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Evaluation of the differences between International Standards on Auditing (ISA) and the standards of the US Public Company Accounting Oversight Board (PCAOB)

Maastricht Accounting, Auditing and
Information Management Research Center (MARC)

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Evaluation of the differences between International
Standards on Auditing (ISA) and the standards of
the US Public Company Accounting Oversight Board
(PCAOB)

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Preface

This report presents the results of a study evaluating differences between ISAs and PCAOB standards. The report should be read with the following perspective and limitations in mind:

- This study was commissioned by the European Commission (EC) and is therefore made from an EU point of view. In particular, the research team was asked to focus on EU capital markets. As a consequence, the results of this study reflect an EU capital market perspective and should be interpreted in an EU context.
- There is a different legislative framework in the EU and the US regarding internal controls in companies. In the US, regulation on an audit of internal control on financial reporting is contained in the Sarbanes-Oxley Act, and subsequently embodied in the PCAOB standards. In the EU, internal control regulations are contained in Company Law of the member states. As a consequence, legislative differences have a pervasive effect on our analysis.
- ISAs and PCAOB standards have been developed with a different scope of application. While PCAOB standards are limited to listed companies in a single jurisdiction, ISAs are designed for audits of all types of companies in multiple jurisdictions.
- The clarified ISAs contain objectives for auditors, requirements and application material. The EC asked the research team to include ISA application material in the comparative analysis as this represents best practice.
- An identification of differences between ethical and independence requirements between ISAs and PCAOB standards is outside the scope of this study.
- It should be clear that this study has no intention to make a qualitative comparison between the two sets of standards.

Executive summary

This report presents the results of a study commissioned by the European Commission (EC) on the evaluation of the differences between clarified International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) and the Auditing and Interim Standards of the US Public Company Accounting Oversight Board (PCAOB).

The EC's request to identify and understand the differences between IAASB and PCAOB standards serves mainly two purposes. A technical examination of the differences will be useful for the European Commission to address the audits of US companies listed in an EU jurisdiction in case the ISAs would be adopted in the EU. In addition, an overview of the differences between ISAs and PCAOB standards may also serve European oversight bodies for inspection purposes.

The EC has therefore defined the two main objectives for this study as follows:

1. Identify the main technical differences between the clarified ISAs and PCAOB Auditing and Interim Standards.
2. Assess the impact of the differences between the clarified ISAs and PCAOB Auditing and Interim Standards on audit practice and the perceptions of financial statements users if both sets of standards were to be applied for an audit.

To meet the first objective of the study the research team prepared a detailed comparative analysis of the two sets of auditing standards based on consultations with a wide range of experts supplemented by their own analysis. To structure our comparative analysis, we consider nine topics under which we classify and compare both sets of standards: (1) General principles and responsibilities with respect to an audit of financial statements; (2) Internal control over financial reporting; (3) Risk assessment and use of analytical procedures; (4) Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements; (5) Audit risk model, audit planning, materiality and sampling; (6) Fraud and illegal acts; compliance with laws and regulations; related parties; (7) Specific tests and evidence; (8) Special topics relating to the audit process; and (9) Audit communications. A comparison of ethical and independence requirements between ISAs and PCAOB standards is outside the scope of this study.

Within each category, we then identified potential differences between the two sets of standards. For a difference to be included in the comparative analysis, it had to meet one of the following three criteria: (1) The difference could have an impact on the audit (in terms of activities, procedures, process, or outcome); (2) The difference is a formal but substantive difference even though it may not have an impact on the conduct of the audit; or (3) The difference arises due to the different context of the US and international audit market (i.e., it may apply to the US or the international arena even though it may not apply to the other).

The second objective of the study was addressed by soliciting input from international technical partners from each of the Big Four audit firms to assess the impact on audit practice of the differences between the two sets of auditing standards. We were particularly interested in assessing what additional work, if any, is required for the audit of financial statements following PCAOB standards in addition to clarified ISAs, and whether it would be possible to come to a different conclusion or audit opinion following the two sets of standards instead of clarified ISAs alone. Further, to assess whether the differences between the two sets of auditing standards were perceived as important by participants in European capital markets, and whether dual auditing standards are perceived to be beneficial, we consulted European capital market experts (hereafter “experts”) and found 11 experts willing to participate in our study, including institutional investors, investment banks, venture capitalists and private equity companies, assets managers, private investors, stock exchanges, financial analysts, and professional advisers. Furthermore, we conducted a large-scale survey among a broad range of experienced financial statement users (hereafter “users”) and received in total 105 responses to our survey, including equity analysts, representatives of European shareholder associations, and asset managers and buy-side analysts working for institutional investors like banks, mutual funds, insurance companies, and pension funds. It is important to note that the survey is tailored to the current EU setting. Hence, the results only reflect the EU capital market perspective, and should therefore solely be interpreted in an EU context.

Consulting experts was a constant in our approach to this study as the subject matter requires a high level of expertise on the clarified ISAs and PCAOB standards. We would like to thank all experts who have contributed to this study, as well as staff members from the IAASB and PCAOB who have provided rigorous and valuable comments on the comparative analysis. Such feedback was highly appreciated. We have evaluated and balanced the views from experts and standard-setters in the analysis as far as we believed there was an objective basis

to do so. During our consultation with staff members of standard-setting bodies, it became clear that it is difficult to find consensus on certain issues. In this regard, it is important to emphasize that the results presented in this study are solely the views of the members of the research team alone.

The main conclusions that we draw from the study are the following;

- Based on the comparative analysis and the consultation of experts, we conclude that the number of areas for which substantive differences exist between the clarified ISAs and PCAOB standards is limited. There are only 5 areas for which experts perceive substantive differences that have a significant impact on the audit. These 5 areas are the following:

(1) Assessing and reporting on internal control over financial reporting:

Developing and implementing an effective system of internal control is a primary responsibility of management. Under PCAOB standards, an auditor is required to express an opinion about the quality of the client's internal control over financial reporting. ISAs do not have a comparable requirement, nor do they require an integrated audit (i.e. include an audit of the effectiveness of internal control as part of the audit of financial statements). It is important to note that the PCAOB standards on internal control and integrated audit are a consequence of SOX 302 and 404.

(2) Use of another auditor for part of a group audit:

In contrast to PCAOB standards, ISAs do not permit the primary auditor to make any reference to the work of another auditor.

(3) Documentation:

Documentation requirements under PCAOB standards and ISAs follow a different approach. While PCAOB standards are perceived to be more prescriptive, ISAs are perceived to rely more on professional judgment (e.g., in contrast to ISA 230, AS 3 requires preparation and maintenance of an engagement completion memorandum). The issue was raised that there might be a link between documentation and enforcement. This question remains outside the scope of the study.

(4) Risk assessment and responses to assessed risks:

The approach to assessing and responding to risk within the ISAs differs from that of the PCAOB standards. International standards

require the auditor to obtain a broad understanding of an entity and its environment, through specific risk assessment procedures in order to identify where there may be risks of material misstatements. This perspective includes that an auditor should understand the entity's business risks (for example, strategic and operating risks) and how the entity responds to them in the course of planning and conducting the audit, in order to assess the risk of material misstatements both at the financial statement and assertion levels. While the PCAOB is currently working on a major revision of their risk assessment standards, at the time of this report, there is no requirement comparable to the ISAs for assessing and responding to risk.

(5) Going concern:

PCAOB standards limit the foreseeable future to 12 months, while under ISAs it is at least, but not limited to, 12 months.

Next to these 5 major differences between the clarified ISAs and PCAOB standards, we conclude from the comparative analysis and the consultation of experts that there are minor differences with regard to auditing related party transactions and disclosures, for which ISAs are more extensive, and inquiry of client's lawyer concerning litigation, claims and assessment, for which PCAOB standards are more extensive.

Finally, we conclude from the comparative analysis and the consultation of experts that there is very little to no difference between the clarified ISAs and PCAOB standards that have an impact on the audit for the following areas:

- General principles and responsibilities with respect to an audit of financial statements;
- Quality control for firms that perform audits of financial statements;
- Analytical procedures;
- Written representations;
- Comparative information included in the financial statements;
- Audit risk model exclusive of risk assessment and responses to assessed risks;
- Planning the audit exclusive of risk assessment and responses to assessed risks;
- Materiality;
- Sampling;

- Fraud;
- Illegal acts and compliance with laws and regulations;
- Fair value accounting and auditing;
- Confirmation process;
- Auditing inventories;
- Auditing accounts estimates;
- The effect of subsequent events on the audit;
- Auditing derivative instruments;
- Auditing information from a service organization;
- The role of internal auditors in the conduct of an external audit;
- Use of a specialist during an audit;
- Communication between predecessor and successor auditors;
- Audit communications.

We further note that when the PCAOB adopts its proposed standards on the auditor's assessment of and response to risk, this is likely to increase the commonality between the two sets of standards.

- If an audit of financial statements has to be performed following PCAOB standards in addition to clarified ISAs, this will lead to additional audit work related to testing the system of internal control (due to the PCAOB standards requiring the integration of an audit of the effectiveness of internal control with the audit of financial statements), completing the audit (due to the PCAOB's additional documentation requirements), and preparing audit reports (due to the PCAOB's additional reporting requirements on internal control).
- While audit firms may perform additional procedures to do the audit of the financial statements following PCAOB standards in addition to that required by the clarified ISAs, auditors believe that it will not result in a different audit opinion on the financial statements (excluding the report on internal control over financial reporting) compared to an audit based on the clarified ISAs alone.
- Experts perceive that clarified ISAs require a more risk-based approach, and are also more principles-based, than PCAOB standards. Experts do not perceive that there is much difference in the extent of auditor judgment needed to apply the clarified ISAs or PCAOB standards. Experts have conflicting views on the extent of guidance and level of precision provided by the two sets of standards. In terms of wording, experts perceive that the use of words such as 'shall',

'must', or 'should' has a moderate impact on the way an audit is performed (i.e., the terminology used in auditing standards matters).

- European capital market experts and financial statement users generally perceive that compliance with both sets of standards provides a slightly higher level of assurance when combined. Further, an audit of internal control over financial reporting as required under PCAOB standards is perceived to add to the assurance obtained during the course of the audit.
- European capital market experts and financial statements users are undecided on whether dual auditing standards add value for investment decisions. Furthermore, many respondents indicated that both ISAs and PCAOB standards are of high quality and do not see much benefit in dual auditing standards, especially given the potentially higher costs that would result.
- Efficient movement of capital on an international basis requires information that is understandable and comparable across borders. Hence, investors are in favor of one set of auditing standards that are followed on a global basis.
- Taken the views of experts and users together, they perceive that while high quality auditing standards certainly contribute to high quality financial reporting, they may be insufficient to achieve high quality auditing as a strong audit environment is perceived to be of equal or even higher importance than the standards alone. A strong audit environment comprises effective internal control, strict regulations to safeguard auditor independence, mechanisms to enforce compliance with auditing standards, and effective public oversight bodies performing inspections and investigations.

In summary, the differences between US-based PCAOB auditing standards and the clarified ISAs promulgated by the IAASB are not perceived as extreme by audit practitioners and the investment community in spite of the differences in structure, organization, topical coverage and specific requirements that we note in our detailed analysis. The five areas where the participants in this study show consensus that there are significant differences are well-defined and not overly surprising. This is especially true for differences related to assessing and reporting on internal control over financial reporting. Furthermore, the current

differences in the area of risk assessment and responding to risk will be reduced when the PCAOB issues its current proposed standards on the topic. Finally, while there is no dispute that auditing standards are important for determining the quality of audits, we view the quality of the standards as just one element that determines the value of auditing in a globalized, complex, evolving and uncertain economic environment. To that end, the differences between US-based PCAOB auditing standards and the ISAs issued by the IAASB may be less important than the actual practice of auditing based on those standards as subject to inspection and enforcement by regulators in different jurisdictions.

Chapter 1: Introduction

MARC (Maastricht Accounting, Auditing and Information Management Research Center) has been commissioned by the European Commission (EC) to perform a study on the evaluation of the differences between International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB), a Board of the International Federation of Accountants (IFAC), and the standards of the US Public Company Accounting Oversight Board (PCAOB). MARC has performed this study in cooperation with the International Center for Research in Accounting and Auditing of the University of Florida to reflect and capture the European, international, and US dimensions of the study.

This study is the second part of a more global study (MARKT/2007/15/F) on auditing standards commissioned by the EC. The first part (MARKT/2007/15/F Lot 1) deals with an evaluation, in terms of costs and benefits, of the possible adoption of ISAs in the European Union (EU).

The motivation of the EC to commission this study is the provision in Article 26 of the revised Eighth Company Law Directive 2006/43/EC, setting criteria¹ which international standards on auditing should meet if the EC decides to adopt them for application in the Community. The Commission is currently examining whether the ISAs are able to meet these criteria. The choice of a single set of international auditing standards is in line with the earlier decision of the Commission under Regulation 1606/2002 to adopt IFRS (International Financial Reporting Standards) as the accounting standards to be used for the group accounts of EU publicly listed companies.²

EU companies with a US listing are subject to the Sarbanes Oxley Act of 2002. The EU auditors involved in the audit of such groups should apply the PCAOB standards for audit reports prepared for the attention of investors on US markets. Hence, these EU auditors have to follow PCAOB standards in addition to the auditing standards applicable in their jurisdiction (which would be replaced by the international standards on auditing if the European Commission decides to adopt

¹ The criteria set forth in Article 26 of the Eighth Company Law Directive 2006/43/EC are: a) whether the standards have been developed with proper due process, public oversight and transparency, and are generally accepted internationally; b) whether the standards contribute a high level of credibility and quality to the annual or consolidated accounts; and c) whether the standards are conducive to the European public good.

² We note that in contrast to IFRS, ISAs might not apply only to listed companies, but to all types of entities requiring a statutory audit under Community Law.

such standards under the above mentioned Article 26 of Eighth Company Law Directive 2006/43/EC). On the contrary, audits of financial statements of US publicly listed companies with a cross-listing in the EU are currently conducted in accordance with the standards of the PCAOB only.

The European Commission needs insight into the effects in terms of audit practice and perceptions of financial statements users, if any, of following two sets of auditing standards (ISAs and PCAOB standards) for the audit of financial statements in a transatlantic capital market setting. An overview of differences between ISAs and PCAOB standards may also serve European oversight bodies for inspection purposes³. This study does not represent an assessment of the equivalence of PCAOB standards versus ISAs under Art 45(5)(d) of Directive 2006/43/EC but could possibly be used as a starting point for the Commission in the event of such an exercise.

To this end, this study has the following two main objectives:

1. Identify the main technical differences between the clarified ISAs and PCAOB Auditing and Interim Standards.
2. Assess the impact of the differences between the clarified ISAs and PCAOB Auditing and Interim Standards on audit practice and the perceptions of financial statements users if both sets of standards were to be applied for an audit.

To address these two objectives a conceptual framework is developed, which we describe in Chapter 2. Subsequently, the remainder of the study is organized as follows.

In Chapter 3, we provide some general background on the ISAs and PCAOB standards which is relevant to position the results presented in this study. In particular, we discuss the background of the two standard-setting bodies, IAASB and PCAOB, and their ongoing standard setting activities. Further, we cover the applicability of the standards and position the standards within their applicable general framework.

³ Article 29 of the Eighth Company Law Directive 2006/43/EC provides that external systems of quality assurance ensure that the inspections in the field of audit firms include an assessment of compliance with applicable auditing standards.

As a start to this study, we have reviewed a broad spectrum of both academic and professional sources. The purpose of this review is to gain insight on the assumption of this study that differences in auditing standards matter, and can affect the audit process and audit outcome. This review is contained in Chapter 4.

The next three chapters contain the core of this study. In Chapter 5, we summarize the results of our comparison between the clarified ISAs and PCAOB standards. This comparison is based on a detailed study by the research team as well as on a consultation of experts. In Chapter 6, we discuss the impact of the differences between the two sets of standards on audit practice. This discussion is based on a consultation of experts eliciting views of international technical partners from each of the Big Four audit firms. In Chapter 7, we present the results of our analysis on the impact of the differences between the ISAs and PCAOB standards on the perceptions of financial statement users. This analysis is based on a large-scale survey questionnaire administered to a broad range of financial statement users as well as on a consultation of experts. Chapter 8 provides a summary and conclusions of this study.

We conclude this introductory chapter by making a couple of important observations that should be taken into account when considering the results presented in this study.

First, during the period in which this study was performed, the IAASB was in the process of revising its ISAs, as part of its Clarity Project (see Chapter 3). As a result, the IAASB released clarified ISAs at different times during the conduct of this study. Furthermore, in February 2008 and March 2009, the PCAOB released a proposed and repropounded standard on engagement quality review and, in October 2008, proposed new auditing standards related to the auditor's assessment of and response to risk. The ongoing activities of the IAASB and PCAOB created a unique challenge for the research team since the comparison of their respective standards was a moving target. Our comparative analysis relates to all clarified ISAs, which will come into effect on or after December 15, 2009. Since the proposed PCAOB standards are still subject to change before final issuance, we have not integrated them in the comparative analysis. However, the PCAOB released a comparison of their proposed standards with the comparable ISAs in an appendix to the proposed standards on auditor's assessment of and response to risk. To indicate how our comparative analysis would be affected if these proposed standards were adopted, we include footnotes in our comparative analysis referring to this PCAOB document.

Second, in our research approach to this study, consultation with experts was a constant. Obviously, the subject matter of this study requires a high level of expertise on the clarified ISAs and PCAOB standards. In this regard, we would like to sincerely thank all experts, to which anonymity was guaranteed, who have contributed to this study, as well as staff members from the IAASB and PCAOB who have provided rigorous comments to the comparative analysis which was very valuable and highly appreciated. The results presented in this study are the product of an academic approach to the objectives of this study. We have processed the views from experts and standard-setters in the analysis as far as we believed there was an objective ground to do so. During our consultation of staff members of standard-setting bodies, it became clear that it is difficult to find consensus on certain issues. Hence, we conclude by emphasizing that the results presented in this study are the views of the members of the research team, which may or may not correspond with views held by staff members from IAASB and PCAOB.

Chapter 2: Conceptual framework

To address the objectives of this study, as described in the introductory chapter, we have developed a conceptual framework, presented in Figure 1.

The first step of the study is to identify the differences between the clarified ISAs and PCAOB Auditing and Interim standards. Our approach for identifying and assessing the differences between the two sets of standards involved an extensive and detailed comparison by the research team, complemented with input from various experts. This approach is described in more detail in Chapter 5, as well as the main results from this comparative analysis.

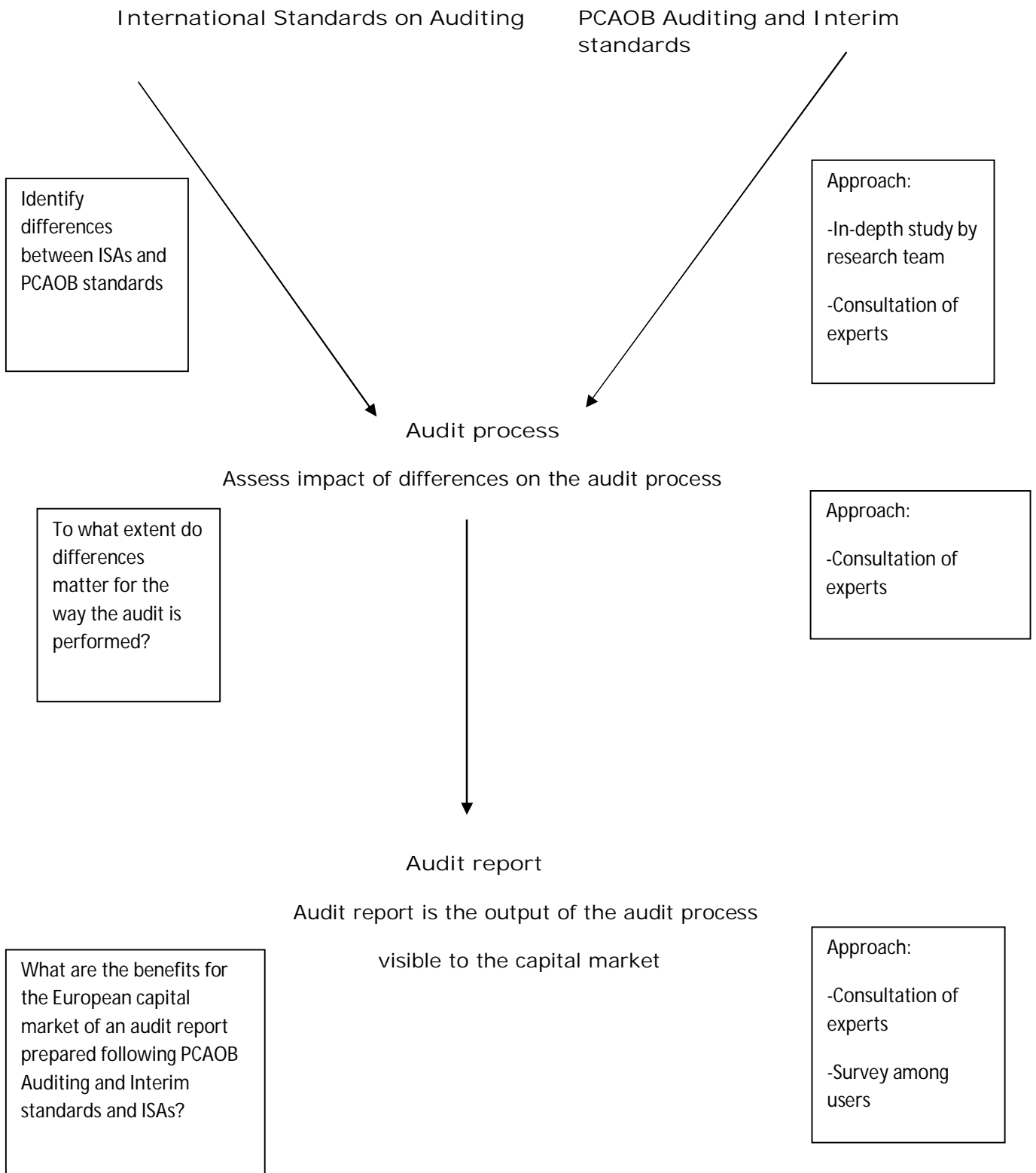
The second step of the study is to assess whether the identified differences in auditing standards have a significant effect on audit practice. Conceptually, this comes down to assessing whether differences in auditing standards affect the audit process, and ultimately the audit report, which is the only visible outcome of the audit process to the capital market.

