
STANDING ADVISORY GROUP MEETING
AUDITING FAIR VALUE MEASUREMENTS AND USING THE WORK OF A
SPECIALIST
OCTOBER 14-15, 2009

Introduction

At the October 14-15, 2009 meeting of the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Standing Advisory Group ("SAG"), the SAG will discuss the potential direction of a standards-setting project on auditing fair value measurements and using the work of a specialist. Although the Board previously discussed these issues with the SAG, it is appropriate to have another discussion due to auditing challenges associated with auditing fair value in the current economic environment.^{1/} In addition, bringing this topic to the SAG will enhance our understanding of certain issues and aid the Board in considering whether to propose new standards or amend the existing standards.

There is ongoing discussion about fair value accounting, especially relating to accounting for financial instruments. The Board has no authority to prescribe the form or content of a public company's financial statements. The auditor is responsible for

^{1/} See September 2004 and June 2007 SAG briefing papers regarding auditing accounting estimates and fair value measurements at [http://www.pcaobus.org/Standards/Standing Advisory Group/Meetings/2004/09-08/Fair Value.pdf](http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2004/09-08/Fair_Value.pdf) and, [http://www.pcaobus.org/Standards/Standing Advisory Group/Meetings/2007/06-21/Accounting Estimates.pdf](http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/06-21/Accounting_Estimates.pdf) respectively. See February 2006 SAG briefing paper regarding using the work of the specialist at [http://www.pcaobus.org/Standards/Standing Advisory Group/Meetings/2006/02-09/Specialists.pdf](http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Specialists.pdf).

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.

determining whether the public company's financial statements are in conformity with the applicable accounting requirements. In fulfilling that responsibility, the auditor should look to the requirements of the U.S. Securities and Exchange Commission ("SEC") and to the accounting principles applicable to that company.^{2/} Regardless of the applicable accounting requirements, it is a fundamental requirement that the auditor obtain sufficient competent audit evidence to provide reasonable assurance that fair value measurements^{3/} and disclosures are in conformity with the applicable accounting principles.

The staff believes that a standards-setting project to revise its existing standards on auditing fair value measurements and using the work of a specialist may be appropriate for a number of reasons.^{4/} Information obtained from the Board's inspection and enforcement programs indicate that some auditors might not be exercising sufficient professional skepticism when performing audit procedures and evaluating results in higher risk areas of the audit. Fair value measurements, and other accounting estimates, and the related use of the work of a specialist frequently entail elevated audit risk.

Certain fair value measurements may present a greater risk of material misstatement due to the unobservable nature of certain key assumptions that drive the valuation. In addition, disclosures have become increasingly important in determining and understanding a company's financial position and operating results. Recently

^{2/} See paragraph .01 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. 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 American Institute of Certified Public Accountants 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.

^{3/} In the context of this briefing paper, fair value measurements, or fair value estimates, do not refer to fair value measurements that are based on quoted prices in active markets for identical assets and liabilities.

^{4/} See AU sec. ("AU sec.") 342, *Auditing Accounting Estimates*, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 332, *Auditing Derivative Instruments, Hedging Activities and Investments in Securities*, and AU sec. 336, *Using the Work of a Specialist*.

issued accounting standards of the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") require additional disclosures to provide users with more qualitative information about the nature of a company's objectives, assumptions, and methods associated with fair value measurements. Given the increased importance of disclosures, it may be appropriate to include additional direction on evaluating disclosures in a standard on auditing fair value measurements.

An evaluation of the existing standard on using the work of a specialist also is appropriate. The staff believes that certain direction in the current standard regarding the auditor's responsibility when evaluating the work of a specialist could be strengthened. For example, the current standard provides similar direction to the auditor when evaluating the work of a specialist engaged by the auditor or the work of the company's specialist. The staff believes it may be appropriate to provide separate direction in these two circumstances. This would be consistent with the approach taken by other standards-setters. Further, the existing standards have different direction for a specialist *engaged* by the auditor and a specialist *employed* by the auditor. Given the similarities between how specialists engaged or employed by the auditor are used, it may be appropriate that a proposed standard have the same direction for a specialist engaged or employed by the auditor.

A proposed standard on auditing fair value measurements could provide additional direction on (1) identifying and assessing risks of material misstatement, and (2) the auditor's evaluation of the adequacy of disclosures related to fair value measurements. Regarding using the work of a specialist, a proposed standard could include specific direction for supervising a specialist engaged by the auditor. The scope of a proposed standard on using the work of a specialist also could include a specialist employed by the auditor. A proposed standard also could provide enhanced requirements for evaluating the work of a specialist whether engaged or employed by the auditor. This briefing paper provides SAG members with background information about each discussion topic and the questions that will be presented during the discussion.

