
28 November, 2003

Dr Kathleen Dermody
Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Suite SG.64
Parliament House
CANBERRA ACT 2600

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Dear Dr Dermody,

CLERP (Audit Reform and Corporate Disclosure) Bill

The Auditing & Assurance Standards Board (AuASB) is pleased to make a submission to the Parliamentary Joint Committee on the draft CLERP Bill in the context of the role and functions of the AuASB. The AuASB recognises that there will be oversight of its activities by the Financial Reporting Council (FRC). It looks forward to working with the Government, the FRC and the Parliamentary Joint Committee in a way that maximises the efficiency and effectiveness of the reforms, and minimises the costs of transition to new institutional arrangements. However, the AuASB has concerns with the draft legislation in relation to the proposal for legal backing for auditing standards and the potential for a diminished mandate for the AuASB beyond the setting of auditing standards.

In respect of the first major concern, the AuASB has a long-standing commitment to international harmonisation and convergence, which requires minimal departure from the wording in International Standards on Auditing (ISAs). Proposed section 227B(1)(c) of the *ASIC Act* recognises the importance of the AuASB participating and contributing to the development of a single set of ISAs. Consequently, priority should be given to adherence to the principle of international harmonisation and convergence, rather than requiring the rewriting and remaking of each auditing standard as a disallowable instrument.

Given the above, the AuASB remains firmly of the view that existing auditing standards should not be regarded as disallowable instruments and receive legal backing under proposed section 336 of the *Corporations Act 2001*. Attaching legal backing to the existing body of auditing standards on an interim basis, as well as the subsequent remaking of auditing standards as disallowable instruments, may conflict with the AuASB's policy of harmonisation and convergence with ISAs. As with the existing Australian auditing standards, ISAs have not been drafted in legal form, nor have they been drafted with a view to them receiving legal backing.

In respect of the second major concern, it is important to note that as well as setting auditing standards, the AuASB conducts important work in relation to assurance standards and provides guidance on both audit and assurance matters. Various types of material for audits, both subject to and not subject to the *Corporations Act*, form part of the AuASB's output. The AuASB is concerned that a mandate to undertake all this work be continued. In this regard, the AuASB believes it important that the functions of the AuASB provided for in the Bill be amended under proposed section 227B(1) of the *ASIC Act* to provide this continuing mandate.

These and other issues in the draft Bill about which the AuASB would like to make comment and recommendations are addressed in the attachment to this letter under the following headings:

1. The implications of "remaking" auditing standards;
2. The standards to which legal backing is provided;
3. The role of auditing standards and the distinction between auditing and assurance;
4. Conceptual framework matters;
5. The date of applicability of standards and of the *CLERP (Audit Reform and Corporate Disclosure) Act*; and
6. Auditor reporting of contraventions of the *Corporations Act* to ASIC.

The AuASB would be pleased to discuss its submission on the CLERP Bill with the Parliamentary Joint Committee, and to provide any further submissions if required at a later date.

Yours sincerely,

(signed)

W.R. Edge
Chairman
Auditing & Assurance Standards Board

1. The implications of “remaking” auditing standards

The AuASB¹ notes the recognition given in the draft Bill that the current wording in standards may not be appropriate and the need to “remake” existing standards under proposed section 336 of the *Corporations Act* during a transitional two-year “sunset” period (Commentary 53). However, an inherent conflict exists between the remaking of standards as disallowable instruments and the AuASB’s long-standing commitment to the principle of international harmonisation and convergence. This is the primary reason why the AuASB believes auditing standards should not be provided legal backing. Resolution of this conflict cannot occur without establishing a hierarchy in relation to the AUASB’s functions under proposed sub-sections 227(1)(a) and (c) of the *ASIC Act*.

Consistent with the AuASB’s commitment to international harmonisation and convergence, which requires minimal departure from the actual wording in ISAs, the AuASB believes an alternative should be found to making each standard a disallowable instrument. One such alternative occurs in Canada where a single clause in the corporations’ legislation there makes reference to compliance with auditing standards.

