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## **THE DEVELOPMENT OF AUDITING STANDARDS IN AUSTRALIA**

*Abstract:* The development of auditing standards in Australia occurred in three phases. The primary professional initiatives have come from the Institute of Chartered Accountants in Australia.

The first phase was marked by F. E. Trigg's presentation to the Australian Congress on Accounting in 1948. In this work Trigg relied heavily on English practice and thought.

The second phase was largely a period of inactivity so far as auditing standards were concerned because of concern for other matters of greater urgency.

The third phase was marked by the adoption of American ideas and, partly in response to continuing criticism of accounting, a commitment to the continuing review of auditing standards.

### *Introduction*

The development of auditing standards and the formal documentation of them has involved a significant effort by the Australian accountancy profession since the early 1950's. The initial effort to formalise these standards was largely contributed by one man. The study of these developments provides an insight into the trend towards a change in the source of international influence on professional concepts and practices in Australia. Evidence is provided of a change from English to American practice as the basis of Australian developments.

Central to this study is the recognition by the profession of its responsibility to identify, codify, and document these standards for the use of its members. Auditing standards provide guidelines to assist auditors in exercising their professional judgment. In the event of litigation involving the auditor, auditing standards provide a basis

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The authors are particularly grateful for detailed comments made on an earlier draft by Mr. F. E. Trigg, formerly senior partner, Price Waterhouse & Co., Sydney. The authors remain responsible for any views of interpretation contained herein.

on which to determine the appropriate level of skill and care which could reasonably have been expected of the auditor in particular situations. Auditing standards should be recognized as differing from auditing procedures. The *Statement of Auditing Standards* presently applicable in Australia provides the following definitions.

Auditing Standards are basic principles governing the auditor's professional responsibilities which he must exercise in the course of his audit and in reporting the results thereof. These apply to every audit. Statements of Auditing Practice, issued for the guidance of members, differ from Statements of Auditing Standards. Practice Statements are concerned with the detailed work or acts which the auditor must carry out to observe the Auditing Standards. They may be varied to meet the requirements of each audit engagement. They do not extend, or limit, the application of the Standards.

The historical development of auditing standards in Australia can be regarded as having occurred in three phases. The initial phase commences with the Australian Congress on Accounting held in Sydney in 1948. The second phase is marked by a change in the relevant organisational structure in the Institute of Chartered Accountants in Australia (ICAA) in 1956. The third and final phase is marked by the issue in 1969 of a statement of auditing standards by the ICAA which differed markedly from its predecessors. It is this document which remains as the foundation of presently applicable auditing standards.

### *Professional Background*

Before proceeding to explain how the formal statement of auditing standards came about, it is useful to explain briefly the structure of the Australian accountancy profession<sup>2</sup> to international readers. The Institute of Chartered Accountants in Australia<sup>3</sup> (ICAA) received its Royal Charter fifty years ago and has grown to about 10,000 members predominantly engaged in public practice. The ICAA members also have a near monopoly on the audit of companies whose securities are traded on the stock exchanges. The Australian Society of Accountants (ASA),<sup>4</sup> formed by an amalgamation of antecedent groups in 1953, now has about 40,000 members predominantly employed in industry, commerce, and government.

The Australian Accountancy Research Foundation (AARF) is jointly sponsored by the ICAA and the ASA. The move to establish

the AARF can be traced on one hand to discussions at the Twelfth Annual Congress of the Australian Chartered Accountants' Research Society that led to a call for the establishment of a research division of the ICAA with a full-time research director and staff. At the same time, the ASA became particularly aware of the need to formulate guides to accounting that would overcome some of the public criticism of the accounting profession at that time and especially the criticism made by government-appointed inspectors of the major company failures of the period.<sup>5</sup> Discussions commenced in March 1964 between officials of the ICAA and ASA, and the AARF was formed in 1965.<sup>6</sup> It was the first positive attempt by the two professional bodies to cooperate on an important project.