Discussion Format of the SAG Meeting

The PCAOB staff will provide background information regarding the project at the SAG meeting. SAG members and observers will then form three break-out groups to discuss the topics outlined in this briefing paper relating to the potential direction of a standards-setting project on auditing fair value measurements and on using the work of a specialist. On the second day of the meeting, a summary of the break-out group discussions will be presented to the SAG, and SAG members will have the opportunity to provide additional commentary.

Background

A number of factors and developments have affected the evaluation of the existing standards. These include, among other things, observations during PCAOB inspections,^{5/} previous recommendations from the SAG,^{6/} a synthesis of academic research,^{7/} changes to relevant accounting standards,^{8/} and the complexities of auditing assets and liabilities measured at fair value.^{9/} As part of its evaluation, the Board also is

^{5/} See PCAOB Release No. 2007-010, *Report on the PCAOB's 2004, 2005, and 2006 Inspections of Domestic Triennially Inspected Firms* (October 22, 2007) and PCAOB Release No. 2008-008, *Report On the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms* (December 5, 2008).

^{6/} See archived Web casts of September 2004 and June 2007 SAG meetings at http://www.pcaobus.org/News_and_Events/webcasts_archive.aspx.

^{7/} See Roger D. Martin, Jay S. Rich, and T. Jeffrey Wilks, "Auditing Fair Value Measurements: A Synthesis of Relevant Research," *Accounting Horizons* (September 2006).

^{8/} FASB Accounting Standards Codification ("FASB Codification") Topic 805, *Business Combinations*, formerly known as Statement of Financial Accounting Standard No. ("FAS") 141 (Revised), *Business Combinations*, requires new fair value measurements for items such as contingent legal liabilities and contingent compensation. FASB Codification Topic 825, *Financial Instruments*, formerly known as FAS 159, *The Fair Value Option for Financial Assets and Liabilities*, allows companies to make an irrevocable election to record specified financial assets and liabilities at fair value, with changes in fair value flowing through the income statement. FASB Codification Topic 820, *Fair Value Measurements and Disclosures*, formerly known as FAS 157, *Fair Value Measurements*, revised the definition of fair values, established a framework for measuring fair value in accordance with generally accepted accounting principles, and expanded the fair value disclosure requirements.

^{9/} The PCAOB staff issued three staff audit practice alerts as an interim measure to address some of these issues. See Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007), Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (December 5, 2008), and Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (April 21, 2009).

considering the work on related topics of other standards-setters and monitoring the activities of the SEC related to fair value accounting and disclosures.^{10/}

Auditors face challenges in auditing many fair value measurements. Because of uncertainties inherent in certain business activities, some financial statement items can only be estimated. Some fair value measurements involve a high degree of judgment and subjectivity, especially those based on models. For many, the method of measurement is complex. This is especially the case where fair value measurements are based on assumptions about matters that are uncertain at the time of measurement.

These challenges also are related to the differences in auditing assets and liabilities recorded at historical cost versus those recorded at fair value.^{11/} In general, for items recorded at historical cost, there is objective evidence of the cost, such as a bill of sale, which the auditor can examine. With respect to fair value, especially in the current economic environment in which markets for certain financial instruments are not active, it may be more challenging for auditors to obtain observable evidence that supports an estimate of what a hypothetical market participant would pay for an asset at the measurement date.

Fair value determinations based on unobservable inputs are particularly challenging for auditors. FASB Accounting Standards Codification ("FASB Codification") Topic 820, *Fair Value Measurements and Disclosures*, provides that "...unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk)."^{12/} In addition, FASB Codification Topic 820 states that:

Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market

^{10/} For example, in December 2008, a SEC staff report, *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting*, was delivered to Congress.

^{11/} Under FASB Codification Topic 820, paragraph 820-10-35-3, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

^{12/} See FASB Codification Topic 820, paragraph 820-10-35-53.

participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.^{13/}

These aspects of fair value accounting may make it challenging for the auditor to substantiate the valuation of certain financial statement accounts recorded at fair value.

The need for professionals with specialized skills or knowledge has increased in response to the challenges of auditing certain fair value measurements. As the use of fair value measurements in accounting and financial reporting requirements has become more prevalent, auditors have been receiving more assistance from professionals with specialized skills or knowledge. Professionals with specialized skills or knowledge may, for example, assist the auditor in determining whether models companies use to estimate fair value are appropriate and whether the key assumptions used in those models are reasonable.

