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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") amendments to auditing standards for using the work of specialists, including amendments to two existing auditing standards and the retitling and replacement of a third standard with an updated standard (collectively, the "proposed rules"). The proposed rules are attached as Exhibit A to this filing. In addition, the Board is also requesting the SEC's approval, pursuant to Section 103(a)(3)(c) of the Act, of the application of the proposed rules to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934. Section 104 of the Jumpstart Our Business Startups Act provides that any additional rules adopted by the Board subsequent to April 5, 2012 do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." *See* Exhibit 3.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its open meeting on December 20, 2018. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to Barbara Vanich, Deputy Chief Auditor (202/207-9363, vanichb@pcaobus.org); Keith Wilson, Deputy Chief Auditor (202/207-9134, wilsonk@pcaobus.org); Lisa Calandriello, Associate Chief Auditor (202/207-9337, calandriello@pcaobus.org); David Hardison, Associate Counsel (202/591-4168, hardisond@pcaobus.org); or Jennifer Williams, Associate General Counsel (202/591-4173, williamsjg@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules Change

(a) Purpose

The Board adopted amendments to its standards for using the work of specialists (i.e., a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing), including amendments to two existing auditing standards and the retitling and replacement of a third standard with an updated standard. The amendments are intended to enhance investor protection by strengthening the requirements for evaluating the work of a company's specialist, whether employed or engaged by the company, and applying a supervisory approach to both auditor-employed and auditor-engaged specialists. The amendments are also designed to be risk-based and scalable, so that the auditor's work effort to evaluate the specialist's work is commensurate with the risk of material misstatement associated with the financial statement assertion to which the specialist's work relates and the significance of the specialist's work to that assertion. These amendments should lead to more uniformly rigorous practices among audit firms of all sizes and enhance audit quality and the credibility of information provided in financial statements.

Companies across many industries use specialists to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors frequently use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

As financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements, accounting estimates have become both more prevalent and significant. As a result, the use of the work of specialists also continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

To address this challenge, the Board has adopted to its auditing standards that primarily relate to auditors' use of the work of specialists. First, AS 1105, *Audit Evidence*, is being amended to add a new Appendix A that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards.

Second, the Board has also amended AS 1201, *Supervision of the Audit Engagement*, to add a new Appendix C on supervising the work of auditor-employed

specialists, and retitling and replacing AS 1210, *Using the Work of a Specialist* ("existing AS 1210"), with new AS 1210, *Using the Work of an Auditor-Engaged Specialist* ("AS 1210, as amended"), which sets forth requirements for using the work of auditor-engaged specialists.

These amendments strengthen the requirements for evaluating the work of a company's specialist and for supervising and evaluating the work of both auditor-employed and auditor-engaged specialists. *See* Exhibit 3 for additional discussion of the purpose of the project.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impact of the proposed rules is discussed in Exhibit 1.

5. Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others

The Board released the proposed rules for public comment on June 1, 2017. *See* Exhibit 2(a)(A). The PCAOB also issued a staff consultation paper ("SCP") for public comment. *See* Exhibit 2(a)(B). The Board received 80 written comment letters relating to its proposed rules and the SCP. *See* Exhibits 2(a)(C) and 2(a)(D). The Board's Standing Advisory Group also discussed the proposed rules and SCP at meetings on June 18, 2015, November 13, 2015, and November 30, 2017. *See* Exhibit 2(a)(E).

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) of for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

Exhibit A - Text of the Proposed Rules

Exhibit 1 - Form of Notice of Proposed Rules for Publication in the Federal Register.

Exhibit 2(a)(A) - PCAOB Release No 2017-003 (Proposing Release)

Exhibit 2(a)(B) - Staff Consultation Paper No. 2015-01

Exhibit 2(a)(C) - Alphabetical List of Comments and Written Comments on the rules proposed in PCAOB Release No. 2017-003

Exhibit 2(a)(D) - Alphabetical List of Comments and Written Comments on Staff Consultation Paper No. 2015-01

Exhibit 2(a)(E) - Transcripts from SAG meetings on June 18, 2015, Nov. 13, 2015, and Nov. 30, 2017.

Exhibit 3 - PCAOB Release No. 2018-006 (Adopting Release) and related materials.

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: 

Phoebe W. Brown
Secretary

March 20, 2019

EXHIBIT A – TEXT OF THE PROPOSED RULES

The Board adopted amendments to (1) AS 1105, *Audit Evidence*; (2) AS 1201, *Supervision of the Audit Engagement*; (3) AS 1210, *Using the Work of a Specialist*, to amend that standard in its entirety and retitle it as *Using the Work of an Auditor-Engaged Specialist*; (4) AS 2101, *Audit Planning*; (5) AS 2110, *Identifying and Assessing Risks of Material Misstatement*; and (6) AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*. The Board also adopted technical and conforming amendments to other standards and auditing interpretations.

The text of these proposed rule changes is set forth below.

AMENDMENTS RELATING TO THE AUDITOR'S USE OF THE WORK OF SPECIALISTS

Amendments to AS 1105, *Audit Evidence*

AS 1105 is amended by adding a note after the first bullet of paragraph .08:

Note: *See Appendix A of this standard for requirements related to the evaluation of evidence from a company's specialist.*

AS 1105 is amended by revising footnote 3 to paragraph .10 to read as follows:

³ When using the work of a company's specialist, *see Appendix A of this standard.*

When using information produced by a service organization or a service auditor's report as audit evidence, *see AS 2601, Consideration of an Entity's Use of a Service Organization*, and for integrated audits, *see AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

AS 1105 is amended by adding a new Appendix A:

Appendix A – Using the Work of a Company's Specialist as Audit Evidence

.A1 This appendix describes the auditor's responsibilities with respect to using the work of a specialist, employed or engaged by the company ("company's specialist"), as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure. The requirements in this appendix supplement the requirements of this standard.

Note: For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

This appendix does not apply when the auditor uses the work of a person with specialized skill or knowledge in income taxes¹ or information technology as audit evidence.²

Note: This appendix does not apply to information provided by a company's attorney concerning litigation, claims, or assessments that is used by the auditor pursuant to AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*. This appendix applies when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.

¹ A note to AS 2505.08 describes the auditor's responsibility regarding the use of written advice or opinion of a company's tax advisor or a company's tax legal counsel as audit evidence.

² This is consistent with the treatment of persons with specialized skill or knowledge in income taxes and information technology who are employed or engaged by auditors. See Appendix C of AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*.

.A2 The requirements in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, for obtaining an understanding of the company's information system relevant to financial reporting include obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls.³

³ See AS 2110.28A.

Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

.A3 The auditor should obtain an understanding of the professional qualifications of the company's specialist in the particular field, and the entity that employs the specialist (if other than the company), and assess the level of knowledge, skill, and ability of the specialist in the particular field. Factors that are relevant to the assessment of the specialist's knowledge, skill, and ability include the following:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work performed, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

.A4 The auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances

exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise).

Note: Examples of potential sources of information that could be relevant to the auditor's assessment include, but are not limited to:

- Information obtained by the auditor from procedures performed pursuant to AS 2410, *Related Parties*;
- Engagement contracts between the company and the specialist, or the specialist's employer;
- Responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company;
- Information provided by the employer of a specialist regarding relationships with the company; and
- Disclosures about relationships with the company in the specialist's report, or equivalent communication, pursuant to requirements promulgated by the specialist's profession or by legislation or regulation governing the specialist.

.A5 The necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company in paragraphs .A3–.A4 depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the

significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.

Evaluating the Work of the Company's Specialist

- .A6 Evaluating the work of a company's specialist involves evaluating:
- a. The data, significant assumptions, and methods used by the specialist; and
 - b. The relevance and reliability of the specialist's work and its relationship to the relevant assertion.

Note: Paragraphs .16–.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed. This includes determining whether an auditor's specialist is needed to evaluate the work of a company's specialist.

- .A7 The necessary evidence from the auditor's evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on:
- a. The significance of the specialist's work to the auditor's conclusion regarding the relevant assertion;
 - b. The risk of material misstatement of the relevant assertion;
 - c. The level of knowledge, skill, and ability of the specialist; and
 - d. The ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Note: When evaluating the specialist's work, the auditor should obtain more persuasive evidence as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's

judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist in the particular field decreases.

.A8 The auditor should:

- a. Test the accuracy and completeness of company-produced data used by the specialist,⁴ and evaluate the relevance and reliability⁵ of data from sources external to the company that are used by the specialist;
- b. Evaluate whether the significant assumptions⁶ used by the specialist are reasonable as follows:

- (1) For significant assumptions developed by the specialist, the auditor should take into account the consistency of those assumptions with relevant information.

Note: Examples of information that, if relevant, should be taken into account include: (1) assumptions generally accepted within the specialist's field; (2) supporting information provided by the specialist; (3) industry, regulatory, and other external factors, including economic conditions; (4) the company's objectives, strategies, and related business risks; (5) existing market information; (6) historical or recent experience, along with changes in conditions and events affecting the company; and (7) significant assumptions used in other estimates tested in the company's financial statements.

- (2) For significant assumptions provided by company management and used by the specialist, the auditor should look to the requirements set forth in

paragraphs .16–.18 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.

- (3) If a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should look to the requirements set forth in AS 2501.17; and
- c. Evaluate whether the methods used by the specialist are appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework.

Note: Evaluating whether the methods are appropriate includes evaluating whether the data (paragraph .A8a) and significant assumptions (paragraph .A8b) are appropriately applied under the applicable financial reporting framework.

⁴ See paragraph .10 of this standard.

⁵ See paragraphs .07 and .08 of this standard.

⁶ See AS 2501.15 for procedures to perform when identifying significant assumptions. For purposes of identifying significant assumptions, the company's assumptions include assumptions developed by a company's specialist.

.A9 The auditor should evaluate the relevance and reliability of the specialist's work and whether the specialist's findings support or contradict the relevant assertion. Factors that affect the relevance and reliability of the specialist's work include:

- a. The results of the auditor's procedures over data, significant assumptions, and methods performed pursuant to paragraph .A8;

- b. The nature of any restrictions, disclaimers, or limitations in the specialist's report or equivalent communication; and
- c. The consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

.A10 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the auditor should perform additional procedures, as necessary, to address the matter.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's findings and conclusions are inconsistent with (i) other information, if any, in the specialist's report, or equivalent communication, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (2) the specialist's report, or equivalent communication, contains restrictions, disclaimers, or limitations regarding the auditor's use of the report or communication; (3) exceptions were identified in performing the procedures described in paragraph .A8 above related to data, significant assumptions, or methods; (4) the auditor has doubt about the specialist's knowledge, skill, and ability, or about the company's effect on the specialist's judgments; or (5) the specialist has a conflict of interest relevant to the specialist's work.

Amendments to AS 1201, *Supervision of the Audit Engagement*

AS 1201 is amended by revising footnote 2 to paragraph .03 to read as follows:

² Appendix C describes further procedures to be performed with respect to the supervision of the work of auditor-employed specialists in conjunction with the required supervisory activities set forth below. AS 1210, *Using the Work of an Auditor-Engaged Specialist*; and Appendix A of AS 1105, *Audit Evidence*, establish requirements for an auditor using the work of an auditor-engaged specialist and a company's specialist, respectively, in performing an audit of financial statements.

AS 1201 is amended by adding a new Appendix C:

Appendix C – Supervision of the Work of Auditor-Employed Specialists

.C1 For engagements in which a specialist employed by the auditor's firm ("auditor-employed specialist") assists the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure, this appendix describes supervisory activities to be performed in conjunction with supervising the work of an auditor-employed specialist in an audit. The requirements in this appendix supplement the requirements in paragraphs .05–.06 of this standard.

Note: For purposes of this standard, a specialist is a person possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply to situations in which a person with specialized skill or knowledge in income taxes or information technology participates in the audit.

Paragraphs .03–.06 of this standard apply in those situations.

.C2 The necessary extent of supervision of an auditor-employed specialist depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist.

Informing the Auditor-Employed Specialist of Work to be Performed

.C3 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:
 - (1) Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;
 - (2) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
 - (3) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement

team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.C4 Pursuant to paragraph .05a(3) of this standard, the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.¹

¹ See AS 1015.07–.09.

.C5 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with paragraphs .21–.26 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*;
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with AS 2501.09–.18; or

- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix A to AS 1105, *Audit Evidence*, and, for accounting estimates, AS 2501.19.

Evaluating the Work of the Auditor-Employed Specialist

.C6 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .C3d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.C7 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work; (3) the specialist's findings and conclusions are inconsistent with

(i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

Amendment to AS 1210, *Using the Work of a Specialist*

AS 1210 is retitled and amended in its entirety to read as follows:

AS 1210: Using the Work of an Auditor-Engaged Specialist

Introduction

.01 This standard establishes requirements regarding the use of a specialist engaged by the auditor's firm ("auditor-engaged specialist") to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

Note: For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

Because income taxes and information technology are specialized areas of accounting and auditing, this standard does not apply to situations in which a person with specialized skill or knowledge in income taxes or information technology participates in the audit. AS 1201, *Supervision of the Audit Engagement*, applies in those situations.

Objective

.02 The objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

Assessing the Knowledge, Skill, Ability, and Objectivity of the Auditor-Engaged Specialist

.03 The engagement partner and, as applicable, other engagement team members performing supervisory activities¹ should assess the specialist's knowledge, skill, and ability in the particular field for the type of work under consideration. This includes obtaining an understanding of the following with respect to the specialist and the entity that employs the specialist:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work under consideration, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

Note: The auditor's assessment of the specialist's knowledge, skill, and ability affects the auditor's determination of: (1) whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform the type of work under consideration (paragraph .04); and (2) the necessary extent of the review and evaluation of the specialist's work (paragraph .10).

¹ See AS 1201.04.

.04 The engagement partner and, as applicable, other engagement team members performing supervisory activities should not use the work of a specialist who does not have a sufficient level of knowledge, skill, and ability.

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities should assess whether the specialist has the necessary degree of objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. This includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or other conflicts of interest relevant to the work to be performed.

Note: The auditor's assessment of the specialist's objectivity affects the nature and extent of the auditor's procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing.²

Note: The evidence necessary to assess the specialist's objectivity depends on the significance of the specialist's work and the related risk of material misstatement. Examples of potential sources of information that could be relevant to the auditor's assessment include, but are not limited to:

- Information obtained by the auditor from procedures performed pursuant to AS 2410, *Related Parties*;
- Engagement contracts between the company and the specialist, or the specialist's employer;
- Responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company;

- Written representations or other information provided by the specialist concerning relationships with the company; and
- Disclosures about relationships with the company in the specialist's report, or equivalent documentation, pursuant to requirements promulgated by the specialist's profession or by legislation or regulation governing the specialist.