### *The Early Period 1948-1955*

It was to be expected that the ICAA, with a high proportion of members involved in public accountancy work, should show more concern for developing auditing standards. The early standards were developed by the ICAA without the aid of, or reference to, the ASA or its antecedents. In May 1942 the General Council of the ICAA set up a Research Co-ordination Committee. This committee "proposed the following year to launch a series of recommendations on auditing standards and procedures, the subject on which the Institute had been invited to prepare a paper for the forthcoming Australian Congress on Accounting."<sup>7</sup> F. E. Trigg was invited to prepare and deliver this paper which was titled "Contemporary Auditing Practice." In it he urged the professional bodies to "give unmistakable leads as to what is best (auditing) practice. . . ."<sup>8</sup> Trigg considered that the general principles of professional auditing practice were not generally understood in Australia; and even where they were understood, they were not, as a rule, applied in practice.<sup>9</sup> Trigg was a senior practitioner with sufficient experience in the profession to make a reasoned assessment of the state of accountancy and auditing in Australia. In considering his subsequent contribution to the formulation of auditing standards, it is instructive to quote his view of auditing in the forties in a recent reflection on that period.

The approach to professional auditing in the forties was, in a large measure, unintelligent. Books were checked and ticked in a stereotyped fashion—the "tick and turn-over method" it was called. This method of course achieved little. Very few audits were planned as to their scope and character—that is to say, based on the auditor's knowl-

edge of a company's business, how the business was organized, the state of accounting and so on, and still less on the auditor's evaluation of the company's system of internal control. In short the entire approach to professional auditing had to be changed and uplifted.<sup>10</sup>

Trigg's views of the state of affairs were further reinforced by the work undertaken by the Research Coordination Committee of the ICAA. The result was that the General Council of the ICAA requested Trigg to produce a statement. Trigg found little enthusiasm for the task amongst his fellow accountants, and the result was his own individual effort.

Trigg is emphatic that his purpose was "to state general principles which should have been recognised and accepted throughout the profession"<sup>11</sup> and that references to auditing procedures were deliberately excluded. Trigg viewed principles as governing procedures in practice while he regarded standards as defining a prescribed level of performance. His work became the direct ancestor of present day statements on auditing standards even though it was issued in 1951 by the ICAA under the title of *Recommendations on General Principles of Professional Auditing Practice*. With Trigg's dismal view of Australian practice already quoted, it is hardly surprising that he found the inspiration for his work overseas, specifically in England. The document covered the distinction between principles and detailed audit procedures; the nature of accounts and the auditors' responsibilities, particularly the duty to exercise reasonable care and skill; the general principles governing an audit and its approach; and the practical implication of general principles.<sup>12</sup>

In the USA the Securities and Exchange Commission had in 1939 sought the inclusion in the auditor's report of a representation as to compliance with generally accepted auditing standards.<sup>13</sup> By 1948 the American Institute of Certified Public Accountants (AICPA) had formally adopted ten broad requirements for audits of financial statements. These American requirements were in no way reflected in Trigg's document, which clearly did not rely on the American example. Nor did Trigg's document depend on a similar document from England, because we have been unable to trace any formal statement by the Institute of Chartered Accountants in England and Wales (ICAEW) prior to 1961.<sup>14</sup>

Trigg relied heavily on his personal knowledge of English practice. Trigg was known to be a vocal advocate of the view that the

English model was best in other areas, including company law, except where different conditions justified departure from the English model. This tendency to follow the English model rested on a more substantial base than any residual colonial inferiority. Trigg considered that there was a high standard of auditing in England.

That came about for various reasons—the requirements and standard of examinations for admission to the Institute and the complex and highly organised business and financial activity in England. There the auditor's practice was much more complicated and specialised than it was in Australia. . . .<sup>15</sup>

Trigg's references to English practice was attuned to the attitudes of the membership of the ICAA. There was a strong English influence within the ICAA. The evolution of the ICAA was closely aided by the Institute of Chartered Accountants in England and Wales (ICAEW). In 1928, the ICAA became the first accountancy body outside the British Isles to receive a Royal Charter. This occurred with the consent of the ICAEW. The ICAA founders were very proud of this Royal Charter. In the 1940's, the founders who had sought this charter were dominant among members of the General Council, which gave final approval to pronouncements. In 1949 the president of the ICAA still referred to the ICAEW as the parent body.<sup>16</sup> It is hardly surprising that under this environment the ICAA placed a lot of credence in English views. There was also the very practical justification of recognising the much larger resources available to the ICAEW. "Trigg believed that the profession should draw on the more mature professional experience of the English Institute, which was an older and larger body than the Australian Institute."<sup>17</sup> It was a commonly shared belief that the ICAA did not have available the resources to do this work on its own. The willingness to adopt the results of the efforts of the ICAEW was demonstrated in a closely related area. The ICAA pronouncements on accounting practice were generally identical with and copied from an English equivalent. An example of this is the 1946 Australian "Recommendations on Accounting Principles," which retained the substance and, in most respects, the detail of the earlier English recommendations. In 1954 the Trigg document was revised as a result of a number of suggestions and comments made by practicing members of the ICAA.<sup>18</sup> The Research Coordination Committee, which had been charged with developing these standards, was terminated two years later.