Discussion Topics

Identifying and Assessing Risks of Material Misstatement

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, states that the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions. Further, according to AU sec. 316 certain accounts, classes of transactions, and assertions that have high inherent risks because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement because they are susceptible to manipulation by management.^{14/} The staff believes that it is important for the auditor to focus on such account balances when planning the audit, performing risk assessment procedures, and performing audit procedures in response to risk.

AU sec. 316 also provides additional direction for identifying fraud risks, including a presumption that improper revenue recognition is a fraud risk, and a requirement that

^{13/} Ibid., paragraph 820-10-35-55.

^{14/} See AU sec. 316.39.

the auditor should consider the risk of management override of controls. The standard requires the auditor to "ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition" and that "[e]ven if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk apart from any conclusions regarding the existence of more specifically identifiable risks."^{15/} AU secs. 316.51-.67 also include general guidance involving the nature, timing, and extent of procedures to address fraud risk, as well as specific direction for addressing fraud risk involving revenue recognition and management override of controls.

AU sec. 316.85 includes, among other things, two examples of fraud risk factors associated with accounting estimates with a high degree of measurement uncertainty: (a) assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate; and (b) significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions. A presumption that fair value measurements with a high degree of measurement uncertainty represent a fraud risk could enhance the auditor's ability to identify the account balances and classes of transactions susceptible to fraud and the related types of material misstatements that could occur. For example, the presumption of a fraud risk could result in the auditor designing procedures to identify those types of misstatements. Those procedures could be similar to the responses contained in AU sec. 316 concerning revenue recognition and management override of controls.^{16/} A requirement to introduce a fraud risk presumption would be intended to be a refinement and improvement to the Board's current requirement in AU sec. 316.

Such a fraud risk presumption might be appropriate because many financial statement accounts involving fair value measurements with a high degree of measurement uncertainty may have high inherent risk^{17/} and involve a high degree of

^{15/} See AU secs. 316.41-.42.

^{16/} For example, AU sec. 316.54 notes the following as an example of a response to identified risks of material misstatement due to fraud that involves improper revenue recognition: "[c]onfirming with customers relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreement."

^{17/} Inherent risk for an assertion is its susceptibility to a material misstatement assuming there are no related controls. See AU sec. 332.08.

management judgment and subjectivity. For example, in estimating the fair value of a financial statement asset in a market that is not active "the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available."^{18/} Such estimates could be manipulated by overriding internal controls or biasing management judgments that affect the models and inputs used to derive these fair value estimates.^{19/}

A proposed standard on auditing fair value measurements could provide factors for auditors to consider in evaluating the degree of measurement uncertainty. The auditor also could use his or her knowledge of the company (including its internal controls over financial reporting), its industry, and its environment, and his or her professional judgment in evaluating the degree of measurement uncertainty. Examples of factors that a proposed standard might include to assist auditors in evaluating the degree of measurement uncertainty related to fair value estimates include:

- Degree of subjectivity or judgment involved in the recognition or measurement of the estimate
- Range of potential valuations based on the sensitivity of the estimate, e.g., a small change in an assumption could result in a significant change in the valuation
- Susceptibility of the estimate to manipulation by management
- Susceptibility of the estimate to override of controls by management

^{18/} FASB Codification Topic 820, paragraph 820-10-35-55A.

^{19/} SEC Release No. 33-8810, *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, also notes the high risk associated with accounting estimates. In that release, the SEC notes that:

[f]inancial reporting elements that involve related party transactions, critical accounting policies, and related critical accounting estimates generally would be assessed as having a higher misstatement risk. Further, when the controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment, or are complex, they should generally be assessed as having higher [internal control over financial reporting] risk.

- Complexity of the valuation technique and model
- Whether the estimate is a "critical accounting estimate" in accordance with the SEC requirement^{20/}

Discussion Questions –

1. Should there be a requirement for the auditor to presume that a fair value measurement with a high degree of measurement uncertainty is a fraud risk? Would such a requirement enhance the auditor's ability to identify the types of material misstatements that could occur?
2. Would a requirement for the auditor to perform specific procedures, similar to those contained in AU sec. 316 concerning revenue recognition and management override of controls, in response to the risks related to fair value measurements with a high degree of measurement uncertainty improve the auditor's ability to identify the types of material misstatements that could occur? If so, what should those procedures be?
3. Would consideration of the factors in the previous paragraph assist the auditor in evaluating which fair value measurements have a high degree of measurement uncertainty? Are there other factors an auditor should consider in making that evaluation?