² Paragraph .06 of this standard requires the auditor to establish and document an understanding with the specialist, including with respect to the data, significant assumptions, and methods the specialist is responsible for testing, evaluating, or developing. Paragraph .11 of this standard addresses how the specialist's objectivity affects the nature and extent of the auditor's procedures.

Informing the Auditor-Engaged Specialist of the Work to be Performed

.06 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:

- (1) Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;
 - (2) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
 - (3) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.07 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, and possible accounting and auditing issues.

.08 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion.

This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with paragraphs .21–.26 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*;
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with AS 2501.09–.18; or
- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix A to AS 1105, *Audit Evidence*, and, for accounting estimates, AS 2501.19.

Evaluating the Work of the Auditor-Engaged Specialist

.09 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .06d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.10 The necessary extent of the review depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, (2) the risk of material misstatement of the relevant assertion, and (3) the knowledge, skill, and ability of the specialist.

.11 If the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity, the auditor should perform additional procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing, pursuant to the engagement team's understanding with the specialist (paragraph .06), or should engage another specialist. The necessary nature and extent of the additional procedures depend on the degree of objectivity of the specialist. As the degree of objectivity increases, the evidence needed from additional procedures decreases. If the specialist has a low degree of objectivity, the auditor should apply the procedures for evaluating the work of a company's specialist.³

³ See AS 1105.A6–.A10.

.12 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant

assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

Amendment to AS 2101, *Audit Planning*

AS 2101 is amended by adding footnote 3A to paragraph .06, such that revised AS 2101.06 reads as follows:

.06 The auditor should perform the following activities at the beginning of the audit:

a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,³

b. Determine compliance with independence^{3A} and ethics requirements, and

Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

c. Establish an understanding of the terms of the audit engagement with the audit committee in accordance with AS 1301, *Communications with Audit Committees*.

³ Paragraphs .14–.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. AS 1110, *Relationship of Auditing Standards to Quality Control Standards*, explains how the quality control standards relate to the conduct of audits.

^{3A} Under PCAOB Rule 3520, *Auditor Independence*, a registered public accounting firm or associated person's independence obligation with respect to an audit client encompasses not only an obligation to satisfy the independence criteria applicable to the engagement set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence

criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

Amendment to AS 2110, *Identifying and Assessing Risks of Material Misstatement*

AS 2110 is amended by adding new paragraph .28A after paragraph .28:

.28A When a company uses the work of a company's specialist, the auditor should obtain an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and the related company processes, including:

- a. The nature and purpose of the specialist's work;
- b. Whether the specialist's work is based on data produced by the company, data obtained from sources external to the company, or both; and
- c. The company's processes and controls^{16A} for using the work of specialists.

^{16A} See paragraph .34 of this standard.

Amendment to AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*

AS 2505 is amended by adding a note at the end of paragraph .08:

Note: The opinion of legal counsel on specific tax issues that he or she is asked to address and to which he or she has devoted substantive attention, as contemplated by this standard, is sometimes necessary evidence to support the auditor's conclusions on significant income tax accounts and disclosures. However, the audit of income tax accounts and disclosures requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, it is not appropriate for the auditor to rely solely on

such legal opinion with respect to those tax issues without performing his or her own evaluation of matters related to the significant tax accounts and disclosures in the financial statements, taking into account the relevant tax and accounting requirements, his or her understanding of the company and its environment, and other relevant evidence obtained during the audit.^{5A}

Appendix A to AS 1105, *Audit Evidence*, applies when an auditor uses the work of a company's attorney as audit evidence in matters relating to legal expertise other than litigation, claims, and assessments (which are covered under this standard) and income taxes. For example, Appendix A to AS 1105 applies when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.

^{5A} Similarly, the written advice of a company's tax advisor on material matters affecting the tax accrual is sometimes necessary evidence to support the auditor's conclusions on the significant accounts and disclosures related to income taxes. As with legal opinions on tax matters, the auditor cannot rely solely on that written advice from tax advisors without performing his or her own evaluation of matters related to the significant tax accounts and disclosures in the financial statements.

OTHER RELATED AMENDMENTS TO PCAOB AUDITING STANDARDS

Amendment to AS 1015, *Due Professional Care in the Performance of Work*

AS 1015 is amended by revising paragraph .06 to read as follows:

.06 Engagement team members should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they

are examining. The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.⁴

⁴ See AS 1201, *Supervision of the Audit Engagement*.

Amendment to AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*

AS 2301 is amended by adding footnote 5A to paragraph .07, such that revised AS 2301.07 reads as follows:

.07 Due professional care requires the auditor to exercise professional skepticism.⁴

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.⁵ Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor,^{5A} or examination of documentation from independent sources.

⁴ AS 1015.07–.09.

⁵ AS 2401.13.

^{5A} Refer to AS 1210, *Using the Work of an Auditor-Engaged Specialist*, and Appendix C of AS 1201, which establish requirements for an auditor using the work of an auditor-engaged specialist and an auditor-employed specialist, respectively, in performing an audit of the financial statements.

Amendment to AS 2310, *The Confirmation Process*

AS 2310 is amended by revising paragraph .03 to read as follows:

.03 In addition, this section does not address matters described in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Amendments to AS 2401, *Consideration of Fraud in a Financial Statement Audit*

AS 2401 is amended by revising the second sentence of the second paragraph of the third bullet of paragraph .54 to read as follows:

In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of an intangible asset), it may be appropriate to use the work of an auditor-employed specialist or an auditor-engaged specialist or develop an independent estimate for comparison to management's estimate.

AS 2401 is amended by revising footnote 22 to paragraph .54 to read as follows:

²² Appendix C of AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*, establish requirements for an auditor using the work of an auditor-employed specialist and an auditor-engaged specialist, respectively, in performing an audit of financial statements.

Amendment to AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors

AS 2610 is amended by revising paragraph .16 to read as follows:

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in AS 1205. Furthermore, the predecessor auditor is not an auditor's specialist, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Amendment to AT 601, Compliance Attestation

AT 601 is amended by revising paragraph .43 to read as follows:

.43 In some compliance engagements, the nature of the specified compliance requirements may require specialized skill or knowledge in a particular field other than accounting or auditing. In such cases, the practitioner may use the work of a specialist and should comply with the requirements for using the work of specialists as set forth in PCAOB auditing standards.

Amendment to AT 701, Management's Discussion and Analysis

AT 701 is amended by revising paragraph .47 to read as follows:

.47 In some engagements to examine MD&A, the nature of complex or subjective matters potentially material to the MD&A presentation may require specialized skill or knowledge in a particular field other than accounting or auditing. For example, the entity may include

information concerning plant production capacity, which would ordinarily be determined by an engineer. In such cases, the practitioner may use the work of a specialist and should comply with the requirements for using the work of specialists as set forth in PCAOB auditing standards.

Amendments to AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*

AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, is amended by revising the title to read: AI 11, *Using the Work of a Specialist: Auditing Interpretations*.

AI 11 is amended by revising paragraph .04 to read as follows:

.04 *Interpretation*—During the audit, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter.

AI 11 is amended by revising paragraph .11 to read as follows:

.11 The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist's findings support management's assertions with respect to the isolation criterion. FASB Statement No. 140's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

AI 11 is amended by revising paragraph .17 to read as follows:

.17 *Interpretation*—No. In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements. Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140.

AI 11 is amended by deleting footnote 14 to paragraph .21.

Amendments to AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*

AI 28 is amended by revising paragraph .16 to read as follows:

.16 In such circumstances, rather than inspecting and obtaining documentary evidence of the client's tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist and rely solely on counsel's opinion as an appropriate procedure for obtaining evidential matter to support his or her opinion on the financial statements?

AI 28 is amended by revising paragraph .18 to read as follows:

.18 The auditor's education, training, and experience enable him or her to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-XXXXX; File No. PCAOB-2019-03)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act" or "Sarbanes-Oxley Act"), notice is hereby given that on [Date of Form 19b-4 Submission], the Public Company Accounting Oversight Board (the "Board" or "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On December 20, 2018, the Board adopted amendments to auditing standards for using the work of specialists (collectively, the "proposed rules"), including amendments to two existing auditing standards and the retitling and replacement of a third standard with an updated standard. The text of the proposed rules appears in Exhibit A to the SEC Filing Form 19b-4 and is available on the Board's website at <https://pcaobus.org/Rulemaking/Pages/docket-044-auditors-use-work-specialists.aspx> and at the Commission's Public Reference Room.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on

the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. In addition, the Board is requesting that, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, the Commission approve the proposed rules for application to audits of emerging growth companies ("EGCs").¹ The Board's request is set forth in section D.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Summary

The Board has adopted amendments to its standards for using the work of specialists (i.e., a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing), including amendments to two existing auditing standards and the retitling and replacement of a third standard with an updated standard. The amendments are intended to enhance investor protection by strengthening the requirements for evaluating the work of a company's specialist, whether employed or engaged by the company, and applying a supervisory approach to both auditor-employed and auditor-engaged specialists. The amendments are also designed to be risk-based and scalable, so that the auditor's work effort to evaluate the specialist's work is commensurate with the risk of material misstatement associated with the financial statement assertion to which the specialist's work relates and the significance of the

¹ The term "emerging growth company" is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(80)). *See also Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act*, Rel. 33- 10332 (Mar. 31, 2017), 82 FR 17545 (Apr. 12, 2017).

specialist's work to that assertion. These amendments should lead to more uniformly rigorous practices among audit firms of all sizes and enhance audit quality and the credibility of information provided in financial statements.

Companies across many industries use specialists to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors frequently use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

As financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements, accounting estimates have become both more prevalent and significant. As a result, the use of the work of specialists also continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

To address this challenge, the Board has adopted amendments to its auditing standards that primarily relate to auditors' use of the work of specialists. First, AS 1105, *Audit Evidence*, is being amended to add a new Appendix A that addresses using the

work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards.

New Appendix A of AS 1105:

- Supplements the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, including requirements related to:
 - Obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls;
 - Obtaining an understanding of, and assessing, the knowledge, skill, and ability of a company's specialist and the entity that employs the specialist (if other than the company) and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
 - Performing procedures to evaluate the work of a company's specialist, including evaluating: (i) the data, significant assumptions, and methods (which may include models) used by the specialist, and (ii) the relevance and reliability of the specialist's work and its relationship to the relevant assertion.
- Aligns the requirements for using the work of a company's specialist with the risk assessment standards and the standard and related amendments

adopted by the Board on auditing accounting estimates, including fair value measurements.

- Sets forth factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.

Second, the Board has also amended AS 1201, *Supervision of the Audit Engagement*, by adding a new Appendix C on supervising the work of auditor-employed specialists, and retitling and replacing AS 1210, *Using the Work of a Specialist* ("existing AS 1210"), with new AS 1210, *Using the Work of an Auditor-Engaged Specialist* ("AS 1210, as amended"), which sets forth requirements for using the work of auditor-engaged specialists.

New Appendix C of AS 1201:

- Supplements the requirements for applying the supervisory principles in AS 1201.05–.06 when using the work of an auditor-employed specialist to assist the auditor in obtaining or evaluating audit evidence, including requirements related to:
 - Informing the auditor-employed specialist of the work to be performed;
 - Coordinating the work of the auditor-employed specialists with the work of other engagement team members; and
 - Reviewing and evaluating whether the work of the auditor-employed specialist provides sufficient appropriate evidence.

Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and whether the specialist's findings and conclusions are consistent with, among other things, the work performed by the specialist.

- Sets forth factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.

AS 1210, as amended:

- Establishes requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence;
- Includes requirements for reaching an understanding with an auditor-engaged specialist on the work to be performed and reviewing and evaluating the specialist's work that parallel the final amendments to AS 1201 for auditor-employed specialists;
- Sets forth factors for determining the necessary extent of review of the work of the auditor-engaged specialist;
- Amends requirements related to assessing the knowledge, skill, ability, and objectivity of the auditor-engaged specialist; and
- Describes objectivity, for these purposes, as the auditor-engaged specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit, and specifies the auditor's obligations when the specialist or the entity that employs the

specialist has a relationship with the company that affects the specialist's objectivity.

The final amendments strengthen the requirements for evaluating the work of a company's specialist and for supervising and evaluating the work of both auditor-employed and auditor-engaged specialists. The amendments also eliminate certain provisions of existing PCAOB standards, under which:

- The auditor has the same responsibilities under existing AS 1210 with respect to both a company's specialist and an auditor-engaged specialist, even though those specialists have fundamentally different roles (i.e., the company uses the work of its specialist in the preparation of the financial statements); and
- Auditor-employed specialists, but not auditor-engaged specialists, are subject to risk-based supervision, even though both serve similar roles in helping auditors obtain and evaluate audit evidence.

The Board adopted the final amendments after substantial outreach, including two rounds of public comment. In May 2015, the PCAOB issued a staff consultation paper to solicit views on various issues, including the potential need for standard setting. In June 2017, the Board requested comments on proposed amendments to the standards on using the work of specialists. The Board received comments on the staff consultation paper and the proposal. The Board's Standing Advisory Group ("SAG") also discussed this issue at several meetings. Commenters generally supported the Board's objective of improving the quality of audits involving specialists, and suggested areas to further improve the amendments, modify proposed requirements that would not likely improve audit quality,

and clarify the application of the amendments. In adopting these amendments, the Board has taken into account all of these comments and discussions, as well as observations from PCAOB oversight activities.

In its consideration of the final amendments, the Board is mindful of the significant advances in technology that have occurred in recent years, including increased use of data analysis tools and emerging technologies. An increased use of technology-based tools, together with future developments in the use of data and technology, could have a fundamental impact on the audit process. The Board is actively exploring these potential impacts through ongoing staff research and outreach. For example, the PCAOB staff is currently researching the effects on auditing of data analytics, artificial intelligence, distributed ledger technology, and other emerging technology, assisted by a task force of the SAG.²

In the context of this rulemaking, the Board considered how changes in technology could affect the use of specialists by companies, the use of the work of companies' specialists by auditors as audit evidence, and the use of auditor-employed and auditor-engaged specialists by auditors to obtain and evaluate audit evidence. The Board believes that the final amendments are sufficiently principles-based and flexible to accommodate continued advances in the use of data and technology by both companies and auditors. The Board will continue to monitor advances in this area and any effect they may have on the application of the final amendments.