Studying if and how differences in the auditing standards affect the audit process provides insights into the overall effort required by an auditor to conduct an audit. In particular, relevant questions are: Do the identified differences in auditing standards affect the audit process and the way the audit is performed? Does compliance with both sets of standards affect the auditor's detection risk? What additional procedures are required if an auditor has to comply with both sets of standards? How does this affect the amount of auditor work effort? *Ceteris paribus*, would an auditor come to a different conclusion and issue a different audit opinion following a single set of auditing standards compared to a dual set of auditing standards? We approach these questions by consulting selected audit partners from each of the Big Four audit firms with international technical expertise and profound knowledge of both sets of standards. We summarize the main findings of the consultation of these international technical audit experts in Chapter 6.

The third and last step of the study is to assess the benefits for the European capital market of an audit report prepared following PCAOB standards and ISAs compared to an audit report prepared under a single set of auditing standards. In this respect, the key questions are: Does compliance with two sets of auditing standards improve the perceived assurance derived from an audit of financial statements from a user perspective? Do dual auditing standards have value for investment decisions? To address these questions, we conducted a small-scale

survey of European capital market experts and a large-scale survey of a broad range of experienced European financial statement users. This approach, as well as a summary of the main findings of our analysis, is presented in Chapter 7.

Figure 1: Conceptual framework



Chapter 3: Background and general framework of ISAs and PCAOB Auditing and Interim Standards

3.1 Introduction

This chapter describes the background and general framework of the International Standards on Auditing and the PCAOB Auditing and Interim Standards. Such general background is relevant to position the results presented in this study. In particular, we discuss the background of the two standard-setting bodies, IAASB and PCAOB, and their ongoing standard setting activities. Furthermore, we cover the applicability of the standards and position the standards within their applicable general framework.

The next paragraph describes the background and general framework of the International Standards on Auditing. Subsequently, we describe the background and general framework of the PCAOB Auditing and Interim Standards. Finally, we provide a summary and conclusions.

3.2 International Standards on Auditing

The International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB). The IAASB is a private standard-setting body that operates under the auspices of the International Federation of Accountants (IFAC). The main objective of the IAASB is twofold. First, the IAASB sets standards on auditing, quality control, review, other assurance, and related services, and second, it facilitates the convergence of national and international standards.

The IAASB, formerly known as the International Auditing Practices Committee (IAPC), was established in 1978. In 1979, the IAPC issued its first International Auditing Guideline. The International Auditing Guidelines were replaced by International Standards on Auditing in 1991. To improve transparency and effectiveness of the standard-setting process, IFAC reviewed the IAPC in 2001, and amongst other actions decided to change IAPC's name to the IAASB on April 1, 2002. Furthermore, a new board was introduced having a broad geographical representation and members from different backgrounds. The IAASB Board consists of 18 members: a full-time chairman and 17 members including practitioners as well as individuals who are not in public practice. Ten members are appointed by the IFAC member bodies, five members are representatives from the Forum of Firms and three members represent the public. Each member

serves on a voluntary basis and is appointed for a period of three years. Furthermore, there are up to three observer members who have speaking rights at IAASB meetings but no voting rights. The IAASB is also supported by a technical staff.

The activities of the IAASB are monitored by the Public Interest Oversight Board (PIOB), which consists of ten members from various professions and branches of regulation. The PIOB members are nominated by the World Bank, the European Commission, the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, and the International Association of Insurance Supervisors. The PIOB is entitled to approve IAASB members and can participate in meetings of the IAASB.

The IAASB develops ISAs based on a formal system of due process. For each ISA, input is obtained from IFAC member bodies and their members, national auditing regulators, the general public, and the IAASB Consultative Advisory Group that represents preparers, regulators and other users of financial statements. Exposure drafts of proposed ISAs are published for comment. After a period of public consultation, the comments are evaluated and, when considered appropriate, incorporated in the final ISA. The final ISAs are then published, and are accompanied by a separate document explaining the decisions with respect to comments received on the exposure draft. To date, the IAASB has published 36 ISAs. More than 100 countries are either using ISAs, are in the process of adopting ISAs or are using them as a basis for drafting national auditing standards. For example in 2006, Canada and mainland China decided to bring their auditing standards closer to ISAs, and Hong Kong announced full convergence to ISAs.

In order to further encourage the use of ISAs, in 2004 the IAASB started a project to improve the clarity and consistent application of the ISAs. As a first step, the IAASB revised its drafting conventions to make the ISAs more readily understood. The key elements of the clarity drafting conventions include the establishment of an objective for auditors regarding the subject matter of each standard, the clear distinction of requirements and guidance on their application, the avoidance of ambiguity by elimination of the present tense to describe actions by auditors and using more imperative language where a requirement was intended, and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Next to revising the drafting conventions, approximately half of the ISAs also underwent a major

revision. These revisions were in progress or almost complete when the clarity project began. The IAASB then decided to defer their finalization, in order to have the revised ISAs redrafted in accordance with the new clarity conventions. This also allowed all redrafted or clarified ISAs to come into effect at one time. In December 2006, the IAASB issued the first four clarified ISAs. The clarity project was completed in December 2008, resulting in a total of 36 clarified ISAs and one clarified quality control standard (ISQC1). The clarified ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009.

The clarity project also changed the structure of the ISAs. Each (clarified) ISA consists of an introductory paragraph (indicating the scope, the setting and the effective date), a paragraph specifying the objectives of the auditor, a definition paragraph, a paragraph with the requirements of the particular standard and a paragraph with application and other explanatory material. These 5 elements together form the complete ISA.

The general framework within which ISAs are developed consists of 6 main areas:

- General Principles and Responsibilities (ISA 200-299);
- Risk assessment and response to assessed risk (ISA 300-499);
- Audit evidence (ISA 500-599);
- Using work of others (ISA 600-699);
- Audit conclusion and reporting (ISA 700-799);
- Specialized areas (ISA 800-899).

The general principles and responsibilities include ISAs on the overall objective of the audit, quality control, documentation, responsibilities to consider fraud, and internal control (e.g. ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, ISA 220 *Quality Control for an Audit of Financial Statements*, ISA 230 *Audit Documentation*, ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*). The area on assessing and responding to risk includes standards on audit planning, materiality and risk assessment (e.g. ISA 300 *Planning an Audit of Financial Statements*, ISA 320 *Materiality in Planning and Performing an Audit*, ISA 330 *The Auditor's*

Responses to Assessed Risks). Confirmations, analytical procedures, audit sampling, subsequent events and going concern are examples of issues covered by ISAs in the area of audit evidence (ISA 505 *External Confirmations*, ISA 520 *Analytical Procedures*, ISA 530 *Audit Sampling*, ISA 560 *Subsequent events*, ISA 570 *Going Concern*). The ISAs in the area of using the work of others deal with audits of group financial statements (ISA 600 *Special considerations – audits of group financial statements (including the work of component auditors)*), using the work of internal auditors (ISA 610 *Using the work of internal auditors*) and experts (ISA 620 *Using the work of an auditor's expert*). ISAs in the area of audit conclusions and reporting relate to for example the forming of an audit opinion (ISA 700 *Forming an opinion and reporting on financial statements*), modifications to the audit opinion (ISA 705 *Modifications to the opinion in the independent auditor's report*), emphasis of matter paragraphs (ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*), and comparative information (ISA 710 *Comparative information – corresponding figures and comparative financial information*). The three ISAs on specialized areas (ISA 800 *Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, ISA 805 *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, and ISA 810 *Engagements to Report on Summary Financial Statements*) are outside the scope of this study.

In the new structure of the international standards, ISA 200 has a prominent place as it stipulates the conventions followed in the standards and the obligations of auditors who follow them. The standard clarifies that the auditor is required to have an understanding of the entire text of an ISA to understand its objectives and to apply its requirements properly. Further, ISA 200 explains that the requirements of the ISAs are designed to enable the auditor to achieve the objectives specified in the ISAs, and thereby the overall objectives of the auditor. Given that the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the ISAs, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the ISAs to meet the objectives specified in the ISAs. ISA 200 also explains that, in addition to objectives and requirements, ISAs contain application and other explanatory materials, which are an integral part of the standard. Such guidance may explain more precisely what a requirement means or is intended to cover, or include examples of procedures that may be appropriate in the circumstances. While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA. ISA 200 also

introduces new guidance with respect to professional judgment, professional skepticism, and the implications of the inherent limitations of an audit. ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, is also worth mentioning because it is a newly drafted ISA that addresses the communication of deficiencies in internal control.

Overall, the clarified ISAs include requirements and guidance that aim to strengthen audit practice in the following areas:

- Materiality in planning and performing an audit, and its use in evaluating misstatements.
- Risk assessment, and the collection and evaluation of audit evidence, in relation to:
 - Accounting estimates (including fair value accounting estimates) and related disclosures;
 - Related party relationships and transactions;
 - An entity's use of a third party service organization.
- Audit evidence considerations in relation to:
 - External confirmations;
 - Written representations (including implications for engagement acceptance considerations).
- Using the work of others, in relation to:
 - Audits of group financial statements, including the work of component auditors;
 - Work of an auditor's expert.
- Communication with those charged with governance.
- Communicating deficiencies in internal control.
- Auditor reporting, in relation to:
 - Modifications to the auditor's opinion;
 - Emphasis of Matter paragraphs in the auditor's report.

- Audit and reporting consideration in the context of special engagements.

Given the extensive revisions of the ISAs, the IAASB has declared a short moratorium on issuing new standards in order to allow professionals time to digest the clarified standards in a stable environment, facilitating the proper implementation of the full set of clarified standards (as well as ISQC1).

3.3 PCAOB Auditing and Interim Standards

The Public Company Accounting Oversight Board (PCAOB) was established as a result of the Sarbanes-Oxley Act of 2002. One of the PCAOB's primary responsibilities is to set standards for the audits of publicly-traded companies in the US under Section 103(a)(1) of the Sarbanes-Oxley Act. Prior to the establishment of the PCAOB, auditing standards in the US for all audits were set by the Auditing Standards Board which is part of the American Institute of Certified Public Accounting, a private sector, professional organization. The Sarbanes-Oxley Act allows the PCAOB to designate a separate standards setting body for auditing but the PCAOB has chosen to retain the authority to set auditing standards for public companies. PCAOB standards must be approved by the Securities and Exchange Commission prior to implementation. The Auditing Standards Board retains the authority to set auditing standards for private sector clients.

At the time of its formation, the PCOAB indicated its intention to develop a full set of auditing standards for the annual audit of companies that fell under its authority. At the time of the writing of this report, the PCAOB had issued six standards since its inception. One of its first actions was the release of Auditing Standard No.1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* which adopted the existing Auditing Standards Board standards as the standards of the PCAOB on an interim basis until such time that they are superseded by the PCAOB's own standards. The "interim" standards of the PCAOB are laid out in the Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* and reflect the standards that existed as of April 16, 2003. With minor changes, many of the interim standards are still in force for public company audits. Other

standards that have been issued by the PCAOB and still in effect at the time this report was prepared are:⁴

Auditing Standard No. 3: *Audit Documentation*;

Auditing Standard No. 4: *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*;

Auditing Standard No. 5: *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*;

Auditing Standard No. 6: *Evaluating Consistency of Financial Statements*.

In general, the standards of the PCAOB are organized along the lines of the ten *Generally Accepted Auditing Standards* as originally promulgated by the Auditing Standards Board. Consequently, the interim standards are codified into the following categories:

AU 100	Statements on Auditing Standards;
AU 200	The General Standards;
AU 300	The Standards of Fieldwork;
AU 400	The First, Second and Third Standards of Reporting;
AU 500	The Fourth Standard of Reporting;
AU 600	Other Types of Reports;
AU 700	Special Topics;
AU 800	Compliance Auditing.

The PCAOB was given a great deal of discretion in establishing the process by which it identifies, evaluates and adopts new auditing standards. The PCAOB has taken the position that the standard setting process should be done in the open with significant public input from key stakeholder groups, including investors, the accounting profession, the preparers of financial statements, and other interested parties. While they expect most new standards to emanate from their own staff

⁴ Auditing Standard No. 2: *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* was superseded by a later standard.

dedicated to the standard setting process, the PCAOB is open to direct input from the public. The PCAOB has also established the Standing Advisory Group (SAG) to advise the PCAOB on the establishment of auditing and related professional practice standards.

Potential new standards are developed through consultation with the SAG and may include such public discussion as is deemed warranted by the Staff of the PCAOB. Formal proposed standards are presented to the PCAOB in a public meeting. The PCAOB then decides whether to publish a proposed standard for public comment. After allowing an appropriate period for public consideration, comments are evaluated by the Staff of the PCAOB and are incorporated into the proposed standard as is deemed appropriate. The final version of a new standard is then presented to the PCAOB in another public meeting. Once the PCAOB accepts the final version of the standard, it is sent to the SEC for their action. A standard does not become effective until the SEC officially adopts the standard.

As of the end of 2008, the PCAOB had two sets proposed standards under consideration:

- *Proposed Standard—Auditor’s Assessment and Response to Risk;*
- *Proposed Standard—Engagement Quality Review.*

The first proposed set of standards is particularly relevant to this study given that a number of differences highlighted later in this report pertain to risk assessment and the manner in which an auditor deals with identified audit risks. Consequently, the release of a new standard may significantly affect the interpretation of the differences in auditing standards identified in our detailed analysis.

The proposed standards on risk assessment and responses to risk incorporate seven specific potential standards:

- Audit Risk in the Audit of Financial Statements;
- Audit Planning and Supervision;
- Identifying and Assessing Risks of Material Misstatement;
- The Auditor’s Responses to the Risks of Material Misstatement;
- Evaluating Audit Results;

- Consideration of Materiality in Planning and Performing the Audit;
- Audit Evidence.

The PCAOB believes that these new standards improve upon the existing framework for assessing risk in the audit as incorporated in the audit risk model, and also incorporate the approach to risk assessment previously adopted in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*.⁵ The proposed standards are designed to reflect the improved risk-based audit methodologies that have been developed by many audit firms in the past decade.

In proposing the new risk assessment standards, the PCAOB explicitly acknowledged the development of comparable standards by the IAASB in the area of risk assessment and responding to risk. The PCAOB began the process by first considering if the IAASB standards would be appropriate for a US issuer and whether they would be consistent with the espoused mission of the PCAOB. While acknowledging the commonality between the IAASB risk assessment standards and the proposed standards, the PCAOB felt it was necessary to modify many of the requirements. Some of these adjustments were required to conform to US securities law or to be consistent with terminology defined in other rules and regulations of the PCAOB.⁶ However, the major difference between the IAASB standards and the proposed standards is the treatment of the application material included in the IAASB standards. In evaluating the application material, the PCAOB included such material that it deemed necessary for the audit of issuers in the body of the standard.

3.4 Common agenda of the IAASB and PCAOB

The historical background and structure of IAASB and PCAOB are quite different so it is not surprising that they have approached standard setting with different philosophies and along different time lines. Nevertheless, the two standard-setting bodies are essentially dealing with the same question: How to improve the standards that govern the conduct of the audit so as to increase the overall quality of the audit? Given this shared objective, it is not surprising that their

⁵ It should be noted that Auditing Standard No. 5 specifically adopted a “top-down risk-based” approach to the Integrated Audit that had previously been established under Auditing Standard No. 2.

⁶ For example, Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*.

respective agendas for the future of standard setting have a great deal in common. A very good example of this commonality is the reduction in the gap between the two sets of standards related to assessing and responding to risk that was discussed above. While the proposed standards of the PCAOB do not exactly mimic the existing standards of the IAASB, the PCAOB acknowledges that the US standards were derived from the ISAs and the resulting proposal would have the effect of narrowing the difference between the two sets of standards in this area. Other examples of a common interest are in the areas of related party transactions, confirmations and fair value for which the PCAOB is considering to develop new guidance and requirements (Standards Advisory Group Meeting, Standards-Setting Accomplishments and Priorities As of October 23, 2008).⁷

A related issue to standard setting is the enforcement of auditing standards. In general, auditing standards are issued for the benefit of auditors. However, to protect the public and to ensure standards are being followed, oversight of audit practices is globally desirable, and mandatory in certain jurisdictions like the EU, the US, Japan and Canada. Consequently, auditing standards also provide the criteria used by oversight bodies in evaluating the quality of audit practice. The PCAOB incorporates both standard setting and enforcement, through their inspection process, in the same entity. A potential benefit of the PCAOB approach is that the experiences learned from the inspection process can be recycled into standard setting. The IAASB is limited to standard setting alone and does not have inspection or enforcement authority. In Europe, inspection of audit quality and enforcement of auditing standards is governed by Article 29 of the Eighth Company Law Directive 2006/43/EC. This requires that there must be external systems of quality assurance that evaluates whether audit firms are in compliance with applicable professional standards. Thus, while the two bodies have similar agendas, differences in how the two bodies perceive enforcement issues may subtly influence their approach to standard setting in different ways.

3.5 Summary and conclusions

This chapter described the background and general framework of the ISAs and the PCAOB Auditing and Interim Standards in order to position the results of this study.

⁷ See www.pcaob.org/Standards/Standing_Advisory_Group/Meetings/2008/10-22/2009_Proposed_Activities_Remarks.pdf

The ISAs are issued by the IAASB which is a private standard-setting body. The IAASB develops ISAs based on a formal system of due process. For each ISA, input is obtained from IFAC member bodies and their members, national auditing regulators, the general public, and the IAASB Consultative Advisory Group. Furthermore, Exposure drafts of proposed ISAs are published for public consultation. After a period of public consultation, the comments are evaluated and, when considered appropriate, incorporated in the final ISA. The final ISAs are then published, and are accompanied by a separate document explaining the decisions with respect to comments received on the exposure draft. In order to improve the clarity and consistent application of the ISAs, the IAASB recently revised and/or clarified the ISAs. As a result, each (clarified) ISA consists of an introductory paragraph (indicating the scope, the setting and the effective date), a paragraph specifying the objectives of the auditor, a definition paragraph, a paragraph with the requirements of the particular standard and a paragraph with application and other explanatory material. These 5 elements together form the complete ISA. The revision or clarification of the ISAs has now been completed, resulting in a total of 36 clarified ISAs and one clarified quality control standard (ISQC1). The clarified ISAs are effective for audits of financial statements for periods beginning on or after December 15, 2009.

The PCAOB was established as a result of the Sarbanes-Oxley Act of 2002. One of its primary responsibilities is to set standards for the audits of publicly-traded companies in the US. At the time of its formation, the PCOAB indicated its intention to develop a full set of auditing standards for the annual audit of companies that fell within its authority. Since its inception, the PCAOB has issued six standards, one of which has been superseded. One of its first actions was the release of Auditing Standard No.1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* which adopted the existing Auditing Standards Board standards as the standards of the PCAOB on an interim basis until such time that they are superseded by the PCAOB's own standards. The "interim" standards of the PCAOB are laid out in the Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* and reflect the standards that existed as of April 16, 2003. With minor changes, many of the interim standards are still in force for public company audits. The standards setting process is done with significant public input from key stakeholder groups, including investors, the accounting profession, the preparers of financial statements, and other interested parties. The PCAOB has also established the Standing Advisory Group (SAG) to advise the PCAOB on the establishment of auditing and related professional practice standards.

Potential new standards are developed through consultation with the SAG. After allowing an appropriate period for public consideration, comments are evaluated by the Staff of the PCAOB and are incorporated into the proposed standard as is deemed appropriate. The final version of a new standard is then presented to the PCAOB in another public meeting. Once the PCAOB accepts the final version of the standard, it is sent to the SEC for their action. A standard does not become effective until the SEC officially adopts the standard.

The history and development of the IAASB and PCAOB have followed different timelines and paths. As a result, their approach to standard setting reveals differences in philosophies and approaches. Nevertheless, the two standard-setting bodies are essentially dealing with the same question: How to establish standards so as to increase the overall quality of the audit? The main objective of auditing standards is to improve the process of auditing so that the reliability of financial reports is enhanced as the result of examination by a professional auditor. Given what is essentially a shared objective for both sets of standards, it is not surprising that the respective agendas of the PCAOB and IAASB for the future of standard setting have a great deal in common. A good example of this commonality is the reduction in the gap between the two sets of standards related to assessing and responding to risk that will occur once the PCAOB finishes its work on new proposed standards in that area. However, differences in the way the two bodies perceive enforcement of standards may also influence their shared agenda. With the current economic crisis and a new administration in the US, it is not clear how the shared interests of the PCAOB and IAASB will develop in the near term but there can be little doubt that the fundamental shared objective of improving audit quality will continue to link the two standard-setting bodies.

Chapter 4: Review of the literature

4.1 Introduction

In the introductory chapter of this report, we have described the objectives of this study, which are (a) to identify main differences between ISAs and PCAOB auditing standards, and (b) assess the impact of these differences on audit practice and financial statement user perceptions. As a foundation, we have reviewed prior academic and professional literature on the assumption of this study that differences in auditing standards matter because they affect the audit process and audit outcome.

In particular, the purpose of our literature review is to gain insight on the following main questions:

- 1) Do auditing standards, and changes in auditing standards, influence the audit process, auditor work effort, and audit fees?
- 2) Do auditing standards, and changes in auditing standards, influence audit outcome and market perceptions?
- 3) Are there international differences in auditor incentives and auditor behavior, and if so, how do these differences affect the application of auditing standards?

