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The Adoption of International Auditing Standards in Canada

BY DAN A. SIMUNIC



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of Canada

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Foreword

To some of us, it may sound like a timeworn cliché to say that the world is rapidly becoming a smaller place. Yet, at this moment, we are entering an entirely new era in the evolution of international financial reporting standards. As we march forward into the new millennium, what happens in the United States, Europe, or the developing nations for that matter, related to accounting and auditing standards, is of profound concern, not only to those countries themselves, but to Canada as well.

It was in 1999 that CGA-Canada took the pioneering step of formally recommending the adoption of international accounting standards here in Canada. At the time, the body we looked to for leadership on international standard setting was the International Accounting Standards Committee (IASC). Many significant events have transpired since that time. The IASC has matured into the International Accounting Standards Board (IASB). It has achieved much progress in its international standards development work. And perhaps most profound of all, we have weathered a severe crisis in investor confidence in North America and Europe, related of course to the Enron and WorldCom debacles and their aftermath.

At the time of this publication, we are not out of the woods yet, when it comes to fully restoring confidence in capital markets. And at the same time, we are seeing, not surprisingly, an increased focus on the evolution of high quality international auditing standards, and on the entire audit process itself.

That is why the publication of Professor Dan Simunic's discussion paper is so timely. The convergence of international financial reporting standards is taking place at a rate not predicted a decade ago. In the post-Enron period of analysis and reflection, standard setters in the United States have recognized that their past reliance on a rules-based system should perhaps give way to a more broad principles-based approach. This is very encouraging and will hasten the inevitable convergence to high quality, globally-recognized international standards.

We are sure that Professor Simunic's discussion paper will contribute significantly to the debate and discussion which is currently taking place. We believe Canada has a leadership role to play worldwide in this regard. Canada and Canadians have always benefited from a unique worldview, and we have charted our own path accordingly. That is why CGA-Canada is pleased to present this important discussion document for your review and comment.

When the time does come that we have a high quality and fully international set of auditing standards in place and in use, we will be extremely proud to have made a significant contribution to that evolution.

Anthony Ariganello

President and Chief Operating Officer

The Certified General Accountants Association of Canada

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1.0 Introduction

The objective of this paper is to critically assess arguments for and against the adoption of International Auditing Standards (ISAs) as the domestic auditing standards for use in Canada. Since the 1930's, Canadian auditing and assurance standards have been set by a committee of the Canadian Institute of Chartered Accountants (CICA), currently the CICA's Auditing and Assurance Standards Board (AASB). These standards, published in the CICA's *Handbook*, have legal authority in Canada as they are referenced in the regulations to the Canada Business Corporations Act and other federal as well as provincial legislation. As of October, 2002, the CICA established the Auditing and Assurance Standards Oversight Council (AASOC) to oversee the activities of the AASB. Since the late 1970's, the International Federation of Accountants (IFAC) has also been developing a comprehensive set of auditing and assurance standards — the International Standards on Auditing (ISA) — through its International Auditing Practices Committee (IAPC). In 2002, the structure and functioning of the IAPC and its supporting staff were significantly revised and strengthened by IFAC. Among other things, the committee received a significant commitment of new resources and was renamed the International Auditing and Assurance Standards Board (IAASB), to better reflect its enhanced role.

Given the continuing development of the global economy, including the growing importance of global organizations such as IFAC and the IAASB, it seems an appropriate time to re-think the Canadian standard setting process for auditing and assurance standards. While there has been an ongoing vigorous debate in Canada, the United States, and elsewhere about the relative merits of national vs. international *accounting* standards,¹ *auditing and assurance* standards have received relatively little attention. Yet a credible auditing function is at least as important, if not more important, than a well designed set of accounting principles and practices, since auditors serve to interpret and enforce accounting rules. The recent *Enron* and *WorldCom* debacles in the United States amply demonstrate the importance of strong auditing institutions — grounded in a set of well designed, comprehensive auditing standards, as well as ethical principles and rules — both to capital markets and to society as a whole. The International Organization of Securities Commissions (IOSCO) has recently (May, 2000) endorsed the use of international accounting standards issued by the International Accounting Standards Board for use in cross-border securities offerings and listings, and the IAASB is currently working with IOSCO to secure a similar endorsement for the cross-border use of international auditing standards. Thus consideration of the adoption of ISAs as the Canadian domestic standards dovetails with the analogous ongoing discussion concerning the use of international accounting standards in Canada.

Whether or not it is desirable for Canada to adopt the ISAs as domestic auditing and assurance standards depends upon the characteristics of Canadian standards vs. the ISAs and the benefits and costs of such a change in regime. The relevant benefits and costs are those that accrue to capital market participants — the reporting companies whose

¹ See Richardson, A.J. and I. Hutchinson, "The Case for International Accounting Standards in Canada: A Detailed Report", Certified General Accountants Association of Canada, 1999.

financial statements are audited, and investors, creditors, auditors and regulators. Thus, the choice of standard setting regime should consider the following factors:

- the relative quality of existing Canadian standards vs. the ISAs
- the quality of Canadian vs. international standard setting processes
- the comparability of standards to other jurisdictions
- the relative benefits minus costs (net benefits) of a Canadian vs. international standard setting regime to the Canadian community of users of auditing and assurance standards.

