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13 October 2005

Dear Ms Kelsall

**Exposure Drafts ED 1/05 - 5/05**

We appreciate the opportunity to comment on the above mentioned Exposure Drafts (EDs) and to contribute to the continued improvement of the Australian auditing standards. We contributed to and support the group submission made on behalf of the profession, a copy of which is attached. In addition, we have attached some specific comments in Appendix 1.

We confirm our support for the overall approach taken by the Auditing and Assurance Standards Board (AUASB) in redrafting the auditing standards to enable them to have the force of law and commend the AUASB on the progress made to date.

Although we generally support the 5 proposed standards, we believe that they can only be effectively interpreted in the context of the proposed Preamble. We understand that the Preamble is still being considered by the AUASB and request the opportunity to comment in more detail on these EDs once the Preamble has been finalised. Many of our detailed comments arise as a result of the issues raised in the group submission, and as such, we have not included them in this response. However, some overall comments are included in Appendix 1.

We would be pleased to discuss our comments with you. Please contact me on (02) 8266 2824 for additional information.

Yours sincerely



Mark Johnson  
Assurance Leader

## Overall comments on ED 1/05 – 5/05

1. Our view is that the Authority Statement in each standard should make reference to the fact that the standard is to be interpreted in accordance with the Preamble.
2. We believe that it is inappropriate to mandate specific audit procedures without the ability to apply alternative procedures when they are more *effective*. For example, Para 11 of ED 5/05 requires the auditor to attend a physical inventory count “unless impracticable”. Whilst it is likely that the auditor will attend an inventory count to obtain evidence of existence and condition, alternative tests to meet the objective should be permitted if more effective.

Although the black letter wording above is in accordance with the ISA, ISA 230 (revised) allows the auditor to depart from a basic principle or essential procedure in exceptional circumstances, provided the auditor can clearly document the reason for the departure and how the alternative procedure achieved the same objective.

The draft Preamble’s “Inability to Comply with an Essential Procedure” refers only to circumstances outside the control of the auditor.

Our view is that either:

- The paragraph in the Preamble should be consistent with the wording in the ISA, or
  - Para 11 of AUS 506 could be worded along similar lines to that of paragraph 5 of AUS 504 “The auditor shall determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination the auditor shall consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.” (underline added)
3. As discussed in the group submission, references to the requirements of other standards in the grey letter guidance are sometimes not obvious in the other standards. For example, para 44 of AUS 504 states “... pursuant to AUS 502, the auditor is required to obtain sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated.” This requirement is not clearly stated in any of the black letter paragraphs of AUS 502. It is important that when references to requirements in other standards are made, that they can be clearly tied back to the black letter requirements in those standards.

11 October 2005

The Chairman  
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MELBOURNE VIC 8007

Dear Ms Kelsall

As previously discussed we are pleased to provide a group submission on the recent release of exposure drafts of the first five proposed new Auditing Standards which are intended to apply to audits of financial reports for periods commencing on or after 1 July 2006.

As a broad overall comment, we are supportive of the approach taken to date by the Auditing and Assurance Standards Board (AUASB) considering the direction and timelines given by the Financial Reporting Council (FRC) and the current development of international auditing standards.

We support the current strategy of the AUASB to only make those essential changes to the current Australian Auditing Standards that are necessary to enable them to have the CLERP 9 "force of law" from 1 July 2006. In particular, this will ensure that the amended Auditing Standards will be largely consistent with the current International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB).

We believe that the style format followed by the Australian Accounting Standards Board (AASB) should be followed so that any changes to the ISA on which the current Australian Auditing Standards are based, can be easily identified by the use of "Aust" type paragraphs that the AASB follows in its Australian equivalent to International Financial Reporting Standards (AIFRS).

Once the "force of law" project is completed we encourage the AUASB to work with the IAASB and consider the relevance of international auditing standards such as those of the US Public Company Accounting Oversight Board (PCAOB) as part of the clarification, maintenance and updating of Auditing Standards.

We have attached some important comments, particularly dealing with the ramifications of these new standards having the force of law and the importance of the draft Preamble, which we consider a vital component for both the tabling of disallowable instruments before each House of Parliament and in their ultimate interpretation by Regulators and Courts. The ISA (on which the new documents are based) are not and, are not intended to be, legally enforceable documents. As such, the drafting does not have the qualities of precision, succinctness and consistency demanded of a statutory instrument of general application. The standards are not always from a strict legal perspective, clearly stated or easy to understand. Accordingly the Preamble will play a crucial role.