The AuASB is also concerned that auditors during the transition period will be exposed unnecessarily to the potential for legal action against them because of wording of existing auditing standards, which, when drafted, were not intended to be regarded as a disallowable instrument enforceable under the *Corporations Act*. For instance, the extensive narrative in auditing standards together with the drafting style currently used (i.e. present and conditional tenses) makes it inappropriate for these standards to be regarded as law.

If existing auditing standards are to be regarded as disallowable instruments, the present guidance provided to explain the application of the basic principles and essential procedures in those standards may be incorrectly interpreted as being prescriptive, instead of what was intended by the AuASB i.e. guidance on matters, which the auditor may ordinarily consider when applying those procedures and principles during an audit engagement. In essence, this highlights that the practice of auditing is no different from other professional fields, which rely heavily on the exercise of professional judgement. To have a situation where auditors feel compelled in the conduct of their audits to become procedure-driven in order to protect against legal action will be inefficient and will potentially threaten audit effectiveness.

Additionally, it remains to clarify what is meant by “relevant and comprehensive guidance” referred to in proposed section 224(aa) of the *ASIC Act*. This is necessary because, for instance, appendices are included in many of the standards. The AuASB is of the view that legal backing should not apply to appendices within the auditing standards designated to attract legal backing.

Recommendations:

1.1 The AuASB recommends that the principle of harmonisation and convergence to

¹ Like the draft Bill, this submission uses the acronyms “AuASB” to represent the current Board, and “AUASB” to represent the new Board.

international auditing standards take precedence and that an alternative be adopted to remaking auditing standards as disallowable instruments.

- 1.2 *The AuASB recommends that legal backing under proposed section 336, if it is to go ahead, be delayed until auditing standards are remade as appropriate, rather than being transitionally provided “interim legal backing”. Language protocols and the status of appendices in standards are issues that need to be resolved before these provisions of the Bill are operative.*

2. The standards to which legal backing is provided

If legal backing is to go ahead as planned in the draft Bill, the AuASB is of the view that neither the proposed section 336 (force of law) nor proposed section 1451 (interim legal backing) of the *Corporations Act*, should apply to the complete list of current standards in Table 1. This is so since not all standards listed are pertinent to engagements under the *Corporations Act*. For instance, AUS 108, AUS806, AUS 808 and AUS 904² relate to neither the *Corporations Act* nor to an audit or review of a financial report.

Appendix 1 documents the categories into which current standards fall in terms of their relevance to the *Corporations Act* and their definition as to “audit”, “assurance” or “neither audit nor assurance”. The AuASB believes there needs to be careful consideration of the existing standards to which legal backing will apply and consultation regarding the process for determining to which future standards legal backing will apply. The AuASB will be pleased to work closely with legislative drafters in this regard.

Recommendation:

- 2.1 *The Regulations to the Bill include only auditing standards that are pertinent to financial reporting engagements subject to the Corporations Act 2001 (refer Appendix 1)*

3. The role of auditing standards and the distinction between auditing and assurance (Commentary issues 1.1 and 1.2)

In 1999 the then Auditing Standards Board in Australia changed its name to the Auditing & Assurance Standards Board (AuASB), reflecting the fact that it published material relating to both auditing and assurance. In 2002 the International Auditing Standards Board did the same, becoming the International Auditing and Assurance Standards Board (IAASB). Since 1999, the AuASB has been issuing new standards as auditing and assurance standards and progressively amending existing auditing standards to auditing and assurance standards to reflect this philosophical approach. This philosophy and these actions align with the Constitution of the Australian Accounting Research Foundation (AARF) in terms of the powers and duties of the AuASB, the relevant extract of which is reproduced as Appendix 2.

² AUS 108 “Assurance Engagements”, AUS 806 “Performance Auditing”, AUS 808 “Planning Performance Audits”, AUS 904 “Engagements to Perform Agreed-upon Procedures”.

As is recognised in the draft Bill, the AuASB is committed to convergence and harmonisation with IAASB pronouncements. The IAASB conceptually places “assurance” as an overarching framework for its activities and then sub-divides its pronouncements into “audits and reviews of historical financial information” and “other assurance engagements” (refer Appendix 3)³. Hence the IAASB and the AuASB place special meaning on the words “audit”, “review” and “assurance”. “Audit and review” are terms reserved to the provision of an opinion in relation to historical financial information. “Assurance”, on the other hand, relates to subject matters other than the historical financial information on which professional accountants provide reports.