In the remainder of the paper, each of these factors is examined in some detail. The final section summarizes the analysis and concludes the paper.

2.0 The Quality of Canadian Auditing and Assurance Standards vs. International Standards on Auditing

How does one evaluate the quality of a set of auditing standards?² In their paper on accounting standard setting, Richardson and Hutchinson (1999) argue that standards in any area of activity fulfill three functions: *protection*, *comparison*, and *co-ordination*. *Protection* concerns the impact of standards on the interests of parties who utilize a product or service where quality is difficult to evaluate directly *ex ante*, and where quality failures have severe consequences. *Comparison* facilitates decision making by various parties by minimizing the need for costly translation between alternative measurement systems. Finally, *co-ordination* is achieved when interacting parties adopt the same set of standards for their work, thereby also reducing costs.

While all three functions apply to auditing standards, protection is clearly the critical function. Unlike accounting standards which govern the production of financial statements that are visible to and utilized directly by investors, creditors, and other users, auditing standards play a supporting role. The product of auditing is the assurance provided to financial statement users that financial statements are not materially misstated. The higher the quality of auditing standards, the higher the assurance that a user can derive from an auditor's opinion on financial statements. Of course, financial statement users will find it desirable if comparable auditing standards are utilized in different jurisdictions so that the assurance levels provided by auditors can be readily determined. In addition, use of the same auditing standards across many jurisdictions will facilitate co-ordination among audit service providers. Thus, comparability and co-ordination are enhanced, the larger is the community that utilizes a set of auditing standards. However, the touchstone of the quality of auditing standards is the level of protection they provide, through the level of assurance implied in an auditor's opinion that financial statements are free of material misstatement.

The level of assurance provided by a set of auditing standards will depend on two characteristics of the standards — their *scope*, and the *specificity* of the guidance they contain. The scope of standards refers to their breadth of coverage of the audit process. A modern audit can be thought of as consisting of four broad phases — audit planning, risk assessment, substantive testing, and completion — with numerous possible procedures performed within each phase.³ For example, the audit planning phase will include obtaining knowledge of the client's business and the industry(ies) in which the client operates, and performing 'attention directing' analysis. The risk assessment phase will, among other things, involve assessing the inherent risk of material misstatements arising from both simple errors (unintentional misstatements) and irregularities (fraud and/or illegal acts), as well as assessing control risk — the risk that a client's internal accounting and control systems fail to prevent or detect material misstatements. The substantive testing phase involves a wide choice of specific tests of transactions and account balance details to verify amounts in

² Hereafter in this paper, I use the term "auditing standards" to denote "auditing and assurance standards".

³ For evidence on procedures performed within audits and factors associated with changes in procedures performed (based on U.S. data) see K. Hackenbrack and W. R. Knechel, "Resource Allocation Decisions in Audit Engagements", *Contemporary Accounting Research*, Fall 1997, pp. 481-499; and H. Blokdiijk, F. Drieenhuizen, D. Simunic, and M. Stein, "Determinants of the Mix of Audit Procedures: Key Factors that Cause Auditors to Change What They Do", working paper, University of British Columbia, 2002 (based on data from the Netherlands).

financial statements and their attendant presentation and disclosure. Finally, completion of an audit would include procedures such as a review for subsequent events, and performing final analysis of financial statements. Clearly, a set of auditing standards that failed to provide guidance in important areas of the audit would be of lower quality than standards that comprehensively covered all important areas of the audit process.

The second characteristic of standards that affects their quality is specificity. A set of standards whose guidance is very vague — that is, allows an auditor to exercise essentially unfettered ‘professional judgement’— would be of low quality. Compliance with such standards would convey little or no information to financial statement users as to the level of assurance associated with the auditor’s opinion, since vague standards do not constrain the audit process. The specificity of standards is enhanced through the use of words such as “should” and “would” that direct the auditor to take certain actions in certain circumstances. Generally speaking, the more specific the guidance in standards, the higher is the assurance level they imply. For example, following the *McKesson and Robbins* fraud in the U.S. in 1938 — which, among other things, involved fictitious balance sheet inventories — annual auditor observation of physical inventory taking (by the client) and making test counts, became required substantive auditing procedures in the U.S.⁴, and later in Canada. This requirement clearly enhanced audit quality at the time. But audit quality does not appear to increase monotonically with increased specificity. As standards become more and more specific, they also become more voluminous and take on the characteristics of a “cookbook”. Rather than simply focusing on the important principles of auditing, such detailed standards tend to incorporate more and more procedural rules. It can be argued that auditing standards in the U.S., as contained in the *Statements on Auditing Standards* issued by the American Institute of Certified Public Accountants, have evolved to become excessively specific and detailed in response to the large volume of litigation against auditors in that country. Rather than enhancing audit quality, such detailed standards take on a protective function and seem largely designed to shield auditors from litigation by making it easier to demonstrate compliance with existing standards — and hence an absence of negligence — in a court of law. For example, the inventory observation requirement has remained in place in U.S. auditing standards, even though the technology of clients’ inventory accounting systems has improved dramatically over time and auditors have changed audit methodologies to emphasize inherent and business risk assessment, rather than maximum substantive testing. As a result, an auditor who assesses the inherent risk of material misstatement in a client’s inventories to be very low, may devote excessive audit resources to this aspect of the audit — simply to comply with the “inventory observation” rule. Thus, increasing specificity of auditing standards is associated with higher audit quality (higher assurance) up to some point, but excessive specificity — however defined — likely fails to improve audit quality.