In the next sections, we refer to a broad spectrum of studies⁸ to provide an answer to each of these 3 questions. We note, however, that the majority of the studies examine country-specific auditing standards, mostly in a US context. We also discuss the few available studies that investigate non-US contexts and/or examine ISAs.

⁸ In preparing our review, we have taken note of the research syntheses prepared by research teams of the Auditing Section of the American Accounting Association for the benefit of the PCAOB in their development of auditing standards. These research syntheses covered the following nine areas: (1) audit confirmations (Caster, Elder, and Janvrin 2008); (2) audit firm quality control (Bedard, Deis, Curtis, and Jenkins 2008; Jenkins, Deis, Bedard, and Curtis 2008); (3) the audit reporting model (Church, Davis, and McCracken 2008); (4) auditor risk assessments (Allen, Hermanson, Kozloski, and Ramsay 2006); (5) communications with audit committees (Cohen, Gaynor, Krishnamoorthy, and Wright 2007); (6) engagement quality review (Schneider and Messier 2007); (7) fair value (Martin, Rich, and Wilks 2006); (8) financial fraud (Hogan, Rezaee, Riley, and Velury 2008); and (9) related party transactions (Gordon, Henry, Louwers, and Reed 2007). Where these research syntheses discuss studies that help us to answer the three questions stated above in the main text, we have incorporated those studies in our literature review.

4.2 Impact of auditing standards on audit process, auditor work effort and audit fees

A substantial number of studies have examined the effect of auditing standards related to fraud risk assessment. Based on an experiment, Zimbelman (1997) finds that, as expected, auditors pay more attention to fraud cues and plan to spend more audit hours in high fraud risk conditions when making explicit fraud risk assessments as required under Statement on Auditing Standard (SAS) No. 82 *Consideration of Fraud in a Financial Statement Audit*, compared to the more general misstatement risk assessments required by its predecessor SAS No. 53 *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. This suggests that SAS No. 82 improved the auditor's responsiveness to risk. Zimbelman's (1997) results are confirmed by Knapp and Knapp (2000) and Glover, Prawitt, Schultz, and Zimbelman (2002), two other experimental studies. Relatedly, for a sample of actual prospective clients of one of the Big audit firms, Johnstone and Bedard (2001) find that auditors intend to respond to higher fraud risk assessed under SAS No. 82 by assigning more specialist personnel, assigning more industry experts, performing more intensive testing, and/or performing additional reviews. Similarly, based on survey evidence, Jakubowski, Broce, Stone and Connor (2002) also report that SAS No. 82 has made auditors more aware of financial reporting fraud risk, and has resulted in increased audit planning for fraud detection, although the respondents indicated that this had not lead to increased discovery of financial reporting fraud or misstatements due to misappropriation of assets. This latter finding is confirmed by Graham and Bedard (2003), who find experimental evidence that assessed fraud risk factors do not appear to be strongly related to the level of assessed fraud risk. Furthermore, interview results from Shelton, Whittington, and Landsittel (2001) and experimental results in Asare and Wright (2004) seem to suggest that auditors' compliance with SAS No. 82 without considering additional evidence that is *not* required by SAS No. 82 reduces the effectiveness of their fraud risk assessments. For SAS No. 82's successor, SAS No. 99 *Consideration of Fraud in a Financial Statement Audit*, and based on an experiment with audit managers, Wilks and Zimbelman (2004) find that auditors who make separate assessments of fraud risks in the three categories of the fraud triangle as presented in SAS No. 99 (management's attitude, opportunities, and incentives) are more sensitive to opportunity and incentive risks in making their overall fraud risk assessments than auditors who make an overall fraud risk assessment only. This is in contrast to survey evidence by Marczewski and Akers (2005), who find that auditors were neutral as to whether SAS No. 82's successor, SAS No. 99 *Consideration of Fraud*

in a Financial Statement Audit, had increased fraud and/or audit effectiveness. However, they did perceive auditor responsibility, accountability, and liability exposure to have increased as a consequence of SAS No. 99. Carpenter (2007) reports experimental results suggesting that the use of brainstorming sessions in assessing fraud risk, as required by SAS No. 99, increases the quality of the fraud risk assessments. However, based on field interviews and observations of brainstorming sessions, Bellovary and Johnstone (2007) find that there is variability in the effectiveness of these sessions.

A couple of studies have investigated auditors' going concern assessments, required as per SAS No. 59 *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. Results of an experimental study by Ponemon and Schick (1991) suggest that auditors can improve their going concern assessments by considering nonfinancial information as well, in addition to financial information as required by SAS No. 59. Two other studies express reservations as to the effectiveness of going concern assessments made under SAS No. 59. SAS No. 59 does not require auditors to perform procedures solely for assessing the justifiability of maintaining the going concern assumption. However, based on experimental evidence, Rau and Moser (1999) suggest that this requirement may be inadequate because auditors' recall of evidence collected earlier in the audit may be biased. Further, in an experimental-markets setting Tucker, Matsumura, and Subramanyam (2003) show that auditors issue fewer going concern opinions when the opinion is likely to be self-fulfilling, i.e., accelerates the company's bankruptcy, as a result of which clients tend to switch to other auditors that are less likely to issue going concern opinions. According to Tucker *et al.* (2003) these results confirm calls for clearer (regulatory) guidance for the auditor in making going concern decisions.

A few older studies have examined external auditors' assessments of internal auditor reliability and related reliance on these internal auditors in the performance of the external audit. Both Brown (1983) and Schneider (1985) find experimental evidence that external auditors are consistent in their assessment of the internal auditor's competence, objectivity and previous audit work, and in relating these to their assessment of the internal auditor's reliability. These findings are in line with the requirements stipulated in SAS No. 9 *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, which was in effect at the time both studies were conducted. However, again based on results from experiments, Brown and Karan (1986) note that external auditors have difficulty in operationalizing the abstract concepts of competence,

objectivity and previous audit work, which could adversely affect their reliability assessments. Whittington and Margheim (1993) consider successor SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and experimentally examine the effects of inherent risk, materiality, and subjectivity of the audited assertion on the external auditor's decision to rely on the internal auditor. Results show that, as stipulated in SAS No. 65, reliance is larger when materiality levels are lower. Inherent risk, however, did not affect the reliance decision. Evidence related to the effect of subjectivity is merely anecdotal and suggests that external auditors rely less on internal auditors for audit assertions that require more subjectivity, in line with SAS 65.

Based on evidence from surveys and interviews, both Ameen and Strawser (1994) and Hirst and Koonce (1996) show that auditors use analytical procedures for planning, substantive testing, and review purposes, as stated in SAS No. 56 *Analytical Procedures*, and that they perform these procedures in line with requirements stipulated in the standard. Allen, Beasley, and Branson (1999) provide case study evidence that the use of disaggregated data in multilocation audits improves audit effectiveness, as suggested in SAS No. 56.

Although Libby, Artman, and Willingham (1985) experimentally find that auditors' assessment of the effect of internal control strength on subsequent audit planning decisions are in line with the audit risk model as per SAS No. 39 *Audit Sampling* and No. 47 *Audit Risk and Materiality in Conducting and Audit*, experimental results from Daniel (1988) in a US setting, and survey evidence from Helliard, Lyon, Monroe, Ng and Woodliff (1996) in a UK setting, suggest that auditors have difficulty in applying the audit risk model. Mixed findings are reported by Elder and Allen (2003) based on information from US auditors' actual workpapers. Although they find a significant relationship between inherent risk assessments and sample sizes, in line with the audit risk model, the strength of this relationship decreases over time and is not significant for all audit firms in the sample. Furthermore, there is only limited evidence of a relationship between control risk and sample sizes. Using similar data, Elder and Allen (1998) conclude that auditors also have difficulties using audit sampling methods. Auditors seem to have particular trouble with projection of sample results to the population, disregarding sampling risk. In a follow-up study, Allen and Elder (2005) also find that the rate of error projection has declined over time, suggesting that audit quality has decreased. Further, in a UK setting Fraser, Hatherly and Henry (2002) present survey evidence showing that auditors consider their ability to detect client illegal acts not to be up to the mark established by Statement of Auditing

Standards (SAS) No. 120 *Consideration of Law and Regulations*, and in an Australian setting, Carey and Clarke (2001) conclude based on survey results that auditors' use of management representation letters as audit evidence is not always in line with requirements of Statement of Auditing Practice (AUP) No. 25 *Representations by Management*. In contrast, although evidence from field-based experiential questionnaires by Janvrin and Jeffrey (2007) shows that auditors consider and examine subsequent events as required by SAS No. 1, AU 560 *Subsequent Events*, respondents also felt that the procedures for doing so as prescribed by SAS AU 560 are not effective in uncovering relevant subsequent events. Also based on experiential questionnaires, Gupta, Umanath, and Dirsmith (1999) find that audit effectiveness is increased when auditor supervision is adapted to the complexity and interdependence of the audit tasks under supervision, as required by SAS No. 22 *Planning and Supervision*.

A number of more recent studies have examined audit process effects of auditor internal control assessments following enactment of Sections 302 (*Corporate Responsibility for Financial Reports*) and/or 404 (*Management Assessment of Internal Controls*) of the Sarbanes-Oxley Act. For auditors examining internal control disclosures made under Section 302 and by nonaccelerated filers, SAS No. 55 *Consideration of Internal Control in a Financial Statement Audit* is the mandated auditing standard, while auditors examining internal control disclosures made under Section 404 are required to audit in accordance with PCAOB Standard No. 5 *An Audit of Internal Control That Is Integrated with an Audit of Financial Statements*.⁹ Results based on large archival datasets made possible by the disclosure requirements in Sections 302 and 404 are uniformly suggestive of increased audit effort as a consequence of the performance of internal control audits and/or detection of client internal control weaknesses. Raghunandan and Rama (2006), Hoitash, Hoitash, and Bedard (2008), and Hogan and Wilkins (2008) all report increases in external audit fees following enactment of Sections 302 and/or 404, and for clients disclosing internal control weaknesses. Similarly, Ettredge, Li and Sun (2006) find that audit delays are longer after enactment of Section 404 and for clients reporting material weaknesses in internal control over financial reporting. Spira and Gowthorpe (2008) performed a large-scale survey for the Institute of Chartered Accountants of Scotland on reporting on internal

⁹ But note that prior to November 15, 2007, auditors were required to follow PCAOB Standard No. 2 *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. The studies discussed below in the main text cover time periods preceding November 15, 2007, making PCAOB Standard No. 2 the relevant auditing standard.

control and show that many respondents, especially those from the investor community and its representatives, expressed support for the objectives of SOX section 404. However, many respondents questioned the balance of costs and benefits, feeling that the former outweighed the latter. Together, these results are indicative of increased audit effort after enactment of the new internal control provisions and for clients with weak internal control.

4.3 Impact of auditing standards on audit outcome and market perceptions

Many studies have investigated audit reporting in relation to auditing standards, examining issues such as compliance with relevant standards, issuance of going concern and other modifications, and user perceptions of audit reports. In contrast to a lot of other research on the effects of auditing standards, most of the studies on compliance with standards are conducted in an international rather than a US setting, and specifically consider relevant ISAs. In particular, examining form and content of audit reports from 27 countries, Hussein, Bavishi and Gangolly (1986), find that agreement with International Auditing Guideline No. 13 *The Auditor's Report on Financial Statements* is not universal across all countries. Using similar approaches, comparable results are reported by King (1999), who benchmarks against the same standard, now renamed ISA No. 13, and García-Benau and Zorio (2004), who compares audit reports with ISA No. 700 *The Auditor's Report on Financial Statements*. However, both Sucher and Zelenka (1998), for a sample of companies from the Czech Republic, and Gangolly, Hussein, Seow, and Tam (2002), for a broad international sample, show that compliance with standards increases over time. For a Maltese sample, however, Farrugia and Baldacchino (2005) show that audit reports issued by non-Big Six firms are often deficient and even noncompliant with relevant ISAs. As a caveat we note that these studies were performed before the Clarity Project of the IAASB and other current efforts (e.g., revised 8th EU Directive) to strengthen audit regulation.

Other issues related to auditor reporting that have been examined in relation to auditing standards are the issuance of going concern and other modifications, both in US and other contexts. There is mixed evidence as to the effect of going concern standards. Based on archival evidence, although Raghunandan and Rama (1995) and Geiger and Raghunandan (1995) report that SAS No. 59 *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* has led to an increase in the issuance of going concern opinions to financially stressed as

well as subsequently bankrupt companies, Geiger, Raghunandan and Rama (1998) show that companies receiving going concern modifications before SAS No. 59, under its predecessor SAS No. 34 *The Auditor's Consideration When a Question Arises About an Entity's Continued Existence*, are no different from those receiving such modifications under SAS No. 59. According to the authors, this could suggest that auditors were already making required going concern assessments pre-SAS No. 59, and that the SAS merely codified existing practice. International evidence comes from two studies. Using data on companies listed in the UK, Citron and Taffler (2004) find evidence that the introduction of a new reporting standard, UK SAS No. 600 *Auditor's Reports on Financial Statements*, resulted in the issuance of more going concern opinions. Similar results have been found in China (DeFond, Wong, and Li 2000), Germany (Ashbaugh and Gassen 2008) and Belgium (Carcello, Vanstraelen, and Willenborg 2009).

Two US studies examine the issuance of other modifications, regulated by SAS No. 58 *Reports on Audited Financial Statements*. While Raghunandan, Grimlund and Schepanski (1991) find experimental evidence that auditors add an additional paragraph to the audit report in the presence of material loss contingencies as required by SAS No. 58, Jordan and Clark (1996) present archival results showing that reasons for report modifications under SAS No. 58 related to changes in accounting principles are diverse and not uniform. The latter suggests that these report modifications may not provide useful information to financial statement users.

A reporting issue that also has been studied in relation to auditing standards concerns user perceptions. Whereas some studies present evidence of the (continued) existence of an audit expectation gap related to auditor reporting,¹⁰ there is other evidence suggesting that audit reports are informative to users. Kelly and Mohrweis (1989) survey bankers and investors, who both indicate that their understandability of the objective of the audit increases with the revised wording in the (then) new SAS No. 58 audit report. However, whereas investors perceive no change in the auditor's responsibility as conveyed by the SAS No. 58 audit report, bankers find that auditors assume less responsibility under the SAS No. 58 report. Also based on survey evidence, Miller, Reed, and Strawser (1993) find that the SAS No. 58 audit report improves bank loan officers' ability to

¹⁰ For example, see Monroe and Woodliff (1994), Gay, Schelluch, and Baines (1998), and Schelluch and Gay (2006) for Australian evidence; Innes, Brown and Hatherly (1997) and Manson and Zaman (2001) for UK evidence; Ponemon and Raghunandan (1994), Epstein and Geiger (1994), and Almer and Brody (2002) for US evidence; and Nazry Fadly and Achmad (2004) for Malaysian evidence.

understand management's and the independent auditor's responsibilities, as well as the communication of scope limitations. Furthermore, for an experiment with US bank loan officers Bamber and Stratton (1997) find that uncertainty modifications required as per SAS No. 58 affect the officers' risk assessments, loan granting decisions, and the offered interest rate, suggesting that these audit reports are informative to users. In addition, Holder-Webb and Wilkins (2000) show that investors have benefited from implementation of SAS No. 59 as a successor of SAS No. 34 since it reduces investor surprise upon bankruptcy announcements. In particular, price responses to bankruptcy announcements are less negative for firms receiving SAS No. 59 going concern opinions than for firms receiving clean opinions under SAS No. 59, and are less negative for firms receiving SAS No. 59 going concern opinions than for firms receiving SAS No. 34 subject-to going concern opinions. In contrast, and for a sample of listed US companies, Schaub and Highfield (2003) show that a name change in the audit report associated with the implementation of SAS Nos. 58 and 59 and related to going concern qualifications does not have significant effects since negative abnormal returns are not significantly different before and after the implementation of the standards. This was expected since the change was assumed to be a mere name change not affecting the underlying information content of the report. Similarly, based on experimental evidence, Anandarajan, Viger, and Curatola (2002) find that Canadian bank loan officers' lending decisions and risk perceptions are not affected by the mode of presentation of going-concern uncertainties.

Another issue related to audit outcome concerns audit adjustments. Libby and Kinney (2000) show experimental evidence that auditors are less likely to require correction to earnings overstatements if that correction could lead to missed analysts' earnings forecasts. They also show that this correction is not more likely under SAS No. 89 *Audit Adjustments*. SAS No. 89 requires management to either accept adjustments recommended by the auditor, or to communicate in writing to the auditor that it considers the adjustments to be immaterial. This is expected to lead to increased correction of immaterial misstatements, but results do not confirm this, suggesting SAS No. 89 did not achieve its intended goal. Finally, Nelson, Smith, and Palmrose (2005) show that the approach used to summarize audit adjustments affect the ultimate adjustment required from management by the auditor. SAS No. 47 (now superseded by SAS No. 107 *Audit Risk and Materiality in Conducting an Audit*) implicitly allowed two different approaches (cumulative and current-period approach), and experimental results in this study show that auditors more likely require adjustment under the approach that makes

the misstatement appear more material. The authors suggested that standards should include a requirement that auditors demand adjustment whenever a misstatement is material under either approach. SAS No. 107 now requires that the auditor should request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatement, other than those that the auditor believes are trivial.

For auditing standards in general, Zhou (2007) finds that the introduction of new auditing standards (modeled after international auditing standards) reduces information asymmetry. For a sample of listed Chinese companies, he finds that companies that had not been previously audited under these new auditing standards have significantly lower bid-ask spreads compared to companies already audited under international auditing standards. These results are suggestive of an improved information environment for investors and other stakeholders.

Academic research has also looked into the issue of precision of auditing standards and its impact on auditor behaviour. In this regard, Willekens and Simunic (2007) argue that "an important characteristic of auditing standards is their precision, and that the more precise are standards, the lower of variance of possible audit quality levels which could be deemed 'in compliance'." In particular, the analytical (i.e. theoretical) study of Willekens and Simunic shows that decreasing the precision of auditing standards initially induces an auditor to produce higher audit quality by exerting more effort. However, beyond a certain critical value, decreasing precision leads to decreasing effort and auditors gamble on violating auditing standards. Furthermore, as legal standards become more imprecise, the precision of auditing standards becomes important and affects the quality of internal control and audit quality demanded. Finally, Willekens and Simunic show that with extremely imprecise GAAS, the auditor does nothing, and simply bears the legal consequences. Related literature in this area shows that clear auditing standards accompanying a vague legal negligence standard have a positive impact on audit quality or effort (e.g., Schwartz, 1998; Willekens et al., 1996). Similarly, audit literature suggests precise standards decrease aggressive reporting because precision can bolster the auditor's negotiating position and make it easier for them to stay independent. For example, Magee and Tseng (1990, 316) show the conditions under which "cut-and-dried" reporting standards, that "leave less room for disagreement among auditors", allow for greater auditor independence; per the audit partners in Gibbins, Salterio and Webb's (2001) survey, clear-cut standards strengthen auditor positions when

negotiating to prevent aggressive accounting; Nelson, Elliott and Tarpley (2002) report that auditors recall being less likely to allow aggressive earnings management when there is a precise accounting standard and the client has not engaged in transaction structuring; and Ng and Tan (2003) find that when precise guidance is absent, their audit manager subjects are more likely to permit aggressive accounting, especially when audit committee oversight is weak.

4.4 International differences in auditor incentives and auditor behavior and their effect on the application of auditing standards

Most studies discussed above are conducted in national settings, and examine effects of (changes in) auditing standards for one country at a time. Notable exceptions are the studies by Hussein, Bavishi, and Gangolly (1986), King (1999), García Benau and Zorio (2004), and Gangolly, Hussein, Seow and Tam (2002). As discussed, these studies find that compliance with international standards on auditor reporting is not universal across all countries.

A number of studies have provided explanations for these differences by suggesting that the role of accounting and auditing differs across countries due to differences in the origins of these countries' legal system, in particular the extent of investor protection offered by those legal systems. These studies use a framework developed by La Porta, Lopez-de Silanes, Shleifer, and Vishny (1997), who find that common-law countries have the strongest and French civil-law countries have the weakest investor protection (La Porta et al. 1998); that countries with stronger investor protection have less concentrated ownership and more minority shareholders (La Porta et al. 1998; 1999); and that these same countries have more developed debt and equity markets (La Porta et al. 1997).

In general, studies using the La Porta et al. framework find that in common-law countries with strong investor protection (1) the value-relevance of earnings is higher (Hung 2000; Ali and Hwang 2000; Bushman and Smith 2001; Fan and Wong 2002; Francis, Khurana, and Pereira 2003); (2) corporate disclosure is more extensive (Jaggi and Low 2000; Hope 2003; Francis, Khurana, and Pereira 2005) and corporate transparency is higher (Bushman, Piotroski, and Smith 2004), which tends to reduce cost of capital (Francis, Khurana, and Pereira 2005); and (3) earnings management is lower (Leuz, Nanda, and Wysocki 2003; Burgstahler, Hail, and Leuz 2006) and reporting is more conservative (Ball, Kothari, and Robin 2000; LaFond 2005; Bushman and Piotroski 2006).

