The Association of Accountants and Financial Professionals in Business

July 15, 2015

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: Staff Consultation Paper No. 2015-01 – The Auditor's Use of the Work of Specialists

Dear PCAOB Board and Staff Members:

The Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) writes to express its views on the PCAOB Staff Consultation Paper, *The Auditor's Use of the Work of Specialists* (Paper).

The IMA is a global association representing over 75,000 accountants and finance team professionals. Our members work for organizations of various sizes, industries, and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org in the Advocacy Activity section under the About IMA tab.

The Paper is clearly one "written by auditors, for auditors." Yet, the broader corporate community would be affected by any significant expansion of the audit requirements for the use of specialists. Corporations would incur not only higher external audit fees for any added audit procedures but also could be required to make costly changes to internal procedures to accommodate new external audit requirements concerning how company employed or engaged specialists are referenced. Thus, we feel it is important for FRC to express its views on this issue, primarily those from a corporate point of view.

We observe that the Paper is quite detailed comprising:

- 54 pages of text,
- 104 footnotes (largely referring to detailed auditing standards), and
- 48 questions on which comments are sought, many of which are multi-part.

Rather than responding to the extremely detailed questions, we believe it is more important to offer a few general observations about the topic. It is important that the Board keep things in perspective and not allow all of the detail to result in losing sight of the forest by focusing on so many trees.

The objective of this project

The press release announcing the issuance of the Paper quoted Chairman Doty saying, "The use of the work of specialists is important to investors because it can help an auditor detect material misstatements in complex areas of a company's financial statements." A sentence at the bottom of page 19 of the Paper builds on this by stating, "If a specialist's work is not properly overseen or evaluated, there may be an increased risk that an auditor will not detect a material misstatement, whether caused by error or fraud." The latter sentence is supported by footnote 45, which cites three SEC Accounting and Auditing Enforcement Releases (AAER) in which "… companies materially misstated financial statements, in part, with the assistance of the companies' specialists. In these cases, the auditor used the work of the company's specialist without performing the procedures required by AU sec. 336."

We have reviewed the three AAERs cited (1452, 2447, and 3264). Our brief summary of each is as follows.

AAER 1452 – First, the auditors failed to perform any procedures or analysis to determine that valuations for timber properties were proper. Instead, "they improperly relied on unsupported management representations." Second, the auditors failed to question a "so-called appraisal" of rain forest property when they knew that similar property had been purchased for a tiny percentage of that value. Finally, they failed to challenge an appraisal based on expected sale of water from the property when they knew that the property was simply held for resale. There were numerous other accounting and auditing issues noted in this release.

AAER 2447 – By far the major issue in this release was falsification of revenue. One ancillary issue was the amount at which to record the acquisition of an equity interest in another entity in exchange for the registrant's restricted stock. The company recorded the transaction based on the value of the latter, although the SEC ruled that such amount was materially overstated based on the fraudulent revenue. A "purported appraisal" was also obtained for the equity interest. The auditors relied "… on management's oral representation, without reviewing the appraisal or ascertaining its basis …"

AAER 3264 – This case involved a company selling working interests in oil and gas leases. As of year-end 2007, oil and gas properties accounted for over 80% of the company's assets. However, the company failed to obtain new or updated reserve reports and instead relied on the ones for 2006. The engagement partner did nothing to challenge that and, therefore, completely failed to comply with AU 336.

It is fair to say that each of these cases involved significant financial reporting issues only some of which were subject to the involvement of specialists. And it is also fair to say that the auditing in question was egregiously deficient. It appears in all three cases that the auditor simply failed to perform **any** procedures related to the company's specialist. Thus, these three cases, dating back as far as fourteen years, should hardly form the basis for a finding that new standards are needed that could require more work for auditors and more cost to companies in all circumstances involving the use of specialists. A simple reminder to "Follow AU 336" would seem to be an effective substitute for new standards!

Our views – keeping things in perspective

Corporate management of public companies is responsible for issuing financial statements to investors. An important part of the preparation of those statements is the development of measurements for many asset and liability accounts, which often include estimates involving considerable judgment. The Paper cites several of these such as fair values of financial instruments, oil and gas reserves, pension obligations, and environmental liabilities. Developing the values that will be included in financial statements for such items often requires the use of specialists. These specialists may be employed by the company if it is large enough or their services may be contracted. Given the securities laws, particularly the CEO and CFO certification requirements under SOX, corporate management takes very seriously the responsibility to prepare accurate financial statements. Thus, management exercises careful oversight when using specialists in the financial reporting process. This would normally include review of the development of the financial statement estimates by the company's disclosure committee in addition to more direct controls of each specialist's process as appropriate.