It is interesting to note that, following the passage of the Sarbanes-Oxley Act of 2002, the U.S. appears to be moving away from its generally *rules based* approach to standard setting. Under the authority of that Act, the U.S. Securities and Exchange Commission (SEC) is reviewing the appropriateness of moving to a more *principles based* set of accounting standards. In addition, as of April, 2003, the legal authority to set auditing and assurance standards for U.S. publicly held companies (i.e. those that come under SEC jurisdiction) has

⁴ D. Solomons, “Setting Auditing Standards: Whose Responsibility”, the Saxe Lectures in Accounting, Baruch School, City University of New York, 1978.

been removed from the AICPA's Auditing Standards Board, and now rests with the Public Company Accounting Oversight Board (PCAOB), which functions under the direct control of the SEC. While the PCAOB has adopted existing U.S. auditing standards as its interim or transitional standards, it seems unlikely that future changes to these standards by the PCAOB will emphasize detailed rules designed to help shield auditors from litigation.

To summarize, high quality auditing standards must be comprehensive in their scope, and should be sufficiently specific so as to act as a meaningful constraint (lower bound) on the audit process. Such standards will tend to be *principles based* — emphasizing the basic principles of auditing — rather than *rules based* — mandating compliance with procedural details that may not apply in a given situation. Principles based standards serve to support and enhance the exercise of an auditor's professional judgement, while avoiding excessively prescriptive detail that can serve as an inappropriate substitute for well reasoned professional judgement.

2.1 Comparing the Quality of Canadian vs. International Auditing Standards

In general, Canadian auditing standards and international auditing standards are quite similar. Both sets of standards are principles based. The CICA's auditing and assurance standards consist of recommendations that "constitute the basic professional standards with which the practitioner should comply when performing an assurance engagement" and recognize that "no rule of general application can be phrased to suit all circumstances... that may arise, nor is there any substitute for the exercise of professional judgement in the determination of what constitutes good practice in a particular case".⁵ All recommendations in the *Handbook* are set in *italic type* in order to highlight them. In addition to recommendations, the *Handbook* includes background material and suggestions as to other desirable practices.

The ISAs are published in the International Federation of Accountants' *Handbook*. The Preface to the ISAs states that the ISAs "contain basic principles and essential procedures together with related guidance".⁶ The basic principles and essential procedures are indicated in black letters, but these basic principles and essential procedures "are to be interpreted in the context of the explanatory and other material that provide guidance for their application" and the ISAs also state that "it is necessary to consider the whole text of the ISA including the explanatory and other material contained in the ISA not just that text which is black lettered".⁷ Thus Canadian and International auditing standards reflect a similar standard setting philosophy.

Given their similar underlying philosophy, it is not surprising that the scope and specificity of Canadian and International auditing standards are also very similar. Section 5101 of the CICA's *Handbook* provides a detailed comparison between the two sets of standards and, overall, the differences are minor. One of the more notable differences occurs in the area of reporting when a client's going concern status is in doubt. When the circumstances underlying the doubt about the appropriateness of the going concern assumption are adequately disclosed in the financial statements, both ISA 570 and Section 5510 of the CICA's *Handbook* require that the auditor normally express an unqualified opinion. However, consistent with U.S. practice, the ISA further requires that the auditor's report be modified with the inclusion of an emphasis of matter paragraph to more fully alert readers as to the potential going concern issue. In the same circumstances, the CICA's *Handbook* prohibits the use of an emphasis of matter paragraph. Since there is some evidence that going concern modified opinions are associated with (negative) stock price reactions in the U.S., and surveys of financial statement users invariably indicate that they regard the red-flag function of modified going concern reports as desirable,⁸ international auditing standards are arguably superior to Canadian standards in this important area.

While the philosophy, scope, and specificity of Canadian and International auditing

⁵ CICA *Handbook*, "Introduction to assurance and related services recommendations".

⁶ IFAC *Handbook*, "Preface to International Standards on Auditing and Related Services", paragraph 10.

⁷ IFAC *Handbook*, "Preface to International Standards on Auditing and Related Services", paragraphs 10 and 11.