The above dichotomy was decided upon as a strategy by the IAASB in 2002 and that body is in the process currently of reorganising the structure of its standards and guidance statements to reflect this decision. In particular, in the future International Standards on Auditing (ISAs) are to relate solely to “auditing” and “review” engagements as defined above, and International Standards on Assurance Engagements (ISAEs) are to relate to “assurance” engagements as defined above. These changes are not yet reflected fully in the structure of either the International or Australian handbooks of standards. It is the intention of the AuASB to revise the structure of its handbook once the IAASB revises its handbook.

Additionally, the provision of information to Australian auditors by the AuASB in formats other than standards is an important part of the AuASB’s current activities. In particular, some of the Guidance Statements arise in connection with the Australian Prudential Regulation Authority (APRA) Prudential Standards and are explicitly referenced therein⁴. Other material provides more general guidance to Australia’s professional accountants providing opinions on various subject matters, and forms an important part of the intellectual capital of the profession. To lose ongoing provision of this guidance would be a mistake in the AuASB’s opinion and potentially threatens the quality of audits. Notwithstanding proposed section 234B of the *ASIC Act*, the AuASB is concerned over its mandate going forward and funding for these important ongoing activities.

In view of the above, the AuASB believes that the proposed section 224(aa) of the *ASIC Act* too narrowly expresses the role of ‘auditing standards’ in the Australian Financial Reporting System. Consequently, the AuASB believes proposed section 224(aa) needs to be amended to reflect the current role of auditing and assurance standards and related guidance, which is broader than that envisaged in the draft Bill. Amended wording is provided in the recommendations below (changes underlined).

The AuASB also believes proposed section 227B(1)(b) of the *ASIC Act* needs to be amended to reflect a broadened mandate than that envisaged in the draft Bill, and that a new sub-section is required to include formulation of guidance on both auditing and assurance matters.

³ Refer July 2003 IAASB meeting, Agenda Item 6 “Proposed Revised Preface”: 8. The Preface was passed at the October 2003 meeting of the IAASB.

⁴ AGS1008 “Audit Implications of Prudential Reporting Requirements for Authorised Deposit-taking Institutions (ADIs)”, AGS1062 “Audit Implications of Prudential Reporting Requirements for General Insurers”. Also relevant is AGS1026 Superannuation Funds: Auditor Reports on Externally Managed Assets”, to be revised for APRA Prudential Standards in respect of Superannuation when they are issued.

Recommendations:

3.1 *Proposed section 224(aa) insert to the ASIC Act be amended as follows:*

“to facilitate the development of auditing and assurance standards and related guidance that:

- i. provide Australian auditors with relevant and comprehensive guidance in forming an opinion about, and reporting on, whether financial reports comply with the requirements of the Corporations Act; and*
- ii. require the preparation of auditors’ reports that are relevant and reliable, facilitate comparability and are readily understandable by the users of the financial reports to which they relate”.*

3.2 *Proposed Section 227B of the ASIC Act be amended as follows:*

- (1) The functions of the AUASB are:
 - (a) to make auditing standards under section 336 of the Corporations Act for the purposes of the corporations legislation; and*
 - (b) to formulate auditing and assurance standards for other purposes; and*
 - (c) to formulate guidance on auditing and assurance matters; and*
 - (d) to participate in and contribute to the development of a single set of auditing standards for world-wide use; and*
 - (e) to advance and promote the main objects of this Part.**

4. Conceptual framework matters (Commentary Issue 1.3)

Currently AUS 106 and AUS 108⁵ function as overview documents for Australian auditing and assurance standards and related guidance. These overview documents function as a “framework” in the sense that they create a framework within which standards are developed, although it may be accurate to say that they do not represent a “conceptual framework” in the true sense of those words. The IAASB is working currently to revise and restructure its equivalent documents (ISA 120 and ISAE 100⁶) to reflect the recently adopted structure represented in its Preface document (referred to above and reproduced as Appendix 3).