More importantly, a number of studies suggest that the role of the auditor differs along with the strength of investor protection provisions in countries' legal systems. Francis et al. (2003) find that countries with stronger investor protection spend more on audit enforcement and that Big Five market shares are larger in these countries, suggesting that audit quality is higher in countries with stronger investor protection. According to the authors this may be due to firm-level agency problems being greater in these countries, where firms have more dispersed ownership, greater separation of ownership and control, and more external financing (Francis et al. 2003). Furthermore, for a sample of French, German, and UK firms, Maijoor and Vanstraelen (2006) find that a stricter audit environment (measured by stricter auditor independence regulations) reduces the magnitude of earnings management, irrespective of the type of auditor (Big Four audit firm or non-Big Four audit firm). Additional evidence comes from Francis and Wang (2008), who argue that auditor incentives to act independently increase when investor protection becomes stronger because auditor litigation risk increases. Auditors concerned with their reputation will therefore more strictly enforce higher earnings quality in regimes with stronger investor protection. Francis and Wang (2008) examine these issues for a sample of firms from 42 countries and their findings confirm this notion, as they show that earnings quality increases with the strength of investor protection, but only for firms with Big Four auditors. Furthermore, when investor protection is weak earnings quality does not differ between firms that are audited by Big Four firms and firms that are audited by non-Big Four auditors. These results again suggest that audit quality is not uniform across countries and that auditors behave differently due to differing incentives in differing legal regimes. The authors also suggest that in such settings, enforcing uniform, global auditing standards may not result in uniform auditing behavior across countries. The studies discussed at the beginning of this section seem to confirm this. Francis and Wang (2008) therefore argue that in addition to auditing standards, the differing underlying institutional environments also require harmonization, in order to achieve uniform audit quality.

4.5 Summary and conclusions

The purpose of our literature review was to provide an answer on the following main questions. First, do auditing standards, and changes in auditing standards, influence the audit process, auditor work effort, and audit fees? Second, do auditing standards, and changes in auditing standards, influence audit outcome and market perceptions? Third, are there international differences in auditor

incentives and auditor behavior, and if so, how do these differences affect the application of auditing standards?

Based on our review of the literature, we find that auditing standards, and in particular major changes in auditing standards, can and do affect the audit process, auditor effort and audit fees. For example, different studies have provided evidence that changes in US auditing standards on fraud have improved auditor fraud risk assessments, and increased auditor work effort. Similarly, research on internal control assessments in compliance with PCAOB Auditing Standard No.5 consistently provides evidence of increased auditor effort and audit fees.

Furthermore, based on our review of the literature we conclude that auditing standards, and changes in auditing standards, can influence the outcome of the audit process and market perceptions of the quality of auditing. A good example in this respect is international research on the impact of changes in standards on the auditor's going-concern assessment and reporting. Another example involves research on the precision of auditing standards which suggests that in the absence of precise guidance, auditors are more likely to permit aggressive accounting, especially when audit committee oversight is weak. Further, there is a general perception that investors benefit from implementation of improved auditing standards.

Finally, there is growing evidence to support the notion that audit quality is not uniform across countries and that auditors' behavior is influenced by differing incentives under different legal regimes. Consequently, auditing standards may have different effects depending on the country in which they are applied. This strongly suggests that a sound and strong institutional environment is needed to enforce compliance with auditing standards. Hence, we conclude that while high-quality auditing standards may be a necessary condition to achieve high-quality auditing, this is likely to be insufficient in an environment with weak enforcement mechanisms.

The overview of the literature that is provided in this chapter relates to a wide range of research. For the purposes of this study, we will focus on the case of ISAs and PCAOB standards, and in particular we will examine whether the differences between the two sets of standards, which are discussed in the next chapter, have an impact on audit practice (see Chapter 6) and influence the perceptions of users of financial statements (see Chapter 7).

Chapter 5: Comparison between ISAs and PCAOB Auditing and Interim Standards

5.1 Introduction

This chapter summarizes the results of a comparative analysis between the clarified ISAs and PCAOB Auditing and Interim Standards, and aims to meet the first objective of this study. The chapter is organized as follows. First, we start with discussing the overarching differences between the two sets of standards. Subsequently, we describe how we performed a more detailed comparative analysis and provide an overview of the main results, which are presented in more detail in the Appendix. Finally, we present the main differences between the two sets of standards from the viewpoint of experts.

5.2 Overarching differences

Before examining the detailed differences in auditing standards, it is appropriate to first consider the overarching differences from which many of the individual differences derive. A few environmental differences may be relevant to interpreting our detailed analysis of differences. First, PCAOB standards are part of the Integrated Audit approach that is required for the audit of public registrants in the US as defined in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. This means that many other standards must simultaneously address issues related to both the audit of the financial statements and the audit of internal control over financial reporting. There is no comparable requirement related to internal control over financial reporting under ISAs so the parts of the PCAOB standards that apply to the Integrated Audit are not comparable to ISAs.¹¹ Furthermore, since the PCAOB has the dual authority to issue standards and also inspect and enforce their implementation, this may color the manner in which the standards are written which may imbue them with an enforcement perspective that is absent from ISAs.

Second, since the PCAOB's authority to issue auditing standards is legally mandated, the standards that they issue have the force of law within the US which makes compliance a legal issue for auditors as well as a professional responsibility. ISAs do not have comparable status in any jurisdiction unless

¹¹ We include some examples of PCAOB's requirements related to the integrated audit in a separate section of the Appendix that contains our comparative analysis.

specifically given the force of law by regulatory or legislative action of an appropriate governmental entity. This point also highlights another environmental difference in the standards, namely, that PCAOB standards are targeted for a single jurisdiction while ISAs are written so as to be applicable to a wide range of jurisdictions. Per force, this suggests that ISAs are written in a more general fashion to facilitate widespread adoption and implementation.

The latter point leads to an oft-cited comment that, in general, ISAs are considered to be more “principles”-based while PCAOB standards tend to be more “rules”-based. While we do not draw a conclusion about this distinction, we do note that the standards are generally structured differently. Specifically, PCAOB standards are considered formal requirements as a whole while ISAs are presented in two parts, a set of general and relatively broad requirements, followed by more specific directions on the application of the standard in practice. However, the application and other explanatory material in the ISAs is not considered a formal requirement so it does not carry the same mandatory imprint as similar material that may appear in comparable PCAOB standards.

Another overarching difference that can be observed in the clarified ISAs is the specific mention of the objectives of a standard in the broader context of the audit process. Although such a structure has been used in the PCAOB’s proposed standards on the assessment of risk and responses to risks, this is not present in other PCAOB standards to date. Rather, the objective of individual PCAOB standards is considered implicit in the Generally Accepted Auditing Standards related to an audit engagement, including the general, fieldwork and reporting standards. Thus, the comparison of the purpose of any given standard is difficult because of the implicit versus explicit recognition of a standard’s objectives.

A final overarching difference is the general perception that ISAs are risk-based while PCAOB standards are more procedural in nature. Again, we do not engage in this debate but we do mention the relative emphasis on risk assessment and responses to risk currently embedded in the standards (e.g., ISA 550 *Related parties*, ISA 540 *Audit accounting estimates, including fair value accounting estimates, and related disclosures*, and ISA 402 *Audit considerations relating to an entity using a service organization*). ISAs require the explicit consideration of the riskiness of a client on a broad, enterprise level (e.g., see ISA 315 *Identifying and assessing the risks of material misstatements through understanding the entity and its environment*). This perspective suggests that an auditor should consider strategic and operating risks in the course of planning and conducting

the audit as well as financial statement and assertion level risks of material misstatements. It recognizes that the risk complexion of a client can not be fully evaluated without a fundamental understanding of the client entity and its environment. Nor can the quality of a client's responses to risks, or the auditor's plans for addressing such risks, be formulated without an understanding of the nature and extent of those risks. From this understanding, an auditor is then able to draw conclusions about the risk of material misstatement within the financial statements that are under audit and carry out the audit with the intent of minimizing such risks.

Current PCAOB standards adopt a more traditional financial statement and assertion-level view of risk as reflected in the audit risk model. While this perspective does not preclude an auditor from considering strategic and operating risks in the broader environment, the effect is to draw an auditor's attention directly to the risk of material misstatement with a somewhat limited perspective on the broader risk complexion of the client. As previously noted, proposed standards of the PCAOB are aimed at reducing this overarching difference. Specifically, the PCAOB considered the ISAs related to risk assessment and responses to risks and made an effort to adapt them to US audits. The extent to which the proposed standards will remove several of the differences noted in our analysis (or, creates new differences) cannot be addressed in this study. In Appendix 10 of the exposure document for the proposed standards the PCAOB compares the extant ISAs to the proposed requirements as currently structured. We refer to the PCAOB's comparative analysis in the Appendix of this report by footnoting the topics in our analysis that the PCAOB feels are affected by the proposed standards. However, we also note that the comment letter on the proposed standards from the Staff of the IAASB indicates that they have a different view on some of the issues in the comparative analysis prepared by the PCAOB. At the time of the writing of this report, the PCAOB standards had not been finalized or officially adopted so it is not possible to be more specific about how they will eventually map to the ISAs.

In the next section, we present the approach that we followed for performing a detailed comparison between the two sets of auditing standards and summarize our main results.

5.3 Results of detailed comparison

Comparing ISAs and PCAOB Auditing and Interim Standards is a challenging task. First, beyond the overarching differences, the complexity and extent of the

standards makes a direct comparison quite difficult. Second, the two sets of standards are not organized in the same manner so they do not align neatly by topic, requiring a great deal of cross-referencing for a comparative analysis (i.e., there is not a one-to-one correspondence in topics covered by the standards). Third, the ongoing activities of the two standard-setting bodies make such a comparison a moving target.

In order to structure our comparative analysis, we consider different subject areas organized into nine topics under which we classify and compare both sets of standards. These nine topics and subject areas are the following:

1. Topic 1: General principles and responsibilities with respect to an audit of financial statements;

Subject areas: Auditor responsibilities, terms of engagement, initial audit engagements, and quality control.

2. Topic 2: Internal control over financial reporting;

Subject area: Internal controls.

3. Topic 3: Risk assessment and use of analytical procedures;

Subject areas: Risk assessment, and analytical procedures.

4. Topic 4: Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements;

Subject areas: Audit documentation, written representations, comparative information, and other information.

5. Topic 5: Audit risk model, audit planning, materiality and sampling;

Subject areas: Materiality, planning, responses to risks, and sampling.

6. Topic 6: Fraud, illegal acts and compliance with laws and regulations; related parties;

Subject areas: Fraud, illegal acts and related parties.

7. Topic 7: Specific tests and evidence;

Subject areas: Inventories, confirmations, estimates and fair value, and subsequent events.

8. Topic 8: Special topics relating to the audit process;

Subject areas: Reliance on service organizations; going concern; other auditors, work of internal auditors, use of specialists, and inquiry of client's lawyer.

9. Topic 9: Audit communications;

Subject areas: Communication with those charged with governance, and auditor's report.

Table 5.1 provides an overview of the standards relating to each topic and subject area. Table 5.2 shows for which ISAs a comparison is made in our analysis, and the corresponding PCAOB Auditing and Interim Standard. We note that Table 5.2 basically contains the same information as Table 5.1 but is now listed in ascending order of the ISAs. We further note that the ISAs and PCAOB standards that are not included in the comparative analysis are beyond the scope of this study. In particular, our comparative analysis excludes ISA 800-899 (Specialized areas), AU Section 600 (Other types of reports), AU 700 (Special topics), AU 800 (Compliance auditing), AU 900 (Special reports of the committee on auditing procedures) as well as rules of independence embodied in the different national laws and regulations. Further, we exclude ISAs for smaller entities and additional guidance for public sector entities.

It is important to reiterate that the organization of the ISAs and the PCAOB standards do not align perfectly by topic on a one-to-one basis. A single ISA may relate to parts of multiple PCAOB standards or vice versa. Table 5.2 indicates how the ISAs align with the various AU sections of the PCAOB standards. Further, we note that there is no direct equivalent in the ISAs for the following PCAOB standards: AU 315 *Communication between predecessor and successor auditors* (some direction on this issue is included in ISA 510 Final), AU 332 *Auditing derivative instruments, hedging activities, and investments in securities* (we note that ISA 540 deals with fair value accounting estimates in general and that the non-authoritative IAPS 1012 is specifically dealing with auditing these financial products), AU 390 *Consideration of omitted procedures after the report date* (although there is some direction in ISQC1, paragraph 52), AU 411 *The meaning of present fairly in conformity with generally accepted accounting principles*, AU 504 *Association with financial statements* (although there is some direction in ISA 710), AU 532 *Restricting the use of an auditor's report* and AU 544 *Lack of conformity with generally accepted accounting principles*.

Table 5.1: Overview of ISAs and PCAOB Auditing and Interim Standards related to each topic

Subject	ISA Number	ISA Title	PCAOB standard Number	PCAOB standard Title
Topic 1: General principles and responsibilities with respect to an audit of financial statements				
AUDITOR RESPONSIBILITIES	ISA 200 Final*	"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"	AU** 110	"Responsibilities and Functions of the Independent Auditor"
			AU 150	"Generally Accepted Auditing Standards"
			AU 201	"Nature of the General Standards"
			AU 210	"Training and Proficiency of the Independent Auditor"
			AU 220	"Independence"
			AU 230	"Due Professional Care in the Performance of Work"
			AS*** 1	"References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board"
TERMS OF ENGAGEMENT	ISA 210 Final	"Agreeing the Terms of Audit Engagements"	AU 310	"Appointment of the Independent Auditor"
INITIAL AUDIT ENGAGEMENTS	ISA 510 Final	"Initial Audit Engagements – Opening Balances"	AU 420	"Consistency of Application of Generally Accepted Accounting Principles"
			AU 315.12-.13	"Communications Between Predecessor and Successor Auditors"
			AS 6	"Evaluating Consistency of Financial Statements"
QUALITY CONTROL	ISA 220 Final	"Quality Control for an Audit of Financial Statements"	QC section 20	"System of Quality Control for a CPA Firm's Accounting and Auditing Practice"
	ISQC**** 1	"Quality Control for Firms that Perform	AU 161	"The Relationship of Generally Accepted

	Final	Audits and Reviews of Financials Statements, and Other Assurance and Related Services Engagements”		Auditing Standards to Quality Control Standards”
Topic 2: Internal control over financial reporting				
INTERNAL CONTROLS	ISA 265 Final	“Communicating Deficiencies in Internal Control to Those Charged With Governance and Management”	AU 325	“Communicating Internal Control Related Matters Identified in an Audit”
			AU 319	“Consideration of Internal Control in a Financial Statement Audit”
			AS 4	“Reporting on Whether a Previously Reported Material Weakness Continues to Exist”
			AS 5	“An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements”
			AU 508	“Reports on Audited Financial Statements”
Topic 3: Risk assessment and use of analytical procedures				
RISK ASSESSMENT	ISA 315 HB***** 2008	“Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”	AU 312	“Audit Risk and Materiality in Conducting an Audit”
			AU 316	“Consideration of Fraud in a Financial Statement Audit”
			AU 329	“Analytical Procedures”
ANALYTICAL PROCEDURES	ISA 520 Final	“Analytical Procedures”	AU 329	“Analytical Procedures”
	ISA 315 HB 2008	“Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its		

		Environment”		
	ISA 330 HB 2008	“The Auditor’s Responses to Assessed Risks”		
Topic 4: Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements				
AUDIT DOCUMENTATION	ISA 230 HB 2008	“Audit Documentation”	AS 3	“Audit Documentation”
	ISQC 1 Final	“Quality Control for Firms that Perform Audits and Reviews of Financials Statements, and Other Assurance and Related Services Engagements”		
WRITTEN REPRESENTATIONS	ISA 580 Final	“Written Representations”	AU 333	“Management Representations”
COMPARATIVE INFORMATION	ISA 710 Final	“Comparative Information – Corresponding Figures and Comparative Financial Statements”	AU 508 paragraphs .64-.74	“Reports on Audited Financial Statements”
OTHER INFORMATION	ISA 720 HB 2008	“The Auditor’s Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements”	AU 550	“Other Information in Documents Containing Audited Financial Statements”
			AU 558	“Required Supplementary Information”
Topic 5: Audit risk model, audit planning, materiality, and sampling				
MATERIALITY	ISA 320 Final	“Materiality in Planning and Performing an Audit”	AU 312	“Audit Risk and Materiality in Conducting an Audit”
	ISA 450 Final	“Evaluation of Misstatements Identified During the Audit”	AS 5, paragraph 20	“An Audit of Internal Control over Financial Reporting that is Integrated with An Audit of Financial Statements”
PLANNING	ISA 300 HB 2008	“Planning an Audit of Financial Statements”	AU 311	“Planning and Supervision”
	ISA 220 Final	“Quality Control for An Audit of Financial Statements”	AS 5, paragraph 9	“Planning the Audit”
	ISA 315 HB	“Identifying and Assessing the Risks of		

	2008	Material Misstatement through Understanding the Entity and its Environment"		
	ISQC 1 Final	"Quality Control for Firms that Perform Audits and Reviews of Financials Statements, and Other Assurance and Related Services Engagements"		
RESPONSES TO RISKS	ISA 330 HB 2008	"The Auditor's Responses to Assessed Risks"	AU 312	"Audit Risk and Materiality in Conducting an Audit"
			AU 313	"Substantive Tests Prior to the Balance Sheet Date"
SAMPLING	ISA 530 Final	"Audit Sampling"	AU 350	"Audit Sampling"
Topic 6: Fraud; illegal acts and compliance with laws and regulations; related parties				
FRAUD	ISA 240 HB 2008	"The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"	AU 316	"Consideration of Fraud in a Financial Statement Audit"
	ISA 315 HB 2008	"Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"		
	ISA 330 HB 2008	"The Auditor's Responses to Assessed Risks"		
ILLEGAL ACTS	ISA 250 Final	"Consideration of Laws and Regulations in an Audit of Financial Statements"	AU 317	"Illegal Acts by Clients"
RELATED PARTIES	ISA 550 Final	"Related Parties"	AU 334	"Related Parties"
Topic 7: Specific tests and evidence				
INVENTORIES	ISA 501 Final	"Audit Evidence – Specific Considerations for Selected Items"	AU 331	"Inventories"
CONFIRMATIONS	ISA 505 Final	"External Confirmations"	AU 330	"The Confirmation Process"
ESTIMATES AND FAIR	ISA 540 HB	"Auditing Accounting Estimates,	AU 342	"Auditing Accounting Estimates"

VALUE	2008	Including Fair Values Accounting Estimates, and Related Disclosures”		
			AU 328	“Auditing Fair Value Measurements and Disclosures”
SUBSEQUENT EVENTS	ISA 560 Final	“Subsequent Events”	AU 560	“Subsequent Events”
			AU 561	“Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report”
			AS 5, paragraphs 93-98	“Subsequent Events”
			AU 530	“Dating of the Independent Auditor’s Report”
AUDIT EVIDENCE	ISA 500 Final	“Audit Evidence”	AU 326	“Evidential Matter”
Topic 8: Special topics relating to the audit process				
RELIANCE ON SERVICE ORGANIZATIONS	ISA 402 Final	“Audit Considerations Relating to an Entity Using a Service Organization”	AU 324	“Service Organizations”
			AS 5, paragraphs B17-B27	“Special Topics”
GOING CONCERN	ISA 570 Final	“Going Concern”	AU 341	“The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern”
			AU 333	“Management Representations”
OTHER AUDITORS	ISA 600 HB 2008	“Special Considerations- Audits of Group Financial Statements (Including the Work of Component Auditors)”	AU 543	“Part of Audit Performed by Other Independent Auditors”
			AS 5, Appendix C, C8-C11	“Special Reporting Situations”
WORK OF INTERNAL AUDITORS	ISA 610 Final	“Using the Work of Internal Auditors”	AU 322	“The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements”
			AS 5, paragraphs	Using the Work of Others”

			16-19	
USE OF SPECIALISTS	ISA 620 Final	"Using the Work of an Auditor's Expert"	AU 336	"Using the Work of a Specialist"
	ISA 500 Final	"Audit Evidence"		
INQUIRY OF CLIENT'S LAWYER	ISA 501 Final	"Audit Evidence – Specific Considerations for Selected Items"	AU 337	"Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments"
Topic 9: Audit communications				
COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE	ISA 260 HB 2008	"Communication with Those Charged with Governance"	AU 380	"Communication with Audit Committees"
AUDITOR'S REPORT	ISA 700 Final	"Forming an Opinion and Reporting on Financial Statements"	AU 508	"Reports on Audited Financial Statements"
	ISA 510 Final	"Initial Audit Engagements – Opening Balances"	AU 410	"Adherence to Generally Accepted Accounting Principles"
	ISA 705 Final	"Modifications to the Opinion in the Independent Auditor's Report"	AU 431	"Adequacy of Disclosure in Financial Statements"
	ISA 706 Final	"Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"		

*Final: Final refers either to a 'Final' ISA or a 'Final IAASB-Approved Draft', which is the text approved by the IAASB and submitted to the PIOB for approval of due process applied; ** AU refers to AICPA codification of auditing standards; *** AS: PCAOB Auditing Standard; ****ISQC: International Standard on Quality Control; ***** HB: IFAC Handbook 2008.