⁸ T. Bell and A. Wright, *Auditing Practice, Research, and Education: A Productive Collaboration*, American Institute of CPAs in cooperation with the Auditing Section of the American Accounting Association, New York, N.Y., 1995, pp.169-170.

standards are fundamentally the same, one could claim that Canadian standards differ in being responsive to and reflecting unique features of the Canadian auditing environment. This is not a compelling argument. As noted above, there are few substantive differences between the two sets of standards. Moreover, the form and content of the auditor's report — the visible product of the audit process from which assurance is derived by financial statements users — are essentially identical, except for the difference in reporting when there are going concern issues discussed above. In addition, adoption of international standards still allows for modification of the ISAs, as needed, to reflect uniquely Canadian conditions. Finally, to the extent that audits, particularly of large corporations, are performed by the international public accounting firms, these firms can — and do — impose additional structure on the audit process through their proprietary audit manuals. This additional structure can be readily accommodated by either set of auditing standards. Conversely, because both Canadian and International auditing standards are principles based, they are each readily adaptable to audits of small business enterprises, which are often performed by local and regional public accounting firms. I conclude that, with respect to quality, there is little to choose between the existing Canadian and International auditing standards.

3.0 The Quality of Canadian vs. International Standard Setting Processes

To evaluate the quality of a standard setting process, one needs to consider the following factors:

- the nature of the process, including the determinants of the standard setting agenda and the technical competence of standard setters
- the openness and transparency of the process, including the accountability of standard setters to various stakeholder groups.

The setting of auditing standards has historically received relatively less attention than the setting of accounting standards because auditing standards are generally seen as being essentially technical in nature, while accounting standard setting has long been recognized as involving social choices that can have significant effects on the creation and distribution of wealth in an economy. For example, there is currently a heated debate, particularly in the U.S., as to the proper method of accounting for stock options — specifically, whether or not the granting of options should result in the recognition of an expense. Various stakeholder interests are involved in this debate, and its resolution can be expected to affect the market value of corporations and the wealth of corporate managers and shareholders. Thus, the setting of accounting standards is commonly (and I believe properly) perceived to be an essentially political process.

In contrast, auditing standards affect the details of the audit process, which are not visible to financial statement users. Therefore, the social choice nature of auditing standard setting is less obvious, and the technical competence of standard setters has traditionally been perceived as especially critical. Consistent with this view, the Final Report of the CICA's Task Force on Standard Setting (TFOSS) states: "The technical issues surrounding auditing standards and their application are primarily of interest to auditors and, to a lesser extent, regulators. Auditing issues are not generally seen as significant by preparers, users, or others."⁹ As a result, both the CICA's Auditing and Assurance Standards Board and IFAC's new International Auditing and Assurance Standards Board, as well as its predecessor the International Auditing Practices Committee, are (have been) heavily dominated by auditing practitioners, particularly from the major international public accounting firms. This dominance by auditing practitioners and the major firms is not without its critics. For example, Sandy Burton, a former Chief Accountant of the U.S. Securities and Exchange Commission has written:

"In general, the standard setting mechanism has not resulted in an innovative approach to the auditing function, but has tended to enshrine or justify current practices. Recent auditing standards have emphasized protection against litigation, and their consideration by AudSEC has been heavily influenced by participation of legal counsel from the major firms. AudSEC has been hesitant to increase auditors' responsibilities, except under pressure from outside forces."¹⁰

⁹ CICA Task Force on Standard Setting, *Final Report*, May 1998, p. 35.

¹⁰ Quoted in Solomons, "Setting Auditing Standards: Whose Responsibility", p. 8. Note that AudSEC denotes the Auditing Standards Executive Committee of the American Institute of CPAs, a predecessor of the current U.S. Auditing Standards Board.

Although these words were written more than 20 years ago and address the rules-based standard setting regime in the U.S., they still resonate. While the incentives and motives of standard setters are unobservable, the composition of boards are public information. Thus the 12 voting members of the CICA's 2003-2004 Auditing and Assurance Standards Board are all Chartered Accountants, 8 of whom are associated with public accounting firms, including one member from each of the Big 4 international firms (Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, and KPMG). There is also one academic member and three members associated with the Auditors General of Canada and two provinces. The three members from the public sector reflect the fact that the AASB issues auditing standards for both private and public sector audits. The recently appointed International Auditing and Assurance Standards Board consists of 18 voting members. While the affiliations of the members are not disclosed on the IAASB web site, the IAPC Review Task Force that developed the structure of the new IAASB, concluded that the new 18 member Board should include 3 "non-auditor members" — a member from academia, one from the public sector, and one from user groups.¹¹ Thus the members of both the Canadian and international auditing standards boards are likely to be highly technically competent individuals, with very similar background and orientation — namely, public accounting practice — with some representation from other stakeholders in the standard setting process.

However, as pointed out by Burton, there is more to audit standard setting than technical competence. Auditing standards are important in defining an auditor's role and responsibilities, which impacts on the quality of information in audited financial statements and hence the market value of reporting firms. The appropriate level of auditor responsibility is obviously a social choice. In recent years, auditing standard setters in Canada, the U.S., and at the international level have been pushed by regulators and the public to clarify and expand their responsibilities in several contentious areas, including the detection and reporting of management fraud and client illegal acts. However, these external forces tend to impact in an *ad hoc* manner, and both Canadian and international auditing standard setters can be criticised for failing to incorporate a meaningful level of non-auditor input (through a significant number of non-auditor voting Board members) to the standard setting process.