### *The Static Period 1956-1969*

Over the next few years there were technical papers written and lectures given by practitioners on the subject of auditing standards. However, the formal activities of the ICAA appear to have remained static in respect to auditing standards while other matters including accounting standards (or principles as they were then designated) received attention.

The Research Coordination Committee was replaced by the Research and Service Foundation in 1956.<sup>19</sup> The Committee on the Whole Future of the Accountancy Profession was charged with reviewing the ICAA role in the future development of the accountancy profession. In 1964 the General Council received a report from this committee which "proposed the creation of two committees, one on accounting principles and the other on auditing practice, both with authority to make pronouncements in the name of the Institute."<sup>20</sup> This recommendation was rejected however, by the General Council which decided to consolidate both functions into a single committee and call it the Accounting Principles and Auditing Practice Committee (AP&AP Committee).<sup>21</sup> Very little in the way of auditing pronouncements was achieved by the AP&AP Committee. It was a committee of busy men, whose primary concern was the continued development of accounting principles. This concern was spurred on by government inspectors who had been making comments critical of accounting practices and the accounting profession in reports of company failures.<sup>22</sup> The financial press had joined in this criticism, adding further urgency to the work. A new structure resulted from a recommendation of the Development and Planning Committee appointed by the ICAA General Council in 1966. Its recommendations followed discussions with Sir Henry Benson and C. A. Evan-Jones, the President and Secretary respectively, of the ICAEW on the ICAEW's organisational structure and committee system. The work of the AP&AP Committee and the Management Committee of the Research and Service Foundation was split between two new committees called Research and Technical, respectively. "The Technical Committee, chaired by F. E. Trigg, was asked to keep under review the standards of technical performance of members generally in the exercise of their professional skills and to prepare statements (for submission to General Council) for the guidance or assistance of members."<sup>23</sup> As a result the Technical Committee issued the practice statements of "Qualification of Auditors Reports," in 1967 with an amended version appearing in 1968, while "Auditors Reports on Group Accounts" appeared in 1968.

More important, however, in the tracing of the development of auditing standards, was the issue in 1969 of a revision of the "Statement on General Principles of Professional Auditing Practice." This revision was again prepared by F. E. Trigg and replaced the earlier statements issued in 1951 and amended in 1954. The revision was designated, "C1, Statement of General Principles of Professional Auditing Practice." Paragraph 17 of this statement reflected the view that professional practice may have been deficient but that there was sufficient evidence available of what auditing practice should be like. It declared, "No fundamental changes in the general principles of auditing which underlie the planning and carrying out of sound auditing procedure has occurred over the passing years." The statement however did discuss the subject of auditing standards more fully than previous statements in an attempt to provide more guidelines for the auditor in the discharge of his duties. Two further reasons were advanced why progress in the development of auditing standards was not spectacular during the 1954-69 period.

On the one hand, the profession has perhaps relied too much on the somewhat subjective standards in the exercise of skill and judgement rather than codified standards. On the other, the sheer pressure on the resources of the profession has imposed a limit on what can be accomplished.<sup>24</sup>

### *1968 On, the Turn Towards America*

In the later part of 1969, the ICAA's Development and Planning Committee was responsible for the replacement of the Research and Technical Committees with a new pair of committees known as the Accounting Principles Committee and the Professional Standards Committee.<sup>25</sup> This has occurred because it was concluded that the drafting and vetting of proposed pronouncements should not be divided between two committees. Other events were occurring which would shape happenings in the 1970's. During the 1960's through domestic growth and the influx of overseas capital (especially from America), commerce in Australia was becoming more complex. There was also a gradual but inevitable change in Australia's international trading relationships away from Europe and towards the Pacific basin.