Table 5.2: Overview of ISAs with corresponding PCAOB Auditing and Interim Standards

ISAs	Corresponding PCAOB Auditing and Interim Standards
ISA 200 Final: Overall objectives of the independent auditor, and the conduct of an audit in accordance with International Standards on Auditing	AU 110, AU 150, AU 201, AU 210, AU 220, AU 230, AS 1
ISA 210 Final: Agreeing the terms of audit engagements	AU 310
ISA 220 Final: Quality control for an audit of financial statements + ISQC1 Final: Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements	QC section 20, AU 161
ISA 230 HB 2008: Audit documentation + ISQC1 Final: Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements	AS 3
ISA 240 HB 2008 : The auditor's responsibilities relating to fraud in an audit of financial statements + ISA 315 HB 2008: Identifying and assessing the risks of material misstatement through understanding the entity and its environment + ISA 330 HB 2008: The auditor's responses to assessed risks	AU 316
ISA 250 Final : Consideration of laws and regulations in an audit of financial statements	AU 317
ISA 260 HB 2008: Communication with those charged with governance	AU 380
ISA 265 Final : Communicating deficiencies in internal control to those charged with governance and management	AS 5, AU 319, AU 325, AS 4, AU 508
ISA 300 HB 2008 : Planning an audit of financial statements + ISA 315 HB 2008: Identifying and assessing the risks of material misstatement through understanding the entity and its environment + ISA 220 Final: Quality control for an audit of financial statements + ISQC1 Final: Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements	AU 311, AS 5 paragraph 9
ISA 315 HB 2008: Identifying and assessing the risks of material misstatement through understanding the entity and its environment	AU 312, AU 316, AU 329
ISA 320 Final: Materiality in planning and performing an audit + ISA 450 Final: Evaluation of misstatements identified during the audit	AU 312, AS 5, paragraph 20

ISA 330 HB 2008: The auditor's responses to assessed risks	AU 312, AU 313
ISA 402 Final: Audit considerations relating to an entity using a service organization	AU 324, AS 5, paragraphs B17-B27
ISA 500 Final: Audit evidence	AU 326
ISA 501 Final: Audit evidence - specific considerations for selected items	AU 331, AU 337
ISA 505 Final: External confirmations	AU 330
ISA 510 Final: Initial audit engagements-opening balances	AU 420, AU 315.12-.13, AS 6
ISA 520 Final: Analytical procedures + ISA 315 HB 2008: Identifying and assessing the risks of material misstatement through understanding the entity and its environment + ISA 330 HB 2008: The auditor's responses to assessed risks	AU 329
ISA 530 Final: Audit sampling	AU 350
ISA 540 HB 2008: Audit accounting estimates, including fair value accounting estimates, and related disclosures	AU 342, AU 328
ISA 550 Final: Related parties	AU 334
ISA 560 Final: Subsequent events	AU 560, AU 561, AS 5, paragraphs 93-98, AU 530
ISA 570 Final: Going concern	AU 341, AU 333
ISA 580 Final: Written representations	AU 333
ISA 600 HB 2008: Special considerations – audits of group financial statements (including the work of component auditors)	AU 543, AS 5, Appendix C, C8-C11
ISA 610 Final: Using the work of internal auditors	AU 322, AS 5, paragraphs 16-19
ISA 620 Final: Using the work of an auditor's expert + ISA 500 Final: Audit evidence	AU 336
ISA 700 Final: Forming an opinion and reporting on financial statements + ISA 510 Final: Initial audit engagements-opening balances + ISA 705 Final: Modifications to the opinion in the independent auditor's report + ISA 706 Final: Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report	AU 508, AU 410, AU 431
ISA 710 Final: Comparative information-corresponding figures and comparative financial statements	AU 508 paragraphs .64-.74
ISA 720 HB 2008: The auditor's responsibility in relation to other information in documents containing audited financial statements	AU 550, AU 558

To identify the main differences between the two sets of standards for each of these nine topics, the members of the research team conducted an in-depth study and detailed comparison of the standards. Furthermore, the research team consulted experts (including staff members from IAASB and PCAOB) to solicit additional input into the analysis. In conducting the comparative analysis, the research team used three criteria to determine whether a potential difference is relevant to report:

1. The difference could have an impact on the audit (in terms of activities, procedures, process, or outcome).
2. The difference is a formal but substantive difference even though it may not have an impact on the conduct of the audit.
3. The difference arises due to the different context of the US and international audit market, i.e., it may apply to the US or the international arena even though it may not apply to the other.

The identification of relevant differences was performed by five academics all of whom have an auditing background, first on an individual and subsequently on a collective basis. In total, the research team identified 96 differences, which are presented in the Appendix. It is important to note that the list of differences included in the Appendix is not intended to be comprehensive, but contains differences that the research team feels meet at least one of the above three criteria. In this regard, we acknowledge that interested parties may have different views on certain items, as became clear during the process of this project. Hence, the differences and discussion contained in the Appendix reflect our own views based on what we believe to be an objective analysis.

Table 5.3 provides an overview of the differences identified per subject area within each of the nine topics that we used for classifying and comparing ISAs and PCAOB standards. The table contains the ID numbers of the differences included and explained in the Appendix for cross-referencing purposes. We note that the brief summaries of the differences in Table 5.3. include ISA application material which represents best practice. For a comparison of the PCAOB standards and ISAs with and without application material, please refer to the appendix.

In the next section, we present the differences we consider to be the most important for audit practice according to a selected panel of experts. In Chapter 6, we examine to what extent these differences influence audit practice if the

audit of the financial statements has to be performed following PCAOB standards in addition to ISAs.

Table 5.3: Differences between ISAs and PCAOB standards

Topic 1: General principles and responsibilities with respect to an audit of financial statements		
Subject:	ID numbers of differences explained in appendix	Brief summary
Auditor responsibilities	1	Auditors need to refer to applicable auditing standards when conducting an audit. Due to the different character of the standards (national laws versus international regulation), audits conducted under PCAOB standards make reference to PCAOB standards, while audit conducted according to the ISAs cannot override local laws and regulations.
Terms of engagement	2, 3, 4, 5, 6	The ISAs address circumstances where the client requests to change the terms of the engagement, whether there are scope limitations prior to the acceptance of the engagement, and whether the terms of engagement in recurring audits need to be revised. PCAOB standards do not address these issues.
Initial audit engagements	7, 8	The ISAs indicate that auditors need to consider the effect of the matter of a modified audit report by the predecessor auditor. PCAOB standards do not explicitly state this as they consider the predecessor's report as part of the overall collection of audit evidence to analyze for opening balances. With respect to the use of the work of the predecessor auditor, the PCAOB standards explicitly state that auditors are not allowed to refer to the predecessor auditor's report or work as the conclusions with respect to opening balances and consistency of accounting principles are the sole responsibility of the incoming auditor. The ISAs contain no direction on this matter.
Quality control	9, 10, 11	The guidance on the firm's quality control system is more elaborate in the PCAOB standards, as aspects such as the limitations of a quality control system and factors that influence the nature, extent and format of quality control, are not included in the ISAs. On the other hand, the ISAs provide more direction in establishing policies and procedures within firms to promote an internal culture based on quality.

Topic 2: Internal control over financial reporting		
Subject:	ID numbers of differences explained in appendix	Brief summary
Internal controls	12, 13, 14, 15, 16, 17, 18	With respect to internal control over financial reporting, the PCAOB standards are stricter and contain more guidance than the ISAs. Under PCAOB standards, auditors are required to express an opinion about the quality of the client's internal control over financial reporting. ISAs do not have such a requirement. PCAOB standards also provide more guidance in communicating deficiencies in internal control.
Topic 3: Risk assessment and use of analytical procedures		
Subject:	ID numbers of differences explained in appendix	Brief summary
Risk assessment	19, 20	Overall, the ISAs provide more direction on how an auditor identifies risks compared to PCAOB standards. Further, they indicate what auditors shall minimally consider in determining which risks are significant, and list significant risks beyond fraud.
Analytical procedures	21, 22	The ISAs discuss the use of analytical procedures as a response to an assessed risk of material misstatement, while the PCAOB standards stress to evaluate the risk of management overriding controls, and test the design and operating effectiveness of controls over financial reporting when performing analytical procedures.
Topic 4: Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements		
Subject:	ID numbers of differences explained in appendix	Brief summary
Audit documentation	23, 24, 25, 26, 27	PCAOB standards concerning documentation are more strict than the ISAs in that they require auditors to assemble a complete and final set of audit documentation and an engagement completion memorandum not more than 45 days after the report release and that they need to retain this for 7 years, while the ISAs prescribe a 60 days preparation and 5 year retention period. PCAOB standards also provide more guidance on

		the location to retain audit documentation (part in central repository) and the responsibility of the lead audit firm to retain all engagement documentation.
Written representations	28, 29	The ISAs require written representations from management, and where appropriate, those charged with governance, whereas the PCAOB standards require written representations from management. Further, the ISAs require that the written representations are dated as near as practicable to, but not after, the date of the auditor's report, while the PCAOB standards require written representation made as of the date of the report.
Comparative information	30, 31, 32, 33, 34	The ISAs differ from the PCAOB standards with respect to the nature of comparative information in financial statements. Although both sets of standards consider comparative financial statements as applicable comparative information, the ISAs also specify corresponding figures as such, while this is not applicable in the US. Furthermore, if the prior period financial statements are not audited, the ISAs require the auditor to perform appropriate audit procedures on opening balances, while PCAOB standards indicate that the auditor has no responsibility beyond reading the financial statements for obvious material misstatements, and explicitly require the auditor to disclaim the opinion.
Topic 5: Audit risk model, audit planning, materiality, and sampling		
Subject:	ID numbers of differences explained in appendix	Brief summary
Materiality	35	PCAOB standards explicitly discuss the relationship between analytical procedures and misstatements, and between sampling and projected misstatements. The application material of the ISAs only covers the latter relationship.
Planning	36	PCAOB standards and the application material of the ISAs provide direction on the supervision of engagements. The PCAOB standards, however, provide more direction than the ISAs, especially regarding matters that assistants should be informed about, review of each assistant's work, and the documentation of disagreements during the audit.
Responses to risks	37, 38, 39	In general, the ISAs are more comprehensive and detailed in addressing how the auditor responds to identified risks (e.g. regarding the overall

		response to risk at the financial statement level). PCAOB standards and the application material of the ISAs provide similar guidance about performing substantive procedures at interim date and between interim date and balance sheet date.
Sampling	40	The ISAs provide more direction with respect to sampling than the PCAOB standards, as they provide specific direction when anomalous deviations or misstatements are discovered.
Topic 6: Fraud; illegal acts and compliance with laws and regulations; related parties		
Subject:	ID numbers of differences explained in appendix	Brief summary
Fraud	41, 42, 43, 44, 45, 46	Both sets of standards provide direction on the engagement team discussion with respect to fraud, the definition of fraud risk factors, the procedures to detect fraud (although specifying a different sequence), and the evaluation of evidence. PCAOB standards, however, give more direction regarding the use of analytical procedures, and the inherent limitations of such procedures in identifying the risks of material misstatement due to fraud. PCAOB standards also provide more guidance in documenting the procedures performed to identify and assess the risks of material misstatements due to fraud.
Illegal acts	47, 48, 49, 50	Unlike the ISAs, the PCAOB standards require the auditor to apply additional procedures if management does not provide satisfactory information that there has been no illegal act, and provide specific direction on auditor reporting, when illegal acts are discovered. Further, the PCAOB standards are very specific about the content of the communication to the audit committee.
Related parties	51, 52, 53, 54, 55	Although both sets of standards provide direction regarding procedures to determine the existence of related party transactions, the ISAs provide additional guidance with respect to related party transactions that management has not previously identified or disclosed, or conducted at arm's length, and the implications of related parties with dominant influence and special-purpose entities as related parties.

Topic 7: Specific tests and evidence		
Subject:	ID numbers of differences explained in appendix	Brief summary
Inventories	56, 57, 58	Both sets of standards provide direction in physical inventory counts. The two main differences are: (1) ISAs permit an exception to observing inventory if attendance at the entity's physical inventory count is impracticable (the auditor then needs to perform alternative procedures), and (2) when inventory under custody is material, under the ISAs, confirmation alone can be sufficient audit evidence under ISAs, whereas under the PCAOB standards more procedures are necessary.
Confirmations	59, 60, 61, 62	The main differences regarding confirmations are that the ISAs provide instructions to auditors who have been refused permission by management to send confirmation requests, while the PCAOB standards do not provide such guidance. Furthermore, unlike the ISAs, the PCAOB standards generally require the confirmation of accounts receivable, and provide more detailed direction on alternative procedures (e.g. negative confirmations) than the ISAs.
Estimates and fair value	63, 64, 65, 66, 67, 68	Although both sets of standards provide direction on auditing accounting estimates, the ISAs generally provide more direction. That is, the ISAs require auditors to evaluate whether management has considered alternative assumptions, to assess the degree of estimation uncertainty and whether estimates give raise to significant risks, and to determine whether the methods for making accounting estimates are applied consistently.
Topic 8: Special topics relating to the audit process		
Subject:	ID numbers of differences explained in appendix	Brief summary
Reliance on service organizations	69	The ISAs allow the auditor to make reference to the work of a service auditor when required by law or regulation or when the auditor's opinion is modified. In both instances the auditor has to make clear that the reference does not diminish the auditor's responsibility for the audit opinion. PCAOB standards do not allow any form of

		reference.
Going concern	70, 71, 72, 73	According to the ISAs, the auditor is responsible to obtain sufficient appropriate evidence about management's appropriate use of the going concern assumption, whereas under PCAOB standards, the auditor should make his own going concern evaluation (and not assess management's evaluation). Another difference is with respect to the time period over which the auditor has a responsibility. The ISAs require the auditor to consider a period of at least (but not limited to) 12 months from the date of the financial statements, while PCAOB standards require the auditor to evaluate whether there is substantial doubt for the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Furthermore, the ISAs contain additional guidance in the event of delay in the approval of the financial statements.
Other auditors	74, 75, 76, 77, 78, 79	The scope of the ISAs and PCAOB standards are different: the ISAs deal with group audits in general and are not limited to the work of component auditors. Further, the standards differ with respect to the responsibility of the group auditor. The ISAs indicate that the group auditor is required to take full responsibility for the audit opinion and shall not refer to a component (other) auditor unless required by law or regulation, i.e. the group auditor is required to take full responsibility for the audit opinion. PCAOB standards allow the auditor to decide whether to make reference to the component (other) auditor, hereby dividing his responsibility with the component auditor. Regarding the communication with the other auditor, unlike the PCAOB standards, the ISAs require that the group auditor communicates clearly and instructs the component auditor on the work to perform, the use of that work and the form and content of the component auditor's communication with the group auditor.
Work of internal auditors	80, 81	Unlike the ISAs, PCAOB standards indicate that if direct assistance from the internal auditors is provided to the external auditor, the external auditor is required to assess the internal auditors' competence and objectivity and supervise, review, evaluate, and test the work performed by the internal auditors.
Use of specialists	82, 83, 84	The ISAs provide more direction on the relationship between the auditor and experts, as the ISAs explicitly require that the auditor needs

		to agree with the expert on their respective roles and responsibilities, and the communication between the two.
Inquiry of client's lawyer	85, 86, 87, 88, 89	PCAOB standards are more explicit about the responsibility of management to identify, evaluate, and account for litigation, claims, and assessments. Furthermore, unlike the ISAs, PCAOB standards are very explicit about the content of a letter of audit inquiry to the client's lawyer. Also, PCAOB standards require the auditor to inform the lawyer that the client has given the auditor assurance that all unasserted claims are discussed, and in case the client has changed lawyers, to consider the reason for the change.
Topic 9: Audit communications		
Subject:	ID numbers of differences explained in appendix	Brief summary
Communication with those charged with governance	90, 91	Overall, the ISAs provide more direction on the communication between the auditor and those charged with governance, as auditors are specifically required to evaluate the adequacy of the two-way communication between the auditor and those charged with governance, and if found not adequate, to evaluate the effect on the assessment of the risk of material misstatement and the ability to obtain sufficient appropriate audit evidence, and take appropriate action.
Auditor's report	92, 93, 94, 95, 96	The most explicit difference between the ISAs and the PCAOB standards with respect to reporting relates to the fact that the PCAOB standards allow the auditor to express an unqualified opinion on one of the financial statements, and express a qualified or adverse opinion, or disclaim an opinion on another, while the ISAs generally prohibit an unmodified opinion when the auditor has expressed an adverse or disclaimer of opinion on the financial statements as a whole. Furthermore, the ISAs provide more guidance on auditor reporting with respect to management-imposed scope limitations. Other differences relate to the character of the two sets of standards (national vs. international regulation) and on referring to the work of another auditor in the auditor's report (which is not allowed according to the ISAs).

5.4 Consultation of experts

To complement our detailed comparative analysis, we consulted a panel of experts to elicit their views on the most important differences between the two sets of standards. A wide range of experts (16 in total) was consulted including representatives of large international audit firms, regulators, the IAASB, and accounting academics. Given its international and geographically dispersed composition, the panel of experts was organized using an electronic environment. More specifically, discussion rounds were organized using an electronic forum. The technical system to organize the electronic forum was hosted by "Surfnet", an independent organization founded by the combined universities in the Netherlands, and specialized in providing technical support and hosting technical systems. Full confidentiality with respect to the discussions in the panel was guaranteed and panel members were not aware of the identity of another panel member. In all panel discussions, participants used pseudonyms (i.e. Expert A, Expert B, etc). Further, confidentiality was guaranteed in terms of output as the information received from individual participants is reported at an aggregate level. The discussion rounds were organized around nine topics (see section 5.3) under which we classified and compared the two sets of standards. Based on their experience, we asked the panel of experts to have a general discussion per topic on the main differences between the two sets of standards that are likely to affect the audit of the financial statements.

Besides the consultation of experts through the electronic panel discussions, we also distributed a survey questionnaire to a selected group of international technical partners from each of the Big Four audit firms. One of the questions dealt with the most important differences between the two sets of standards for audit practice. Their responses to this question are incorporated into the aggregate results described below. The results of the other questions contained in the survey are summarized in Chapter 6.

At an aggregate level, we deduce from our consultation of experts that the five most important differences between the clarified ISAs and PCAOB standards that are perceived to have a significant impact on the audit relate to:

1. *Internal control over financial reporting*: Developing and implementing an effective system of internal control is a primary responsibility of management. Under PCAOB standards, an auditor is required to express an opinion about the quality of the client's internal control over financial reporting. ISAs do not have a comparable requirement, nor do they require an integrated audit (i.e. include an

audit of the effectiveness of internal control as part of the audit of financial statements). It is important to note that the PCAOB standards on internal control and integrated audit are a consequence of SOX 302 and SOX 404. In the US, Sarbanes Oxley sections 302 and 404 define the roles and responsibilities of CEOs, CFOs and external auditors regarding internal control. Section 302 addresses the corporate responsibility of CEOs and CFOs for establishing and maintaining internal controls. Section 404 introduces requirements for enhanced disclosure by requiring CEOs and CFOs to certify the effectiveness of internal controls (financial controls only). The SEC's final rules on section 404(a) require a company's annual report to include an internal control report from the management of a company. Section 404(b) requires the external audit firm that audited the financial statements to issue an attestation report on management's assessment of the registrant's internal control over financial reporting¹².

AS5, para.3: "The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting."

AS5, para.6: "The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits".

2. *Use of another auditor for part of a group audit:* In contrast to PCAOB standards, ISAs do not permit to make reference to another auditor.

ISA 600, para. 11.: " ...the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference."

AU 543, para. 03.: "If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report to the audit performed by another auditor."

3. *Documentation:* Documentation requirements under PCAOB standards are perceived to be more prescriptive and specific as compared to ISAs (e.g., in

¹² We note that AS5 has changed the auditor's requirements to only provide an opinion on the effectiveness of internal control over financial reporting. In particular, AS5 has the following footnote: "This auditing standard supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act."

contrast to ISA 230, AS 3 requires preparation and maintenance of engagement completion memorandum).

AS3, para. 13.: "The auditor must identify all significant findings or issues in an engagement completion document. This document may include either all information necessary to understand the significant findings, issues or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively be as specific as necessary in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues."

ISA 230, application material A11.: "The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information."

4. *Risk assessment and responses to assessed risks:* The approach to assessing and responding to risk within the ISAs differs from that of the PCAOB standards. (see section 5.2).

5. *Going concern:* PCAOB standards limit the foreseeable future to 12 months, while under ISAs it is at least, but not limited to, 12 months.

ISA 570, para. 13.: "In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in ISA 560 (Redrafted),⁴ the auditor shall request management to extend its assessment period to at least twelve months from that date."

AU 341, para. 02.: "The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a reasonable period of time)."

For a further specific description of these differences, we refer to Table 5.3 and the Appendix.

We explicitly asked the international technical partners of the Big Four audit firms to identify areas where they perceive that PCAOB standards exceed ISAs, areas

where ISAs exceed PCAOB standards, and areas where there is little or no difference between PCAOB standards and ISAs. Table 5.4 presents the results of this consultation. From Table 5.4 we conclude that in the opinion of experts the number of areas in which there are substantive differences between the two sets of standards that have an impact on the audit is limited. On balance, there is high consensus among the technical partners that PCAOB standards exceed ISAs on the following issues:

- Internal control over financial reporting; and
- Form and extent of documentation.

Similarly, there is high consensus among the technical partners on the perception that ISAs exceed PCAOB standards on the following issues:

- Risk assessment and responses to risks;
- Consideration of going concern problems; and
- Use of another auditor for part of a group audit.

Issues for which there is moderate to high consensus among the technical partners that there is little difference between the two sets of standards that have an impact on the audit include:

- General principles and responsibilities with respect to an audit of financial statements;
- Quality control for firms that perform audits of financial statements;
- Analytical procedures;
- Comparative information included in the financial statements;
- Audit risk model exclusive of risk assessment and responses to assessed risks;
- Planning the audit exclusive of risk assessment and responses to assessed risks;
- Materiality;
- Sampling;
- Fraud;
- Illegal acts and compliance with laws and regulations;
- Fair value accounting and auditing;

- Confirmation process;
- Auditing inventories;
- Auditing accounts estimates;
- The effect of subsequent events on the audit;
- Auditing derivative instruments;
- Auditing information from a service organization;
- The role of internal auditors in the conduct of an external audit;
- Use of a specialist during an audit;
- Communication between predecessor and successor auditors;
- Audit communications.

Finally, there are two areas, i.e. written representations and auditing related party transactions and disclosures, where experts appear to have mixed views on whether these areas contain substantive differences for the audit. While we are unable to determine the source of these mixed views from the evidence we have available, based on our comparative analysis, we consider the differences relating to written representations to be of minor importance. The ISAs require written representations from management, and where appropriate, those charged with governance, whereas the PCAOB standards require written representations from management. There is also a difference with respect to when written representations are to be obtained.

With regard to auditing related party transactions and disclosures, we conclude from our comparative analysis that although both sets of standards provide direction regarding procedures to determine the existence of related party transactions, the ISAs provide additional guidance with respect to related party transactions outside the normal course of business, that management has not previously identified or disclosed, or conducted at arm's length, and the implications of related parties with dominant influence and special-purpose entities as related parties.