On page 3 the Paper states, "The use of specialists in audits is important to investors because, in the staff's view, an auditor's appropriate use of the work of a specialist may increase the likelihood that the auditor will detect a material misstatement in the company's financial statements." As noted earlier, the Paper cites a few cases where such material misstatements were not detected initially. Suggestions in the Paper that current auditing standards for the use of specialists be "improved," "extended," or "enhanced" imply that new standards in this area will result in higher quality financial statement estimates.

While independent auditors add confirmation value to the financial reporting process, they should not be expected to overcome basic deficiencies in the information to be assessed. Nor should they be expected to be able to improve the accuracy of estimates that are inherently subject to a range of reasonable outcomes. We are concerned that by possibly requiring more work to be done by auditors the PCAOB expects the independent audit process to improve the accuracy of accounting estimates rather than merely increase the detection of material misstatements of financial statements. This not only confuses the responsibilities of management and external auditors in the financial reporting process, it also creates a false expectation of increased precision for many financial statement measures that are simply not that precise in nature.

We fully recognize the need for external auditors to have an independent, objective mindset when approaching their work. The Paper emphasizes this and particularly notes the need for skepticism. But we also suggest that the Board should try to have an overall balanced view as it moves forward on this project and other auditing standards. There is too much of an implication that management will always try to bias its financial reporting so that auditors have to be extra sensitive to this "bias." For example, on page 22, "A company's specialist might be influenced by the same factors that may cause bias in other personnel of the company who are involved in preparing the company's financial statements." As noted above, nearly all companies want to report properly in accordance with GAAP and we are concerned that auditing standards might be expanded to require added costs for all companies when there may be only a few outliers.

Without getting into all of the detailed questions in the Paper, we do wish to highlight two matters that follow from the comment about expanding auditing standards in all cases because of a relatively few cases of non-compliance. First, we believe it would be a mistake to attempt to extend auditor independence requirements to specialists engaged by an accounting firm or a company. There are many different types of specialists whose work is used or referred to in an audit, just some of which are listed in Figure 1 of the Paper. While many of these specialists are subject to their own professional guidelines, few, if any, presently operate under the extremely restrictive PCAOB/SEC independence rules. It would be difficult to police execution of independence rules by specialists. And independence restrictions might well reduce the pool of competent specialists available to assist auditors.

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Second, we are concerned about any significant expansion of auditor responsibility with respect to company specialists. For example, existing auditing standards appropriately require the auditor to review the reasonableness of the work of company specialists, including challenging whether major assumptions used are appropriate, etc. However, taken to an extreme, an accounting firm that employs specialists might fully repeat a company's actuarial study, asset impairment valuation, etc. Given that the auditor gains comfort with the important assumptions used by the specialist through its audit procedures, that would add significant cost to an audit with little, if any, improvement in the quality of the financial information reported to investors, and any such expansion of audit standards should be avoided.

As a minor comment, we were somewhat surprised to see two academic Papers (Boritz et al and Griffith – one apparently unpublished) referenced no fewer than a dozen times in footnotes. Given that the staff had analyzed data from 50 large audits and 318 smaller audits (see footnotes 9 and 10), we would have expected more reference to the staff's analysis of actual audits in the Paper vs. what seemed to us as selective quoting from the two academic papers.

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In summary, we urge the PCAOB to be cautious before making extensive changes to the auditing standards for the use of specialists. While the Paper raises a large number of interesting questions, it is important to keep the big picture in mind and not allow dozens of questions to suggest a need for specific answers and new auditing procedures in all cases. In this regard, please refer to our specific comments in our letter dated February 25, 2015 on the PCAOB Staff Consultation Paper, *Auditing Estimates and Fair Value Measurements*.

Finally, we encourage the PCAOB to use a plain English approach in future publications to better obtain broad feedback. In addition to an Executive Summary, we suggest the inclusion of a decision tree to clarify the issues and possible future requirements. We believe that auditors' responsibilities regarding the determination of qualifications, independence and objectively, the supervision and the evaluation of evidence are ultimately the same. No matter which type of specialist depicted in Figure 2 is used, the procedures and processes to fulfill such responsibilities differ. A decision tree to filter through the requirements under each specialist scenario could provide clarity for the boarder corporate community.

We would be pleased to discuss our comments with the Board or Staff at your convenience.

Sincerely,

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