² See PCAOB, *Changes in Use of Data and Technology in the Conduct of Audits*, available at <https://pcaobus.org/Standards/research-standard-setting-projects/Pages/data-technology.aspx>.

The amendments will apply to all audits conducted under PCAOB standards. Subject to approval by the Commission, the amendments take effect for audits for fiscal years ending on or after December 15, 2020.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

Not applicable. The Board's consideration of the economic impacts of the proposed rules is discussed in section D below.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment in *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2017-003 (June 1, 2017) ("Proposal"). The PCAOB also issued for public comment *Staff Consultation Paper No. 2015-01, The Auditor's Use of the Work of Specialists* (May 28, 2015) ("SCP"). Copies of Release No. 2017-003, the SCP, and the comment letters received in response to the PCAOB's requests for comment are available on the PCAOB's website at <https://pcaobus.org/Rulemaking/Pages/docket-044-auditors-use-work-specialists.aspx>. The PCAOB received 80 written comment letters. The Board's response to the comments received and the changes made to the rules in response to the comments received are discussed below.

Background

Companies across many industries use various types of specialists to assist in

developing accounting estimates in their financial statements.³ Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. In addition, auditors frequently use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

The use of fair value measurements and other accounting estimates continues to grow in financial reporting with, for example, increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.⁴ If a specialist's work is not properly overseen or evaluated, however, there is heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

The amendments to the standards for using the work of specialists are intended to improve audit quality by strengthening the requirements for evaluating the work of a company's specialist and applying a risk-based supervisory approach to both auditor-

³ As used in this notice, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

⁴ See, e.g., Karin Barac, Elizabeth Gammie, Bryan Howieson, and Marianne van Staden, *The Capability and Competency Requirements of Auditors in Today's Complex Global Business Environment*, at 83 (Mar. 2016) (report commissioned by the Institute of Chartered Accountants of Scotland and the Financial Reporting Council) (stating that "audit teams now include many more experts than in the past, and for some industries, particularly financial services, this was a welcome development.").

employed and auditor-engaged specialists. These enhancements should also lead to improvements in practices, commensurate with the associated risk, among audit firms of all sizes. The expected increase in audit quality should also enhance the credibility of information provided to investors.

Rulemaking History

The amendments to the auditing standards adopted by the Board (“final amendments” or “final requirements”) reflect public comments on both the SCP and the Proposal. In May 2015, the PCAOB issued the SCP to solicit comments on various issues related to the auditor's use of the work of a company's specialist and an auditor's specialist, including possible approaches for changes to PCAOB standards and the potential economic impacts of those alternatives.

In June 2017, the PCAOB issued the Proposal to solicit comments on amendments to PCAOB standards to strengthen the requirements for the auditor's use of the work of specialists. The Proposal was informed by comments on the SCP. The Board received 35 comment letters on the Proposal from commenters across a range of affiliations. The final amendments are informed by comments on the Proposal. Those comments are discussed throughout this notice.

In addition, the Board's approach has been informed by, among other things: (1) observations from PCAOB oversight activities and SEC enforcement actions; (2) the International Auditing and Assurance Standards Board's ("IAASB") and the American Institute of Certified Public Accountants' Auditing Standards Board's auditing standards

and IAASB's post-implementation review;⁵ (3) substantial outreach, including discussions with members of the SAG;⁶ and (4) the results of academic research.

Overview of Existing Requirements

The primary standard that applies when auditors use the work of auditor-engaged specialists or company specialists is existing AS 1210. The primary standard that applies when auditors use the work of auditor-employed specialists in an audit is AS 1201.

Existing AS 1210 was adopted by the Board in 2003 shortly after the PCAOB's inception.⁷ AS 1201 was one of eight risk assessment standards adopted by the Board in 2010.⁸

⁵ See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review*, at 44–45 (July 2013).

⁶ See SAG meeting briefing papers and webcast archives (Nov. 29–30, 2017, Nov. 30–Dec. 1, 2016, Nov. 12–13, 2015, June 18, 2015, Oct. 14–15, 2009, and Feb. 9, 2006), available on the Board's website.

⁷ See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003). AS 1210 was originally adopted by the PCAOB as AU sec. 336. The PCAOB renumbered AU sec. 336 as AS 1210 when it reorganized its auditing standards. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015).

⁸ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010). Prior to 2010, auditors supervised employed specialists under AU sec. 311, *Planning and Supervision*. Additionally, paragraph .16 of AS 2101, *Audit Planning*, requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

Existing AS 1210 provides that a specialist is "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing."⁹

Existing AS 1210 also states that income taxes and information technology ("IT") are specialized areas of accounting and auditing, and therefore are outside the scope of the standard.¹⁰ Existing AS 1210 applies when (1) a company engages or employs a specialist and the auditor uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions or (2) an auditor engages a specialist and uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions.¹¹

AS 1201 establishes requirements for the supervision of the audit engagement, including supervising the work of engagement team members.¹² The auditor supervises a specialist employed by the auditor's firm who participates in the audit under AS 1201.¹³ As members of the engagement team under PCAOB auditing standards, auditor-employed specialists are to be assigned based on their knowledge, skill, and ability.¹⁴ AS 1201 also applies in situations in which persons with specialized skill or knowledge in IT

⁹ See existing AS 1210.01.

¹⁰ See footnote 1 of existing AS 1210.

¹¹ See existing AS 1210.03.

¹² See AS 1201.01.

¹³ See AS 1201.05–.06.

¹⁴ See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*. In addition, the requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing the independence of auditor-employed specialists. See AS 2101.06b.

or income taxes participate in the audit, regardless of whether they are employed or engaged by the auditor's firm.¹⁵

Using the work of a company's specialist and an auditor-engaged specialist under existing AS 1210. Existing AS 1210 requires that the auditor perform the following procedures when using the work of a company's specialist or an auditor-engaged specialist:

- Evaluate the professional qualifications of the specialist;¹⁶
- Obtain an understanding of the nature of the specialist's work;¹⁷
- Evaluate the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity;¹⁸ and
- In using the findings of the specialist:¹⁹
 - Obtain an understanding of the methods and assumptions used by the specialist;
 - Make appropriate tests of data provided to the specialist; and
 - Evaluate whether the specialist's findings support the financial statement assertions.

¹⁵ See footnote 1 of existing AS 1210.

¹⁶ See existing AS 1210.08.

¹⁷ See existing AS 1210.09.

¹⁸ See existing AS 1210.10–.11.

¹⁹ See existing AS 1210.12.

*Using the work of a company's specialist when auditing fair value measurements under AS 2502.*²⁰ In circumstances when a company's specialist develops assumptions used in a fair value measurement and the auditor tests the company's process, the auditor is required to evaluate the reasonableness of those assumptions as if the assumptions were developed by the company,²¹ as well as to comply with the requirements of existing AS 1210.

Supervising the work of auditor-employed specialists under AS 1201. This standard establishes requirements regarding the auditor's supervision of an audit engagement, including supervising the work of auditor-employed specialists and other members of the engagement team. AS 1201, as it relates to the supervision of auditor-employed specialists, provides that:

- (1) The engagement partner and others who assist the engagement partner in supervising the audit should:
 - Inform engagement team members of their responsibilities;
 - Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities; and

²⁰ AS 2502, *Auditing Fair Value Measurements and Disclosures*, is being superseded in a separate PCAOB release. See *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2018-005 (Dec. 20, 2018) ("Estimates Release").

²¹ See footnote 2 of AS 2502.

- Review the work of engagement team members to evaluate whether:
 - The work was performed and documented;
 - The objectives of the procedures were achieved; and
 - The results of the work support the conclusions reached.²²

(2) The necessary extent of supervision depends on, for example, the nature of the work performed, the associated risks of material misstatement, and the knowledge, skill, and ability of those being supervised.²³

Existing Practice

The PCAOB's understanding of audit practice at both larger audit firms²⁴ and smaller audit firms²⁵ under existing PCAOB standards has been informed by, among other things, the collective experience of PCAOB staff, observations from oversight

²² See AS 1201.05.

²³ See AS 1201.06.

²⁴ Unless otherwise indicated, the term "larger audit firms" refers to U.S. audit firms that are registered with the PCAOB and issue audit reports for more than 100 issuers (and are therefore annually inspected by the PCAOB). This term also refers to non-U.S. audit firms that are registered with the PCAOB and affiliated with one of the six largest global networks, based on information on network affiliations reported by non-US. audit firms on Form 2 in 2017 and identified on the "Global Network" overview page, available on the Board's website.

²⁵ Unless otherwise indicated, the term "smaller audit firms" refers to PCAOB-registered audit firms that do not meet the definition of a "larger audit firm" as provided in footnote 24. These firms generally consist of firms that issued audit reports for 100 or fewer issuers and are not affiliated with any of the six largest global networks identified on the "Global Network" overview page, available on the Board's website.

activities of the Board, enforcement actions of the SEC, comments received on the Proposal, and discussions with the SAG, audit firms, and specialist entities.

These discussions have included outreach by the PCAOB staff to audit firms and specialist entities to obtain information on: (1) how auditors evaluate the competence and objectivity of auditor-engaged specialists and company specialists; (2) how auditors evaluate the work performed by an auditor-employed specialist, an auditor-engaged specialist, and a company's specialist; and (3) economic and demographic considerations relating to the market for services provided by specialists. The outreach has informed the PCAOB's understanding of existing practice at both larger and smaller audit firms. Most commenters who addressed the topic agreed that the Proposal accurately described existing audit practices regarding the use of the work of specialists. Commenters also generally supported the PCAOB's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements.

Overview of Existing Practice

When existing AS 1210 was originally issued in the early 1970s, the use of the work of specialists was largely confined to pension obligations, insurance reserves, and extractive industry reserves. Since then, the use of the work of specialists has increased in both frequency and significance.

Companies across many industries use the work of specialists to: (1) assist them in developing accounting estimates, including fair value measurements presented in the companies' financial statements; (2) interpret laws, regulations, and contracts; or (3) evaluate characteristics of physical assets, as shown in Figure 1 below. In those

circumstances, the reliability of a company's financial statements may depend in part on the quality of the work of a company's specialist.

Figure 1: Examples of Activities that Involve the Work of Specialists

Valuation

Assets acquired and liabilities assumed in business combinations

Environmental remediation contingencies

Goodwill impairments

Insurance reserves

Intangible assets

Pension and other post-employment obligations

Impairment of real estate or other long-term assets

Financial instruments

Legal interpretations

Legal title to property

Laws, regulations, or contracts

Evaluation of physical and other characteristics

Materials stored in stockpiles

Mineral reserves and condition

Oil and gas reserves

Property, plant, and equipment useful lives and salvage values

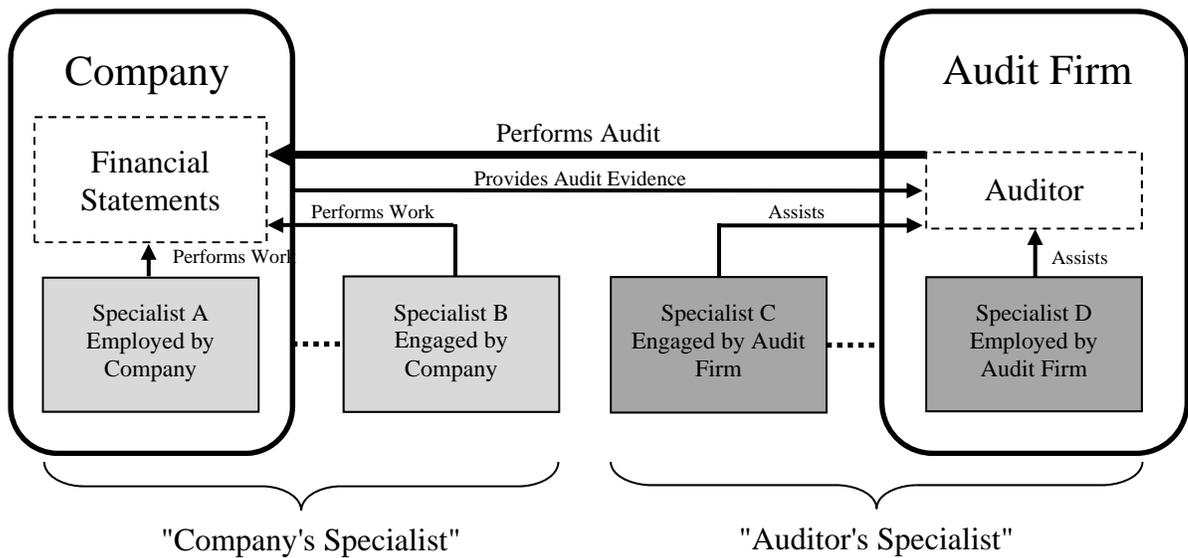
Auditors also increasingly use the work of specialists in their audits. Auditors

may:

- Use the work of a company's specialist—employed or engaged—as audit evidence; or
- Use the work of an auditor's specialist—employed or engaged—to assist the auditor in obtaining and evaluating audit evidence.

Figure 2 illustrates potential ways that auditors use specialists in an audit.

Figure 2: Potential Ways Auditors Use Specialists in an Audit



The company's specialist (A and B above) is employed or engaged by the company to perform work that the company uses in preparing its financial statements, which the auditor may use as audit evidence with respect to auditing significant accounts and disclosures. The auditor's specialist (C and D above) performs work to assist the auditor in obtaining and evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

The PCAOB understands that audit practices under existing PCAOB standards vary among smaller and larger audit firms when auditors use the work of a specialist in

an audit.²⁶ For example, smaller audit firms are more likely to use the work of a company's specialist than to employ or engage their own specialist. Larger audit firms generally require their engagement teams to evaluate the work of the company's specialist, including the specialist's methods and assumptions, and often employ specialists to assist their audit personnel in evaluating that work.²⁷ The following paragraphs discuss in more detail the practices of smaller firms and larger firms in audits of issuers, brokers, and dealers under existing PCAOB standards.

Smaller firm practices. Smaller firm practices generally are based on the required procedures in existing PCAOB standards, primarily existing AS 1210. Smaller firms typically evaluate the competence, relationships to the company, and work of the company's specialist through inquiries of the company's specialist. For example, smaller firms may send a company's specialist a questionnaire to obtain information regarding the specialist's professional qualifications and the existence of relationships with the company that could impair the specialist's objectivity. Further, smaller firms typically do not evaluate the appropriateness of a specialist's methods (it is not required by existing AS 1210), and any evaluation by smaller firms of the assumptions of a company's specialist is generally confined to circumstances when the specialist develops assumptions used in a fair value measurement covered by AS 2502.