Investment in [the] three forms—ownership of shares or debentures in Australian companies by oversea companies or individuals; inter-company accounts involving assets in



Australia of branches of oversea companies [shows this trend]. The United Kingdom's portion of these totals has fallen from about two-thirds in the 1960s to around 25% in the 'seventies. The United States accounts for about 30% and a smaller amount comes from Canada. An increasing proportion has come from Japan. Of new investments in 1974-75, the United Kingdom accounted for 12%, North America 44%, Japan 7% and others 37%. These totals do not give a complete indication of the value of oversea investment in Australian companies, partly because they do not make full allowance for accumulation of reserves, which represent increasing oversea investment.<sup>26</sup>

The development of the accounting profession itself during this period was marked by the establishment of formal links between existing local firms and the big international accounting firms most of which, regardless of their historical origins, are perceived to be directed principally from their American offices. At the same time the composition of the membership of the ICAA's General Council was changing. "The new General Councillors brought with them a conviction that the ICAA should play a more central and active role in the advancement of professional standards."<sup>27</sup> The extent to which these changes have led to a reorientation of influence in the accounting profession must remain subjective. The American influence has certainly been pervasive in the academic world. Developments in accounting standards in the seventies have certainly reflected increasing American influence. The adoption of the all inclusive income statement and the interperiod allocation of corporate taxation are two prime examples.

There was also some limited evidence of a growing concern about auditing standards among the wider membership of the accountancy profession. A paper by L. G. Faulk and B. M. Robertson presented to the Twelfth Annual Congress of the Australian Chartered Accountants' Research Society (New South Wales Division)<sup>28</sup> and a subsequent series of articles in the *Chartered Accountant in Australia* appears to have stimulated active discussion and directed attention at the form of the AICPA *Statement on Auditing Standards*. The discussion groups at this Congress concluded it was desirable for the ICAA to pronounce auditing standards as minimum standards of performance and for these to be subject to regular review. Furthermore, as noted in outlining the origins of the Australian Accountancy Research Foundation (AARF), there was a call for a full-time research organisation. It took some time for an

effective response to this call, but by 1970 the ICAA and the ASA had agreed to channel all new projects covering accounting and auditing standards through the AARF;<sup>29</sup> and in 1971, with the appointment of Kenley as Research Director, the AARF became fully operational.<sup>30</sup>

Yet another force towards encouraging a more positive attitude to auditing standards was the Pacific Acceptance case in 1970.<sup>31</sup> In this case, Justice Moffit went further than in previous cases in his dicta on the weight to be given to professionally promulgated auditing standards. Compliance with professional standards was considered by the court to be the satisfaction of minimum requirements rather than the performance of best practice. "Further, if professional standards are not appropriate to modern conditions, then they are neither persuasive nor conclusive evidence of reasonable skill and care; they are no defence at all."<sup>32</sup> Therefore, relevance is the criterion upon which auditing standards will be judged. Once the profession has established its auditing standards, it must continually update them over time to ensure that they remain relevant to modern conditions. This updating procedure must not be a once-and-for-all act but part of a continual process so as to ensure the best possible service to clients. Here, more than anywhere else, it was emphasized that the professional bodies might not be the sole source of auditing standards. This is especially so if those standards promulgated by the profession do not satisfy the relevance criterion. No longer will the courts allow the profession to be judged on its own standards. The court expects standards to conform to the expectations of the reasonable man, not the auditor. The court in this case stated that the auditor may be held to a standard higher than currently demanded by his profession if those standards are not relevant to today's needs. The judge then went on to say, "It follows, if the audit profession or most of them fail to adopt some step which despite their practice was reasonably required of them, such failure does not cease to be a breach of duty because all or most of them did the same."<sup>33</sup> "The presumption that the requirements of the profession and the law are compatible has been rudely shattered"<sup>34</sup> by the Pacific Acceptance Corporation case. This is not the place to discuss the details of the principles of negligence as dealt with in the case. Its relevance lies in

the fear engendered in practitioners' minds that the present time is good hunting for many people who think they have a case against the auditor for astronomical damages, as compensation for what they regard, rightly or wrongly, as a breach of duty.<sup>35</sup>

The combination of changing attitudes and the events outlined above can be seen as the motivation behind the issue of an amended statement of auditing standards known as CS.1 in November 1974.<sup>36</sup> What was now presented was an adaption of the AICPA statement, and it was claimed the standards "do not represent a significant departure from those which would be generally accepted by the profession in Australia."<sup>37</sup> The turn away from England to the USA was complete.