¹¹ Final Report of the IAPC Review Task Force, 2 November 2001.

3.1 Developing Auditing Standards

The development of auditing standards follows a systematic process, which can be summarized as follows:¹²

- appearance of an issue on a standard setting Board's agenda
- development of an issues paper and/or point outline of basic principles
- drafting, and redrafting of the standard
- issuance of an exposure draft
- evaluating exposure draft comments and incorporating changes deemed appropriate
- issuance of a final standard

These tasks are accomplished through a mixture of effort by staff, Board subcommittees, and the full Board. During the standard setting process there is continuing discussion with the objective of developing a consensus among members of the Board as to the standard's content. While the time elapsed from appearance on an agenda to final issuance of a standard varies, 3 years seems typical for both Canadian and international auditing standards. Moreover, the general process (described above) is essentially the same for the CICA's Auditing and Assurance Standards Board and the International Auditing and Assurance Standards Board.

An important consideration in evaluating the relative merits of Canadian vs. International auditing standard setting is the source of issues that appear on the respective Boards' agendas. As noted earlier, given their constituent members, both Boards can be expected to (and do) respond to issues encountered in public practice. In addition, both Boards continuously scan the regulatory environment, with the CICA's AASB naturally paying particular attention to Canadian domestic regulators, but also — given the importance of Canada-U.S. cross-border commerce — to the U.S. Securities and Exchange Commission. The IAASB, on the other hand, is particularly focused on the International Organization of Securities Commissions, in which the U.S. SEC is a major player.¹³ Thus U.S. regulators are important to both Canada and internationally, but the U.S. SEC — which is arguably the most credible and activist securities' regulator in the world — has, in the past, impacted most directly on the standard setting work of the AICPA through its Auditing Standards Board. Therefore, it is hardly surprising that standard setting issues that have surfaced at the AASB and IAASB (IAPC) often followed closely on the heels of similar efforts by U.S. auditing standard setters. As noted earlier, now that the setting of auditing standards that apply to U.S. publicly held companies has been assumed directly by the SEC through the PCAOB, the importance of U.S. regulators to both Canadian and international standard setters will likely increase in the future.

The “expectations gap” standards issued by the AICPA in 1988 are a good example of this process. These American pronouncements drove Canadian and international standard

¹² See D. Simunic, “The A..B..C's of Standard Setting”, *CGA Magazine*, January, 1993 for details and comments on the development of a typical standard by the IAPC.

¹³ The Ontario Securities Commission and the Commission des valeurs mobilières du Québec are also members of IOSCO, and both are currently members of the Executive Committee of that organization.

setting efforts in the 1990's — and continue to have an important impact.¹⁴ In 1988, responding to public criticism of the work of U.S. auditors, the AICPA issued 10 auditing standards that covered such contentious topics as fraud and illegal acts by clients, the use of analytical procedures in an audit, evaluation of clients' internal controls, and reporting when a client's "going concern" status is in doubt. In addition, the AICPA revised the wording of the auditor's report to more fully cover the respective responsibilities of client management and the auditor for financial statements, and more completely describe the nature of the audit process. It appears that the motivation for revising the auditor's report was largely "defensive", and done in the hope that better explication of auditor responsibility and the audit process would serve to curb litigation against American auditors. What is interesting is that revised audit reports, with identical wording, were quickly adopted by the CICA in 1991, and internationally by the IAPC in 1993. That is, both Canadian and international auditing standard setters followed the American lead with virtually no deviation.¹⁵ While the auditor's report represents a somewhat extreme case of "follow the leader" standard setting, the other American "expectations gap" standards yielded much the same substantive outcome — although less detailed standards — in both Canada and internationally. Therefore, it is arguable whether a separate Canadian version of auditing standards that are often driven by events and outcomes in the U.S., and lead to similar *principles based* international auditing standards, is useful.

Finally, let us consider the transparency and openness of the Canadian and international standard setting processes, and their accountability to stakeholders. As noted above, there is no substantial difference in the basic manner in which issues arrive on the agendas of the two standard setting bodies, nor in the manner in which standards are developed. The input of non-auditor stakeholders in the financial reporting process has traditionally been limited to minimal Board representation in both cases, along with an unrestricted ability of all interested parties to comment on exposure drafts of proposed standards. However, commentary on exposure drafts is, in my experience, of limited value and likely to have limited impact. By the time a standard has reached the exposure draft stage, positions on issues of principle have been extensively debated by the Board to the point that a consensus (or near consensus sufficient to issue a standard) among the members has been reached. Thus dissenting comments on basic principles by "outsiders" at the exposure draft stage are highly unlikely to lead to fundamental changes in standards, unless such views are shared by many, diverse respondents.

Input to the standard setting process is thus likely to be most effective before and during — rather than after — the development of a standard. To its credit, the IAASB (and its predecessor, the IAPC) has, since 1993, solicited input from a Consultative Advisory Group, whose membership includes important international organizations, including the European Commission, the International Monetary Fund, and the International Organization of Securities Commissions. While it's my impression that the Group has not been particularly active, it meets at least once a year and provides input to the IAASB's work program. Turning to Canadian standards, it is laudable that, since 2002, the operations of the AASB have been overseen by the Auditing and Assurance Standards Oversight Council. The AASOC

¹⁴ For example, standard setters continue to delineate the auditor's responsibility for the detection and reporting of fraud and illegal acts by clients.