²⁶ As discussed in section D, an analysis of inspection data by PCAOB staff suggests that larger audit firms generally use the work of specialists more often than smaller audit firms do.

²⁷ An analysis by PCAOB staff indicates that smaller firms predominantly use the work of an auditor's specialist in valuation areas, and seldom use the work of an auditor's specialist in other areas, whereas larger firms tend to use the work of an auditor's specialist in a wider range of audit areas, even though they also primarily use the work of specialists in valuation areas.

In circumstances when smaller firms engage an auditor's specialist, some firms perform the procedures specified in existing AS 1210. Other firms perform procedures similar to those in AS 1201 for supervising members of the engagement team. For example, some firms evaluate whether the auditor-engaged specialist's work supports the financial statement assertions, while other firms go further by also evaluating whether (1) the specialist's work was performed and documented, (2) the objectives of the specialist's procedures were achieved, and (3) the results of the specialist's work support the conclusions reached. One commenter noted that smaller firms may also use an auditor's specialist in evaluating the work of a company's specialist.

Larger firm practices. Some larger audit firms evaluate the methods and assumptions used by company specialists when they test the company's process for developing accounting estimates, even though this evaluation is currently required only for significant assumptions developed by the company's specialist in conjunction with fair value measurements and disclosures.²⁸ Many larger firms employ their own specialists, who serve on engagement teams and assist with the evaluation of the work of company specialists.

Auditor-employed specialists at larger firms are generally involved early in the audit, usually during planning meetings with other members of the engagement team. Also, in planning the audit, auditors generally reach an understanding with auditor-employed specialists, documented in a memorandum, regarding the scope of work to be performed and the respective responsibilities of the auditor and the specialist. The items covered in that memorandum typically include: (1) the nature, scope, and objectives of

²⁸ See footnote 2 of AS 2502.

the specialist's work;²⁹ (2) the role and responsibilities of the auditor and the specialist;³⁰ and (3) the nature, timing, and extent of communication between the auditor and the specialist.³¹ The auditor communicates with the specialist as the work progresses to become aware of issues as they arise. When the specialist completes his or her work, the auditor reviews the specialist's work, which is typically documented in a separate report or memorandum.

In some instances, larger firms may use the work of a company's specialist without involving an auditor's specialist, particularly when the risk of material misstatement is low or the firm does not employ a specialist with expertise in the particular field. Alternatively, although infrequently, larger firms may engage a specialist with expertise in the particular field. When larger firms engage specialists, some firms perform the procedures specified in existing AS 1210 described above. Other firms perform procedures in such situations that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

Observations from Audit Inspections and Enforcement Cases

The Board's understanding of audit practice under existing PCAOB standards has been informed in part by observations from PCAOB oversight activities and SEC

²⁹ Examples include whether the specialist is testing (or assisting in testing) the company's process for developing an accounting estimate or developing (or assisting in developing) an independent expectation of the estimate.

³⁰ For example, the documentation might identify the respective responsibilities of the auditor and the specialist for evaluating data, significant assumptions, and methods used by the company or the company's specialist.

³¹ Examples include administrative matters, such as the timing, budget, and other staffing-related issues relevant to the specialist's work, or the protocols for discussing and resolving findings or issues identified by the specialist.

enforcement actions, including (1) audit deficiencies of both larger and smaller firms, and related remedial actions to address the deficiencies and (2) enforcement actions where the work of a specialist was used in the audit.

Inspections observations. Over the past several years, the observations from PCAOB inspections have included instances in which the auditor used the work of a company's specialist without performing the procedures required by existing PCAOB standards.³² Recent findings include instances in which auditors did not: (1) evaluate the reasonableness of assumptions used by a company's specialist in developing fair value measurements; (2) obtain an understanding of methods or assumptions used by the company's specialist; (3) test the accuracy and completeness of company-provided data used by the company's specialist; or (4) evaluate the professional qualifications of the company's specialist.

Over the past several years, the observations from PCAOB inspections also have indicated that auditors, at times, did not fulfill their responsibilities under existing standards when using the work of an auditor's specialist. These findings were more common than those related to using the work of a company's specialist over the same period. The observations included instances in which auditors did not: (1) reach an understanding with the specialist regarding his or her responsibilities; (2) adequately evaluate the work performed by the specialist; or (3) consider contradictory evidence identified by the specialist or resolve discrepancies or other concerns that the specialist identified. More recently, PCAOB inspection staff have observed a decline in the number

³² See existing AS 1210 and AS 2502.

of instances by some firms in which auditors did not perform sufficient procedures related to the work of an auditor's specialist.

There are indications that some firms have undertaken remedial actions in response to the findings related to the auditor's use of the work of an auditor's specialist. In most cases, such actions included enhancements to firm methodologies to improve coordination between the auditor and the auditor's specialist through earlier and more frequent communications. These enhancements may have contributed, at least in part, to the decline in findings described above. Not all firms, however, have changed their methodologies, resulting in inconsistent practices in this area. In addition, unlike the findings related to the auditor's use of the work of an auditor's specialist, PCAOB inspections staff have not observed a similar change in the frequency of findings related to the auditor's use of the work of a company's specialist.

Enforcement actions. Both the SEC³³ and the PCAOB³⁴ have brought enforcement actions involving situations where auditors allegedly failed to comply with auditing standards when using the work of specialists. For example, such proceedings

³³ See, e.g., *KPMG LLP and John Riordan, CPA*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3888 (Aug. 15, 2017); *Miller Energy Resources, Inc., Paul W. Boyd, CPA, David M. Hall, and Carlton W. Vogt, III, CPA*, AAER No. 3673 (Aug. 6, 2015); *Troy F. Nilson, CPA*, SEC AAER No. 3264 (Apr. 8, 2011); and *Accounting Consultants, Inc., and Carol L. McAtee, CPA*, SEC AAER No. 2447 (June 27, 2006).

³⁴ See, e.g., *Tarvaran Askelson & Company, LLP, Eric Askelson, and Patrick Tarvaran*, PCAOB Release No. 105-2018-001 (Feb. 27, 2018); *Grant Thornton LLP*, PCAOB Release No. 105-2017-054 (Dec. 19, 2017); *KAP Purwantono, Sungkoro & Surja, Roy Iman Wirahardja, and James Randall Leali*, PCAOB Release No. 105-2017-002 (Feb. 9, 2017); *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045 (Dec. 5, 2016); *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007 (Apr. 1, 2015); and *Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA*, PCAOB Release No. 105-2011-003 (Apr. 8, 2011).

have involved allegations that auditors failed to (1) perform audit procedures to address the risks of material misstatements in a company's financial statements that were prepared in part based on the work of a company's specialist³⁵ or (2) comply with certain requirements of existing AS 1210 when using the work of a company's specialist (for example, requirements to evaluate the professional qualifications of the specialist, obtain an understanding of the methods and assumptions used by the specialist, evaluate the relationship of the specialist to the company, and apply additional procedures to address a material difference between the specialist's findings and the assertions in the financial statements).³⁶ Several of those proceedings were brought in recent years, suggesting that problems persist in this area.

Reasons to Improve Auditing Standards

The improvements to PCAOB standards are intended to direct auditors to devote more attention to the work of a company's specialist and enhance the coordination between an auditor and the auditor's specialist—employed or engaged. The final amendments also align with the Board's risk assessment standards and acknowledge more clearly the different roles of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. The Board believes that these improvements will enhance

³⁵ See, e.g., *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007.

³⁶ See, e.g., *Grant Thornton LLP*, PCAOB Release No. 105-2017-054; *KAP Purwantono, Sungkoro & Surja*, PCAOB Release No. 105-2017-002; *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045; *Chisholm, Bierwolf, Nilson & Morrill, LLC*, PCAOB Release No. 105-2011-003; and *Miller Energy Resources, Inc.*, SEC AAER No. 3673.

both audit quality and the credibility of the information provided in a company's financial statements.

Areas of Improvement

The Board has identified two important areas where improvements are warranted to existing standards, discussed below: (1) strengthening the requirements for evaluating the work of a company's specialist and (2) applying a risk-based supervisory approach to auditor-employed and auditor-engaged specialists.

Strengthening the requirements for evaluating the work of a company's specialist

Existing AS 1210 is the primary standard that applies when auditors use the work of an auditor-engaged specialist or a company's specialist. By its terms, existing AS 1210 applies when (1) a company engages or employs a specialist and the auditor uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions or (2) an auditor engages a specialist and uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions.

In practice, however, a company's specialist and an auditor-engaged specialist have fundamentally different roles: the company uses the work of a specialist in the preparation of its financial statements, whereas an auditor's specialist performs work to assist the auditor in obtaining and evaluating audit evidence. By imposing the same requirements for using the work of a company's specialist and an auditor-engaged specialist, existing AS 1210 does not clearly reflect the different roles of such specialists.

In addition, existing AS 1210 does not expressly require an auditor to evaluate the appropriateness of a company specialist's methods and assumptions.³⁷ Instead, it requires the auditor to obtain an understanding of the methods and assumptions used by the specialist, a less rigorous procedure. Existing AS 1210 also includes certain provisions that circumscribe the auditor's responsibilities related to the work of a specialist, including statements that: (1) the appropriateness and reasonableness of methods and assumptions used, and their application, are the responsibility of the specialist; (2) the auditor ordinarily would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.³⁸

When an auditor uses the work of a company's specialist, the requirements in existing AS 1210 allow the auditor to plan and perform audit procedures that may not be commensurate with the risk of material misstatement inherent in the work of the specialist, thereby allowing the auditor to use the work and conclusions of a company's specialist without performing procedures to evaluate that specialist's work. Some audit firms, primarily larger firms, go beyond the requirements in existing AS 1210 and generally require their engagement teams to evaluate the work of a company's specialist,

³⁷ The evaluation of the reasonableness of assumptions developed by a company's specialist is required only in circumstances when the specialist develops assumptions used in a fair value measurement in accordance with AS 2502. AS 2502 is being superseded in a separate PCAOB release. *See* Estimates Release, *supra* note 20.

³⁸ *See* existing AS 1210.12–.13.

including the specialist's methods and assumptions, and often employ specialists to assist their audit personnel in evaluating that work. Existing audit practices in this regard, however, vary among firms.

The foregoing factors indicate that improvements to PCAOB standards for using the work of a company's specialists are needed and that increasing auditors' attention to the work of a company's specialists with respect to significant accounts and disclosures will enhance investor protection. In the Board's view, investor protection will be enhanced by requiring auditors to do more than merely obtain an understanding of the methods and significant assumptions used by the specialist.

Applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists

The primary standard that applies when auditors use the work of an auditor-employed specialist in an audit is AS 1201. That standard establishes requirements regarding the auditor's supervision of the audit engagement, including supervision of a specialist employed by the auditor's firm who participates in the audit. While AS 1201 is risk-based and scalable, it does not specifically address how to apply its supervisory procedures to promote effective coordination between an auditor and a specialist and evaluation by the auditor of the work of an auditor-employed specialist.

The primary standard that applies when auditors use the work of an auditor-engaged specialist in an audit is existing AS 1210. The requirements in this standard differ from and are less rigorous than the requirements that apply when using auditor-employed specialists, even though auditor-employed and auditor-engaged specialists serve similar roles in helping auditors to obtain and evaluate audit evidence. For example, existing AS 1210 provides that the auditor should "obtain an understanding" of the nature

of the work performed by an auditor-engaged specialist, including the objectives and scope of the specialist's work, whereas AS 1201 requires the auditor to review the work of an auditor-employed specialist to "evaluate" whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached.

The PCAOB's observations regarding existing audit practices in this area also reveal differences in the application of the auditing standards regarding the use of the work of auditor-employed and auditor-engaged specialists. For example, in circumstances when audit firms engage specialists, some firms perform the procedures specified in existing AS 1210, while other firms perform procedures that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

These factors indicate that investor protection can be enhanced by improving PCAOB standards for applying a risk-based supervisory approach to auditor-employed specialists, and extending those requirements to auditor-engaged specialists. This should promote a more uniform approach to the supervision of an auditor's specialists, whether employed or engaged, reflecting their similar roles. Specifically, investor protection can be enhanced by supplementing the existing supervision requirements under PCAOB standards with more specific direction on applying those principles when supervising the work of auditor-employed and auditor-engaged specialists. This includes, among other things, additional direction on reaching an understanding with auditor-employed and auditor-engaged specialists on the work to be performed and on reviewing and evaluating their work.

Comments on the Reasons for Standard Setting

Many commenters on the Proposal broadly expressed support for revisions to the Board's standards for using the work of specialists or stated that the Proposal would lead to improvements in audit quality. For example, some commenters agreed with statements in the Proposal that the increasing use of specialists, due in part to the increasing use of fair value measurements in financial reporting frameworks and increasing complexity of business transactions, warranted strengthening existing requirements. A number of commenters also indicated that the requirements for using specialists should be risk-based and more closely aligned with the Board's risk assessment standards than existing standards. One of these commenters stated that the Board should be proactive in addressing issues relating to auditors' use of the work of specialists through standard setting as an alternative to devoting additional resources to inspections and enforcement based on existing standards.

In addition, a number of commenters generally agreed with developing separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. One commenter noted that separating these requirements could lead to better application in practice, especially among smaller CPA firms, while another commenter indicated that providing separate guidance for using the work of company specialists, auditor-employed specialists, and auditor-engaged specialists would be an improvement over existing standards. One commenter stated that inspections of audits involving the use of specialists had shown a need for improvement, and that the rationalization and enhancement of existing requirements would improve the efficiency and quality of audits.

A few commenters on the Proposal questioned the reasons for revisions to PCAOB auditing standards relating to the use of the work of specialists.³⁹ One commenter stated that the Proposal presented no clear evidence that audit deficiencies found by the PCAOB relating to the use of specialists resulted from deficiencies in the auditing standards. Another commenter stated that inspection findings did not necessarily warrant revisions to auditing standards and that it continued to question whether a fundamental change in audit standards was necessary. A third commenter stated that it did not believe that the case had been made for having separate standards for the use of auditor-employed and auditor-engaged specialists. Finally, a fourth commenter suggested that the Board should develop additional information on potential costs before proposing or adopting revisions to existing auditing standards, including through field testing of potential changes.⁴⁰

The SAG has discussed specialist-related issues at a number of meetings.⁴¹ Many SAG members expressed support for: (1) greater auditor responsibility for evaluating the work performed by a company's specialists; (2) similar responsibilities when auditors use the work of auditor-employed specialists and auditor-engaged specialists; and (3) better

³⁹ Some commenters provided comments or expressed concerns about specific aspects of the proposed revisions to the Board's existing standards for using the work of specialists. The Board's consideration of these comments is discussed further below.