We cannot emphasise enough the significant change this force of law aspect has when we are dealing with long standing auditing concepts of “reasonable assurance” and “professional judgement”. Our attached comments provide some suggestions of how these essential concepts can be given added importance in both the Preamble and the various Authority Statements.

We look forward to providing further comments as more Exposure drafts are issued and the current draft Preamble continues to be developed.

Yours faithfully

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Graham Ezzy, EY

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# APPENDIX

## 1. Overall observations on the AUASB's approach

- 1.1. The proposed new standards are based on existing Australian standards which are in turn based on International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB). In making amendments to the standards to enable them to have the force of law, the principal approach by the AUASB is to change the word "should" where it appears in the bold-type paragraphs of the standards to "shall". Accordingly, where an ISA (and a current Australian standard which is based on an ISA) uses the word "should" in a bold-text paragraph, the AUASB will change the word "should" to "shall".
- 1.2. There is an issue that the change from "should" to "shall" may potentially be construed by lawyers (who will have a significant new role in advising on or enforcing the standards as legislative instruments), regulators and ultimately by the courts, to have the effect of extending the content and definition of the obligations of auditors, unless there are appropriate principles of interpretation applying to the standards which avoid that effect.
- 1.3. In short, the word "shall" instead of "should" may in many bold-type paragraphs (if read in isolation from any applicable principles of interpretation) have the potential to allow the paragraph to be construed so as to:
  - diminish or eliminate the element of judgement which fundamentally permeates the application of auditing standards and the work of the auditor generally; and
  - require an outcome which would have the effect of the audit providing absolute assurance, that is, beyond the intended outcome of auditing standards as providing reasonable assurance.
- 1.4. The legislature provided for auditing standards to have the force of law to make them easier to enforce, and to extend the liability consequences of an auditor's failure to comply with the auditing standards. There is no suggestion that the legislature intended that the content and definition of the obligations of auditors should also be extended. An extension of the content and definition of the obligations of auditors, in standards which are not, from a legal perspective, either clearly stated or easy to understand, will add significantly to the cost and efficiency of audits. In our view such a consequence is adverse to the public interest and should therefore be avoided.
- 1.5. It is apparent that the draft Preamble (discussed below) is intended to prescribe principles of interpretation and application of the standards. In our view the AUASB's apparent intentions as to the interpretation of the standards should, taken as whole and if given effect, avoid the consequence of extending the content and definition of the obligations of auditors. However in our view the Preamble should be clearer and more comprehensive in prescribing the relevant principles of interpretation and application. We outline our suggestions below. To give context to our suggestions, we will first describe in more detail the possible implications of the change from "should" to "shall".

## 2. Possible implications of the change of "should" to "shall"

- 2.1. As a matter of construction, the word "should" suggests a statement of principle. Principles are, of their nature, generally matters for judgment. In the context of the auditing standards, the "should" formulation suggests principles to be applied by auditors in forming their professional judgement. It suggests a process of reasoning or an intellectual discipline to be applied, with due care and skill (that is, implying the general law obligations of auditors), in considering the matter referred to.
- 2.2. In contrast, the word "shall" suggests a rule. Rules are generally construed as absolute requirements which are either satisfied or not, and hence (unless expressly so qualified) leave no scope for the application of judgement as to their application. In

the context of the auditing standards, the word "shall" tends to shift the focus from a process to be followed onto an objectively determinable outcome or result.

- 2.3. For example, paragraph 5 of AUS 502 (which is based on ISA 500) currently reads:

“The auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.”

Under the revised AUS 502 proposed by the AUASB, paragraph 5 will read:

“The auditor shall obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.”

- 2.4. The word "should" in the context of paragraph 5 of AUS 502 suggests a process which the auditor must apply in forming a professional judgment as to the reasonableness of the basis of the audit opinion. The focus is on the auditor's process, which includes forming a judgement as to the sufficiency and appropriateness of audit evidence.<sup>1</sup> The change to the word "shall" tends to shift the focus onto an objective outcome – reasonable conclusions. In the context of a rule which requires *sufficient* and *appropriate* audit evidence to establish the conclusions, it may suggest a meaning of the term *reasonable* which is more akin to "correct". On that construction, the auditor may be argued to fail to meet the standard if the financial report is found to be misstated and thus the audit opinion reaches what is in fact a wrong conclusion, since that would (it could be said) necessarily result from the auditor not obtaining sufficient appropriate audit evidence. Under the "should" formulation, the audit opinion may be found to have reached a wrong conclusion but if the auditor followed the requisite process of considering, with due care and expertise, the sufficiency and appropriateness of the audit evidence as a basis on which to form the audit opinion, there would be no breach of the standard.