Table 5.4: Differences between ISAs and PCAOB standards according to the perception of experts

	PCAOB standards exceed ISAs	Little difference among PCAOB standards and ISAs	ISAs exceed PCAOB standards	Mixed views
Topic 1: General principles and responsibilities with respect to an audit of financial statements				
General principles and responsibilities with respect to an audit of financial statements				
Quality control for firms that perform audits of financial statements				
Topic 2: Internal control over financial reporting				
Internal control over financial reporting				
Topic 3: Risk assessment and use of analytical procedures				
Risk assessment and responses to assessed risks				
Analytical procedures				
Topic 4: Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements				
Written representations				
Comparative information included in financial statements				
Form and extent of documentation				
Topic 5: Audit risk model, audit planning, materiality, and sampling				
Audit risk model exclusive of risk assessment and responses to assessed risks				
Planning the audit exclusive of risk assessment and responses to assessed risks				
Materiality				
Sampling				

Topic 6: Fraud; illegal acts and compliance with laws and regulations; related parties				
Fraud				
Illegal acts and compliance with laws and regulations				
Auditing related party transactions and disclosures				
Topic 7: Specific tests and evidence				
Fair value accounting and reporting				
Confirmation process				
Auditing inventories				
Auditing accounting estimates				
The effect of subsequent events on the audit				
Auditing derivative instruments				
Topic 8: Special topics relating to the audit process				
Consideration of going concern problems				
Auditing information from a service organization				
The role of internal auditors in the conduct of an external audit				
Use of another auditor for part of a group audit				
Use of a specialist during an audit				
Topic 9: Audit communications				
Communications between predecessor and successor auditors				
Audit communications				

5.5 Summary and conclusions

In this chapter, we have presented the results of our comparative analysis between the clarified ISAs and PCAOB Auditing and Interim Standards. We first discussed the overarching differences between the two sets of standards, followed by a more detailed analysis based on analyses by the research team and the opinions of our group of experts. We structured our comparative analysis around nine topics: (1) General principles and responsibilities with respect to an audit of financial statements; (2) Internal control over financial reporting; (3) Risk assessment and use of analytical procedures; (4) Nature of management assertions and documentation requirements; management representations; comparative information; other information in documents containing financial statements; (5) Audit risk model, audit planning, materiality and sampling; (6) Fraud and illegal acts; compliance with laws and regulations; related parties; (7) Specific tests and evidence; (8) Special topics relating to the audit process; and (9) Audit communications.

The results of our comparative analysis are presented in the Appendix, and relate to 96 differences. For a difference to be included in the final analysis, it had to meet one of the following three criteria:

1. The difference could have an impact on the audit (in terms of activities, procedures, process, or outcome).
2. The difference is a formal but substantive difference even though it may not have an impact on the conduct of the audit.
3. The difference arises due to the different context of the US and international audit market, i.e., it may apply to the US or the international arena even though it may not apply to the other.

We emphasize that the differences included in the Appendix are not intended to be a comprehensive list of all differences. The Appendix includes only those differences that the research team deemed to meet one of our three pre-defined criteria. In this regard, we acknowledge that interested parties may have different views on certain items, as became clear during the process of this study. Hence, the differences and discussion included in the Appendix represent the views of the research team, and may or may not correspond with the views from staff members of IAASB or PCAOB. While the differences included in the appendix should not be considered as a checklist, they may provide some guidance or serve as a starting point to European audit regulators if they have to conduct inspections of audits carried out under PCAOB standards, which was one of the motivations for this study.

Based on the input of the professionals involved in this study, we conclude that there are only a limited number of substantive differences between the two sets of standards. In particular, there are five areas for which experts perceive substantive differences that have a significant impact on the audit: (1) assessing and reporting on internal control over financial reporting; (2) use of another auditor for part of a group audit; (3) documentation; (4) risk assessment and responses to assessed risks; and (5) going concern.

We note that when the PCAOB adopts some form of its proposed standards on the auditor's assessment of and responses to risk, this is likely to reduce the number of differences between the two sets of standards, although it may also create new differences. As stated in the press release¹³ accompanying the release of the PCAOB's proposed standards: "The proposed standards reflect the PCAOB's effort to reduce unnecessary differences with the risk assessment standards of other auditing standard setters...(…)...While many of the procedures described in the IAASB standards appear to be generally suitable for audits of issuers, the PCAOB believes that certain changes to those standards would be necessary for the PCAOB to adopt them as standards of the PCAOB. Accordingly, there is a degree of commonality between the proposed standards and the IAASB's recently updated risk assessment standards, though they do not mirror them word-for-word".

In the next chapter, we examine in more detail to what extent the differences between the two sets of standards matter for audit practice.

¹³ http://www.pcaob.org/News_and_Events/News/2008/10-21.aspx.

Chapter 6: Impact of differences between ISAs and PCAOB Auditing and Interim Standards on audit practice

6.1 Introduction

In this chapter we examine the impact of the differences between the clarified ISAs (referred to as ISAs hereafter) and PCAOB Auditing and Interim Standards on audit practice. To this end we solicited input from international technical partners from each of the Big Four audit firms. In particular, each Big Four audit firm was presented with a survey containing questions on the extent to which differences between the two sets of standards matter for the audit of financial statements. More specifically, we were interested in what additional work would be required if the audit of the financial statements is performed following PCAOB standards in addition to ISAs. The responses received from our discussions with the international technical partners are presented below. We received one response per Big Four audit firm, which represented a summary of the views of the international technical partners of that particular audit firm. We note that the clarified ISAs will be effective for audits of financial statements periods beginning on or after December 15, 2009. This should be taken into consideration when evaluating the results of the consultation of the international technical partners (referred to as experts hereafter) of the major audit firms.

6.2 Consultation of experts

Standard textbooks on auditing (e.g., Knechel, Salterio, and Ballou, 2007) describe the audit process to consist of the following stages: (1) client acceptance and retention; (2) risk evaluation; (3) planning tests of financial statement assertions; (4) completion of audit; and (5) audit reporting.

We asked experts to what extent differences between ISA and PCAOB standards affect each of these stages of the audit process. In particular, we asked how each of these stages would be affected if the audit of the financial statements has to be performed following PCAOB standards in addition to ISAs. The views of the experts on the impact of the differences between the two sets of standards on the different stages of the audit process are summarized in Table 6.1.

Table 6.1: Impact of performing an audit following PCAOB standards in addition to ISAs on different stages of the audit process

Items	Yes, since PCAOB standards exceed ISAs	No, since ISAs exceed PCAOB standards	No, since there is little difference between PCAOB standards and ISAs
1. Client acceptance and retention			
2. Risk evaluation			
3. Planning tests of financial statement assertions			
4. Completion of audit			
5. Audit reporting			

The results presented in Table 6.1 show that if the audit has to be performed following PCAOB standards in addition to ISAs, this will lead to additional work for the auditor in two stages of the audit process: the completion of the audit, and audit reporting. Completion of the audit following PCAOB standards in addition to ISAs mainly results in having to meet the additional documentation requirements of the PCAOB standards. For example, AS 3 requires that an engagement completion memorandum be prepared and maintained in the audit documentation, while this is not required in ISA 230. Audit reporting requirements following PCAOB standards in addition to ISAs mainly comes down to the additional requirement to report on the effectiveness of internal control over financial reporting. AS 5 requires the audit of internal control over financial reporting to be integrated with the audit of the financial statements. This is not required under ISAs. Reporting on internal control under the ISAs is incidental to the audit of the financial statements and mainly carried out for the purpose of assessing the risk of material misstatements. The other stages of the audit are not perceived to be affected as experts see little difference between the two sets of standards for client acceptance and retention, and planning tests of financial statement assertions. For risk evaluation, ISAs are perceived to exceed PCAOB standards.

Subsequently, we asked the experts to what extent differences between the two sets of standards affect risk evaluation procedures and tests of accounting information. Following Knechel et al. (2007), we distinguish between the following risk evaluation procedures: (a) procedures to understand the client’s environment; (b) evaluation of information system reliability; (c) tests of controls; and (d) preliminary analytical procedures. Similarly, following Knechel et al. (2007), we distinguish the following tests of accounting information: (a) substantive analytical procedures; (b) tests of transactions (c) tests of accounts; and (d) tests of presentation and disclosure.

The views from the experts on the overall impact of the differences on risk evaluation procedures are presented in Table 6.2.

Table 6.2: Impact of performing an audit following PCAOB standards in addition to ISAs on risk evaluation procedures

Items	Yes, since PCAOB standards exceed ISAs	No, since ISAs exceed PCAOB standards	No, since there is little difference between PCAOB standards and ISAs
1. Procedures to understand the client's environment			
2. Evaluation of information system reliability			
3. Tests of controls			
4. Preliminary analytical procedures			

Table 6.2 indicates that if an audit of financial statements has to be performed following PCAOB standards in addition to ISAs, this will have an impact on the tests of controls as a risk evaluation procedure. The requirements under PCAOB standards for performing tests of controls are perceived to lead to additional work compared to what would be done under ISAs. This finding is to be attributed to the fact that PCAOB standards require an integrated audit. As mentioned above, AS 5 requires the audit of internal control over financial reporting to be integrated with the audit of financial statements while this is not required under ISAs. In the opinion of experts, performing an audit following PCAOB standards in addition to ISAs has no other significant impact on risk evaluation procedures. In particular, experts consider that there is little difference between the two sets of standards for the evaluation of information system reliability and preliminary analytical procedures. For procedures to understand the client's environment, ISAs are perceived to exceed PCAOB standards.

Table 6.3 summarizes the views of experts on the overall impact of the differences between the two sets of standards on tests of accounting information.

Table 6.3: Impact of performing an audit following PCAOB standards in addition to ISAs on tests of accounting information

Items	Yes, since PCAOB standards exceed ISAs	No, since ISAs exceed PCAOB standards	No, since there is little difference between PCAOB standards and ISAs
1. Substantive analytical procedures			
2. Tests of transactions			
3. Tests of accounts			
4. Tests of presentation and disclosure			

Table 6.3 indicates that in the opinion of experts, performing on audit of the financial statements following PCAOB standards in addition to ISAs does not have an impact on any of the different types of tests of accounting information.

Finally, we asked experts to what extent performance of a financial statement audit following PCAOB standards in addition to ISAs affect (a) risk reduction, and (b) extent and form of documentation. The answers to this question are summarized in Table 6.4.

Table 6.4: Impact of performing an audit following PCAOB standards in addition to ISAs on other issues

Items	None	Small	Moderate	Large	Conflicting views
Impact on risk reduction					
Impact on extent and form of documentation					

Table 6.4 indicates that experts have conflicting views on whether following PCAOB standards in addition to ISAs results in a reduction of the risk of undetected material misstatements. While two Big Four audit firms find that it does not result in a risk reduction, the other two Big Four audit firms find that it leads to a moderate reduction of risk. One expert commented that this is due to *'additional work on controls'*. Another commented that this reduction is due to *'the requirement for management to report on the effectiveness of internal control and auditor reporting causes the risk of material misstatement to decline before the audit is performed'*. The experts do agree that following PCAOB standards in addition to ISAs has a moderate impact on the extent and form of documentation that is required. This is illustrated with following comment: *'More detailed requirements throughout the PCAOB standards, coupled with inspection by PCAOB that centers on documentation.'*

The next set of questions presented to experts related to the overall characteristics of ISAs compared to PCAOB standards. In particular, we asked experts whether in their perception there is a difference between the two sets of standards in terms of: (a) risk-based audit approach; (b) principles-based approach; (c) need of auditor judgment; (d) extent of guidance; and (e) extent of precision. The responses to this question are summarized in Table 6.5.

Table 6.5: Overall characteristics of ISAs compared to PCAOB standards

Items	PCAOB standards exceed ISAs	ISAs exceed PCAOB standards	Little difference between PCAOB standards and ISAs	Conflicting views
Risk-based audit approach				
Principles-based approach				
Need of auditor judgment				
Extent of guidance				
Extent of precision				

Table 6.5 indicates that experts perceive that ISAs require a more risk-based audit approach compared to PCAOB standards. Furthermore, ISAs are perceived to be more principles-based standards compared to PCAOB standards. In the opinion of experts, there is not much difference between the two sets of standards in terms of level of auditor judgment needed. For the extent of guidance and precision provided in the two sets of standards, there appear to exist conflicting views among the experts. Some perceive PCAOB standards to provide more guidance, while others perceive ISAs to provide more guidance, and similarly for extent of precision.

We also asked experts to what extent the use of words as ‘shall’, ‘must’ and ‘should’, which may have different meanings to different individuals, have an impact on the way an audit is performed. The results to this question show that the impact is perceived to be moderate.

For a client cross-listed on a US stock exchange, differences between ISAs and PCAOB standards may affect the way an audit is performed in terms of approach and procedures to be followed. This is illustrated by the following comments from experts:

‘Differences in standards may require additional procedures to be performed. However, our methodology and processes are the same because we have one global methodology.’

‘Our methodology is based on the ISAs and we add the additional PCAOB requirements. Many of the additional PCAOB requirements are matters that are in ISA guidance so even though they are additional requirements they do not necessarily represent additional work to what we actually do under the ISAs. Often the additional requirements are about additional documentation.’

‘Testing of effectiveness of internal control drives a control based approach to the audit, including a different approach to lower risk controls; separate identification of material weaknesses in internal control; and approach to testing IT general controls.’

An audit of financial statements is concluded with the issuance of an audit report. This opinion of the auditor is the only visible outcome of the audit process and therefore crucial for assessing audit quality from a user’s perspective. While differences in standards may require additional procedures to be performed, a fundamental question is whether this ultimately will result in a different outcome. In other words, is it possible that an auditor could come to a different conclusion and issue a different audit opinion on the financial statements (excluding the report on internal control over financial reporting) following both sets of standards instead of following only ISAs? The response to this question, presented in Table 6.6, was unanimous: none of the respondents perceive that an auditor would issue a different opinion.

Table 6.6: Overall impact of following PCAOB standards in addition to ISAs on audit outcome

	Yes	No
Different audit opinion		

A final set of questions presented to the experts relate to the importance of standards and enforcement mechanisms for high-quality audits. The responses to this set of questions are summarized in Table 6.7. We first asked the experts what the most important condition is for high-quality audits: auditing standards or high-quality mechanisms to enforce these standards. The responses to this question show that they are perceived to be equally important. As an aside but related to the above question, we asked experts, in view of the clarity project, whether the inclusion of objectives in the clarified ISAs has an impact on the conduct of an audit. The experts perceive this impact to be moderate. In this regard, one expert commented that *‘objectives will help auditors apply better judgments about the application of the auditing standards.’*

Subsequently, we asked the experts whether stricter enforceability inherent to one set of auditing standards for the audit of financial statements compared to another set of auditing standards plays a role in the perceived quality of the audit. The views on this question are divided. While one Big Four audit firm does not perceive this to be the case, two Big Four audit firms perceive the opposite as illustrated by the following comments:

‘Perception of stricter enforceability drives auditor behavior.’

‘The inspection process can bring a different interpretation of standards or a focus on certain issues that are important to regulators for audit quality. Both will drive audit firms to implement changes to their existing audit process. Over time, this will bring more consistency to the audit profession and contribute to audit quality.’

Another Big Four audit firm argues that *“it is a mistake to write standards primarily so that they can be enforced strictly and objectively. Doing so necessarily drains them of*

application of judgment and produces the dreaded checklist mentality that undermines both the actual and perceived quality of the audit. I believe standards should be written to present clear principles and establish a sound framework for the application of judgment. In order to accomplish this, standards must contain requirements in sufficient detail to promote consistency in the application of judgment while still promoting the use of judgment. This is a very delicate balance. I also believe that there must be a credible and independent inspection process. A successful inspection process is one that concentrates on good quality through sound application of judgment rather than enforcing prescriptive rules without regard to the context of their application."

Further, we solicited the views from experts on the importance of different enforcement mechanisms in terms of their effect on compliance with auditing standards. In particular, we ask experts to consider the importance of: (a) auditor code of conduct; (b) audit firm quality control standards; (c) independence rules; (d) peer review inspections; and (e) regulatory practice inspections. The responses to this question, also reflected in Table 6.7 below, show that experts perceive the auditor code of conduct and ethical standards as well as independence rules to have little importance. Peer review inspections are perceived to be moderately important. High importance is attributed to regulatory practice inspections, and audit firm quality control standards are perceived to be the most important.

Finally, we provided experts the opportunity to share any other thoughts or comments on the differences between ISAs and PCAOB standards and the effect that these differences may have on the audit of financial statements if the audit has to be performed under both sets of standards. The following informative comments were received:

'Variations in standards can have an impact on audit quality. They also lead to unnecessary cost and complexity. Convergence of standards towards one set of global standards should be a significant priority of standard setters and regulators.'

'The fundamental differences between the PCAOB standards and the clarified ISAs relate to the number and level of detail of the requirements. PCAOB standards tend to have more requirements, many of which are in the clarified ISA guidance. These additional requirements in turn create greater documentation burden on auditors which adds little or nothing to audit quality. I believe this difference between the standards is largely driven by the perceived need for detailed and very objective requirements to facilitate inspections. The clarified ISAs strike a much better balance between principles and rules and are superior standards to those of the PCAOB. However, in order to improve audit quality in the USA and in Europe a reformed approach to inspection that emphasizes the quality of the application of judgment to the circumstances is badly needed. This is no easy thing but is the most important task before us. Effective internal

and external inspection processes are critical to effective implementation. Inspection processes can also produce negative results by causing too much of a compliance and documentation focus at the expense of sound judgment and performance of effective procedures. In short it is time to move on from the task of writing standards and concentrate on improving their application. The PCAOB should adopt the ISAs and add their internal control requirements. Jurisdictions around the world should adopt the ISAs and also get on with the work of implementation.'

'The most significant and substantive difference between the two sets of standards is the scope of the audit engagement -- the PCAOB standards being designed to meet the requirements of the Sarbanes-Oxley Act for an audit of the financial statements and of the internal control over financial reporting, whereas the ISAs are for the audit of financial statements only. Another key difference between PCAOB standards and the ISAs is that the PCAOB standards address audits of listed companies only, whereas the ISAs are designed for audits of any entity (both listed and unlisted companies). Whilst there are some other specific differences between PCAOB standards and ISAs, they do not generally have a substantive impact on practice for the larger networks as generally our methodologies and tools are common across territories. The revised ISAs were designed to increase the rigour of those standards and are perceived to "raise the bar". In many ways, a more significant driver affecting auditor behaviour is the legal environment, which can influence how requirements are approached and interpreted in practice (e.g., a preference for standards to be more explicit as they may provide greater protection in legal proceedings).'

Table 6.7: Importance of standards and enforcement mechanism for high-quality audits

	Auditing standards		High-quality enforcement mechanisms		Equally important
Most important condition for high-quality audits: auditing standards or high-quality mechanisms to enforce these standards					
	Yes		No		Conflicting views
Does enforceability inherent to a set of auditing standards play a role in the perceived quality of audit?					
Importance of the following enforcement mechanisms in terms of their effect on compliance with auditing standards	Very little Importance	Little importance	Moderate importance	High importance	Very high importance
<ul style="list-style-type: none"> • Auditor code of conduct and ethical standards 					
<ul style="list-style-type: none"> • Audit firm quality control standards 					
<ul style="list-style-type: none"> • Independence rules 					
<ul style="list-style-type: none"> • Peer review inspections 					
<ul style="list-style-type: none"> • Regulatory practice inspections 					

6.3 Summary and conclusions

In this chapter we have presented the results from our consultation with technical experts on the impact of differences between IAASB and PCAOB standards on audit practice. We were particularly interested in the question what additional work is required for the audit of financial statements following PCAOB standards in addition to ISAs, and whether it would be possible to come to a different conclusion or audit opinion following the two sets of standards instead of ISAs alone. The responses received from international technical partners representing the views from each of the Big Four audit firms to these main questions can be summarised as follows.

First, performing an audit of financial statements following PCAOB standards in addition to ISAs is perceived to lead to additional work for testing the system of internal control. This finding can be attributed to the fact that PCAOB standards require an integrated audit. In the opinion of experts, there is no effect on the other risk evaluation procedures (i.e., procedures to understand the client's environment, evaluation of information system reliability, and preliminary analytical procedures). Furthermore, there is overall consensus among the experts that following PCAOB standards in addition to ISAs does not lead to additional work in performing the different tests of accounting information (i.e. substantive analytical procedures, tests of transactions, tests of accounts, and tests of presentation and disclosure).

Second, experts perceive that if the audit of the financial statements has to be performed following PCAOB standards in addition to ISAs, this will lead to additional work for the auditor in the completion and reporting stages of the audit. For the completion stage, this mainly implies that the auditor has to fulfil additional documentation requirements, and for the reporting stage this implies that the auditor also has to report on internal control. No effect is perceived on the other stages of the audit process (i.e., client acceptance and retention, and planning substantive tests of financial statement assertions).

Third, experts appear to have conflicting views on whether or not following PCAOB standards in addition to ISAs results in a reduction of the risk of undetected material misstatements. Experts do agree that it will lead to a moderate increase in the extent and form of documentation that needs to be prepared and maintained.

Finally, while audit firms may perform additional audit procedures for a client that is cross-listed on a US stock market, there is overall consensus among the experts that following PCAOB standards in addition to ISAs will not result in a different audit opinion on the financial statements (excluding the report on internal control over financial reporting) compared to following ISAs only.

We also solicited the views from experts on the characteristics of ISAs compared to PCAOB standards. In this regard, experts perceive that ISAs require a more risk-based approach and that ISAs are more principles-based standards. Experts do not perceive that there is much difference in the extent of auditor judgment needed following ISAs or PCAOB standards. On the extent of guidance and level of precision provided by the two sets of standards, experts appear to have conflicting views. In terms of wording, experts perceive that the use of words as 'shall', 'must', or 'should' has a moderate impact on the way an audit is performed (i.e., the terminology used in auditing standards matters in audit practice).