^{20/} See Release Nos. 33-8350; 34-48960; FR-72, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (<http://www.sec.gov/rules/interp/33-8350.htm>). That release requires that:

[w]hen preparing disclosure under the current requirements, companies should consider whether they have made accounting estimates or assumptions where...[1]...the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and...[2]...the impact of the estimates and assumptions on financial condition or operating performance is material.

If so, companies should provide disclosure about those critical accounting estimates or assumptions in their [Management's Discussion and Analysis of Financial Condition and Results of Operations].

Evaluating the Adequacy of Fair Value Disclosures

Fair value measurements and related disclosures have become increasingly important for issuers and auditors in determining and understanding a company's financial position and operating results. Recently issued accounting standards of the FASB and the IASB include additional disclosure requirements that provide users with more *qualitative* information about the nature of a company's objectives, assumptions, and methods associated with fair value measurements. Examples of such *qualitative* disclosure requirements are discussed below:

FASB Codification Topic 820, paragraph 820-10-50-1, provides general discussion about fair value disclosures:

The reporting entity shall disclose information that enables users of its financial statements to assess both of the following: (a) for assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition (for example, trading securities), the inputs used to develop those measurements, [and] (b) for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on earnings (or changes in net assets) for the period.

In addition, the FASB has recently proposed an amendment to paragraph 820-10-50-1 that would require an entity to disclose "the total effect(s) of changes in reasonably possible alternative inputs." The FASB stated in the exposure draft that:

[f]or fair value measurements using significant unobservable input (Level 3) if changing one or more of those inputs to reasonably possible alternative inputs would increase or decrease the fair value measurements significantly (sometimes referred to as sensitivity disclosures) the reporting entity would state that fact and disclose the total effect(s) of the changes on the fair value measurement.^{21/}

FASB Codification Topic 815, *Derivatives and Hedging*, formerly referred to as FAS 161, *Disclosures about Derivative Instruments and Hedging Activities – An Amendment of FASB Statement No. 133*, paragraph 815-10-50-1A, requires that:

^{21/} See FASB, Proposed Accounting Standards Update, *Fair Value Measurement and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements* (August 28, 2009).

An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments) shall disclose all of the following (a) its objectives for holding or issuing those instruments, (b) the context needed to understand those objectives, [and] (c) its strategies for achieving those objectives.

International Financial Reporting Standard No. 7, *Financial Instruments: Disclosure*, paragraph 30, requires "for an investment in equity instruments that do not have a quoted market price in an inactive market":

[A]n entity shall disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value...including...information about the market for the instruments [and] information about whether and how the entity intends to dispose of the financial instruments...

Auditors have a responsibility to evaluate whether the disclosures about fair value measurements are in conformity with applicable accounting principles. Under the existing auditing standards, the auditor is required to:

- Evaluate whether the disclosures about fair value estimates made by management are in conformity with applicable accounting principles and are properly disclosed^{22/}
- Obtain sufficient competent audit evidence that the valuation principles are appropriate under applicable accounting principles and are being consistently applied, and that the method of estimation and significant assumptions used are adequately disclosed in accordance with applicable accounting principles^{23/}

^{22/} See AU sec. 328.43.

^{23/} See AU sec. 328.44.

- If an item contains a high degree of measurement uncertainty, assess whether the disclosures are sufficient to inform users of such uncertainty.^{24/}

Under AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, the auditor's opinion should be based on, among other things, whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation. Additionally, AU sec. 431, *Adequacy of Disclosure in Financial Statements*, requires that the auditor consider whether financial statements include adequate disclosure of material matters and whether there are particular matters that should be disclosed in light of the circumstances and facts of which he [or she] is aware at the time.^{25/}

A proposed standard could provide additional requirements for evaluating the adequacy and sufficiency of the financial statement disclosures related to fair value estimates. For example, a proposed standard could include a requirement for the auditor to specifically assess whether the company has disclosed qualitative information in a transparent and understandable manner. Evaluating the adequacy of qualitative information could involve, e.g., assessing how a company has disclosed how and why it uses derivatives and how derivative instruments affect (1) an entity's financial position, (2) an entity's financial performance, and (3) an entity's cash flows.^{26/}

Discussion Question –

4. Given the movement towards more qualitative disclosures about assets and liabilities measured at fair value and the related risks and disclosures about the sensitivity of certain assumptions, is there a need for additional requirements for evaluating the adequacy of disclosures? If so, how could the requirements for evaluating the adequacy of disclosures be improved?

^{24/} See AU sec. 328.45.

^{25/} See AU sec. 411.04(c) and AU sec. 431.02

^{26/} See FASB Codification Topic 815, *Derivatives and Hedging*, formerly referred to as FAS 133, *Accounting for Derivatives Instruments and Hedging Activities*, paragraph 815-10-50-1.