- 2.5. To take a starker example, paragraph 5 of the revised AUS 402 reads:

“The auditor shall obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial report due to fraud or error, and sufficient to design and perform further audit procedures.”

It could be argued that any misstatement in the financial report results from a failure by the auditor to obtain an understanding of the entity sufficient to assess the risk of such a misstatement, and hence any misstatement involves a breach of the standard. Under a "should" formulation, the standard would require that the auditor apply the intellectual discipline of obtaining what in the auditor's professional judgement is considered sufficient to assess the risks of material misstatement. If, having followed that process, a material misstatement is nevertheless later discovered, there would be no breach. In this case the "shall" formulation could be construed to require an outcome which has the effect of requiring absolute assurance as to the accuracy of the financial statements, rather than the (to date) generally accepted understanding that an audit can do no more than provide reasonable assurance.<sup>2</sup>

- 2.6. We do not suggest that the change from "should" to "shall" would always potentially result in a possible difference in the effect of a standard. There is a large number of bold-type paragraphs in the standards and it is not possible to generalise accurately the effect of the change on all of them. However, there is such a number of instances where the change might allow a possible construction which could have that effect that it is necessary to ensure that this issue is addressed.

<sup>1</sup> This construction is effectively confirmed in paragraph .11 of AUS 106, the current explanatory framework for auditing standards.

<sup>2</sup> as noted in AUS 106 at paragraph .10 and AUS 402 at paragraph .08

### 3. The draft Preamble generally

3.1. The draft Preamble taken as a whole suggests an intention by the AUASB that the change from "should" to "shall" should not have the effect discussed above. The following statements are noted:

- "In accordance with the standards, the auditor applies principles and performs procedures to obtain reasonable assurance...about the reliability of management's representations<sup>3</sup> in the financial report or other historical financial information."<sup>4</sup><sup>5</sup>
- "The auditor uses professional judgement in applying the standards to varying circumstances, including any special conditions that may apply to public sector or small entities."<sup>6</sup>
- "As the standards are principles-based, the auditor is expected to use professional judgement in applying the mandatory requirements in light of the given circumstances."<sup>7</sup>

However, in our view the drafting of the Preamble should be improved in order to better ensure that the standards are each interpreted and applied in accordance with, and not in extension of, the above basic tenets.

3.2. In this regard, there is some tension between the above statements and other statements in the guidance emphasising the mandatory nature of the bold-type paragraphs, for example: "the word 'shall', appearing in bold-type mandatory requirements is an imperative, legally binding and enforceable obligation on auditors".<sup>8</sup>

3.3. Another statement in the Preamble appears to combine the concepts of absolute obligation and professional judgement: "statements of principle are incorporated in mandatory requirements. Such statements of principle impose a directive obligation, wherein the auditor is required to exercise judgement in the application of the principle(s) according to a given set of circumstances".<sup>9</sup> The draft Preamble appears to draw a distinction between "basic principles" and "essential procedures". We assume that the reference in the statement just quoted to "statements of principle" means those mandatory requirements which are "basic principles" as opposed to "essential procedures". In any event, it appears to us that every standard necessarily requires and imports the exercise of judgement. It is therefore relevant and appropriate to underscore the intention that judgement permeates all standards. That intention should be more clearly expressed, to emphasise that it is professional judgement (not absolute outcomes) which is required by all bold-type paragraphs, whether they are "basic principles" or "essential procedures".

3.4. **[Recommendation 1]** There should be a clear statement to the effect that:

- the objective of an audit in accordance with the auditing standards is for the auditor to obtain reasonable assurance about the reliability of assertions in the

<sup>3</sup> It is not clear what is intended by the expression "management's representations". We assume that is intended to be a reference to "assertions".

<sup>4</sup> It is not clear what is intended by the expression "other historical financial information". This should be clarified.

<sup>5</sup> Page 2 under the heading "Purpose of the Standards"

<sup>6</sup> Page 4 under the heading "Type of Entity"

<sup>7</sup> Page 6 under the heading "Professional Judgement"

<sup>8</sup> Page 6, see "SHALL"

<sup>9</sup> Page 5 under the heading "AUASB Drafting Objectives"

financial report or other historical financial information to which the auditing standards apply;

- mandatory requirements are statements of principle which impose a directive obligation pursuant to which the auditor is required to exercise judgement as to their application according to a given set of circumstances in order to achieve the objective of reasonable assurance;
- mandatory requirements are to be construed consistently with, and within the parameters of, the objective of reasonable assurance.

