

EXPOSURE DRAFT

ED 4/05
(August 2005)

Proposed Auditing Standard: External Confirmations (Re-issuance of AUS 504)

Prepared and Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

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ISSN 1030-603X

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PREFACE

Reasons for Issuing ED 4/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 504) *External Confirmations* due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards will be legislative instruments under the *Legislative Instruments Act 2003*.

Main Proposals

This proposed Auditing Standard:

- (a) establishes standards and provides guidance on the use of external confirmations as a means of obtaining audit evidence;
- (b) provides guidance on the matters to be considered in determining whether and to what extent to use external confirmations under the audit risk model; and
- (c) identifies issues to be addressed in implementing external confirmations as an effective audit procedure.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from existing AUS 504 (July 2002)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the Australian Accounting Research Foundation that it supersedes, AUS 504 *External Confirmations* (July 2002), is that in this proposed Auditing Standard:

1. the word 'shall', in the '**bold-type**' paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility was previously described by the word 'should';
2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance; and
3. the terminology and overall concepts have been aligned to the Audit Risk Standards. The issue and re-issue of the Audit Risk Standards in February 2004, comprising:
 - AUS 202 "Objective and General Principles Governing an Audit of a Financial Report";
 - AUS 402 "Understanding the Entity and Its Environment and Assessing the Risks of Misstatement";
 - AUS 406 "The Auditor's Procedures in Response to Assessed Risks"; and
 - AUS 502 "Audit Evidence"gave rise to necessary conforming amendments to certain existing AUSs, including AUS 504.

A Table of Proposed Changes, excluding conforming amendments mentioned at point 3 above, is provided as an attachment to the Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 504) *External Confirmations* by 14 October 2005. The AUASB would prefer that respondents express a clear overall opinion on

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whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

AUTHORITY STATEMENT

Auditing Standard << >> *External Confirmations* is set out in paragraphs 1 to 45.

The requirements of this Auditing Standard set out in **bold-type** paragraphs are mandatory. These requirements are to be applied by auditors in conjunction with the requirements of other applicable Auditing Standards.

The explanatory paragraphs in this Auditing Standard provide guidance and illustrative examples to assist auditors in the application of the mandatory requirements.

AUDITING STANDARD

External Confirmations

Application

- 1 **This Auditing Standard applies to:**
 - (a) **an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
 - (b) **an audit of a financial report for any other purpose.**
- 2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

- 3 **This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.**

Introduction

- 4 The purpose of this Auditing Standard is to establish standards and to provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.
- 5 **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.**
- 6 AUS 502, "Audit Evidence", states that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. It indicates that, while recognising exceptions may exist, the following generalisation about the reliability of audit evidence may be useful:
 - Audit evidence is more reliable when it is obtained from independent sources outside the entity.

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- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Accordingly, audit evidence in the form of original written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other audit procedures, may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

- 7 External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial report or related disclosures. In deciding to what extent to use external confirmations the auditor ordinarily considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.
- 8 External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. External confirmations may also be used to obtain audit evidence about the absence of certain conditions, for example, the absence of a ‘side agreement’ that may influence revenue recognition. Other examples of situations where external confirmations may be used include the following:
- Bank balances and other information from bankers.
 - Accounts receivable balances.
 - Inventory held by third parties at bonded warehouses for processing or on consignment.

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- Property title deeds held by lawyers or financiers for safe custody or as security.
 - Investments purchased from stockbrokers but not delivered at balance date.
 - Loans from lenders.
 - Accounts payable balances.
- 9 The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in designing the external confirmation requests, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor's Assessments of the Risk of Material Misstatement

- 10 AUS 402, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement", discusses the auditor's responsibility to obtain an understanding of the entity and its environment including its internal control; and to assess the risks of material misstatement. It outlines the audit procedures performed to assess the risks of material misstatement of the financial report sufficient to design and perform further audit procedures
- 11 AUS 406, "The Auditor's Procedures In Response to Assessed Risks", discusses the auditor's responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the financial report and assertion levels. In particular, pursuant to AUS 406, the auditor is required to determine the nature and extent of audit evidence to be obtained from the performance of substantive procedures in response to the related assessment of the risk of material misstatement and that, irrespective of the assessed risk of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance and disclosure. These substantive procedures may include the use of external confirmations for certain assertions.