¹⁵ I served as a Canadian Technical Advisor to the IAPC at that time, and recall that the discussion of alternative wording consisted of a "mock debate", since the outcome — adopting the U.S. language — was seemingly pre-ordained.

draws its members from a broad cross-section of non-auditor constituencies and not only appoints AASB members, but also provides input to the standard setting process. Thus the AASOC has the potential to ensure that the AASB's standards are responsive to the public interest. Finally, it is worth noting that as of June, 2002, the actual meetings of the IAASB are open to the public. While the public are only invited as observers, I believe that this step can potentially have an important impact by bringing the entire standard setting process "into the sunshine" so that arguments underlying positions taken by Board members can be critically evaluated by observers. Moreover, having access to the deliberations of the IAASB increases the opportunities for input to individual Board members through informal channels during the time a standard is being developed. At this time, AASB meetings in Canada are not open to the public.

In summary, the Canadian and international standard setting processes are broadly similar and responsive to similar external influences. The International Auditing and Assurance Standards Board has also taken a potentially important step by opening its meetings to the public. This feature of international standard setting enhances the transparency of the standard setting process and increases the likelihood that interested stakeholders can effectively provide input prior to the time a proposed standard reaches the exposure draft stage. On balance, I conclude that the international standard setting process is as good, and perhaps somewhat superior to the existing process used by the CICA in Canada.

4.0 The Comparability of Standards to Other Jurisdictions

I have already observed that Canadian auditing standards are quite similar to international auditing standards, both in their scope of coverage of the audit process and in the degree of specificity of the guidance they provide. With respect to both attributes, Canadian standards are much more similar to international standards than they are to U.S. auditing standards, which are *rules based* and — at least until now — have been designed for a highly litigious environment where the protection of auditors against charges of negligence loomed large in the decision process of standard setters. Thus, there is little reason for Canada to choose American auditing standards over existing Canadian standards, and I do not consider that alternative in this paper. Note that the CICA's TFOSS also did not consider it appropriate for Canada to adopt U.S. auditing standards because the differences between U.S. and Canadian standards are largely seen as reflecting the differences in the litigation environments in the two countries.¹⁶

The maintenance of separate Canadian auditing standards and a separate standard setting process can, however, be justified if international standards have limited global recognition. While this may have been true in the past, international auditing standards have achieved wide acceptance in recent years. A 1998 survey of IFAC member bodies — that is, the professional accounting associations in various countries¹⁷ — found that of the 65 countries responding to the survey, 46 (71%) had either adopted ISAs directly as their national standards or reported that there were no significant differences between their national standards and the ISAs.¹⁸ Of the 10 (15%) countries reporting significant differences, most involved differences in the form of the auditor's report, rather than matters of audit process. The remaining 9 (14%) respondents were unable to identify the nature of any differences between their domestic standards and the ISAs.¹⁹

In addition, Robert Roussey, a former Chair of the IAPC, cites the following additional evidence for the growing acceptance of the ISAs:²⁰

- a number of large international accounting firms use ISAs as the basis for their world-wide auditing standards;
- a number of regulatory bodies (e.g. the London Stock Exchange) accept financial statements audited using the ISAs for regulatory filings²¹;
- global organizations, such as the Organization for Economic Cooperation and Development, have endorsed ISAs for use in auditing financial statements; and
- IOSCO is currently working with the IAASB with the objective of endorsing the ISAs as a basis for audits of financial statements used in cross-border securities filings.

Another major push for the use of ISAs comes from the European Union (EU) where

¹⁶ CICA Task Force on Standard Setting, *Final Report*, May 1998, p. 35.

¹⁷ As of May, 2002, the IFAC Web site states that 156 accounting associations in 114 countries are members of IFAC.

¹⁸ An announcement by the Institute of Chartered Accountants of Jamaica concerning that country's adoption of ISAs for the audits of domestic financial statements also states that the ISAs have been implemented in over 70 countries as of October, 2001.

¹⁹ R. Roussey, "The Development of International Standards on Auditing", *The CPA Journal*, Vol. 69, No. 10, 1999, pp. 14-20.

²⁰ *Ibid.*, p. 15.