#### **4. The various roles of guidance – definition and qualification**

- 4.1. The draft preamble notes that normal-type paragraphs merely provide guidance and illustrative examples, or an elaboration of the mandatory requirements. The AUASB notes that explanatory guidance does not extend mandatory requirements or impose additional obligations.
- 4.2. The normal-type guidance in fact often performs a crucial function in the interpretation and application of the bold-type paragraphs.
- 4.3. Many bold-type paragraphs make no sense without the accompanying guidance. (Take, for example, paragraph 32 of revised draft of AUS 402: "The auditor shall obtain an understanding of the nature of the entity".) The guidance often contains definitions which give sense to the expressions used in the bold-type paragraphs. It can be expected that a court would look to the explanatory guidance for relevant definitions where the bold-type requirement can only sensibly be construed by reference to such definitions, as otherwise the standard would likely be considered void for uncertainty.
- 4.4. In addition to providing definitions, the guidance often fundamentally qualifies and limits the bold-type paragraphs. For example, paragraph 5 of AUS 502 referred to above is fundamentally qualified by paragraph 18 (which is cross referenced in a footnote to the normal-type paragraph 6) which makes it clear that:

“In forming the audit opinion, the auditor does not examine all the information available because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor ordinarily finds it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance, the auditor is not satisfied with audit evidence that is less than persuasive. The auditor uses professional judgement and exercises professional scepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.”

(This formulation of the content of paragraph 5 of AUS 502 is in fact consistent with the analysis of the "should" formulation discussed above.)

- 4.5. To take another example, paragraph 9 of AUS 402 referred to above fundamentally qualifies the ambit of paragraph 5:

“The auditor uses professional judgement to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor’s primary consideration is whether the understanding that has been obtained is sufficient to assess the risks of material misstatement of the financial report and to design and perform further audit procedures. The depth of the overall understanding that is required by the auditor in performing the audit is less than that possessed by management in managing the entity.”



(Again, this formulation of the content of paragraph 9 of AUS 402 is consistent with the analysis of the "should" formulation discussed above.)

- 4.6. The Preamble should expressly refer to and acknowledge the effect of the guidance in qualifying and limiting the ambit of the bold-type requirements. Without that reference and acknowledgement, there is a risk that the courts will not give that effect to the guidance. As noted above, a court will likely have regard to definitions in the guidance where the bold-type paragraphs make no sense on their own, as that would be necessary for their enforceability. It is, however, not clear whether a court will necessarily have regard to the limiting effect of guidance on the express terms of bold-type paragraphs where the bold-type paragraphs can be sensibly construed in accordance with their express terms without reference to the guidance. A clear rule of construction is prudent to ensure that the court will have regard to the guidance in limiting the ambit of the bold-type paragraphs.
- 4.7. The Preamble contains the statement: "Explanatory guidance does not extend mandatory requirements or impose additional obligations".<sup>10</sup> There is also a statement: "Explanatory guidance includes definitions...".<sup>11</sup> There is, however, no reference to the limiting effect of guidance.
- 4.8. **[Recommendation 2]** We recommend that the Preamble contain a consolidated statement along the following lines: "Explanatory guidance may contain definitions of terms used in a mandatory requirement. Such definitions are to be applied in the interpretation of that mandatory requirement. Further, where explanatory guidance explains the ambit of a mandatory requirement in a way which may limit or qualify the literal wording or effect of that mandatory requirement, that limitation or qualification applies to the mandatory requirement. Explanatory guidance does not, however, extend mandatory requirements or impose additional obligations".

## 5. Relevance and extent of application of standards to particular audits

- 5.1. The Preamble clearly suggests that not all standards are relevant to all audits – we refer to the first bullet point under *Mandatory Requirements* on page 3. That is a proposition that should go without saying. However to assist in the clarity of the interpretation of the standards we recommend that it be made clear that a mandatory requirement is required to be applied to an audit only to the extent that the auditor considers, in the auditor's professional judgement, that it is relevant to the circumstances of the entity being audited.
- 5.2. Further, the extent (or depth) of application of standards will differ from entity to entity. An audit of a small entity, for example, will not require the same extent or depth of application of a standard as will a large entity. That intention is alluded to in the statement in the Preamble under the heading *Type of Entity* on page 4: "The auditor uses professional judgement in applying standards to varying circumstances, including any special conditions that may apply to public sector or small entities".
- 5.3. **[Recommendation 3]** We suggest that a statement be inserted to the effect that:
  - a mandatory requirement is required to be applied to a particular audit only to the extent that the auditor considers, in the auditor's professional judgement, that it is relevant to the circumstances of the entity being audited; and
  - the extent and depth of application of a mandatory requirement to a particular audit is to be determined by the auditor in the auditor's professional judgement, having regard to the circumstances of the entity (for example, an audit of a small

<sup>10</sup> Page 3 under the heading "*Explanatory Guidance*"

<sup>11</sup> Page 3 under the heading "*Explanatory Guidance*"

entity will not require a mandatory requirement to be applied to the same extent and in the same depth as an audit of a large entity).