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- 12 AUS 406 indicates that the higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. Consequently as the assessed risk of material misstatement increases, the auditor ordinarily designs substantive procedures to obtain more reliable and relevant audit evidence, or more persuasive audit evidence, at the assertion level. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.
- 13 The lower the assessed risk of material misstatement, the less assurance the auditor ordinarily needs from substantive procedures to form a conclusion about an assertion. For example, an entity may have a loan that it is repaying according to an agreed schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has led to the risk of material misstatement over the balance of the loan outstanding being assessed as low, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.
- 14 When the auditor has identified a risk as being significant (see AUS 402), the auditor may give particular consideration to whether confirmations of certain matters may be an appropriate way of reducing the risk of misstatement. For example, unusual or complex transactions may be associated with higher assessed risk than simple transactions. If the entity has entered into an unusual or complex transaction that results in a higher assessed risk of material misstatement, the auditor ordinarily considers confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

- 15 AUS 502 requires the use of assertions in assessing risks and designing and performing audit procedures in response to the assessed risks. AUS 502 categorises the assertions into those relating to classes of transactions, account balances and disclosures. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.
- 16 External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date. Confirmation also provides audit evidence regarding the operation of cut-off procedures. However, such confirmation

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does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

- 17 Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.
- 18 The relevance of external confirmations to auditing a particular assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain audit evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.
- 19 AUS 502 provides guidance on other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures when obtaining audit evidence for assertions is not adequately addressed by confirmations.

Design of the External Confirmation Request

- 20 **The auditor shall tailor external confirmation requests to the specific audit objective.**
- 21 When designing the request, the auditor ordinarily considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures.
- 22 Also, in designing the request, the auditor ordinarily considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the audit evidence obtained. For example, certain respondents' information systems

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may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

- 23 Confirmation requests ordinarily include management's authorisation to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorisation, and in some cases may be unable to respond unless the request contains management's authorisation.

Use of Positive and Negative Confirmations

- 24 The auditor may use positive or negative external confirmation requests or a combination of both.
- 25 A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.
- 26 A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit audit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the auditor ordinarily considers performing other substantive procedures to supplement the use of negative confirmations.
- 27 Negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when:

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- (a) the assessed risk of material misstatement is low;
- (b) a large number of small balances is involved;
- (c) a substantial number of errors is not expected; and
- (d) the auditor has no reason to believe that respondents will disregard these requests.

28 A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

29 **When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor shall consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's request. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor shall apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.**

30 **If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor shall consider the possible impact on the auditor's report.**

31 When considering the reasons provided by management, the auditor applies an attitude of professional scepticism and considers whether the request:

- has any implications regarding management's integrity; and
- may indicate the possible existence of fraud or error.

If the auditor believes that fraud or error exists, the auditor, pursuant to:

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- AUS 210 “The Auditor’s Responsibility to Consider Fraud in an Audit of a Financial Report”; and
- AUS 218 “Consideration of Laws and Regulations in an Audit of a Financial Report”

is required to apply the requirements of those standards.

Pursuant to paragraph 29 of this standard, the auditor is also required to consider whether the alternative audit procedures will provide sufficient appropriate audit evidence regarding that matter.

