
STANDING ADVISORY GROUP MEETING

USING THE WORK OF A SPECIALIST

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Introduction

The Standing Advisory Group ("SAG") will discuss several issues central to a potential standards-setting project on specialists. This briefing paper provides background information about the auditor's use of specialists in performing an audit, discusses current issues in applying existing auditing standards, and seeks feedback about appropriate auditor responsibilities related to the role and the use of specialists.

Background

For many years specialists have been used by both companies and auditors to assist in preparing financial statements and to assist in evaluating audit evidence. For instance, specialists have been used to perform valuations, determine the existence and quantity of natural resources, and interpret technical and legal requirements.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

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The interim auditing standard on specialists, AU section ("AU sec.")^{1/} 336, *Using the Work of a Specialist*, applies when a company engages or employs a specialist and the auditor uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions. The standard also applies when the auditor engages a specialist and uses that specialist's work as evidential matter. AU sec. 336 defines a specialist as "a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing." Specialists include actuaries, appraisers, engineers, environmental consultants, geologists, and attorneys, in certain circumstances (such as in interpreting the provisions of a contractual agreement). AU sec. 336 indicates that the auditor may encounter complex or subjective matters that are potentially material to the financial statements and may require using the work of a specialist to obtain competent audit evidence, and cites the following examples as the types of matters that the auditor may decide require the use of a specialist:

- valuation (for example, special-purpose inventories, complex financial instruments, environmental contingencies, among others);
- determination of physical characteristics relating to quantity on hand or condition (for example, quantity or condition of minerals, mineral reserves, or materials stored in stockpiles);
- determination of amounts derived by using specialized techniques or methods (for example, actuarial determinations for employee benefit obligations and disclosures, and determinations for insurance loss reserves); and
- interpretation of technical requirements, regulations, or agreements.

^{1/} References to AU sections ("AU secs.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at www.pcaobus.org.

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The use of specialists has increased and evolved since AU sec. 336, was issued. A significant example as to why the use of specialists has increased is the proliferation of accounting pronouncements over the past decade that require fair value measurement, including standards on derivatives, goodwill, intangible assets, mortgage servicing rights, impaired assets, and compensation expense related to employee share options. To make the fair value measurements required by generally accepted accounting principles frequently involves methods and techniques that are typically outside accountants' expertise.

Auditor Competencies and the Need to Use Specialists

In general, the auditor's education, training, and experience should provide him or her with the skills to perform an audit. AU sec. 210, *Training and Proficiency of the Independent Auditor*, states that "in the performance of the audit which leads to an opinion, the independent auditor holds himself out as one who is proficient in accounting and auditing." AU sec. 336 provides that the auditor is expected to possess expertise in accounting, auditing, and tax matters. In addition, AU sec. 336.06 states that the auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.

At the November 2004 SAG meeting, there was discussion about whether the auditor competency requirements should be explicitly established to include the (1) evaluation of information systems and internal controls, (2) prevention and detection of fraud, and (3) evaluation of fair value. One SAG member said that auditors should have a "baseline knowledge in these three areas." Another SAG member said that "a minimum level of knowledge would be expected for the three items...[but] maybe a little less so in fair value." The SAG member indicated that fair value is a complex area and the use of a specialist is often needed.

Discussion Questions –

1. What kind of expertise should be considered within an auditor's competencies? When should an auditor be able (or even encouraged) to rely on the expertise of someone other than an auditor?

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2. What skills will be needed for auditors in the future? Are there areas of expertise that should become part of an auditor's skills?
3. Should an auditor's procedures to evaluate the work of a specialist vary depending on whether the subject matter is in an area only partly beyond the auditor's competence (e.g., valuation of complex financial instruments) or in an area requiring entirely differently skills and knowledge (e.g., geology)?

Specialized Skills in Accounting and Auditing

Another issue related to the subject of specialists is whether the definition of specialists should be broadened to include expertise in specialized areas of accounting and auditing. Some have questioned whether it is reasonable to require auditors to be experts in all specialized accounting and auditing matters. This view holds it to be reasonable that on any engagement, there may be particular areas of accounting and auditing in which an auditor may not possess expertise. The opposite point of view is that auditors should be responsible for possessing the requisite accounting and auditing expertise to competently perform the audits they undertake.