The final set of questions presented to the experts related to the importance of auditing standards and enforcement mechanisms for high-quality audits. Experts perceive standards and enforcement mechanisms to be equally important. The most important enforcement mechanism is considered to be audit firm quality control, followed by regulatory practice inspections. Peer review inspections are perceived to be of moderate importance while auditor code of conduct and ethical standards (including independence rules) are considered to be the least important.

In the next chapter, we assess the benefits, if any, for the European capital market if the audit of financial statements is performed following PCAOB standards in addition to ISAs.

Chapter 7: Impact of differences between ISAs and PCAOB Auditing and Interim Standards on perceptions of financial statement users

7.1 Introduction

This chapter presents the results of our analysis of the impact of differences between ISAs and PCAOB standards on the perceptions of financial statement users. This analysis is based on a small-scale survey of European capital market experts and a large-scale survey of a broad range of experienced European financial statement users. Consequently, the results relate to the perceptions of a small group of capital market experts (referred to as “experts” hereafter) and a wide and diverse group of financial statement users (referred to as “users” hereafter).

The main objective of this analysis is to assess whether experts and users perceive any benefits for European capital markets of an audit report prepared following both ISAs and PCAOB standards, compared to an audit report prepared under a single set of auditing standards. Ancillary goals are to assess the perceived benefits and perceived importance of:

1. Conducting an audit of internal control over financial reporting over and above an audit of the financial statements;
2. Mechanisms to enforce compliance with auditing standards for the audit of financial statements (such as inspection of audit work by public oversight bodies);
3. Strict auditor independence regulations (for example a ban on non-audit services, or mandatory partner rotation);
4. Auditing standards in general.

We deliberately focus on perceived benefits and importance, and not on perceived costs or the perceived trade-off between costs and benefits. The reason for this is that costs are arguably less relevant from a user perspective. The remainder of this chapter is organized as follows. Section 7.2 details our approach. Section 7.3 presents the results of the survey of experts. Section 7.4 describes the results of the survey of users. Section 7.5 summarizes and concludes.

7.2 General approach

In order to assess whether experts and users perceive any benefits for European capital markets of an audit report prepared following both ISAs and PCAOB standards, we have focused on two special cases:

1. Publicly listed US companies with a cross-listing in the EU; and
2. Publicly listed European companies with a cross-listing in the US.

The reason for focusing on the former is that audits of the financial statements of US public companies with a cross-listing in the EU are in the current situation conducted in accordance with the standards of the PCAOB only. This situation allows us to confront experts and users with a hypothetical situation in which the audit of the financial statements of these companies would be conducted in accordance with ISAs in addition to the standards of the PCAOB.

The reason for focusing on publicly listed European companies with a cross-listing in the US is similar. In the current situation, audits of financial statements of publicly listed European companies with a cross-listing in the US are conducted in accordance with the standards of the PCAOB in addition to the national auditing standards or ISAs¹⁴. This situation allows us to confront experts and users with a hypothetical situation in which the audit of the financial statements of these companies would be conducted in compliance with ISAs only.

With these foci in mind, we have developed a survey instrument that is suitable for experts as well as for users. The survey instrument consists of five statements accompanied by a Likert item with room for additional comments, six closed questions with room for additional comments, two open-ended questions, and finally six exit questions to obtain general background information on the respondents.

¹⁴ Currently, auditors of EU companies cross-listed on US stock exchange have to follow PCAOB standards in addition to the auditing standards applicable in their jurisdiction (which would be replaced by the international auditing standards if the European Commission decides to adopt such standards under Article 26 of Eighth Company Law Directive 2006/43/EC). However, "results of IFAC Member Body Compliance Program indicate that more than 100 countries use auditing standards that are ISAs, either adopted as written or locally adapted, or national standards that are compared with ISAs to eliminate differences". (Source: IAASB Strategy and Work Program 2009-2011, p.9).

7.3 Survey of experts

The group of experts that we approached for this study comprises of high-level representatives of various participants in the European capital markets, including representatives of institutional investors, investment banks, venture capitalists and private equity companies, assets managers, private investors, stock exchanges, financial analysts, and professional advisers.

In total we contacted 22 representatives with a request to share their views and opinions with the MARC research team. In case a person was willing and able to do so, he or she was offered the opportunity to share his/her opinions by participating in an online or paper-based survey, or by engaging in a phone interview. In the end, eight experts completed the online survey, two experts exchanged their views with the research team by phone, and one expert communicated his/her opinion on a particular issue in an e-mail to the research team.

7.3.1 Main findings survey of experts

Case 1 – Publicly listed US companies with a cross-listing in the EU

In line with the general approach presented above, the first statement that we present to the experts is the following hypothetical situation: *If the audit of the financial statements of a US company with a cross-listing in the EU would be conducted in compliance with ISAs in addition to the standards of the PCAOB, the perceived assurance on European capital markets derived from reading the audit report would be higher compared to the situation where the audit is based on PCAOB standards only.* The responses of the experts are tabulated below.

	<i>n</i>	<i>%¹⁵</i>
1. Strongly agree	1	(13)
2. Agree	3	(38)
3. Undecided	2	(25)
4. Disagree	1	(13)
5. Strongly disagree	0	(0)
Don't know	1	(13)

¹⁵ Please note that in this and subsequent tables the percentages may not sum up to 100% due to rounding.

Overall, experts agree that perceived assurance on European capital markets derived from reading the audit report would be higher if, in a hypothetical situation, the audit of the financial statements of a US company with a cross-listing in the EU would be conducted in compliance with ISAs in addition to the standards of the PCAOB. More precisely, four of the eight experts who responded to this statement accept it (agree or strongly agree), one expert rejects it (disagrees), two experts are undecided, and one expert has no opinion. One of the experts who agrees with this statement nuances his/her opinion as follows: "Whilst compliance with two sets of standards is likely to imply some marginally higher level of assurance, the incremental difference should be relatively small as the standards of the PCAOB are not unreasonable, albeit less familiar for European capital markets." The expert who strongly agrees with this statement also refers to a potential lack of familiarity of PCAOB standards by commenting that "it would ease analysis because European analysts and investment managers are more used to ISA standards in their daily activity". The expert adds that "it could also ensure better comparability between US and EU companies". One of the two experts who is undecided comments as follows: "The goal of both ISA and PCAOB standards is to improve the auditing process. It is our belief that the quality of both standards is good. We would prefer ISA because we feel they have a more global acceptance. However, we do not think that ISA are better or worse than PCAOB standards. We must also think about the administrative costs for both companies and auditing firms".

To gain further insight in the perceived benefits for investors if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards, we further ask the experts: *Would it add value for investment decisions if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards, compared to PCAOB standards only?* The responses are tabulated below.

	<i>n</i>	<i>%</i>
Yes	2	(25)
No	2	(25)
Don't know	4	(50)

Despite overall agreement on the first statement, most experts don't know whether it would add value for investment decisions if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards. Only two of the eight experts indicate that it would add value.

One of them nuances this opinion by stating that “this should provide marginal incremental assurance”. The other expert comments that “it would provide higher safety”. Two experts indicate that it would not add value. One of them repeats the comment that “both ISA and PCAOB standards are of high quality”.

Case 2 – Publicly listed European company with a cross-listing in the US

In line with our general approach, the second statement that we present to the experts is the following hypothetical situation: *If the audit of the financial statements of a European company with a cross-listing in the US would be conducted in compliance with ISAs only, the perceived assurance on European capital markets derived from reading the audit report would be lower compared to the situation where the audit is based on PCAOB standards in addition to ISAs.* The responses are tabulated below.

	<i>n</i>	<i>%</i>
1. Strongly agree	0	(0)
2. Agree	4	(50)
3. Undecided	2	(25)
4. Disagree	1	(13)
5. Strongly disagree	0	(0)
Don't know	1	(13)

Overall, experts agree that the perceived assurance on European capital markets derived from reading an audit report on the financial statements of a European company with a cross-listing in the US would be lower if, in a hypothetical situation, the audit would be conducted following ISAs only, compared to the situation where the audit is based on both ISAs and PCAOB standards. More precisely, four experts accept the statement (they agree), one expert rejects the statement (disagrees), two experts are undecided, and one expert has no opinion. One of the experts who agrees with the statement again nuances his/her opinion by commenting that “consistent with the previous comment, it is likely that any perceived lowering of assurance is fairly marginal”.

As a follow-up to the second statement, we ask the experts: *In your opinion, what is the benefit to the European capital market of an audit of the financial statements of an EU company being conducted in accordance with both ISAs and PCAOB standards?* Of the eight experts who completed the survey, only five experts answered this open question. This perhaps suggests that the other three experts do not recognize clear benefits. In addition, two experts who exchanged

their views with the research team in a phone interview gave their opinion on this question. The responses are summarized below.

	<i>n</i>	%
No clear benefit	5	(71)
Some benefit	2	(29)

In total, five of the seven responding experts do not recognize clear benefits to the European capital markets of an audit of an EU company being conducted in accordance with both ISAs and PCAOB standards. Their views range from “I don't see much benefit” (3 times) to “both ISA and PCAOB are of high quality, preparing financial statements in accordance with ISA should be sufficient” and, more cynically, “no benefit, except for auditing firms turnover”. Only two experts recognize some benefit for European capital markets. They comment: “none, except if we want to facilitate comparison, for instance between a European company and US competitors”, and “as compared to just ISAs, the benefit is marginal incremental assurance, but there is some greater benefit of consistency and familiarity”.

7.3.2 Ancillary findings survey of experts

Beside the two special cases, we put several statements and questions to the experts to attain our ancillary goals, i.e., assess the perceived benefits and perceived importance of conducting an audit of internal control over financial reporting, auditor independence regulations, auditing standards in general, and mechanisms to enforce compliance with auditing standards.

Audit of internal control over financial reporting

The third statement that we present to the experts is as follows: *Conducting an audit of internal control over financial reporting in addition to conducting an audit of the financial statements gives users of the financial statements higher assurance that the financial statements are reliable (compared to an audit of the financial statements only)*. The responses are tabulated below.

	<i>n</i>	%
1. Strongly agree	6	(75)
2. Agree	1	(13)
3. Undecided	0	(0)
4. Disagree	1	(13)
5. Strongly disagree	0	(0)
Don't know	0	(0)

Overall, the experts strongly agree with this statement. One of the experts who strongly agrees comments that “an audit of internal control over financial reporting will bring more safety for investors (in our case, investment managers)”. Another expert who strongly agrees adds that “an additional control on the financial reporting certainly improves the quality of financial reporting”. One of the experts who agrees is more cautious and comments that “it is likely to be perceived that the more work that is required the more assurance is obtained. In practice the difference may be small, as performance of a financial statements audit is very likely to involve significant work to obtain comfort regarding the procedures and controls from which the numbers are derived.”

In addition to this statement, we asked the experts how *much the presence of an audit opinion on internal control over financial reporting would contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses, tabulated below, are in line with the responses to the third statement. Overall, experts perceive a strong contribution to assurance of an audit opinion on internal control over financial reporting.

	<i>n</i>	<i>%</i>
1. Very strong contribution	1	(13)
2. Strong contribution	5	(63)
3. Moderate contribution	1	(13)
4. Weak contribution	1	(13)
5. No contribution	0	(0)
Don't know	0	(0)

Auditor independence regulations

To assess experts' view on the perceived importance of auditor independence regulations, we asked them *how much the presence of strict auditor independence regulations (for example a ban on non-audit services, or mandatory partner rotation) contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses are tabulated below.

	<i>n</i>	<i>%</i>
1. Very strong contribution	1	(13)
2. Strong contribution	5	(63)
3. Moderate contribution	2	(25)
4. Weak contribution	0	(0)
5. No contribution	0	(0)
Don't know	0	(0)

From these responses it appears that there is general consensus that the presence of strict auditor independence regulations strongly contributes to perceived assurance. One of the two experts who perceives only a moderate contribution comments: “We do not think that regulation for strict auditor independence will improve assurance of financial statements. Auditing firms know that an independent audit is of high importance. Regular changing the lead auditor can contribute to that independence. We do not object to advisory services within auditing firms. Knowledge of for example risk management processes can contribute to the quality of the audit.”

Auditing standards in general

To elicit experts’ opinions on the perceived importance of auditing standards in general, we asked them *how much auditing standards contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses are tabulated below.

	<i>n</i>	<i>%</i>
1. Very strong contribution	1	(13)
2. Strong contribution	2	(25)
3. Moderate contribution	4	(50)
4. Weak contribution	0	(0)
5. No contribution	0	(0)
Don't know	1	(13)

From these responses it appears that the general opinion among experts is that auditing standards moderately contribute to perceived assurance.

Taken the responses above together, they indicate that experts attach more importance to an audit of internal control over financial reporting and auditor independence regulations compared to auditing standards in general. In particular, experts perceive that the presence of strict auditor independence regulations and the presence of an audit opinion on internal control over financial reporting strongly contribute to the perceived assurance derived from an audit of financial statements, while the auditing standards applicable for the audit are perceived to moderately contribute to the perceived assurance.

Mechanisms to enforce compliance with auditing standards

To elicit experts’ opinions on the benefits of mechanisms to enforce compliance with auditing standards, the fourth statement that we present to the experts is as follows: *Mechanisms to enforce compliance with auditing standards for the audit*

of financial statements (such as inspection of audit work by public oversight bodies) positively affect the perceived assurance derived from audits of financial statements. The responses are tabulated below.

	<i>n</i>	<i>%</i>
1. Strongly agree	1	(13)
2. Agree	6	(75)
3. Undecided	1	(13)
4. Disagree	0	(0)
5. Strongly disagree	0	(0)
Don't know	0	(0)

In general, experts agree that mechanisms to enforce compliance with auditing standards positively affect the perceived assurance derived from audits of financial statements. As one of the experts comments: "It is hard to believe that the overlay of such further mechanisms would not have some beneficial impact on perceived assurance".

When asked directly whether *the reliability of financial statements depends more on the set of auditing standards that are used (e.g., PCAOB standards or ISAs), or more on the accounting framework under which the financial statements are prepared (e.g., US GAAP or IFRS)*, experts respond as follows.

	<i>n</i>	<i>%</i>
1. Auditing standards are more important	0	(0)
2. Both are equally important	5	(63)
3. Accounting framework is more important	3	(38)
Don't know	0	(0)

While three experts believe that the accounting framework is more important than auditing standards, the majority views them as equally important. As one of the experts comments "the two work in tandem".

Finally, some experts provided us with other, more general, thoughts and comments on the role of auditing standards in providing reliable financial information to participants in European capital markets. For example, an expert who represents the European stock exchanges further comments that "the long-term plan to have a global set of auditing standards is to be welcomed, but one should note that if this does not happen backed by an open and transparent

dialogue between the EU and the US, it might end up having unintended consequences for our markets, i.e., it could even mean that US firms, to avoid additional costs, would de-list from our markets.”

Relationship assurance derived from audit and cost of capital

Several statements and questions discussed in the previous section assess the impact of various matters on perceived assurance on European capital markets derived from audits of financial statements. To further assess the importance of perceived assurance derived from audits of financial statements, we asked the experts to what extent they agree that *lower perceived assurance derived from audits of financial statements in general increases companies' cost of capital*. The responses are tabulated below.

	<i>n</i>	<i>%</i>
1. Strongly agree	2	(25)
2. Agree	5	(63)
3. Undecided	1	(13)
4. Disagree	0	(0)
5. Strongly disagree	0	(0)
Don't know	0	(0)

These responses indicate that experts generally agree that lower perceived assurance derived from audits of financial statements is linked to companies' cost of capital. One of the experts who agrees argues that “less confidence in reliability of financial statements leads to a ‘risk premium’ and therefore increases companies' cost of capital in order to keep attracting investors”. One of the two experts who strongly agrees points to “the development of credit spreads of certain companies in the current credit crisis”. The other expert who strongly agrees adds “particularly now that investors are more concerned; perhaps a couple of years ago the effect would have been less marked”. In contrast, an expert who is undecided notes that “any such effect is likely to be extremely small for most large companies”.

Clarified ISAs

Finally we asked the experts whether they believe that their opinions and answers would have been materially different if they were asked to fill out this questionnaire for clarified ISAs instead of extant ISAs. The responses are tabulated below.

	<i>n</i>	<i>%</i>
Different	0	(0)
Not different	7	(88)
Don't know	1	(13)

There is consensus among experts that their opinions and answers would not have been materially different if the statements and questions would have addressed clarified ISAs instead of extant ISAs.

7.4 User survey

After the small-scale survey of experts, we conducted a large-scale survey of a broad range of experienced users of financial statements. In total, we examined three groups of users, referred to below as group A, B and C.

Group A consists of European sell-side analysts working for brokerage firms, mostly equity research analysts. We contacted 889 equity analysts by e-mail with a request to share their views and opinions with the MARC research team in an online survey. 63 equity analysts (7%) completed the most important part of the survey, i.e., the first and second statement of the survey; 54 analysts (6%) completed the entire survey.

Group B consists of high-level representatives of European shareholder associations. We contacted 44 of these representatives by e-mail with a request to share their views and opinions with the MARC research team in an online or paper-based survey. In total, 11 representatives of shareholder associations (25%) completed the first and second statement of the survey; 9 representatives (20%) completed the entire survey.

Group C consists of miscellaneous participants in the European capital markets, mostly asset managers and buy-side analysts working for institutional investors like banks, mutual funds, insurance companies, and pension funds. We contacted members of this group in various ways, including e-mail, regular mail, and phone. They were requested to share their views with the MARC research team in an online or paper-based survey. Because several persons within companies were contacted indirectly, we do not know exactly how many persons received our request for participation. In the end, 31 persons completed the first and second statement of the survey; 28 persons completed the entire survey.

7.4.1 Main findings user survey

Case 1 – Publicly listed US companies with a cross-listing in the EU

In line with the general approach that we followed in our survey of experts, we presented the following statement to the users relating to a hypothetical situation: *If the audit of the financial statements of a US company with a cross-listing in the EU would be conducted in compliance with ISAs in addition to the standards of the PCAOB, the perceived assurance on European capital markets derived from reading the audit report would be higher compared to the situation where the audit is based on PCAOB standards only.* The responses of the three user groups are tabulated below.

	Group A		Group B		Group C		Total	
	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%
1. Strongly agree	8	(13)	2	(18)	5	(16)	15	(14)
2. Agree	30	(48)	5	(45)	16	(52)	51	(49)
3. Undecided	9	(14)	0	(0)	4	(13)	13	(12)
4. Disagree	9	(14)	3	(27)	3	(10)	15	(14)
5. Strongly disagree	4	(6)	0	(0)	2	(6)	6	(6)
Don't know	3	(5)	1	(9)	1	(3)	5	(5)

From these responses it appears that all three groups of users generally agree that perceived assurance on European capital markets derived from reading the audit report would be higher if, in a hypothetical situation, the audit of the financial statements of a US company with a cross-listing in the EU were conducted in compliance with ISAs in addition to the standards of the PCAOB. In total, 63% of the users accepts the statement (i.e., agrees or strongly agrees), 20% rejects the statement (i.e., disagrees or strongly disagrees), 12% is undecided, and 5% does not know.

Comments from European equity research analysts (group A) who agree with the statement are that “comparability improves”, and also that “a single international common standard like for instance with IFRS/IAS should be striven for”. Comments from equity research analysts who strongly agree are that “comparability should increase which is important”, that “a single regulatory framework puts all companies on a level playing field and are therefore comparing like with like”, and also that “unification efforts should never be one-sided”.

A representative of a shareholder association who agrees with the statement comments that: “More information is better for investors. If there are two standards, investors can compare the reports to see where the differences came from.” A representative of a shareholder association who disagrees with the statement comments: “I would be in favor of just one standard audit report – worldwide”.

To gain further insight in the perceived benefits for investors if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards, we also ask the users: *Would it add value for investment decisions if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards, compared to PCAOB standards only?* The responses are tabulated below.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
Yes	22	(39)	5	(50)	11	(37)	38	(39)
No	11	(19)	2	(20)	4	(13)	17	(18)
Don't know	24	(42)	3	(30)	15	(50)	42	(43)

From these responses it appears that users generally don't know whether it would add value for investment decisions if a US company cross-listed in the EU would publish an audit report carried out under ISAs in addition to PCAOB standards. It should be noted though that the total proportion of users who does not know (43%) is only slightly larger than the proportion of users who perceives that it would add value (39%). In the group of representatives of European shareholder associations (group B), a small majority (50%) believes that it adds value. In all three groups, users who think it will not add value are in the minority.

The comment most provided by users who think that it would add value is greater comparability (10x), e.g., “it would be easier to make a EU peer comparison”, “ISA standards would increase comparability of investment in this company with investments in European companies”, and “it is essential to know that the company is audited following the same standards as comparative companies; consistency across the investment universe is very important and investors need to know that they are comparing like-for-like”. The second most provided comment by users who think that it would add value is higher perceived assurance (6x), e.g., “when both standards are used one would presume more audit quality”, “gives more assurance”, and “more confirmation that statements are also in accordance with EU regulations”. Another frequently provided

comment by users who perceive that it would add value relates to lack of familiarity with PCAOB standards (5x), e.g., “because I am more familiar with the ISA”. Some miscellaneous comments of users who perceive that it would add value are that “it would be especially interesting to know where the areas of conflict between standards lay”, and “in my opinion it would be mutually beneficial if auditing procedures as well as auditing rules would follow a global uniform set of standards”.

Two users who think that it would not add value commented that “the PCAOB standard report would be sufficient”, and that “US reports are more explicit due to SEC requirements”. Other comments of users who think that it would not add value are that “most investors wouldn't know the difference”, and that “investors are in favor of just one set of standards.”