Characteristics of Respondents

- 32 The reliability of audit evidence provided by a confirmation is affected by the respondent’s competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor ordinarily attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity’s long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.
- 33 The auditor ordinarily assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent’s competence, knowledge, motivation, ability or willingness to respond may come to the auditor’s attention. The auditor ordinarily considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional audit procedures are necessary. The auditor ordinarily considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate audit evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial report, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor ordinarily considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

- 34** When performing confirmation procedures, the auditor shall maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.
- 35 Control is maintained over communication between the intended recipient and the auditor to minimise the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. Pursuant to paragraph 34 of this standard, the auditor is required to ensure that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor ordinarily considers whether replies have come from the purported sender.

No Response to a Positive Confirmation Request

- 36** The auditor shall perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures shall be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.
- 37 Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, pursuant to paragraph 36 of this standard, the auditor is required to use alternative audit procedures. The nature of alternative audit procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative audit procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide audit evidence for the existence assertion, and examination of sales near the period-end to provide audit evidence for the cut-off assertion. In the examination of accounts payable, alternative audit procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide audit evidence of the existence assertion and examination of other records, such as goods received notes, to provide audit evidence of the completeness assertion.

Reliability of Responses Received

- 38 The auditor ordinarily considers whether there is any indication that external confirmations received may not be reliable. The auditor ordinarily considers the response's authenticity and performs audit

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procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor, pursuant to paragraph 34 of this standard, is required to request the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor ordinarily considers validating the source of replies received in electronic format (for example, fax or electronic mail). Pursuant to AUS 208, "Documentation", the auditor is required to document oral confirmations in the work papers. If the information in the oral confirmations is significant, the auditor ordinarily requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

39 When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor shall perform additional audit procedures to obtain sufficient appropriate audit evidence.

40 In forming the conclusion, the auditor ordinarily considers the:

- (a) reliability of the confirmations and alternative audit procedures;
- (b) nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
- (c) audit evidence provided by other audit procedures.

Based on this evaluation and pursuant to paragraph 39 of this standard, the auditor is required to determine whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

41 The auditor ordinarily considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, pursuant to AUS 306, "Materiality and Audit Adjustments", and AUS 514, "Audit Sampling and Other Selective Testing Procedures", the auditor is required to determine the reasons for the misstatement and assesses whether it has a material effect on the financial report. If an exception indicates a misstatement, pursuant to paragraph 39 of this standard, the auditor is required to reconsider the nature, timing and

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extent of audit procedures necessary to provide the audit evidence required.

Evaluating the Results of the Confirmation Process

- 42 **The auditor shall evaluate whether the results of the external confirmations process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited.**
- 43 See AUS 406, “The Auditor’s Procedures in Response to Assessed Risks”, and AUS 514, “Audit Sampling and Other Selective Testing Procedures”, for guidance in conducting this evaluation.

External Confirmations Prior to the Year-End

- 44 When the auditor uses confirmation as at a date prior to the balance date to obtain audit evidence to support an assertion, 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. Depending on the assessed risk of material misstatement, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance date. As with all types of pre-year-end work, pursuant to AUS 406, the auditor considers the need to obtain further audit evidence relating to the remainder of the period. AUS 406 provides additional guidance when audit procedures are performed at an interim date.

Conformity with International Standards on Auditing

- 45 This Auditing Standard conforms with International Standard on Auditing ISA 505, “External Confirmations”, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants.

Compliance with this Auditing Standard enables compliance with ISA 505.

Table of Proposed Changes from AUS 504 <i>External Confirmations</i>

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1, 2	Requirement & Guidance	New Application paragraphs
3	Requirement	Re-position Operative Date paragraph
5, 20, 29, 30, 34, 36, 39, 42	Requirement	Replaced “should’ with “shall”.
7, 12, 13, 14, 21, 22, 26, 32, 33, 35, 38, 40, 41	Guidance	Inserted “ordinarily” to clarify implied obligations.
11, 31, 35, 37, 38, 40, 41, 44	Guidance	Inserted “pursuant to...the auditor is required to...” to clarify implied obligations.
19, 43	Guidance	Re-word
31	Guidance	Reformat and reword