### *Continuing Review*

The Australian Audit Standards Committee (AASC) was set up under the aegis of the AARF for the continual review of these standards. This was done in an attempt to satisfy the relevance criterion demanded of auditing standards by Justice Moffit in Pacific Acceptance. The AASC held its first meeting in November 1974. It was decided at this meeting that the most urgent task facing the committee was the review of CS.1. If this review suggested change was necessary in order to keep the standards relevant to modern conditions, a revised document would be issued as a joint statement by both professional bodies. "Work on this review was therefore put in hand as a staff project, and for part of 1976 members of the AASC spent many hours considering possible refinements and/or amendments. In this work a great deal of attention was of course given to recent pronouncements of overseas bodies in the same area."<sup>38</sup> The result was the issue, in April 1976, of the first jointly prepared Exposure Draft on auditing standards.<sup>39</sup> It was issued to all members of the ICAA and ASA by inclusion in the official journals of the respective organisations. Copies were also sent to academics. Comments, criticisms and suggestions were requested by May 31, 1976. "There were thirty-eight letters of comment on the Exposure Draft, and the breakdown of the sources from which these letters were received is as follows:<sup>40</sup>

Public Accountancy Firms	13
Academics	8
Individuals and/or Groups	15
Others	2
	<u>38</u>

The lack of response registered here is mitigated to a certain extent, when it is realized that 13 of the replies were received from larger firms, and thus present the view of the membership of those firms. Possibly this lack of response indicated confidence in the proposed

standard rather than lack of interest. The suggestions mainly concerned themselves with the specific terminology of the Statement. Other suggestions were designed to tighten the principle governing the proper conduct of an audit. A study of them by a sub-committee of the AASC resulted in two principal changes: (a) "To emphasize the responsibility of an auditor to conduct an audit and to report on the 'accounts' as defined in S161 and S5 of the Companies Act," [and] (b) "a significant change in the order and wording of the reporting standards."<sup>41</sup> The result of all this work was CS1/351 "Statement of Auditing Standards" issued in 1977. Like Statement CS1, CS1/351 was basically an Australian adaption of the AICPA Statement.

### *Recent Developments 1978*

A formal joint statement has been issued in May 1978 outlining changes to the organisation of the AARF by the Presidents of the ICAA and ASA.<sup>42</sup> This reorganisation has been undertaken to speed up the flow of accounting and auditing standards. In this way the AARF will be strengthened and streamlined through the appointment of a high-level Foundation Executive Committee (FEC). This new FEC will progressively assume the functions now being exercised by the Accounting Research, Accounting Standards, Accounting Standards Review, Auditing Standards, Taxation, and Legislation Review Committees of the joint accounting bodies. At its first meeting office bearers were appointed, comprising five chartered accountants representing the ICAA and five members of the ASA from industry and government. Important changes also were instituted in the organisation of the work in hand with an emphasis on the use of consultants working on a contract basis instead of various functional committees preparing the various stages of documentation of standards. It is hoped that these new procedures will allow a greater number of projects to be developed at any one time. It is also envisaged that they will widen the range and sources of advice to the profession. The AARF will in future issue exposure drafts in its own name. However, the endorsement of proposed standards will remain the responsibility of the Joint Standing Committee, comprising the Executive Committees of the ICAA and ASA, and the publication of the standards will continue to be in the names of the individual accounting bodies acting together. It is to be expected that the future will not be marked by long periods of inactivity as in the past and that the AARF will concern itself with auditing standards.

### **Conclusion**

In Australia there has been a continual improvement in auditing practice as the profession has become more aware of requirements for effective auditing practice. The development of formal statements of auditing standards has likewise proceeded throughout most of the past thirty years. The voice crying in the wilderness of the forties has led to professional auditing practice improvement with the increasing acceptance of the content of the formal statements issued by the accounting profession.