The interim standards recognize that the auditor may need to supplement his or her auditing expertise in some respects, including evaluating the design and effectiveness of the company's controls over its information technology ("IT") systems. Professionals with specialized skills in IT are generally not considered to be specialists, as defined in AU sec. 336. Rather, such professionals are considered members of the engagement team who require the same supervision as any assistant on the audit engagement. AU secs. 311, *Planning and Supervision*, and 319, *Internal Control in a Financial Statement Audit*, discuss the auditor's use of a professional in the IT area. For example, AU sec. 311.10 provides that the auditor should consider whether specialized skills are needed to (1) consider the effect of IT on the audit, (2) understand the controls, and (3) design and perform audit procedures. AU sec. 319.31 has similar requirements specifically directed toward IT internal controls. If specialized skills are needed in the IT area, AU sec. 311 directs the auditor to seek the assistance of a professional possessing IT skills. Such a professional may be either on the auditor's staff or a third-party professional.

Often the professionals with specialized expertise in accounting and auditing are involved with helping the auditor design tests and analyze test results that will provide

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the evidential matter for the auditor. For example, an auditor may use a professional with expertise in statistical sampling to help select a representative sample of transactions from the company's entire population of transactions for a period, for the purpose of determining the effectiveness of internal controls. The professional might also help analyze the results of testing the selected transactions in order for the auditor to reach the appropriate conclusion about whether a particular internal control was performing effectively.

Specialized skill and knowledge in auditing and accounting are considered to be aspects of the financial statement audit process. As such, professionals who possess the specialized skill and knowledge are subject to the planning and supervision requirements found in AU sec. 311.

AU secs. 311.12-.14 provide that supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Requirements include the following:

- assistants should be informed of their responsibilities and objectives of procedures that they are to perform;
- the auditor with final responsibility for the audit should direct assistants to bring to his or her attention significant accounting and auditing questions raised during the audit so he or she may assess the significance;
- the work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions in the auditor's report; and
- the auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel.

However, AU sec. 311 does not specifically address the supervision of professionals who possess specialized skills or knowledge in auditing or accounting. As noted above, AU sec. 311.10 provides some direction regarding assistants who have expertise in IT auditing and requires the auditor to:

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- have sufficient computer-related knowledge to communicate the objectives of the IT professional's work;
- evaluate whether the specified procedures will meet the auditor's objectives; and
- evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

Discussion Question –

4. Should the auditing standards provide more specific guidance for planning, overseeing, and evaluating the work of professionals with specialized skills or knowledge in accounting or auditing, or should those professionals be included within the scope of a standard on specialists?

Using the Specialist's Work

The auditor is responsible for determining that the procedures performed on an audit are adequate to achieve specific objectives and that the evidence is sufficient to form conclusions concerning the validity of the individual assertions embodied in the financial statements.^{2/} Accordingly, the auditor needs to ensure that he or she has adhered to these responsibilities when using the work of a specialist—either the company's specialist or one engaged by the auditor. If the auditor decides to use the work of a specialist, AU sec. 336 outlines auditing procedures directed towards evaluating the qualifications and work of the specialist, the relationship of the specialist to the client, and the findings of the specialist. The procedures do not make a distinction between the company's specialist and the auditor's specialist, and are as follows:

- *Qualifications and work of the specialist* (AU sec. 336.08-.09) – The auditor should consider the professional qualifications of the specialist in determining whether the specialist possesses the necessary skill or

^{2/} Assertions are representations by the company that are embodied in financial statement components and can be classified according to the broad categories of existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure. See AU sec. 326, *Evidential Matter*.

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knowledge in the particular field. The auditor also should obtain an understanding of the nature of the work performed or to be performed by the specialist.

- *Relationship of the specialist to the client* (AU sec. 336.10-.11) – The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity.
- *Findings of the specialist* (AU sec. 336.12) – The auditor should:
 - obtain an understanding of the methods and assumptions used by the specialist;
 - make appropriate tests of data provided to the specialist, considering the auditor's control risk assessment; and
 - evaluate whether the specialist's findings support the related assertions in the financial statements.

With regard to the findings of the specialist, AU sec. 336.12 states that "the appropriateness and reasonableness of the methods and assumptions used by the specialist and their application are the responsibility of the specialist." AU sec. 336.12 further provides that the auditor ordinarily "would use the work of a specialist unless the auditor's procedures lead him or her to believe that the specialist's findings are unreasonable in the circumstances. If the auditor believes that the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist." This direction regarding evaluating "unreasonableness" of the specialist's findings is a different approach from a requirement for the auditor to directly evaluate the reasonableness of the specialist's methods, assumptions, and findings.

In addition to AU Sec. 336, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, provides direction regarding the auditor's use of a specialist when auditing certain aspects of fair value. Unlike AU sec. 336, which applies only when the auditor decides to use the work of a specialist, AU sec. 328.20 directs the auditor to consider whether to engage a specialist and use that work as evidential matter in performing substantive tests. In addition, AU sec. 328 states that a company's assumptions used in making fair value measurements include those developed by a specialist employed or engaged by the company.