²¹ The Ontario Securities Commission allows financial statements audited in accordance with the ISAs to be filed by non-Canadian listed companies, so long as there is adequate disclosure of any material differences in the form and content of the audit report compared to a Canadian GAAS audit report, and the audit report is accompanied by a statement confirming that the auditing standards applied are substantially equivalent to Canadian generally accepted auditing standards (GAAS).

the Fédération des Experts Comptables Européens (FEE) has proposed to the European Commission that by 2005 auditors in the EU countries should be required to perform audits of financial statements in accordance with the ISAs, report on financial statements in accordance with the ISAs, and perform additional audit procedures and report on additional matters in response to specific legal, regulatory or other needs established at the national level.²² FEE also proposed that scarce national financial and technical resources now being devoted to auditing standard setting at the national level by EU countries, should instead be devoted to supporting the work of the IAASB. The European Commission has largely adopted this position and “envisages the use of ISAs for all EU statutory audits from 2005 onwards”.²³ Interestingly, the European Commission has also suggested that the IAASB’s standard setting activities should be separated from the International Federation of Accountants, because these activities are now fundamentally conducted by and for the audit profession. While the EU recognizes that improvements in transparency and due process have been made in the 2002 transition from the IAPC to the IAASB structure, the Commission argues that:

“A standard-setting body independent of IFAC, operating primarily from a public interest perspective, under a governance structure with a majority of (non-practitioners) international stakeholders would be more credible from a public interest perspective and could be more easily recognized by the EU.”²⁴

It is noteworthy that this proposal is essentially consistent with the movement of audit standard setting from the accounting profession to the PCAOB that has recently occurred in the U.S.

Perhaps of most relevance to Canada is the fact that a number of countries that formerly set domestic auditing standards independent of the ISAs are abandoning that process in favour of a system where ISAs are used as the basic standards and modified, as appropriate, to suit specific local circumstances. As of 1999, this step had been taken by standard setters in the Netherlands and the United Kingdom,²⁵ and more recently in Australia.²⁶ These countries still maintain domestic auditing standard setting boards, but the role of these boards is not to develop standards “from scratch”. Rather, members of the board and the related professional accounting bodies, provide support for the country’s representative(s) to the IAASB, critically comment on exposure drafts of proposed international standards, and — where necessary to deal with unique local circumstances — modify the guidance in ISAs to make it suitable for domestic use. As noted above, the proposals by FEE and the European Commission are designed to accelerate this trend in Europe.

In addition to their increasing use in economically developed countries, the ISAs, modified for local conditions, are the auditing standards being chosen for domestic reporting by a number of important countries that have developed market-based economies in recent years. This is true of both Russia and China, and — for the first time — China is represented by a member on the new IAASB.

22 FEE, *Proposal on International Standards on Auditing in the EU*, Brussels, Belgium, November 2001.

23 Commission of the European Communities, *Communication from the Commission to the Council of the European Parliament: Reinforcing the Statutory Audit in the EU*. Brussels, May 21, 2003, p. 7.

24 *ibid.*, p.7.

25 *ibid.*, p. 16.

26 As per the Web site of the Australian Accounting Research Foundation.

To summarize, international auditing standards have already achieved wide acceptance globally — among both highly economically developed and developing countries — and that trend appears to be accelerating. Moreover, several countries that formerly set domestic auditing standards on an independent basis have abandoned that approach in favour of supporting the work of the IAASB, while maintaining reduced domestic standard setting mechanisms in order to provide input to the IAASB, and to modify ISAs to suit local circumstances. If Canada adopted a similar approach, our domestic auditing standards would be essentially the same as auditing standards in use in most of the world. As a result, the level of assurance implied by an audit of financial statements in Canada would be transparent to both domestic and foreign investors, creditors, regulators, customers, and other stakeholder in the financial reporting process.

5.0 The Relative Net Benefits of a Canadian vs. International Standard Setting Regime

Let me review the argument to this point. In prior sections of this paper, I have argued that existing Canadian and international auditing standards and standard setting processes are essentially equal in quality and that international auditing standards have already found wide and increasing levels of acceptance outside of Canada. This wide acceptance of international auditing standards can be expected to reduce costs borne by financial statement users who must infer a level of assurance associated with an auditor's opinion. In addition, for public accounting firms that operate in both Canada and other jurisdictions, co-ordination costs in auditing financial statements will be reduced. The fact that several large international accounting firms now use ISAs as the basis for their worldwide staff audit manuals is consistent with this argument.

So what are the potential “downsides” to the adoption of international auditing standards by Canada? Why does Canada continue to issue its own auditing standards, while Australia, for example, has essentially abandoned domestic auditing standard setting in favor of a regime that provides support for the IAASB while adjusting international standards, as needed, to the Australian environment? Why, for example, is the European Union poised to adopt a similar standard setting regime? The CICA's Task Force on Standard Setting examined its standard setting position vis-a-vis international standard setting, and concluded that — while the ultimate goal should be one set of internationally accepted auditing standards — the CICA should “continue to develop national standards as it deems most appropriate to meet the needs of its Canadian constituents”.²⁷ This conclusion was reached while, at the same time, noting that “Canadian constituencies are apparently not adversely affected by the few existing, relatively minor differences between Canadian and....IAPC standards..”.²⁸

From the above, it would appear that a principal reason the CICA has set the formal adoption of ISAs as domestic auditing standards in Canada as a laudable but somewhat distant target is simply that maintaining control of auditing standard setting in Canada is in the CICA's self-interest. Since this control is voluntarily maintained, control of the auditing (and accounting) standard setting process(es) must yield net benefits to the CICA and its members. However, as I noted at the beginning of the paper, the private net benefits to the CICA and its membership are not an appropriate basis for the choice of auditing standards in Canada. Rather, this is a social choice that should consider the relative quality of existing international vs. Canadian standards, the relative quality of the respective standard setting processes, and the aggregate costs and benefits to the community of users of auditing standards under each of the two regimes.