⁴⁰ See below for a more detailed discussion of the final amendments and clarifications of certain aspects of the proposed amendments, as set forth in the Proposal.

⁴¹ See SAG meeting briefing papers and webcast archives (Nov. 29–30, 2017, Nov. 30–Dec. 1, 2016, Nov. 12–13, 2015, June 18, 2015, Oct. 14–15, 2009, and Feb. 9, 2006), available on the Board's website.

communication between auditors and their specialists, whether employed or engaged. Some SAG members, however, questioned the need for changes to the existing standards, asserting that auditors may not always have the necessary level of expertise to evaluate the work of certain specialists and, as a result, may need to rely on the work of specialists.

In adopting the final amendments, the Board has taken into account the comments received on the Proposal, as well as its other outreach activities. The information available to the Board—including the current regulatory baseline, observations from the Board's oversight activities, and substantial outreach—suggests that investors would benefit from strengthened and clarified standards for auditors in this area. The Board notes that aspects of the required procedures in the final amendments are similar to current auditing practices by some larger and smaller audit firms. While the Board does not expect that the final amendments will eliminate inspection deficiencies observed in practice, the final amendments are intended to clarify the auditor's responsibilities and align the requirements for using the work of specialists more closely with the Board's risk assessment standards. The final amendments also reflect a number of changes that were made after the Board's consideration of comments received on the Proposal about the potential impact of the proposed requirements on auditors, issuers, and specialists.⁴²

Overview of Final Rules

The final amendments: (1) add an appendix to AS 1105 with supplemental requirements for using the work of a company's specialist as audit evidence; (2) add an

⁴² See below for a more detailed discussion of changes reflected in the final amendments and section D for a more detailed discussion of economic considerations related to the adoption of the final amendments.

appendix to AS 1201 with supplemental requirements for supervising an auditor-employed specialist; and (3) replace existing AS 1210 with an updated standard for using the work of an auditor-engaged specialist. The key aspects of these amendments, which are intended to enhance the requirements in existing standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, are discussed in this section. The ways in which the final amendments address the need for change from an economic perspective are discussed in section D.

The final amendments have been informed by the Board's outreach activities. They are aligned with the Board's risk assessment standards, so that the necessary audit effort is commensurate with, among other things, the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and the associated risk. Many commenters on the Proposal supported aligning any new standards on using the work of specialists with any new standards related to auditing accounting estimates, including fair value measurements. The final amendments are aligned with the Estimates Release.

Figure 3 summarizes the auditor's responsibilities and primary PCAOB standards for using the work of specialists applicable before and after the effective date of the final amendments.

*Figure 3: Auditor Responsibilities and Primary Standards
for Using the Work of Specialists*

	<i>Nature of Specialist's Involvement</i>	<i>Before Effective Date of Final Amendments</i>	<i>After Effective Date of Final Amendments</i>
<i>Company's Specialist</i>	Specialist employed or engaged by the company	Auditor performs the procedures required by existing AS 1210	Auditor performs the procedures required by AS 1105 (including Appendix A), as amended
<i>Auditor's Specialist</i>	Auditor-engaged specialist		Auditor applies the supervisory procedures required by AS 1210, as amended
	Auditor-employed specialist	Auditor supervises the specialist under AS 1201	Auditor supervises the specialist under AS 1201 (including Appendix C), as amended

In brief, the final amendments make the following changes to PCAOB auditing standards:

- *Amend AS 1105.*
 - Add a new Appendix A⁴³ that supplements the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, related to:
 - Obtaining an understanding of the work and report(s), or equivalent communication, of the company's

⁴³ As proposed, these requirements would have been set forth as Appendix B to AS 1105.

specialist(s) and related company processes and controls;⁴⁴

- Obtaining an understanding of and assessing the knowledge, skill, and ability of a company's specialist and the entity that employs the specialist (if other than the company) and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
- Performing procedures to evaluate the work of a company's specialist, including evaluating: (i) the data, significant assumptions, and methods (which may include models) used by the specialist,⁴⁵ and (ii) the relevance and reliability of the specialist's work and its relationship to the relevant assertion;
- Align the requirements for using the work of a company's specialist with the risk assessment standards and the standard and related amendments adopted by the Board on auditing accounting estimates, including fair value measurements,⁴⁶ and

⁴⁴ See AS 1105.A2, as adopted. Additionally, as amended, AS 2110, *Identifying and Assessing Risks of Material Misstatement*, sets forth requirements for understanding company processes and controls related to the use of specialists.

⁴⁵ This evaluation is not explicitly required under the Board's existing standards, other than under AS 2502 with respect to the significant assumptions of a company's specialist regarding fair value measurements and disclosures.

⁴⁶ Certain provisions of the final amendments include references to a new

- Set forth factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.
- *Amend AS 1201.*
- Add a new Appendix C that supplements the requirements for applying the supervisory principles in AS 1201.05–.06 when using the work of an auditor-employed specialist to assist the auditor in obtaining or evaluating audit evidence, including requirements related to:
 - Informing the auditor-employed specialist of the work to be performed;
 - Coordinating the work of the auditor-employed specialists with the work of other engagement team members; and
 - Reviewing and evaluating whether the work of the auditor-employed specialist provides sufficient appropriate evidence. Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and whether the specialist's findings and

auditing standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* ("AS 2501, as adopted"), which has been adopted by the Board in a separate release. *See* Estimates Release, *supra* note 20.

conclusions are consistent with, among other things, the work performed by the specialist.

- Set forth factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.
- *Replace existing AS 1210.*
- Replace with AS 1210, as amended, *Using the Work of an Auditor-Engaged Specialist*, which establishes requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence;
- Include requirements for reaching an understanding with an auditor-engaged specialist on the work to be performed and reviewing and evaluating the specialist's work that parallel the final amendments to AS 1201 for auditor-employed specialists;
- Set forth factors for determining the necessary extent of review of the work of the auditor-engaged specialist;
- Amend requirements related to assessing the knowledge, skill, ability, and objectivity⁴⁷ of the auditor-engaged specialist; and
- Describe objectivity, for purposes of the standard, as the auditor-engaged specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit;

⁴⁷ Under the final amendments, the term "objectivity" is reserved for the auditor-engaged specialist and not used to describe the relationship to the company of a company's specialist or an auditor-employed specialist. *See* below for further discussion of objectivity.

and specify the auditor's obligations when the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity.

The Board has also adopted a single standard to replace its existing standards on auditing accounting estimates and fair value measurements and set forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.⁴⁸ Certain provisions of the final amendments in this notice include references to AS 2501, as adopted.

Most of those who commented on the proposed requirements regarding the use of the company's specialist expressed support for strengthening the requirements for evaluating the work of a company's specialist and aligning them with the Board's risk assessment standards. For example, one commenter stated that it agreed with statements in the Proposal that the proposed requirements may result in some auditors gaining a better understanding of a company's critical accounting estimates related to relevant financial statements and disclosures. Another commenter stated that the application of a risk-based approach to the testing and evaluation of the work of a company's specialist would reduce the risk of an auditor failing to sufficiently address the risks of material misstatement.

⁴⁸ As discussed in the Estimates Release, *supra* note 20, the Board is retitling and replacing existing AS 2501, *Auditing Accounting Estimates*, and superseding AS 2502 and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AS 2501, as adopted, also includes a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence.

A few commenters disagreed with the approach, or aspects of the approach, for evaluating the work of a company's specialist as described in the Proposal. One commenter asserted that additional clarification for using the work of a company's specialist was needed to address practicability issues and avoid unnecessary costs. Another commenter suggested that the amendments should place greater weight on the professional requirements and certifications for certain company specialists.

The Board recognizes that the auditor does not have the same expertise as a person trained or qualified to engage in the practice of another profession. At the same time, establishing a uniform, risk-based approach for using the work of a company's specialist more clearly acknowledges the different roles of a company's specialist and an auditor's specialist and builds upon improvements observed in the practices of certain firms. The final amendments also clarify aspects of the proposed amendments, including the procedures for evaluating the work of a company's specialist, so that the required procedures are both practical and risk-based, and reasonably designed to lead to improvements in audit quality.⁴⁹

Commenters on the proposed requirements for using an auditor's specialist generally agreed with a risk-based supervisory approach for both auditor-employed and auditor-engaged specialists. For example, one commenter agreed that this approach would promote an improved, more uniform approach to the supervision of an auditor's specialists. Consistent with the view of these commenters, the final amendments apply a

⁴⁹ See below for a more detailed discussion of the final amendments and clarifications regarding using the work of a company's specialist.

risk-based supervisory approach to both auditor-employed and auditor-engaged specialists, which should enhance investor protection.

The subsections that follow discuss in more detail the final amendments. The subsections also include a comparison of the final requirements with the analogous requirements of the following standards issued by the IAASB and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants:

IAASB Standards

- International Standard on Auditing 500, *Audit Evidence* ("ISA 500"); and
- International Standard on Auditing 620, *Using the Work of an Auditor's Expert* ("ISA 620").

ASB Standards

- AU-C Section 500, *Audit Evidence* ("AU-C Section 500"); and
- AU-C Section 620, *Using the Work of an Auditor's Specialist* ("AU-C Section 620").

The comparison included in these subsections may not represent the views of the IAASB or ASB regarding the interpretation of their standards. The information presented in the subsections does not cover the application and explanatory material in the IAASB standards or ASB standards.⁵⁰

⁵⁰ Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement" but "is relevant to the proper application of the requirements of an ISA." Paragraph .A64 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that, although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the

Scope of Final Amendments

The final amendments apply when an auditor uses the work of a "specialist." Thus, the scope of the requirements hinges largely on the meaning of the term "specialist." As described in the Proposal, the Board sought to carry forward the meaning of the term "specialist" from existing AS 1210, that is, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. The Board also sought to carry forward the concept from existing AS 1210 that income taxes and IT are specialized areas of accounting and auditing and thus are outside the scope of the final amendments.⁵¹ As discussed below, the final amendments retain, as proposed, the meaning of the term "specialist," including the concept regarding income taxes and IT.

Some commenters on the Proposal agreed with retaining the existing meaning of the term "specialist." Other commenters suggested that the Board extend the scope of the Proposal to include persons with specialized skill or knowledge in certain areas of income taxes and IT (e.g., unusual or complex tax matters, artificial intelligence, and blockchain). One of these commenters also asserted that income tax and IT professionals often support both audit and consulting practices and, as a practical matter, are treated as specialists by auditors. One commenter requested guidance for applying the proposed requirements when a legal specialist is involved, while another commenter suggested that the Board explain in the final amendments that an individual who specializes in complex taxation law would be a legal specialist.

requirements of an AU-C section."

⁵¹ See footnote 1 of existing AS 1210.

One commenter suggested eliminating the distinction between expertise "inside" or "outside" the field of accounting and auditing with respect to an auditor's specialist because, in its view, determining when fields of expertise are outside of accounting and auditing is becoming more difficult. Another commenter stated that, in practice, it can be less than straightforward to differentiate between expertise in auditing and accounting and other areas. Other commenters, however, asserted that the Board should retain the concept in existing AS 1210 that an auditor is not expected to have the expertise of a person trained or qualified to engage in the practice of another profession or occupation.

As used today, the term "specialist" is generally understood by auditors, and observations from PCAOB oversight activities do not indicate that there is significant confusion over the meaning of the terms "specialist" and "specialized area of accounting and auditing," as they have been used in the standards. After considering the comments received on the Proposal, however, the final amendments retain the meaning of the term "specialist" as proposed, with certain clarifications discussed below.

Specifically, the Board included a note to clarify when the final amendments apply to the work of an attorney used by the company.⁵² As under existing AS 1210, specialists under the final amendments include attorneys engaged by a company as specialists, such as attorneys engaged by the company to interpret contractual terms or provide a legal opinion. The final amendments apply when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure

⁵² See second note to AS 1105.A1, as adopted.

under the applicable financial reporting framework. The final amendments also clarify that the scope of these amendments does not apply to information provided by a company's attorney concerning litigation, claims, or assessments that is used by the auditor pursuant to AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Consistent with existing AS 1210, income taxes and IT are outside the scope of the final amendments because they are specialized areas of accounting and auditing. For example, while specialized areas of income tax law involve legal specialists, accounting for income taxes remains an area of accounting and auditing. The Board added a footnote to Appendix A of AS 1105 that references AS 2505.08, as amended.⁵³ A note to AS 2505.08, as amended, clarifies the auditor's responsibility regarding the use of the written advice or opinion of a company's tax advisor or a company's tax legal counsel as audit evidence.⁵⁴ Also, to the extent that IT is used in information systems, auditors will still need to maintain sufficient technical knowledge to identify and assess risks and design procedures to respond to those risks and evaluate the audit evidence obtained. Accordingly, the Board does not believe that the need exists at this time to change the approach reflected in existing AS 1210 and designate particular areas of either income taxes or IT as outside the field of "accounting and auditing."

Comparison with Standards of Other Standard Setters

ISA 620 uses the terms "auditor's expert" and "management's expert" in a manner analogous to the term "specialist" in the final amendments. ISA 620, however, does not

⁵³ See footnote 1 to AS 1105.A1, as adopted.

⁵⁴ See note to AS 2505.08, as amended.

address whether IT is a specialized field outside of accounting and auditing. The term "management's expert" is also defined in ISA 500.

AU-C Section 620 and AU-C Section 500 use the word "specialist" instead of "expert."

Amendments Related to Using the Work of a Company's Specialist

The final amendments set forth requirements for using the work of a company's specialist as audit evidence. The amendments, which supplement the existing requirements of AS 1105, include:

- Obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls;
- Obtaining an understanding of and assessing the knowledge, skill, and ability of the specialist and the entity that employs the specialist (if other than the company), and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
- Performing procedures to evaluate the work of a company's specialist, including evaluating: (1) the data, significant assumptions, and methods (which may include models) used by the specialist; and (2) the relevance and reliability of the specialist's work and its relationship to the relevant assertion.⁵⁵

⁵⁵ Key principles from Auditing Interpretation AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, and Auditing Interpretation AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*, related to the auditor's use of the work of a company's attorney and the use of written tax advice or

Commenters on the Proposal generally supported a risk-based approach for using the work of a company's specialist, as set forth in the proposed amendments. Many commenters also stated that there was a need to establish a separate standard for using the work of a company's specialist. However, a number of commenters questioned various aspects of the amendments, including the need for revisions to existing AS 1210 relating to the use of the work of a company's specialist. Additionally, some commenters requested clarifications or suggested changes to the proposed requirements. These and other comments are discussed below. A number of these comments resulted in revisions and clarifications to the final amendments.