Although not currently on its agenda, the IAASB may in future devote resources to the development of a conceptual framework forming part of the ISAs, which the AuASB could adopt in Australia. Accordingly, the AuASB believes it is not necessary for the AUASB’s functions to specifically include the development of a conceptual framework, since this activity would implicitly form part of its standard setting functions, and should not be distinguished from those functions. As such, Note 2 to section 227B of the *ASIC Act* is not required.

Recommendations:

4.1 *The AUASB not be conferred a special function to develop a conceptual framework as this function is included implicitly in its standard setting role.*

⁵ AUS 106 “Explanatory Framework for Standards on Audit and Audit Related Services” and AUS 108 “Assurance Engagements”.

⁶ ISA 120 “Framework of International Standards on Auditing” and ISAE 100 “Assurance Engagements”.

4.2 *Note 2 to proposed section 227B of the ASIC Act, reproducing the equivalent Australian Accounting Standards Board (AASB) Note, is unnecessary and should be deleted.*

5. The date of applicability of standards and of the CLERP (Audit Reform and Corporate Disclosure) Act

Proposed section 336(3) of the *Corporations Act* provides that in the absence of a specific commencement date in a standard, the standard applies to each financial period ending after the commencement of the standard. Whilst proposed section 1450 of the *Corporations Act* provides that proposed sections 307A and 989CA apply in respect of a financial year that begins on or after the day on which the Act commences. However, audit reports are provided on the whole period to which the financial report applies. This period does not necessarily equate to commencement of standards or the Act.

Furthermore, there appears to be inconsistency between proposed subsection 336(3) and section 1450 in terms of timing with the former nominating periods ending and the latter periods beginning.

Recommendation:

5.1 *Auditing standards and the new Corporations Act provisions under the Bill related to the audit or review of financial reports to be applicable to financial periods commencing on or after the commencement date of the standards and the commencement date of the new provisions of the Act.*

6. Auditor reporting of contraventions of the Corporations Act to ASIC

Proposed section 311 of the *Corporations Act* imposes a requirement on auditors to report directly to ASIC within seven days if the auditor is aware of circumstances that the auditor has reasonable grounds to suspect amount to a contravention of the *Corporations Act*. Failure by the auditor to do so will create a strict liability offence.

The proposal is for the existing section 311 to be repealed. This existing section permits the auditor to exercise appropriate judgement as to whether the auditor believes that a suspected contravention of the *Corporations Act* has been or will be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors, before requiring the suspected contravention to be reported to ASIC. The AuASB believes that this aspect of the existing section 311 requirement is adequate, and provides a reasonable basis for the auditor to either confirm or dispel his/her suspicions before proceeding to report any matters to ASIC.

With regard to the proposed section 311, the AuASB believes the proposed reporting period of '*as soon as practicable, and in any case, within seven days*' to be too short a timeframe for an auditor to consider all relevant matters, particularly if further professional advice and opinion is required to be obtained. The imposition of such a restrictive time limit to report to ASIC does not give the auditor sufficient time to discuss relevant matters with a company's board of directors. If a time limit for reporting suspected contraventions is to be imposed, we suggest that a more reasonable time frame (e.g. 30 days) be allowed for.

Openness and transparency in the auditor-client relationship is important. If those charged with governance are fearful disclosures they make to the auditor in confidence can be virtually immediately reported to ASIC, then full and frank disclosure will be inhibited and the quality of the audit may be prejudiced. Introducing this requirement and the attached penalty for auditors brings potential for ASIC to receive many section 311 reports, with no distinction between serious and non-serious potential breaches of the Act.

Recommendations:

- 6.1 The existing section 311 of the Corporations Act be retained.*
- 6.2 If a time limit for reporting suspected contraventions is to be provided for in section 311 - the time period within which auditors must report to ASIC be extended to, for example, 30 days.*