It is our opinion, based on this evidence, that English views in this area influenced the early pronouncements of the Australian profession on auditing standards. However, in more recent times the Australian profession has increasingly looked to the United States for guidance. This trend is expected to continue into the foreseeable future. The Pacific Acceptance case stung the profession out of its lethargy concerning the development of auditing standards and into decisive action. Since the Pacific Acceptance case, the profession has committed itself to the continual development of auditing standards. The stimulus of public censure in the future, however, will not be necessary to force the profession to promulgate relevant auditing standards. This commitment has been made because the profession realizes the necessity to formalise auditing standards. The Foundation Executive Committee set up by the AARF is evidence of this commitment and represents the means by which auditing standards can be effectively established. Its system of contractors, committees, and exposure drafts allows the scope for a review to be open to the input of many diverse sources.

There is no evidence to show that the standards formulated in CS1/351 have been derived from a systematic body of knowledge about the audit function. The events which have been described concern the documentation of commonly used auditing practices. It is apparent that these standards have their origins in the practicing arm of the profession. Thus it should be remembered by all auditors that "the issue of numerous auditing standard pronouncements does not presage the abandonment of the prime test of skill and judgement which has been the cornerstone of the auditing profession since its foundation."<sup>43</sup> These statements should act not as set rules but as a guide to auditors in performing their attest function.

It will be of interest to review future developments in due course to confirm whether the change in orientation of auditing standards presented above continues to be reflected in those developments.

## FOOTNOTES

- <sup>1</sup>Institute of Chartered Accountants and Australian Society, (1977).  
<sup>2</sup>Gibson, p. 196.  
<sup>3</sup>Marshall.  
<sup>4</sup>Australian Society, (1962).  
<sup>5</sup>Australian Society, (1966).  
<sup>6</sup>Zeff, p. 43.  
<sup>7</sup>Zeff, p. 5.  
<sup>8</sup>Trigg, (1949), par. 123.  
<sup>9</sup>Trigg, (1979).  
<sup>10</sup>Trigg, (1979).  
<sup>11</sup>Trigg, (1979).  
<sup>12</sup>Robertson, p. 4.  
<sup>13</sup>American Institute, p. 204 and Robertson, p. 4.  
<sup>14</sup>Institute of Chartered Accountants in England and Wales, (1961).  
<sup>15</sup>Trigg, (1979).  
<sup>16</sup>Way.  
<sup>17</sup>Zeff, p. 9.  
<sup>18</sup>Institute of Chartered Accountants, (1954).  
<sup>19</sup>Institute of Chartered Accountants, (1955).  
<sup>20</sup>Zeff, p. 11.  
<sup>21</sup>Institute of Chartered Accountants, (1964).  
<sup>22</sup>Australian Society, (1966).  
<sup>23</sup>Zeff, p. 13.  
<sup>24</sup>Institute of Chartered Accountants, (December, 1974).  
<sup>25</sup>Institute of Chartered Accountants, (January, 1970), (March, 1970), (July, 1971).  
<sup>26</sup>Australia and New Zealand Banking Group.  
<sup>27</sup>Zeff, p. 12.  
<sup>28</sup>Faulks and Robertson.  
<sup>29</sup>Australian Accountancy Research Foundation, p. 189.  
<sup>30</sup>Institute of Chartered Accountants, (March, 1971).  
<sup>31</sup>Pacific Acceptance v Forsyth.  
<sup>32</sup>Gilling, p. 105.  
<sup>33</sup>Quoted by Gilling, p. 105.  
<sup>34</sup>Gilling, p. 105.  
<sup>35</sup>Trigg, (1979).  
<sup>36</sup>Institute of Chartered Accountants, (1974).  
<sup>37</sup>Robertson, p. 4.  
<sup>38</sup>Kenley, p. 31.  
<sup>39</sup>Institute of Chartered Accountants and Australian Society, (1976).  
<sup>40</sup>Australian Audit Standards Committee, p. 28.  
<sup>41</sup>Australian Audit Standards Committee, p. 29.  
<sup>42</sup>Institute of Chartered Accountants and Australian Society, (1978).  
<sup>43</sup>Institute of Chartered Accountants, (December, 1974).

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