Since:

- the quality of international auditing standards is essentially equal to existing Canadian standards;
- the quality of the international standard setting process is also equal to the Canadian

²⁷ CICA Task Force on Standard Setting, *Final Report*, p 38.

²⁸ *ibid.*, p. 38.

process, and — under pressure from the European Commission and other stakeholders — is likely to continue to improve; and

- international auditing standards obviously have much greater usage throughout the world than domestic Canadian standards, thereby reducing comparison and co-ordination costs;

it would seem that — even if the out-of-pocket costs to Canadians of operating an independent standard setting regime were the same as simply participating in international standard setting — adopting international standards in Canada would be a net benefit maximizing, dominant social choice. However, abandoning independent domestic standard setting is also very likely to reduce standard setting costs (since they are shared with other countries) and allow Canada to utilize the scarce standard setting expertise that exists around the world, thus further increasing the net advantage of relying on an international standard setting regime.

While the potential net benefits of adopting international auditing standards for use in Canada appear to be compelling, one needs to recognize that the current rules of the U.S. Securities and Exchange Commission may pose an impediment to a speedy adoption of ISAs as domestic Canadian auditing standards. This is so because SEC rules essentially require that any audited filings of foreign registrants must be audited in accordance with U.S. generally accepted auditing standards²⁹. However, an exception is made for Canadian companies that participate in the Canadian Multi-Jurisdictional Disclosure System.³⁰ These firms are allowed to fulfill SEC rules by submitting the same documents that they file pursuant to Canadian law with relevant Canadian securities authorities — which includes financial statements audited under existing Canadian generally accepted auditing standards. Since a large number of Canadian publicly held companies whose shares are traded in U.S. markets³¹ are registered with and report to the U.S. SEC, this exception from normal U.S. rules is important and would (presumably) not apply if Canada adopted ISAs as domestic auditing standards. Therefore, unless and until SEC rules are changed to allow the filing of financial statements audited in accordance with the ISAs by foreign registrants, a switch to the use of ISAs in Canada would impose some additional compliance costs on Canadian firms registered with the U.S. SEC. I suspect that this change in U.S. rules is only likely to occur following a future endorsement by IOSCO of the use of ISAs in cross border securities filings.

²⁹ See U.S. Securities and Exchange Commission, *Division of Corporate Finance: International Financial Reporting and Disclosure Issues*, May 2001, p. 12.

³⁰ *ibid.*, pp. 12-13.

³¹ Per the U.S. Securities and Exchange Commission's Web site, there were 503 companies incorporated in Canada and registered and reporting with the SEC as of December 31, 2001 (up from 481 companies at December 31, 2000), whose securities are traded on the New York Stock Exchange (15%), American Stock Exchange (6%), the Over-the-Counter market (58%), and on the Nasdaq (21%).

6.0 Conclusion

In this paper, I assess the arguments for and against the adoption of International Standards on Auditing as the domestic auditing standards for use in Canada. In doing so, I assess the relative quality of existing Canadian vs. international standards, the relative quality and transparency of the Canadian vs. international standard setting process, and the present and likely future degree of acceptance of international auditing standards by other countries where Canadian companies may do business. I also examine the relative net benefits of independent domestic standard setting vs. abandoning the domestic setting of auditing standards in favor of a regime where international auditing standards — adjusted, as needed for unique Canadian circumstances — are used in Canada. Through this analysis, I find few good reasons for retaining the present system of domestic auditing standard setting by the Auditing and Assurance Standards Board of the Canadian Institute of Chartered Accountants. I therefore conclude that, from a social policy perspective, the maintenance of separate Canadian domestic auditing standards is difficult to justify.

A change from the current regime to the use of international auditing standards in Canada would entail some legislative changes, including revision of the regulations to the Canada Business Corporations Act, as well as the regulations of the Ontario Securities Commission and other Canadian securities regulations. While such changes are not without cost, these are “one time” costs while the benefits of change accrue over all the future periods that international standards would be in use. In addition, given the current position of the U.S. SEC, a change to international auditing standards would likely impose some additional compliance costs on Canadian companies registered with the SEC. Specification of all the adjustment and implementation costs of changing standard setting regimes would require a detailed economic study that is beyond the scope of this paper. However, I have argued that such a change can be expected to yield net benefits. It is noteworthy that the U.S. Congress, through the Sarbanes-Oxley Act, has recently removed the authority for setting auditing standards to be applied to the audits U.S. publicly held companies from the AICPA’s Auditing Standards Board to an independent body (the PCAOB). Moreover, many other jurisdictions — particularly the countries in the European Union — appear poised to make necessary changes in their domestic laws and regulations and fully embrace ISAs as their domestic auditing standards. In my opinion, Canadian companies, financial statement users, and the broad population of Canadian accountants and auditors, would be well served if Canada moved quickly in the same direction.

