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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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Executive Summary

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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.