Obtaining an Understanding of the Work of the Company's Specialist

See AS 1105.A2, as adopted, and AS 2110.28A, as adopted

The proposed amendments to AS 1105 provided that obtaining an understanding of the company's information system relevant to financial reporting would encompass obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls.⁵⁶

Some commenters supported the proposed requirement because, in their view, an understanding of the company's processes for using the work of company specialists is integral to the auditor's understanding of the information system relevant to financial reporting. Two commenters asserted that such controls are important for the auditor to consider when evaluating the work of a company's specialist and determining the

opinions as audit evidence have been incorporated in AS 1105.A1, as adopted, and a note added to AS 2505.08, as amended.

⁵⁶ See proposed AS 1105.B2.

necessary audit procedures. One commenter expressed concern that the proposed requirement was too broad and suggested that the auditor's understanding should instead be part of the evaluation of the specialist's objectivity. In addition, two commenters questioned whether the Board intended to require the auditor to evaluate the design of controls over the use of company specialists, even if the auditor was not performing an audit of internal control over financial reporting or planning to rely on controls for the related assertions. These commenters and others suggested that placing the proposed requirement for obtaining an understanding of the specialist's work in AS 2110 would better link the requirement to the auditor's risk assessment procedures, thereby reducing the likelihood that auditors would consider only the factors in proposed AS 1105.B2 and fail to consider other relevant factors set forth in AS 2110.

The Board considered these comments and is adopting the requirement substantially as proposed, but relocating the requirement to AS 2110 as suggested by certain commenters.⁵⁷ The procedure builds upon a requirement in existing AS 1210 that the auditor obtain an understanding of the nature of the work performed or to be performed by a specialist,⁵⁸ but is more closely aligned with the required risk assessment procedures in AS 2110. The required procedure is important because it informs the auditor's evaluation of the work of the company's specialist, and not merely the assessment of the specialist's objectivity.

Placing the requirement for obtaining an understanding of the specialist's work and report(s), or equivalent communication, in AS 2110, and framing the required

⁵⁷ Specifically, the requirements are located in AS 2110.28A, as adopted.

⁵⁸ See existing AS 1210.09.

procedure as a risk assessment procedure, provides better direction regarding the necessary audit effort for the procedure. The necessary audit effort for performing this procedure is governed primarily by the general requirements in AS 2110 for obtaining a sufficient understanding of the company's internal control over financial reporting.⁵⁹ This includes consideration of whether the auditor plans to use the specialist's work as audit evidence.

While the requirement, as adopted, likely will not represent a major change in practice, particularly for those firms whose practices already go beyond existing PCAOB standards, it should prompt auditors to appropriately consider the interaction of the specialist's work and the company's related processes and controls. For example, under the final amendments, the auditor should obtain an understanding of controls for using the work of specialists that are relevant to the audit, including evaluating the design of those controls and determining whether those controls have been implemented.⁶⁰

Comparison with Standards of Other Standard Setters

⁵⁹ See AS 2110.18, which provides that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to: (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design further audit procedures. See also AS 2110.19, which further provides that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting. In addition, AS 2110.20 provides that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

⁶⁰ AS 2110.34 provides additional direction for determining controls relevant to the audit.

The requirements in ISA 500 and AU-C 500 have some commonality with the requirements in the final amendments. Paragraph 8(b) of ISA 500 states that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, obtain an understanding of the work of that expert.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

See AS 1105.A3–A5, as adopted

The final amendments set forth requirements similar to existing AS 1210 for evaluating the knowledge, skill, and ability of the specialist and the relationship of the specialist to the company.⁶¹

Knowledge, Skill, and Ability

The Proposal set forth a requirement similar to that in existing AS 1210 for evaluating the professional qualifications of the specialist and generally provided the same factors for the auditor's assessment of the specialist's knowledge, skill, and ability.⁶²

⁶¹ Existing AS 1210.08 and AS 1210.10–.11 require the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

⁶² Existing AS 1210.08 provides that the auditor should consider certain information in evaluating the professional qualifications of the specialist to determine that the specialist possesses the necessary skill or knowledge in the particular field. The information to be considered in that evaluation is: (1) the professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate; (2) the reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance; and (3) the specialist's experience in the type of work under consideration.

The Proposal differed from existing AS 1210, however, in certain respects. First, the Proposal extended the required understanding to expressly include the entity that employs the specialist, if the specialist is not employed by the company. Second, the Proposal expressly referred to the specialist's "level" of knowledge, skill, and ability. As with the auditor's assessment of competence under AS 2605, *Consideration of the Internal Audit Function*, this approach recognized that specialists may possess varying degrees of knowledge, skill, and ability. Third, the Proposal provided that the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist would depend on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. Under this approach, the persuasiveness of the evidence the auditor would need to obtain increases as the significance of the specialist's work to the auditor's conclusion or the risk of material misstatement of the relevant assertion increases.⁶³

The Board is adopting the requirement for evaluating the professional qualifications of the specialist as proposed. Most commenters on this aspect of the Proposal acknowledged the need for the auditor to obtain an understanding of and assess the knowledge, skill, and ability of a company's specialist. One commenter asserted that the proposed requirement was not well-suited to assessing the qualifications of the entity that employs the specialist. The Board considered this comment and notes that the final requirement retains the concept in existing AS 1210 that a specialist may be an individual or an entity. Accordingly, auditors should be familiar with assessing the qualifications of

⁶³ Illustrative examples on the application of these factors when testing and evaluating the work of a company's specialist appear in the discussion on determining the necessary audit effort under AS 1105.A7, as provided below.

entities that are specialists or employ specialists. Furthermore, a strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, an employer with a poor reputation or little expertise in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted.

Some commenters asked for more direction on how to obtain an understanding of the professional qualifications of the company's specialist and the entity that employs the specialist (for example, by including in the rule text the discussion from the proposing release of potential sources of information about a specialist's qualifications). One of these commenters asserted that there are practical limits on obtaining evidence related to a company-engaged specialist's competence.

The Board considered these comments, but notes that the final requirement is similar to a requirement in existing AS 1210. Outreach to audit firms suggests that firms have policies and procedures for evaluating the qualifications of specialists, whether individuals or entities. Auditors should therefore be familiar with the process of assessing the knowledge, skill, and ability of entities that employ specialists.

As with existing AS 1210, the final amendments do not set forth specific steps to perform in assessing the specialist's knowledge, skill, and ability. It is not practicable to provide detailed direction in this area because of the variety of types of specialists that may be encountered. Examples of potential sources of information that, if available, could be relevant to the auditor's evaluation include:

- Information contained within the audit firm related to the professional qualifications and reputation of the specialist or the entity that employs the

specialist (if other than the company) in the relevant field and experience with previous work of the specialist;

- Professional or industry associations and organizations, which may provide information regarding: (1) qualification requirements, technical performance standards, and continuing professional education requirements that govern their members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against, the specialist;
- Discussions with the specialist, through the company, about matters such as the specialist's understanding of the financial reporting framework, the specialist's experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- Information obtained as part of audit planning, when obtaining an understanding of the company's processes and identifying controls for testing;
- Information included in the specialist's report about the specialist's professional qualifications (e.g., a biography or resume);
- Responses to questionnaires provided to the specialist regarding the specialist's professional credentials; and
- Published books or papers written by the specialist.

Requirements applicable to a specialist pursuant to legislation or regulation also could help inform the auditor's assessment of the specialist's knowledge, skill, and ability.

Some of the examples listed above may provide more persuasive evidence than others.⁶⁴ For example, relevant information from a source not affiliated with the company or specialist, the auditor's experience with previous work of the specialist, or multiple sources generally would provide more persuasive evidence than evidence from the specialist's uncorroborated representations about his or her professional credentials. Additionally, the reliability (and thus persuasiveness) of information about the specialist's credentials and experience increases when the company has effective controls over that information, e.g., in conjunction with controls over the selection of qualified specialists.

Some commenters asked for clarification as to how the company's controls and processes for using the work of a company's specialist should be considered when performing the assessment of knowledge, skill, and ability. As discussed earlier, the interaction of the specialist's work and the company's processes should be considered by the auditor in assessing and responding to risk in the related accounts and disclosures, especially when the specialist's work is significant to the auditor's conclusion regarding the relevant assertion and the accounts or disclosures have higher risk. Therefore, the company's controls and processes are considered in identifying and appropriately assessing the risks of material misstatement of the relevant assertion, which is one of the two factors that the auditor considers under AS 1105.A5, as adopted, in determining the necessary evidence for assessing the specialist's level of knowledge, skill, and ability.

Relationship to the Company

⁶⁴ As previously discussed, the risk of material misstatement of the relevant assertion and the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion affect the persuasiveness of the evidence needed with respect to the knowledge, skill, and ability of the company's specialist.

The Proposal provided that the auditor would assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise). The proposed requirement was similar to existing AS 1210.10, but expanded the list of matters that the auditor should consider to include financial and business relationships with the company.

The Board is adopting this requirement substantially as proposed, with the addition of a note that sets forth examples of potential sources of information that could be relevant to the auditor's assessment.

Some commenters supported the proposed requirement for the auditor to assess the specialist's relationship to the company and stated that it was appropriate. Two commenters, however, asserted that there could be practical challenges to assessing the relationship to the company of the entity that employs the specialist (e.g., if the entity that employs the specialist lacks systems to track such relationships or the auditor does not have access to those systems). The Board considered these comments, but notes that existing AS 1210 already requires an evaluation of the relationship of the specialist, whether an individual or an entity, to the client. Outreach to audit firms suggests that firms have policies and procedures for evaluating the objectivity of specialists, whether individuals or entities. Therefore, auditors should be familiar with assessing the qualifications of entities that are specialists or employ specialists.

Other commenters asked for additional direction regarding the necessary effort to obtain information regarding the specialist's relationship to the company. One commenter also emphasized the importance of considering ethical and performance requirements promulgated by a specialist's profession or by legislation or regulation governing the specialist. The final amendments do not prescribe specific steps to perform in assessing the specialist's relationship to the company, because additional specificity would make the requirements unnecessarily prescriptive. The Board has added a note to the final requirement, however, that includes non-exclusive examples of potential sources of information that could be relevant to the auditor's assessment of the relationship to the company of both the specialist and the specialist's employer (if other than the company).⁶⁵ These examples include disclosures by the specialist about relationships with the company in the specialist's report, or equivalent communication, pursuant to requirements promulgated by the specialist's profession or by legislation governing the specialist.⁶⁶ As with the auditor's assessment of a specialist's knowledge, skill, and ability, certain sources of information may provide more persuasive evidence than others. In situations where more persuasive evidence is required under these requirements, it may be appropriate to perform procedures to obtain evidence from multiple sources.

⁶⁵ See note to AS 1105.A4, as adopted. These examples were based on examples set forth in the Proposal, but have been refined to better reflect their application in practice.

⁶⁶ While the Proposal had suggested that information regarding such requirements could be relevant to the auditor's evaluation of the specialist's relationships to the company, disclosures about relationships pursuant to such requirements are more relevant to the auditor's assessment than merely information about the legal or professional requirements.

Some commenters also expressed a preference for retaining the term "objectivity" with respect to a company's specialist and further acknowledging that objectivity may exist along a spectrum. Similar to the Proposal, the final amendments reserve the term "objectivity" for specialists engaged by the auditor to assist in obtaining and evaluating audit evidence. The work of a company's specialist is different in nature from the work of an auditor's specialist, since a company's specialist performs work that the company frequently uses as source material for one or more financial statement accounts or disclosures, including accounting estimates. With respect to the existence of objectivity along a spectrum, the final amendments recognize that a company's ability to significantly affect a specialist's judgment may vary and, as discussed below, provide a spectrum for evaluating the company's ability to significantly affect the specialist's judgments.

As was proposed, the final amendments provide that, if the auditor identifies relationships between the company and the specialist (or the specialist's employer, if other than the company), the auditor has a responsibility to assess whether the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings.⁶⁷ Examples of the types of circumstances that might give the company the ability to affect the specialist's judgments include, but are not limited to:

- The reporting relationship of a company-employed specialist within the company;

⁶⁷ See AS 1105.A4, as adopted.

- Compensation of a company's specialist based, in part, on the outcome of the work performed;
- Relationships a company-engaged specialist has with entities acting as an agent of the company;
- Personal relationships, including family relationships, between the company's specialist and others within company management;
- Financial interests, including stock holdings, company specialists have in the company; and
- Ownership, business relationships, or other financial interests the employer of a company-engaged specialist has with respect to the company.

The auditor's assessment that the company has the ability to influence the specialist, however, does not preclude the auditor from using the work of a company's specialist, whether employed or engaged, as audit evidence. Rather, consistent with existing AS 1210, it is a factor in determining the necessary audit effort to evaluate that specialist's work.⁶⁸ In general, the necessary audit effort increases as the company's ability to affect the specialist's judgments increases.

Determining the Necessary Evidence

The Proposal differed from existing AS 1210 in that it set forth scalable requirements for determining the necessary evidence for evaluating both the knowledge,

⁶⁸ See AS 1105.A7–.A10, as adopted. Examples that illustrate how relationships between the company and the company's specialist can affect the necessary audit effort in evaluating the work of a company's specialist under the final amendments appear in the discussion on determining the necessary evidence, as provided below.

skill, and ability of the specialist and the relationship of the specialist to the company.

The Board is adopting these requirements as proposed. Under the final amendments, the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.⁶⁹

No commenters opposed the proposed framework for determining the necessary evidence. A number of commenters, however, asked for clarification on the application of the requirement when performing the relevant evaluations. The Board's analysis of these comments is discussed above in connection with the required evaluations of the specialist's knowledge, skill, and ability, and the relationship of the specialist to the company.

Comparison with Standards of Other Standard Setters

Paragraph 8(a) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the competence, capabilities, and objectivity of that expert.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

Evaluating the Work of the Company's Specialist

See AS 1105.A6-.A10, as adopted

⁶⁹ See AS 1105.A5, as adopted.