Using the Work of a Specialist

The auditor's responsibilities regarding using the work of a specialist are contained in the Board's auditing standard, AU sec. 336, *Using the Work of a Specialist* ("AU sec. 336"). AU sec. 336 applies when (1) management engages or employs a specialist and the auditor uses that specialist's work in performing substantive tests, (2) management engages a specialist employed by the auditor's firm to provide advisory services and the auditor uses that specialist's work in performing substantive tests, and (3) the auditor engages a specialist ("outside specialist") and uses that specialist's work as evidential matter in performing substantive tests.^{27/} AU sec. 336 does not apply to situations covered by AU sec. 311, *Planning and Supervision*, in which a specialist employed by the auditor's firm ("employee specialist") participates in the audit.

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 could include actuaries, appraisers, engineers, environmental consultants, and geologists. In certain circumstances (such as in interpreting the provisions of a contractual agreement), attorneys may also be specialists.

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. AU sec. 336 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)

^{27/} The second option has little, if any, practical application in light of the SEC's independence rules.

- Interpretation of technical requirements, regulations, or agreements.

Scope of a Proposed Standard on Using the Work of a Specialist Engaged or Employed by the Auditor

As noted in the previous section, AU sec. 336 applies when the auditor uses the work of an outside specialist, while AU sec. 311 applies when the auditor uses an employee specialist. Although the auditor ordinarily uses the outside and employee specialists for the same purpose, the requirements in AU sec. 336 and AU sec. 311 are not the same. A proposed standard could, in contrast, apply the same requirements for using the work of a specialist engaged or employed by the auditor ("auditor's specialist").^{28/} Requirements for evaluating the work of the company's specialist could be addressed in a separate standard. Regardless of whether the auditor uses an outside or an employee specialist, the requirement that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, would continue to exist.

AU sec. 336 provides, among other things, direction for evaluating the work of a specialist engaged by the auditor. However, it does not specifically address the supervision of a specialist. Under AU sec. 311, the use of a specialist who is effectively functioning as a member of the audit team requires the same supervision and review as any assistant on the audit engagement. AU sec. 311.11 provides 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. AU sec. 311.11 further notes that the "extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work." Supervision requirements include the following:

- Assistants should be informed of their responsibilities and the objectives of procedures that they are to perform. They should be informed of matters that may affect the nature, extent, and timing of procedures they are to perform.^{29/}

^{28/} International Standards on Auditing ("ISA") 620, *Using the Work of an Auditor's Expert*, follows such an approach.

^{29/} See AU sec. 311.12.

- The engagement partner 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^{30/}
- 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^{31/}
- The engagement partner and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit^{32/}

Under AU sec. 336, if the auditor engages a specialist, or management engages or employs a specialist, and the auditor uses that specialist's work as evidential matter, the auditor is required to:

- Evaluate the professional qualifications of the specialist
- Evaluate the relationship of the specialist to the client
- Obtain an understanding of the methods and assumptions used by the specialist
- Make appropriate tests of data provided to the specialist
- Evaluate whether the specialist's findings support the related assertions in the financial statements^{33/}

In addition, AU sec. 336.12 notes that "ordinarily the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings

^{30/} Ibid.

^{31/} See AU sec. 311.13.

^{32/} See AU sec. 311.14.

^{33/} See AU secs. 336.08, 336.10, and 336.12.

are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures...."

Discussion Question –

5. Should the same requirements apply for using an outside specialist and an employee specialist? If so, should those requirements reflect the AU 311 approach, the AU 336 approach, or a combination of both? Are there situations in which it would be impractical to impose the supervision requirements in AU 311?

Further, the staff believes that the requirements for evaluating the work of an outside specialist in AU sec. 336.12 could be improved. The staff also believes that the requirements for determining whether the work of the employee specialist was adequately performed in AU sec. 311.13 also could be improved.

One approach for evaluating the work of the auditor's specialist can be found in International Standards on Auditing ("ISA") 620, *Using the Work of an Auditor's Expert*. ISA 620, among other things, requires that:

[t]he auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

- (a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
- (b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and
- (c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.^{34/}

A proposed standard could enhance the requirements for the auditor's evaluation of the work of the auditor's specialist and provide additional direction beyond that in AU sec. 336.12 and AU sec. 311.13.

^{34/} See ISA 620, paragraph 12.

Discussion Question –

6. What additional direction should a standard provide when evaluating the work of the auditor's specialist, given that the auditor engages a specialist since he or she does not have the requisite specialized knowledge or skills?

* * *

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.