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The International Auditing and Assurance Standards Board ("IAASB") currently has a project on its agenda to revise the International Standard on Auditing 620, *Using the Work of an Expert*.^{3/} As a part of this project, the IAASB is considering both how the auditor should evaluate the work of management's specialist (e.g., whether the work of management's specialist should be evaluated in a different light than other work performed by management), and a specialist engaged by the auditor.

Discussion Questions –

5. Are the procedures described in AU sec. 336.12 adequate for evaluating the work of the:
 - a. company's third-party specialist;
 - b. employee specialist of the company; and
 - c. specialist engaged or employed by the auditor?
6. Should the auditor have a responsibility to directly evaluate the reasonableness of the methods and assumptions of the company's specialist?
7. If an auditor uses his or her own specialist to help in evaluating the work of the company or its specialist, how should the auditor evaluate the findings of his or her own specialist? Are the procedures in AU sec. 336.12 appropriate?

Independence and Objectivity Considerations

Under the current standard, the procedures for evaluating objectivity are the same whether the specialist is engaged by the company or the auditor. The auditor has a responsibility to evaluate the relationship of the specialist to the company under audit, including circumstances that might impair the specialist's objectivity. Such

^{3/} The Auditing Standards Board of the American Institute of Certified Public Accountants undertook a project on the use of specialists and, in May 2005, submitted recommendations on the use of specialists to the IAASB.

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circumstances include situations in which the company has the ability, such as through contractual right or employment, to directly or indirectly control or significantly influence the specialist.

AU sec. 336.11 provides that the work of a specialist who has a relationship with the company may be acceptable under certain circumstances. If there is a relationship, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes that the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or should engage another specialist for that purpose.

Although the procedures for evaluating the specialist are the same for both specialists engaged by the company and those engaged by the auditor, the auditor also is required to be independent of the company whose financial statements are being audited. Specifically, the auditor is required to adhere to independence rules that place specific restrictions regarding the types of non-audit services he or she may provide to the audit client, the types of business and employment relationships the auditor may have with the audit client, and the types of financial interests the auditor may have with the audit client.

In some instances, the auditor may determine that he or she needs to engage the services of a third-party specialist to assist in the performance of auditing procedures in areas that involve special skill or knowledge. In general, a third-party specialist engaged by the auditor is not required to be independent of the audit client.

Extending independence restrictions to third-party specialists engaged by the auditor could be viewed as enhancing the overall objectivity of an audit that involves such specialists. If such a specialist is independent of the company, the specialist is unlikely to have interests that could create bias with respect to the company. However, to require specialists, who are otherwise under no obligation to adhere to the auditor's independence requirements, to be independent would likely place the burden of monitoring and enforcing those requirements on the auditor. This added responsibility would be a significant burden to both the auditor and the specialist firm and might also result in a significant reduction in specialists that are available to the auditor.

It is, nevertheless, important that a specialist engaged by the auditor be objective, unbiased, and free of conflicts of interest that could impair his or her

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objectivity. AU sec. 336 currently requires the auditor to evaluate the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity. Therefore, it seems reasonable that auditors should be able to effectively evaluate the specialist's objectivity and the relationships between the specialist and the audit client that might bias the specialist's findings.

Although AU sec. 336 does not provide guidance for evaluating the specialist's objectivity, it does provide guidance for evaluating the qualifications of a specialist. For instance, under AU sec. 336.08, the auditor should consider the following:

- professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate;
- reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance; and
- specialist's experience in the type of work under consideration.

AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, might provide some additional guidelines for evaluating the specialist engaged by the auditor. AU secs. 322.09-.11 provide direction that could be used for evaluating the competence and objectivity of specialists and specialist companies. For instance, the auditor could evaluate factors such as:

- educational level and professional experience of specialists;
- the specialist company's policies, programs, and procedures;
- practices regarding assignment of specialists to accounting firm clients;
- supervision and review of specialists by the specialist company;
- quality of the specialist's working paper documentation, reports, and recommendations;
- the specialist company's evaluation of the performance of its employees; and

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- the specialist company's policies to maintain objectivity for its clients.

There are other ways that the auditor could promote objectivity. There could be a requirement that the individual specialist assigned by the specialist company and, possibly, his or her supervisor, be independent of the company under audit. There also could be a requirement that the auditor and the company under audit not use the same specialist company.

Discussion Questions –

8. Should the auditor consider the objectivity of a specialist who is an employee of the company differently from the objectivity of a specialist who is a third-party contractor of the company? If so, what type of direction related to this difference in objectivity should be provided to the auditor?
9. Should there be a requirement that the auditor and the company under audit not engage the same specialist company?
10. Should a standard provide additional guidance for the auditor on evaluating the objectivity of his or her third-party specialist?

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.