## 6. Use of the term "ordinarily"

- 6.1. The use of the term "ordinarily" in the standards tends to suggest usual or common practice, and hence a departure from the matter referred to would constitute a departure from common practice. The Preamble seeks to define the term "ORDINARILY" on page 6 with sufficient clarity, in our view, to avoid that construction – although it would have been preferable, in our view, to have used a more neutral word such as "might".
- 6.2. **[Recommendation 4]** In order to further assist in overcoming any implication that the term "ordinarily" implies common or usual practice, we suggest that the sentence: "The word ordinarily is not intended to create, or to be interpreted as, a rebuttable presumption" should have the following phrase added at the end "and an auditor is not required to document the reason for any non-application of any such method(s) or means". (For completeness, that point should also be reflected in AUS 208 when it is reissued.)

## 7. Use of the phrase "pursuant to" in conjunction with "is required to"

- 7.1. These phrases are used in the guidance, with "pursuant to" referring to a bold-type paragraph and "is required to" denoting what that mandatory requirement can entail. As a matter of construction, it is difficult to avoid this formulation (read in isolation) having the effect of extending the bold-type mandatory requirement. That construction is of course inconsistent with the understanding that guidance does not extend mandatory requirements. As against that understanding, however, there is the explanation of the term "IS REQUIRED TO" on page 6 of the Preamble as denoting an elaboration of the mandatory requirement. It is difficult to make a clear distinction between an elaboration and an extension.
- 7.2. **[Recommendation 5]** In order to ensure that the guidance does not have the unintended effect of extending the mandatory requirements, we recommend that the term "is required to" is not used. We suggest that it be replaced with "ordinarily considers", with "ordinarily" being given the meaning just discussed.<sup>12</sup>
- 7.3. The intention of this recommendation is to ensure consistency with the basic principle that guidance does not extend mandatory requirements. If, however, the AUASB considers that an element in the guidance preceded by "is required to" should be treated as a mandatory element, we suggest that a list of such elements be provided for consideration and further submissions.

## 8. Method of incorporation of rules of interpretation

- 8.1. It is prudent to ensure that the rules of interpretation of the auditing standards are clearly stated as rules to be applied. In this regard we understand that the AUASB will promulgate the Preamble as a standard (and hence a statutory instrument) in its own right. We agree that such a step is appropriate.
- 8.2. **[Recommendation 6]** The Preamble should itself be promulgated as a standard.
- 8.3. **[Recommendation 7]** In its current form, statements of intention as to the interpretation and application of the standards are scattered throughout the draft Preamble. We recommend that the rules of interpretation and application of the auditing standards be set out in one section of the Preamble under a heading such as

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<sup>12</sup> An alternative which might be considered is to delete the "is required to" formulation and to continue the use of the present tense, with an appropriate explanation of that usage in the Preamble.

"Rules for the interpretation and application of auditing standards" which makes it clear that the rules are to be applied to all auditing standards and will prevail over any contrary construction which may otherwise be suggested by the terms of any particular standard.

- 8.4. **[Recommendation 8]** We recommend that the Authority Statement at the beginning of each standard notes that the Preamble sets out the rules of interpretation and application of the standard and that such rules of interpretation must be applied in the interpretation of the standard.
- 8.5. **[Recommendation 9]** It would also be prudent for the authority statement to set out the essential rules of interpretation and application of the auditing standards, to ensure the reader of a particular standard is reminded of them.
9. **Inability to comply with an essential procedure**
  - 9.1. The Preamble requires a departure from an "essential procedure" which is relevant to the audit to be documented.<sup>13</sup> As noted above, the distinction between a "basic principle" and an "essential procedure" is not clear.
  - 9.2. **[Recommendation 10]** We recommend that, for clarity, the "essential procedures", which the AUASB considers should require documentation where there is any departure from them, should be listed for consideration.<sup>14</sup>

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<sup>13</sup> Page 7, under the heading "Inability to Comply with an Essential Procedure"

<sup>14</sup> We understand that the AUASB is considering the appropriateness of the discussion on page 7 under the heading "Inability to Comply with an Essential Procedure". This recommendation assumes that the AUASB will retain that discussion in the Preamble.