Case 2 – Publicly listed European company with a cross-listing in the US

The second statement that we present to the users is the following hypothetical situation: *If the audit of the financial statements of a European company with a cross-listing in the US would be conducted in compliance with ISAs only, the perceived assurance on European capital markets derived from reading the audit report would be lower compared to the situation where the audit is based on PCAOB standards in addition to ISAs.* The responses are tabulated below.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
1. Strongly agree	3	(5)	1	(9)	1	(3)	5	(5)
2. Agree	20	(32)	6	(55)	7	(23)	33	(31)
3. Undecided	10	(16)	1	(9)	7	(23)	18	(17)
4. Disagree	27	(43)	2	(18)	13	(42)	42	(40)
5. Strongly disagree	0	(0)	0	(0)	3	(10)	3	(3)
Don't know	3	(5)	1	(9)	0	(0)	4	(4)

From these responses it appears that there is no consensus among users whether perceived assurance on European capital markets derived from reading the audit report would be lower if, in a hypothetical situation, the audit of the financial statements of a European company with a cross-listing in the US would be conducted in compliance with ISAs only. Representatives of European shareholder associations (group B) generally agree that the perceived assurance would be lower, but the miscellaneous participants in European capital markets (group C) generally disagree, and European equity research analysts (group A) are generally undecided (the median response for group A equals 3).

One of the equity research analysts who is undecided comments that: “There should be one set of accounting and auditing standards for any company regardless of location. Two sets accounting and auditing standards is too many, it is excess costs and a waste of time”. One of the miscellaneous participants in European capital markets who disagrees comment that “at least there should be a situation where both companies are equally treated”.

As a follow-up to the second statement, we ask the users: *In your opinion, what is the benefit to the European capital market of an audit of the financial statements of an EU company being conducted in accordance with both ISAs and PCAOB standards?* The responses are summarized below.

	<i>n</i>	<i>%</i>
Negligible benefit	15	(38)
Higher assurance or transparency	12	(31)
Greater comparability across markets	10	(26)
Other	2	(5)

The most frequently provided answer of users to this open question is that benefits to the European capital market are negligible. While explicitly asked to mention benefits, five users add to this comment that it will only lead to higher costs. Then again, the second and third most frequently provided answer to this question is higher assurance or transparency, and greater comparability across markets. Some users indirectly answer the question by indicating a preference for one standard.

7.4.2 Ancillary findings user survey

In line with the general approach that we followed in our survey of experts, we also put several statements and questions to the users to achieve our ancillary goals, i.e., assess the perceived benefits and perceived importance of conducting an audit of internal control over financial reporting, auditor independence regulations, auditing standards in general, and mechanisms to enforce compliance with auditing standards.

Audit of internal control over financial reporting

The third statement that we present to the users is as follows: *Conducting an audit of internal control over financial reporting in addition to conducting an audit of the financial statements gives users of the financial statements higher assurance that the financial statements are reliable (compared to an audit of the financial statements only)*. The responses are tabulated below.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
1. Strongly agree	11	(18)	1	(9)	9	(30)	21	(21)
2. Agree	30	(50)	6	(55)	14	(47)	50	(50)
3. Undecided	11	(18)	0	(0)	6	(20)	17	(17)
4. Disagree	5	(8)	3	(27)	1	(3)	9	(9)
5. Strongly disagree	1	(2)	0	(0)	0	(0)	1	(1)
Don't know	2	(3)	1	(9)	0	(0)	3	(3)

From these responses it appears that users generally agree that conducting an audit of internal control over financial reporting in addition to conducting an audit of the financial statements gives them higher assurance that the financial statements are reliable. One of the users who disagrees however argues that: "The auditor has the choice between system or data oriented approach; he chooses the most efficient way, the audit should always be effective."

In addition to this statement, we asked the users *how much the presence of an audit opinion on internal control over financial reporting would contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses are tabulated below.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
1. Very strong contribution	1	(2)	1	(10)	2	(7)	4	(4)
2. Strong contribution	20	(34)	7	(70)	15	(50)	42	(43)
3. Moderate contribution	26	(45)	1	(10)	10	(33)	37	(38)
4. Weak contribution	7	(12)	1	(10)	3	(10)	11	(11)
5. No contribution	1	(2)	0	(0)	0	(0)	1	(1)
Don't know	3	(5)	0	(0)	0	(0)	3	(3)

From these responses it appears that equity research analysts (group A) generally perceive a moderate contribution to assurance of an audit opinion on internal control over financial reporting, and that representatives of shareholders

organizations (group B) and miscellaneous European capital market participants (group C) perceive a strong contribution to assurance due to such an opinion.

Auditor independence regulations

To find out users' perceived importance of auditor independence regulations, we asked them *how much the presence of strict auditor independence regulations (for example a ban on non-audit services, or mandatory partner rotation) contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses are tabulated below.

	<i>Group A</i>		<i>Group B</i>		<i>Group C</i>		<i>Total</i>	
	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>
1. Very strong contribution	12	(21)	1	(10)	4	(13)	17	(17)
2. Strong contribution	25	(43)	8	(80)	17	(57)	50	(51)
3. Moderate contribution	19	(33)	1	(10)	6	(20)	26	(27)
4. Weak contribution	1	(2)	0	(0)	1	(3)	2	(2)
5. No contribution	0	(0)	0	(0)	1	(3)	1	(1)
Don't know	1	(2)	0	(0)	1	(3)	2	(2)

From these responses it appears that all three groups of users generally perceive that the presence of strict auditor independence regulations strongly contributes to assurance on European capital markets derived from audits of financial statements. As one of the users comments "independence is fundamental and should be granted by the external auditor, with no direct relation with the firm audited". Another user adds that "in addition of independence regulation, auditors for a company should be selected by a supervision authority, not the company".

Auditing standards in general

In order to obtain users' opinions on the perceived importance of auditing standards in general, we asked them *how much auditing standards contribute to the perceived assurance on European capital markets derived from audits of financial statements*. The responses are tabulated below.

	<i>Group A</i>		<i>Group B</i>		<i>Group C</i>		<i>Total</i>	
	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>
1. Very strong contribution	3	(5)	4	(40)	2	(7)	9	(9)
2. Strong contribution	23	(40)	4	(40)	12	(40)	39	(40)
3. Moderate contribution	22	(39)	2	(20)	11	(37)	35	(36)
4. Weak contribution	5	(9)	0	(0)	3	(10)	8	(8)
5. No contribution	0	(0)	0	(0)	0	(0)	0	(0)
Don't know	4	(7)	0	(0)	2	(7)	6	(6)

From these responses it appears that users generally perceive that auditing standards applicable for the audit moderately to strongly contribute to the perceived assurance on European capital markets derived from audits of financial statements.

Overall, from the responses on the three questions above, we conclude that from a user perspective the presence of strict auditor independence regulations matter the most for the level of assurance derived from audits of financial statements.

Mechanisms to enforce compliance with auditing standards

In order to obtain users' opinions on the benefits of mechanisms to enforce compliance with auditing standards, the fourth statement that we present to them is as follows: *Mechanisms to enforce compliance with auditing standards for the audit of financial statements (such as inspection of audit work by public oversight bodies) positively affect the perceived assurance derived from audits of financial statements.* The responses are tabulated below.

	<i>Group A</i>		<i>Group B</i>		<i>Group C</i>		<i>Total</i>	
	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>
1. Strongly agree	7	(12)	3	(30)	6	(20)	16	(16)
2. Agree	42	(70)	6	(60)	18	(60)	66	(66)
3. Undecided	7	(12)	0	(0)	5	(17)	12	(12)
4. Disagree	1	(2)	0	(0)	1	(3)	2	(2)
5. Strongly disagree	1	(2)	1	(10)	0	(0)	2	(2)
Don't know	2	(3)	0	(0)	0	(0)	2	(2)

From these responses it appears that all three groups of users generally agree that mechanisms to enforce compliance with auditing standards for the audit of financial statements positively affect perceived assurance derived from audits of financial statements. One of the users who strongly agrees comments that "quality and compliance with ISAs or other standards are fundamental for the stakeholders assurance" and that "quality should be granted by government

regulators". A user who agrees comments that "there has to be a fairly high probability of government inspection both as a deterrent to wrongdoing as well as to convince markets of the integrity of the financial statements". Another user who agrees however remarks that one needs to "keep in mind the costs connected". Other users who agree comment that "it is a positive since it adds a new layer of checks and potential sanctions, and thus incentivizes the auditors to act more independently", but also remark that "whether the government inspectors are unbiased or any good, of course, is a separate question".

When asked directly whether *the reliability of financial statements depends more on the set of auditing standards that are used (e.g., PCAOB standards or ISAs), or more on the accounting framework under which the financial statements are prepared (e.g., US GAAP or IFRS)*, users respond as follows.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
1. Auditing standards are more important	4	(7)	1	(10)	2	(7)	7	(7)
2. Both are equally important	24	(41)	7	(70)	12	(40)	43	(44)
3. Accounting framework is more important	23	(40)	2	(20)	13	(43)	38	(39)
Don't know	7	(12)	0	(0)	3	(10)	10	(10)

These responses indicate that while a substantial proportion of users perceive that the accounting framework is more important, users overall perceive that auditing standards and the accounting framework are equally important. One of the users who perceives them to be equally important comments: "Auditing standards tell me about the integrity of the financial statements, accounting standards tell me about their informational content."

Many users provided us with a diversity of other, more general, thoughts and comments on the role of auditing standards in providing reliable financial information to participants in European capital markets. While only one user directly states that "ISAs are more preferable", a repeatedly heard comment of users is that they are "in favor of just one standard" and that "as with accounting standards, there should be a push for agreed global international standards as we live in a world of global markets". These users believe that "there should be convergence in the future" and that "authorities from the US and the EU should try to agree on a common framework which would help to reduce costs in the future". Miscellaneous comments from users are that "auditing standards must be

clear, concise and consistently applied to all participants in European capital markets”, that “substance is preferred over form”, that “international comparability is a key issue”, and that “auditing standards are essential to ensuring the integrity of financial statements”. Finally, one of the users notes “that investors would applaud stricter auditing standards until they realize the costs of such measures and the impact on earnings”.

At various points in the survey, users bring up other issues related to auditing of financial statements. Two users give recommendations for the content of the audit report by commenting that “accounting firms need to be more transparent as to what they have and have not certified, and what risks there are to their opinion” and that “the audit report must include a description of the tasks performed and the percentage of operations reviewed”.

Relationship assurance derived from audit and cost of capital

To further assess the importance of perceived assurance derived from audits of financial statements, we also asked the users to what extent they agree that *lower perceived assurance derived from audits of financial statements in general increases companies’ cost of capital*. The responses are tabulated below.

	Group A		Group B		Group C		Total	
	n	%	n	%	n	%	n	%
1. Strongly agree	17	(28)	1	(10)	4	(13)	22	(22)
2. Agree	26	(43)	7	(70)	18	(60)	51	(51)
3. Undecided	10	(17)	0	(0)	6	(20)	16	(16)
4. Disagree	5	(8)	2	(20)	1	(3)	8	(8)
5. Strongly disagree	0	(0)	0	(0)	0	(0)	0	(0)
Don't know	2	(3)	0	(0)	1	(3)	3	(3)

From these responses it appears that all three groups of users generally agree that lower perceived assurance derived from audits of financial statements increases companies’ cost of capital. A comment of a user who strongly agrees is as follows: “Few events hurt a company's share price (and thus implied cost of equity capital) more than a perception of negative accounting issues. There is obviously a question of degree as to the degree of perceived assurance or negative issues”. One of the users who agrees notes that “the effect is very minimal; only obscure or non-existent audit regulation would lead to a much higher cost of capital”. One of the users who is undecided notes that “cost of capital depends on so many factors, but in general one could say that lower

perceived assurance from financial statements does not generally help to lower a company's risk profile”.

Clarified ISAs

Finally we also asked the users whether they believe that their opinions and answers would have been materially different if they were asked to fill out this questionnaire for clarified ISAs instead of extant ISAs. The responses are tabulated below.

	<i>Group A</i>		<i>Group B</i>		<i>Group C</i>		<i>Total</i>	
	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>n</i>	<i>%</i>	<i>N</i>	<i>%</i>
Different	0	(0)	1	(11)	0	(0)	1	(1)
Not different	36	(65)	6	(67)	19	(68)	61	(66)
Don't know	19	(35)	2	(22)	9	(32)	30	(33)

From these responses it appears that there is consensus among all three groups of users that their opinions and answers would not have been materially different if the statements and questions would have addressed clarified ISAs instead of extant ISAs.

7.4.3 Background information users

While representatives of European shareholder associations (group B) and miscellaneous participants in European capital markets (group C) were asked to specify for what type of organization they are currently working and what their function is within this organization (not reported here), equity research analysts (group A) were asked *how many years of professional experience they have in equity research*. The responses are tabulated below.

	<i>Years</i>
Median	10
Mean	10.7
S.D.	7.7
Min	1
Max	39

From these responses it appears that the responding analysts have considerable experience in equity research. Additionally we asked the equity research analysts whether they *have a professional degree or hold a professional charter in financial analysis or an equivalent field (such as the CFA charter)*. From the responses

tabulated below we can conclude that about half of the responding equity research analysts have such a degree.

	<i>Professional</i>	
	<i>n</i>	<i>%</i>
Yes	28	(51)
No	27	(49)

7.4.4 Limitations user survey

A caveat when interpreting the findings of the survey of users is that all three groups of users likely have limited detailed knowledge of PCAOB standards and ISAs (both clarified and extant). The answers of users to three exit questions that asked them to self-assess their knowledge generally confirms this expectation. While this makes it more difficult to interpret some of the opinions and answers, we intentionally didn't present the users with a detailed overview of differences between ISAs and PCAOB standards reported in chapter 5. The main reason for this is that users lack such information in practice. Interestingly, one of the users recommends standard setters to "educate users more in an easy to understand way" on different auditing standards, for instance by putting "the objectives, similarities and differences on one page".

7.5 Summary and conclusions

Our main findings and conclusions are twofold. First, for US companies with a cross-listing in the EU, experts and users generally agree that perceived assurance on European capital markets derived from reading an audit report would be higher if, in a hypothetical situation, the audit of the financial statements of these companies was conducted in compliance with ISAs in addition to the standards of the PCAOB, compared to a situation where the audit is based on PCAOB standards only. However, experts and users generally do not know whether it would add value for investment decisions if such companies would be audited under ISAs in addition to PCAOB standards. Only users representing European shareholder associations believe that this would be the case.

Second, we conclude that for European companies with a cross-listing in the US, experts generally agree that perceived assurance on European capital markets derived from reading an audit report would be lower if, in a hypothetical situation, the audit of the financial statements of these companies was conducted in compliance with ISAs only, compared to a situation where the audit is based on PCAOB standards in addition to ISAs. In contrast, there seems to be no

consensus among users on this issue: representatives of European shareholder associations generally agree with experts that the perceived assurance would be lower, European equity research analysts are generally undecided, and miscellaneous participants in European capital markets generally disagree. When viewed more broadly, most experts do not recognize much benefit to European capital markets of an audit of an EU company being conducted in accordance with both ISAs and PCAOB standards. While many users agree with experts that benefits are negligible, and that it only leads to higher costs, others believe that it might lead to higher assurance, or to greater comparability across markets.

Next, we assessed the perceived benefits and perceived importance of conducting an audit of internal control over financial reporting, mechanisms to enforce compliance with auditing standards, auditor independence regulations, auditing standards in general, and mechanisms to enforce compliance with auditing standards. From the findings we conclude first that there is general consensus that conducting an audit of internal control over financial reporting in addition to conducting an audit of the financial statements gives users higher assurance that the financial statements are reliable (compared to an audit of the financial statements only). Second, we conclude that there is general consensus that the presence of strict auditor independence regulations (for example a ban on non-audit services, or mandatory partner rotation) strongly contributes to the perceived assurance on European capital markets derived from audits of financial statements. Third, we conclude that perceived contribution of auditing standards applicable for the audit to assurance on European capital markets derived from audits of financial statements ranges from moderate to strong. Taken the views of experts and users together, it appears that the presence of strict auditor independence regulations seem to matter most to the capital market in terms of the level of assurance derived from the audit of financial statements, and is generally considered to be more important compared to the auditing standards applicable to the audit. Furthermore, we conclude that there is general consensus that mechanisms to enforce compliance with auditing standards for the audit of financial statements (such as inspection of audit work by public oversight bodies) positively affect the perceived assurance derived from audits of financial statements. Finally, we conclude that there is general consensus that lower perceived assurance derived from audits of financial statements increases companies' cost of capital.

Chapter 8: Conclusions

The purpose of this study as commissioned by the EC was to evaluate the differences between International Standards on Auditing (ISAs) issued by the IAASB and Auditing Standards adopted by the PCAOB in the United States. As defined by the EC, the project has two main objectives:

1. Identify the main technical differences between the clarified ISAs and PCAOB Auditing and Interim Standards.
2. Assess the impact of the differences between the clarified ISAs and PCAOB Auditing and Interim Standards on audit practice and the perceptions of financial statements users if both sets of standards were to be applied for an audit.

This study assumes that differences in auditing standards are important because they affect the audit process, the quality of audit reporting and the perceptions of users of the financial statements. In this regard, we first reviewed a large body of research to determine whether there is general support for this assumption. Based on our review of a wide range of research, we conclude that auditing standards, and in particular major changes in auditing standards, can influence the audit process, auditor work effort, audit fees, audit outcome, and market perceptions. For the purposes of this study, we specifically consider whether differences between ISAs and PCAOB standards influence audit practice and perceptions of financial statement users.

Our next step was to identify the differences between clarified ISAs and PCAOB standards. We conducted a detailed comparative analysis of the standards and undertook extensive consultations with a wide range of audit experts. We classified the differences in subject areas organized into 9 topics. We report differences between the two sets of standards that meet one of three pre-defined criteria:

1. The difference could have an impact on the audit (in terms of activities, procedures, process, or outcome).
2. The difference is a formal but substantive difference even though it may not have an impact on the conduct of the audit.
3. The difference arises due to the different context of the US and international audit market, i.e., it may apply to the US or the international arena even though it may not apply to the other.

We specifically identified five subject areas where we believe substantive differences exist between the two sets of standards:

- a. Assessing and reporting on internal control over financial reporting;
- b. Use of another auditor for part of a group audit;
- c. Documentation;
- d. Risk assessment and responses to assessed risks;
- e. Reporting on going concern.

It is important to reiterate that the differences and discussion included in the Appendix solely represent the views of the research team.

The fact that there are a limited number of subject areas where substantive differences exist may not be surprising given that there have been many common themes reflected in the past agendas of the two standard-setting bodies (i.e., nature of the standards in process of revision). As noted in the 2006 IAASB annual report by John Kellas, former chairman of the IAASB: "There is no doubt that we [IAASB] and the PCAOB have a common purpose. If we focus on what we share—a desire for high quality auditing, using standards that are objectives-based—I [John Kellas] know there is common ground on which we could agree, at least at some level, so that the essential differences between our respective standards can be both minimized and clearly understood by practitioners. This would reduce the cost of compliance with cross-border requirements and improve the quality of that compliance, while recognizing the need to respect cultural and other differences". In a sense, this is echoed by a recent PCAOB press release related to their efforts on proposed standards concerning an auditor's assessment of and response to risk: "The proposed standards reflect the Board's effort to reduce unnecessary differences with the risk assessment standards of other auditing standard setters. (...). Accordingly, there is a degree of commonality between the proposed standards and the IAASB's recently updated risk assessment standards, though they do not mirror them word-for-word".

The next phase of the project was to solicit input from a small set of professionals in audit practice and the technical partners of the Big Four audit firms to determine what, if any, additional work is required for the audit of financial statements following PCAOB standards in addition to clarified ISAs, and whether dual standards could result in a different audit outcome than an audit under a single set of standards. From our consultation of experts, we conclude that an

audit performed under PCAOB standards in addition to clarified ISAs will result in additional work for the auditor related to testing the system of internal control, completing the audit (mainly due to additional documentation requirements), and reporting on the outcome (because of PCAOB's additional reporting requirements on internal control). However, in spite of any additional audit work, the experts are unanimous that it will not result in a different audit opinion on the financial statements compared to an audit based solely on the clarified ISAs. Hence, while prior research has shown that in general differences in auditing standards can influence the outcome of the audit process, we find for our specific case that an audit performed under clarified ISAs and PCAOB standards is not perceived to result in a different outcome compared to following only clarified ISAs.

The final phase of the study involved a survey of a broad range of experienced European financial statement users and capital market experts to assess whether dual auditing standards are perceived as being beneficial to European capital markets. The experts and users perceive that compliance with both ISAs and PCAOB standards would provide a slightly higher level of assurance when combined. Further, an audit of internal control over financial reporting as required under PCAOB standards adds to the assurance obtained during the course of the audit. In spite of these differences, the overarching conclusion of European financial statement users is that dual auditing standards do not necessarily add value for investment decisions since the individual sets of standards are both of such high quality that compliance with both may not be worth any extra costs that might arise. In the end, the European financial statements users recognized the importance of comparability across international markets which could be interpreted as a plea for one set of auditing standards that are accepted globally.

While the core of this study related to differences in auditing standards and how they affect audit practice and market perceptions, we conclude this study by arguing that the importance of auditing standards has to be put in perspective since high quality standards may be insufficient to achieve high quality auditing. Consistent with the findings from our review of the literature, we conclude from our consultation of auditors, and European capital market experts and users of financial statements that while auditing standards certainly contribute to high quality financial reporting, a strong audit environment seems to be of equal or even stronger importance. A strong audit environment consists of effective internal control, strict regulations to safeguard auditor independence, mechanisms to enforce compliance with auditing standards, and effective public

oversight bodies performing inspections and investigations. Consequently, we view the quality of auditing standards as just one element that determines the value of auditing in a globalized, complex, evolving and uncertain economic environment. To that end, the differences between US-based PCAOB auditing standards and the ISAs issued by the IAASB may be less important than the actual practice of auditing based on those standards as subject to inspection and enforcement by regulators in different jurisdictions.

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