In general, a specialist's work involves using data, assumptions, and methods. The auditor's responsibilities under existing AS 1210 with respect to the data, assumptions, and methods used by the specialist are limited to (a) obtaining an understanding of the methods and assumptions used by the specialist and (b) making appropriate tests of data provided to the specialist.⁷⁰ In addition, the auditor should evaluate whether the specialist's findings support the related assertions in the financial statements.⁷¹ Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead the auditor to believe the findings are unreasonable in the circumstances.⁷² If the auditor believes the specialist's findings are unreasonable, he or she is required to apply additional procedures, which may include potentially obtaining the opinion of another specialist.⁷³ Notably, before the final amendments, PCAOB standards have not expressly addressed how to determine the necessary audit effort to be applied in performing those procedures.

The Proposal sought to enhance the requirements for testing and evaluating the work of the company's specialist by:

⁷⁰ For fair value measurements, however, another standard requires the auditor to evaluate the reasonableness of significant assumptions of the specialist. *See* footnote 2 of AS 2502. This standard is being superseded in the Estimates Release, *supra* note 20.

⁷¹ *See* existing AS 1210.12.

⁷² *Id.*

⁷³ *Id.*

- Extending the auditor's responsibilities for evaluating the specialist's assumptions to include all significant assumptions used by the specialist (not just those used in fair value measurements);
- Expanding the auditor's responsibilities with respect to data to include evaluating external data used by the specialist (not just data provided by the company to the specialist);
- Adding a requirement for the auditor to evaluate the appropriateness of the methods used by the specialist, including whether the data was appropriately applied;
- Setting forth a requirement for the auditor to comply with the Board's proposed estimates standard⁷⁴ when the auditor tests management's process for developing an estimate and a company's specialist was used; and
- Providing direction for determining the necessary audit effort for testing and evaluating the specialist's work, based on the risk of material misstatement and other factors set forth in the standard.

Commenters expressed mixed views on the premise underlying the Proposal that the auditor should test and evaluate the work of a company's specialist. While a number of commenters supported that premise, other commenters opposed expanding the auditor's responsibilities with respect to the specialist's methods and assumptions beyond

⁷⁴ See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017).

existing AS 1210. Some of these commenters expressed concerns that the auditor may not be qualified to evaluate the work of a specialist and recommended retaining the more limited audit approach reflected in existing AS 1210, including the statement that "the auditor is not expected to have the expertise of a person trained for or qualified to engage in practice of another profession or occupation."

A number of commenters also addressed specific aspects of the proposed requirements for testing and evaluating the work of company specialists. Some commenters questioned the proposal's general use of the term "test" in describing the auditor's responsibilities, as well as the proposed requirement to also comply with the proposed estimates standard in circumstances where the auditor tests management's process for developing an estimate and a company's specialist was also used. Those commenters asserted that the expected audit effort was unclear. Two commenters stated that the proposed requirements in this area could be interpreted as requiring reperformance of the specialist's work, which one of these commenters asserted would be beyond the expertise of most auditors and thus require auditors to use an auditor's specialist.

In addition, some commenters requested clarification on the expectations for evaluating a specialist's models, especially in situations where auditors are unable to gain access to proprietary models used by company-engaged specialists. Some commenters also expressed concern about the proposed requirement to evaluate whether data was appropriately used by the specialist. Some of these commenters asserted that this requirement appeared to require auditors to reperform the specialist's work and suggested clarifying or eliminating that requirement. Additionally, some commenters suggested

allowing auditors to rely on the issuer's controls over the use of specialists in determining the necessary procedures for evaluating the specialist's work.

A number of commenters acknowledged that the proposed requirements were intended to be scalable. However, some commenters questioned whether they would be scalable in practice. Other commenters asked for guidance on tailoring audit procedures based on risk and the other factors set forth in the Proposal, especially procedures under the proposed requirement to also comply with the proposed estimates standard. Also, some commenters asserted that the requirements did not adequately distinguish the audit effort based on whether the specialist was engaged or employed by the company.

After considering the comments on the Proposal, the Board is retaining the fundamental approach in the Proposal – under which the auditor evaluates the data, significant assumptions, and methods used by the specialist. This approach is intended to increase audit attention on the work of a company's specialist, particularly when that work is significant in areas of higher risk, to increase the likelihood that the auditor would detect material financial statement misstatements related to that work.

Taking into account comments on specific aspects of the proposed requirements, however, the final amendments reflect a number of clarifying revisions to eliminate or revise certain proposed requirements that may have been perceived by commenters as unnecessarily complex or prescriptive. The revisions address concerns expressed by certain commenters, while preserving the intended benefits of the final amendments, and include:

- Removing the word "test" from the requirements to evaluate the work of the company's specialist, except in relation to company-produced data; and
- Reframing the requirements for evaluating the data, significant assumptions, and methods used by the specialist to describe the key considerations in making those evaluations.

In addition, the final amendments clarify the applicability of the requirements in circumstances when the company's specialist is involved in developing an accounting estimate, such as developing assumptions and methods used in an accounting estimate. In such circumstances, the requirements in Appendix A of AS 1105 apply to evaluating the data, significant assumptions⁷⁵, and methods developed (or generated) by the specialist, or sourced by the specialist from outside the company, as well as to testing company-produced data. In contrast, for significant assumptions provided by management to the specialist, the auditor is required to look to the requirements in AS 2501, as adopted. The final amendments are discussed in more detail below.

Evaluating the Specialist's Work: Data, Significant Assumptions, and Methods

See AS 1105.A6 and .A8, as adopted

The revisions reflected in the final amendments clarify the auditor's responsibilities for evaluating the work of a company's specialist, and are intended to avoid potential confusion that the auditor is required to reperform the work of the

⁷⁵ A footnote to AS 1105.A8, as adopted, refers the auditor to AS 2501.15, as adopted, for the procedures to perform when identifying significant assumptions. For purposes of identifying significant assumptions, the company's assumptions include assumptions developed by the company's specialist.

company's specialist. Among other things, the revised requirements reserve the use of the term "test" for procedures applied to company-produced information used by the specialist, consistent with its usage in AS 2501, as adopted.⁷⁶

Notably, instead of requiring the auditor to comply with AS 2501, as adopted, the auditor would be required to apply a set of analogous procedures for evaluating data, significant assumptions, and methods that are tailored to situations in which specialists are used.⁷⁷ For example, under the final amendments, the auditor's responsibilities with respect to data, significant assumptions, and methods used by the specialist generally are:

- *Company-produced data*: Test the accuracy and completeness of company-produced data used by the specialist (*see* AS 1105.A8a, as adopted);⁷⁸
- *Data from sources external to the company*: Evaluate the relevance and reliability of the data from sources external to the company that are used by the specialist (*see* AS 1105.A8a, as adopted);
- *Significant assumptions*: Evaluate whether the significant assumptions used by the specialist are reasonable:
 - (1) *Assumptions developed by the specialist*: taking into account the consistency of those assumptions with relevant information (*see* AS 1105.A8b(1), as adopted);

⁷⁶ *See* Estimates Release, *supra* note 20.

⁷⁷ A note to AS 1105.A6, as adopted, emphasizes that paragraphs .16–.17 of AS 2101 describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed. This includes determining whether an auditor's specialist is needed to evaluate the work of a company's specialist.

⁷⁸ *See also* AS 1105.10 for procedures when the auditor uses information produced by the company as audit evidence.

- (2) *Assumptions provided by company management and used by the specialist*: looking to the requirements set forth in AS 2501.16–.18, as adopted (*see* AS 1105.A8b(2), as adopted);
 - (3) *Assumptions based on the company's intent and ability to carry out a particular course of action*: looking to the requirements set forth in AS 2501.17, as adopted (*see* AS 1105.A8b(3), as adopted); and
- *Methods*: Evaluate whether the methods used by the specialist are appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework (*see* AS 1105.A8c, as adopted).

Under the final amendments, the focus of the auditor's evaluation of the work of the company's specialist does not require reperforming the specialist's work or evaluating whether the work complies with all technical aspects in the specialist's field. Instead, the auditor's responsibility is to evaluate whether the specialist's work provides sufficient appropriate evidence to support a conclusion regarding whether the corresponding accounts or disclosures in the financial statements are in conformity with the applicable financial reporting framework.

With respect to the specialist's methods, the auditor's responsibilities under PCAOB standards have historically been to understand the method used. The final amendments extend that obligation to encompass evaluating whether the method is appropriate under the circumstances, taking into account the requirements of the

applicable financial reporting framework.⁷⁹ In many cases, evaluating a method's conformity with the applicable financial reporting requirements is the same as evaluating its appropriateness under the circumstances (e.g., if the applicable accounting standard requires a particular method for determining the estimate). However, if the applicable financial reporting framework allows more than one method, or if the appropriate method under the framework depends on the circumstances, evaluating conformity with the framework involves consideration of other relevant factors, such as, the nature of the estimate and the auditor's understanding of the company and its environment.

A note to the final amendments also clarifies that evaluating the specialist's methods includes assessing whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework.⁸⁰ Evaluating the application of the data encompasses, for example, whether the data is selected and adjusted in conformity with the requirements of the applicable financial reporting framework. Similarly, evaluating the application of significant assumptions encompasses evaluating whether the assumptions were selected in conformity with the requirements of the applicable financial reporting framework.

The final amendments do not require the auditor to obtain access to proprietary models used by the specialist. Rather, the auditor's responsibility is to obtain information to assess whether the model is in conformity with the applicable financial reporting framework. Depending on the model and the factors set forth in AS 1105.A7, as adopted, this might involve, for example, obtaining an understanding of the model, reviewing

⁷⁹ See AS 1105.A8c, as adopted.

⁸⁰ See note to AS 1105.A8c, as adopted.

descriptions of the model in the specialist's report or equivalent communication, testing controls over the company's evaluation of the specialist's work, or assessing the inputs to and output from the model (if necessary, using an alternative model for comparison).

With respect to the specialist's significant assumptions, auditors have historically had an obligation under PCAOB standards to understand the assumptions⁸¹ and, for fair value measurements, to evaluate the reasonableness of the assumptions.⁸² The final amendments extend the auditor's obligation to include evaluating the reasonableness of significant assumptions used by the specialist. This involves comparing the assumptions to relevant information. The note accompanying AS 1105.A8b(1), as adopted, provides examples of information that, if relevant, should be taken into account: (1) assumptions generally accepted within the specialist's field; (2) supporting information provided by the specialist; (3) industry, regulatory, and other external factors, including economic conditions; (4) the company's objectives, strategies, and related business risks; (5) existing market information; (6) historical or recent experience, along with changes in conditions and events affecting the company; and (7) significant assumptions used in other estimates tested in the company's financial statements. These examples—including examples (1) and (2), which were suggested by commenters—point to information that generally would be available to the auditor (e.g., through other procedures performed on the audit or the auditor's knowledge or the company and its industry).

Furthermore, the final amendments provide that, if a significant assumption is provided by company management and used by the specialist, the auditor should look to

⁸¹ See existing AS 1210.09.

⁸² See footnote 2 of AS 2502.

the requirements in AS 2501.16–.18, as adopted. The final amendments also provide that, if a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should look to the requirements set forth in AS 2501.17, as adopted. This applies regardless of whether the significant assumption was developed by the company or the company's specialist.

Determining the Necessary Audit Effort for Evaluating the Specialist's Work

See AS 1105.A7, as adopted

Similar to the Proposal, the final amendments set forth four factors that affect the necessary evidence from the auditor's evaluation of the specialist's work to support a conclusion regarding a relevant assertion. Specifically, under the final amendments, the necessary evidence depends on the: (1) significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) risk of material misstatement of the relevant assertion; (3) level of knowledge, skill, and ability of the specialist;⁸³ and (4) the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Some commenters asked for additional clarification or direction on how to apply the four factors to determine the necessary audit effort for evaluating the specialist's work. One commenter requested that the Board elaborate upon certain terms (e.g., terms "extensively" and "less extensive procedures") that were used in two of the three examples that were included in the Proposal to illustrate how certain factors could affect the necessary audit effort in evaluating the work of a company's specialist. Another

⁸³ As noted previously, this factor includes consideration of professional requirements the specialist is required to follow.

commenter requested that the Board provide additional examples of less complex scenarios.

In addition, some commenters asserted that the Proposal did not adequately account for differences between company-employed and company-engaged specialists. These commenters stated that the nature and extent of an auditor's procedures with respect to the work of a company-engaged specialist with the necessary knowledge, skill, and objectivity should not necessarily be the same as those for the work of a company-employed specialist. One commenter suggested expressly including in the list of factors performance standards that the specialist is required to follow.

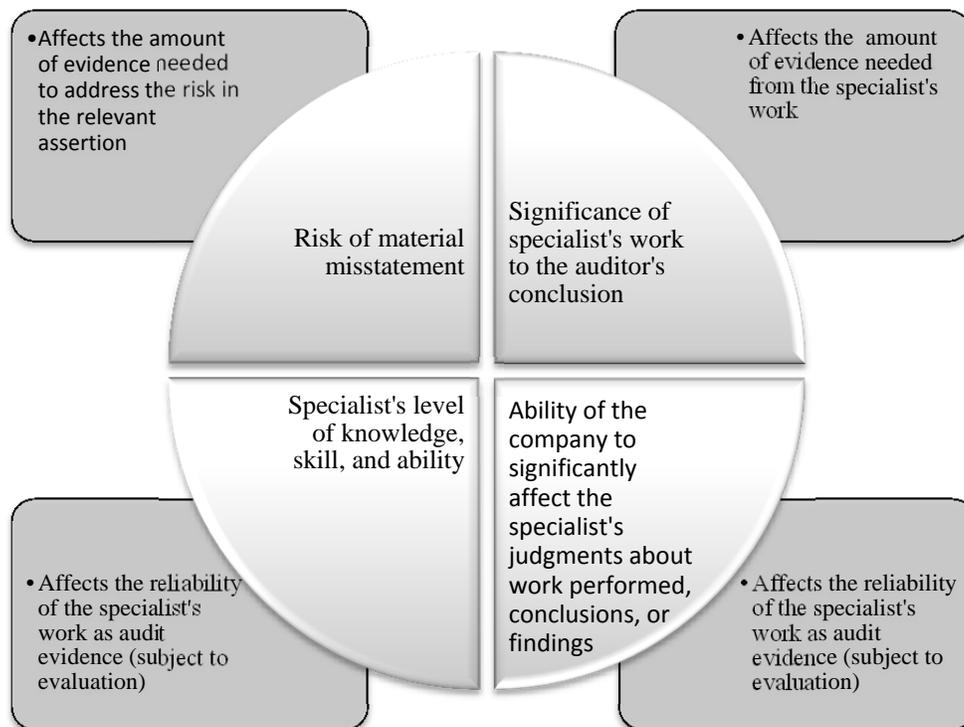
The requirements regarding determining the necessary audit effort for evaluating the specialist's work were adopted substantially as proposed. The changes to the procedural requirements for evaluating the data, significant assumptions, and methods used by the specialist should help address concerns about the necessary level of effort under the appendix. Also, the three examples included in the Proposal have been revised to align with the final amendments and expanded to address factors that lead to more or less audit attention and illustrate how the additional attention may be directed under the circumstances.

