 3143, 0407 408 000 or via e-mail at tom.ravlic@nia.org.au .

Kindest Regards

Tom Ravlic PNA
Policy Adviser – Financial Reporting and Governance
National Institute of Accountants