Appendix 1: Categories of AuASB Standards

Type of Engagement	<i>Relevant to Both Corporations Act and Non-Corporations Act Engagements</i>	<i>Not Relevant to Corporations Act Engagements</i>
Both Audit and Other Assurance	AUS 102 Foreword to Australian Auditing and Assurance Standards and Guidance Statements AUS 104 Glossary of Terms AUS 106 Explanatory Framework for Standards on Audit and Audit Related Services	
Other Assurance	AUS 810 Special Purpose Reports on the Effectiveness of Control Procedures	AUS 108 Assurance Engagements AUS 806 Performance Auditing AUS 808 Planning Performance Audits
Audit	AUS 202 Objective and General Principles Governing an Audit of a Financial Report AUS 204 Terms of Audit Engagements AUS 206 Quality Control for Audit Work AUS 208 Documentation AUS 210 The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report AUS 212 Other Information in Documents Containing Audited Financial Reports AUS 214 Auditing in a CIS Environment AUS 218 Consideration of Laws and Regulations in an Audit of a Financial Report AUS 302 Planning AUS 304 Knowledge of the Business AUS 306 Materiality and Audit Adjustments AUS 402 Risk Assessments and Internal Controls AUS 404 Audit Implications Relating to Entities Using a Service Entity AUS 502 Audit Evidence AUS 504 External Confirmations AUS 506 Existence and Valuation of Inventory AUS 508 Inquiry Regarding Litigation and Claims AUS 510 Initial Engagements - Opening Balances AUS 512 Analytical Procedures AUS 514 Audit Sampling & Selective Testing Procedures AUS 516 Audit of Accounting Estimates AUS 518 Related Parties AUS 520 Management Representations AUS 522 Audit Evidence Implications of Externally Managed Assets of Superannuation, Provident or Similar Funds AUS 524 The Auditor's Use of the Work of the Actuary and the Actuary's Use of the Work of the Auditor in Connection with the Preparation and Audit of a Financial Report AUS 526 Auditing Fair Value Measurements & Disclosures AUS 602 Using the Work of Another Auditor AUS 604 Considering the Work of Internal Auditing AUS 606 Using the Work of an Expert AUS 702 Audit Report on a General Purpose Financial Report AUS 704 Comparatives AUS 706 Subsequent Events AUS 708 Going Concern AUS 710 Communication with Management on Matters Arising from an Audit AUS 802 The Audit Report on Financial Information Other than a General Purpose Financial Report AUS 804 The Audit of Prospective Financial Information AUS 902 Review of Financial Reports	
<i>Neither Audit nor Other Assurance</i>		AUS 904 Engagements to Perform Agreed-upon Procedures

Appendix 2: Australian Accounting Research Foundation Constitution (extract)

9.2 The Auditing & Assurance Standards Board has the following powers and duties:

- (a) to devise and implement a process for the formulation and maintenance of Statements dealing with Auditing and Assurance Standards and Guidance Statements dealing with auditing and assurance matters;
- (b) to prepare proposed Statements dealing with Auditing and Assurance Standards for the approval of the National Boards respectively of ICAA and CPAA and issuance by the Foundation on behalf of ICAA and CPAA;
- (c) to prepare and issue Auditing and Assurance Guidance Statements and exposure drafts dealing with Statements of Auditing and Assurance Standards, subject to the right of the National Presidents respectively of ICAA and CPAA, acting jointly, to intervene;
- (d) to provide the JSC with interpretative advice on auditing and assurance matters;
- (e) to keep under review existing Statements dealing with Auditing and Assurance Standards and the application thereof, and if considered appropriate to prepare draft amendments to those statements for consideration and approval by the National Boards respectively of ICAA and CPAA;
- (f) to keep under review existing Auditing and Assurance Guidance Statements and the application thereof, and if appropriate to prepare and issue amendments to them, subject to the right of the National Presidents respectively of ICAA and CPAA, acting jointly, to intervene;
- (g) in consultation with the Executive Director, to direct contractors or members of the staff of the Foundation to perform work on behalf of the Board including -
 - (i) research on any auditing and assurance topic, and
 - (ii) the drafting of memoranda, exposure drafts and guidance notes on auditing and assurance matters;
- (h) to publish discussion papers, audit guides, audit and assurance alerts, guidance notes, newsletters, monographs and other research materials related to auditing and assurance matters;
- (i) to contribute to the development of the business plans and annual budgets of the Foundation when requested by the JSC and to report regularly to the JSC on the accomplishment of those plans as they relate to the activities of the Board; and
- (j) to liaise from time to time with the JSC and the other Boards and Committees of the Foundation.

Appendix 3: Extract from IAASB Proposed Revised Preface