With respect to the distinction between company-employed and company-engaged specialists, the Board believes that the final amendments provide an appropriate framework for distinguishing the work effort when using the work of such specialists. In particular, one of the four factors related to determining the necessary audit effort is the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings. This factor is discussed in more detail above.

Specifically, under the four factors set forth in the final amendments, the auditor should obtain more persuasive evidence as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist decreases. In general, the required audit effort when evaluating the work of a company's specialist would be greatest when the risk of material misstatement is high; the specialist's work is critical to the auditor's conclusion; the specialist has a lower level of knowledge, skill, and ability in the particular field; and the company has the ability to significantly affect the specialist's judgments. These factors are also illustrated in Figure 4, below.

Figure 4: Factors that Affect the Necessary Evidence

From the Auditor's Evaluation of the Company's Specialist's Work



Under the final amendments, the first two factors, in combination, relate to the persuasiveness of the evidence needed from the work of the company's specialist, as follows:

- Risk of Material Misstatement. Consistent with the risk assessment standards, under the final amendments, the higher the risk of material misstatement for an assertion, the more persuasive the evidence needed to support a conclusion about that assertion.⁸⁴ Pursuant to existing PCAOB standards, tests of controls are required if the risk of material misstatement is based on reliance on controls.⁸⁵
- Significance of the Specialist's Work. The significance of the specialist's work refers to the degree to which the auditor would use the work of the company's specialist to support the auditor's conclusions about the assertion. Generally, the greater the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, the more persuasive the evidence from the specialist's work needs to be. The significance of the specialist's work stems from:
 - *The extent to which the specialist's work affects significant accounts and disclosures in the financial statements*. In some situations, the specialist's work might be used only as a secondary check for a significant account or disclosure, while in other

⁸⁴ See paragraph .09a of AS 2301.

⁸⁵ See AS 2301.16, which addresses testing controls to modify the nature, timing, and extent of planned substantive procedures.

situations that work might be a primary determinant in one or more significant accounts and disclosures in the financial statements.

- *The auditor's approach to testing the relevant assertion.* When a company's accounting estimate is determined principally based on the work of a company's specialist, an auditor testing the company's process for developing the accounting estimate would plan to use the work of the company's specialist for evidence regarding the estimate. On the other hand, if the auditor tests an assertion by developing an independent expectation, the auditor would give less consideration to the work of the company's specialist.⁸⁶

The other two factors—the specialist's level of knowledge, skill, and ability, and the ability of the company to significantly affect the specialist's judgments—relate to the degree of reliability of the specialist's work as audit evidence (i.e., the extent to which the specialist's work could provide persuasive evidence, if relevant and found to be satisfactory after the auditor's evaluation).

In some situations, if the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments, the auditor might choose not to use the work of the company's specialist, instead of performing additional procedures with respect to evaluating the specialist's work. The final amendments do not

⁸⁶ As another example, the auditor might develop an independent expectation using certain assumptions or methods of the company's specialist. In those instances, the auditor's evaluation would focus on those assumptions or methods that the auditor used in developing his or her independent expectation.

preclude the auditor from pursuing other alternatives to using that specialist's work. Such alternatives might include developing an independent expectation of the related accounting estimate or seeking to use the work of another specialist.

The following examples illustrate various ways in which the factors discussed above can affect the necessary audit effort in evaluating the work of a company's specialist under the final amendments. The examples assume that the auditor will evaluate, as appropriate, the data, significant assumptions, and methods used by the specialist, and evaluate the relevance and reliability of the work of the company's specialist and its relationship to the relevant assertion.

Example 1 – An oil and gas production company employs an experienced petroleum reserve engineer to assist in developing the estimated proved oil and gas reserves⁸⁷ that are used in multiple financial statement areas, including: (1) the company's impairment analysis; (2) depreciation, depletion and amortization calculations; and (3) related financial statement disclosures, such as reserve disclosures. A substantial portion of the engineer's compensation is based on company earnings, and the engineer has a reporting line to the company's chief financial officer. The auditor concludes that the risk of material misstatement of the valuation of oil and gas properties is high, and the reserve engineer's work is significant to the auditor's conclusion regarding the assertion. Thus, the auditor would need to obtain more persuasive audit evidence commensurate with a high risk of material misstatement, devoting more audit attention to the data, significant assumptions, and methods that are more important to the specialist's

⁸⁷ See Rule 4-10(a)(22) of Regulation S-X, 17 CFR 210.4-10(a)(22).

findings and more susceptible to error or significant management influence. On the other hand, relatively less audit evidence might be needed for the work of an individual reserve engineer if the company has several properties of similar risk, and the reserve studies are performed by different qualified reserve engineers who are either (1) engaged by the company, having no significant ties that give the company significant influence over the specialists' judgments or (2) employed specialists for which the company has implemented compensation policies, reporting lines, and other measures to prevent company management from having significant influence over the specialists' judgments.

Example 2 – A financial services company specializes in residential mortgage and commercial mortgage loans, which are either sold or held in its portfolio. During the financial statement audit, the auditor may inspect appraisals prepared by the company's specialists for the real estate collateralizing loans for a variety of reasons, including in conjunction with testing the valuation of loans and the related allowance for loan losses. Under these circumstances, the persuasiveness of the evidence needed from (and the necessary degree of audit attention devoted to evaluating the methods, significant assumptions, and data used in) an individual appraisal would depend, among other things, on the importance of the individual appraisal to the auditor's conclusion about the related financial statement assertion. In general, more audit attention would be needed for appraisals used in testing the valuation of individually large loans that are valued principally based on their collateral than for appraisals inspected in loan file

reviews for a portfolio of smaller loans with a low risk of default and a low loan-to-value ratio.

Example 3 – A manufacturing company engages an actuary to calculate the projected pension benefit obligation ("PBO") for its pension plan, which is used to determine the related accounts and disclosures in the financial statements. The auditor has assessed the risk of material misstatement for the valuation of the PBO as high and concluded that the actuary's work is significant to the auditor's conclusion. The actuary has extensive experience and is employed by a highly regarded actuarial firm with many clients. The actuary and actuarial firm have no relationships with the company other than performing the actuarial pension plan calculations for the company's financial statements. Under these circumstances, the necessary level of audit attention is less than it otherwise would be for a situation where a specialist has a lower level of knowledge, skill and ability, or the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings. When more audit attention is needed, the auditor would focus on those aspects of the specialist's work that could be affected by the issues related to the specialist's knowledge, skill, and ability or by the company's ability to significantly affect the specialist's judgments.

The three examples above are provided only to illustrate the auditor's consideration of the four factors set forth in the final amendments when determining the necessary audit effort for evaluating the work of the company's specialist. Differences in circumstances, or additional information, could lead to different conclusions. The

examples are not intended to prescribe the specific procedures to be performed in evaluating the work of a company's specialist in any particular situation, which should be determined in accordance with the final amendments.

Evaluating the Specialist's Work: Findings

See AS 1105.A9–.A10, as adopted

The Proposal set forth requirements for evaluating the relevance and reliability of the specialist's findings. The proposed requirements built upon the existing requirements to evaluate the specialist's findings and were aligned with the risk assessment standards.⁸⁸ The Proposal also provided factors that affect the relevance and reliability of the specialist's work. Additionally, the proposed requirements described examples of situations in which additional procedures ordinarily are necessary. Commenters on this aspect of the Proposal generally supported the proposed approach. A few commenters asked for an explanation of the additional procedures to be performed. One commenter stated that certain restrictions, disclaimers, or limitations are common in specialists' reports and that auditors may have no choice but to accept them.

After considering the comments received, the Board is adopting the requirements as proposed with one modification discussed below. The final requirements in AS 1105.A10, as adopted, provide that the auditor should perform additional procedures, as necessary, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence. The

⁸⁸ Existing AS 1210.12 requires the auditor to evaluate whether the specialist's findings support the related assertions in the financial statements. It does not specify, however, what might lead an auditor to conclude that he or she should perform additional procedures or obtain the opinion of another specialist.

final requirements also provide examples of situations in which additional procedures ordinarily are necessary, such as when the specialist's report, or equivalent communication,⁸⁹ contains restrictions, disclaimers, or limitations regarding the auditor's use of the report or the auditor has identified that the specialist has a conflict of interest relevant to the specialist's work. The final requirements do not prescribe specific procedures to be performed because the necessary procedures depend on the circumstances creating the need for the procedures.

A specialist's report may contain restrictions, disclaimers, or limitations that cast doubt on the relevance and reliability of the information contained in the specialist's report and affect how the auditor can use the report of the specialist. For example, a specialist's report that states "the values in this report are not an indication of the fair value of the underlying assets" generally would not provide sufficient appropriate evidence related to fair value measurements. On the other hand, a specialist's report that indicates that the specialist's calculations were based on information supplied by management may still be appropriate for use by the auditor to support the relevant assertion, since the auditor would already be required to test the company-supplied data used in the specialist's calculations.

The requirements in AS 1105.A10, as adopted, do not require the auditor to perform procedures specifically to search for potential conflicts of interest that a

⁸⁹ AS 1105.A9–A10, as adopted, added the phrase "or equivalent communication," which was not part of the proposed amendments, because a company's specialist may communicate his or her findings or conclusions in a memorandum or other written alternative to a formal report. AS 1201, Appendix C, as adopted, and AS 1210, as amended, refer to a specialist's report "or equivalent documentation." The difference in terminology is intended to distinguish information provided by the auditor's specialist from information provided by the company's specialist.

company's specialist might have, other than those resulting from the specialist's relationship with the company. However, the auditor may become aware of conflicts of interest arising from relationships with parties outside the company (e.g., through obtaining information about the specialist's professional reputation and standing, reading the specialist's report, or performing procedures in other audit areas). For example, in reviewing an appraisal of the collateral for a material loan receivable, the auditor may become aware that the appraiser has a substantial financial interest in the collateral. If the auditor becomes aware of a conflict of interest that could affect the specialist's judgments about the work performed, conclusions, or findings, the auditor would need to consider the effect of that conflict on the reliability of the specialist's work, and perform additional procedures if necessary to obtain sufficient appropriate evidence regarding the relevant financial statement assertion.

Comparison with Standards of Other Standard Setters

Paragraph 8(c) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

Amendments Related to Supervising or Using the Work of an Auditor's Specialist

The final amendments set forth requirements for supervising or using the work of an auditor's specialist, taking into account differences in the auditor's relationship with employed specialists and engaged specialists. A new appendix to AS 1201 applies to the

supervision of auditor-employed specialists, and AS 1210, as amended, applies when using the work of auditor-engaged specialists.

Commenters on the Proposal generally supported the proposed approach for overseeing and coordinating the work of an auditor's specialists, which was risk-based and set forth largely parallel requirements when using the work of both auditor-employed and auditor-engaged specialists. A few commenters, however, expressed concerns with the practicality and clarity of certain aspects of the proposed requirements. These comments and others are discussed below.

Amendments to AS 1201 for Supervising the Work of an Auditor-Employed Specialist

Appendix C of AS 1201, as adopted, supplements the existing requirements in AS 1201.05–.06 by providing more specific direction on applying the general supervisory principles in AS 1201 to the supervision of an auditor-employed specialist who assists the auditor in obtaining or evaluating audit evidence.

"Meaning of "Auditor-Employed Specialist"

See AS 1201.C1, as adopted

The Proposal used the term "auditor-employed specialist" to mean a "specialist employed by the auditor's firm," consistent with existing requirements.⁹⁰ Two commenters asked for clarification of how to apply the terms "auditor-employed" and "auditor-engaged" specialists when specialists are employed by entities that are affiliated with the audit firm and those specialists are subject to the same quality control policies and procedures and independence requirements as employees of the audit firm.

⁹⁰ See existing AS 1210.05, which states that AS 1201 applies to situations in which "a specialist employed by the auditor's firm participates in the audit."

The final amendments retain the existing concept that an "auditor-employed specialist" is a "specialist employed by the auditor's firm." Given that the terms "auditor-employed specialist" and "auditor-engaged specialist" in the final amendments are consistent with existing requirements, auditors should be familiar with this distinction. The Board recognizes, however, that there may be instances where an auditor uses the work of a specialist who is a partner, principal, shareholder or employee of an affiliated entity that is not an accounting firm and treats that specialist as if he or she were employed by the auditor's firm (i.e., as an auditor-employed specialist). While it is not practicable to address all the legal structures or affiliations between accounting firms and specialist entities that may give rise to such situations, the final amendments are not intended to change current practice where the specialist is employed by an affiliated entity that adheres to the same quality control and independence requirements as the auditor's firm. In such circumstances, the Board understands that the auditor would assess the qualifications and independence of that specialist in the same ways as an engagement team member employed by the firm.

Comparison with Standards of Other Standard Setters

ISA 620 covers the auditor's use of the work of both auditor-employed experts and auditor-engaged experts, but the requirements in ISA 620 for the auditor's evaluation of the objectivity of an auditor-employed expert differ from those for evaluating the objectivity of an auditor-engaged expert.

AU-C Section 620 is similar to ISA 620 in both respects.

Determining the Extent of Supervision

See AS 1201.C2, as adopted

The Proposal supplemented, in proposed Appendix C of AS 1201, the factors set forth in AS 1201.06 for determining the necessary extent of supervision of engagement team members in circumstances involving the use of the work of an auditor-employed specialist.⁹¹

No commenters opposed the proposed requirement for determining the extent of supervision. One commenter stated that the proposed requirement for determining the extent of supervision appeared scalable to the size and complexity of the audit engagement. The Board is adopting this requirement as proposed. The final requirements provide that the necessary extent of supervision depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the auditor-employed specialist relevant to the work to be performed by the specialist.

Comparison with Standards of Other Standard Setters

Paragraph 8 of ISA 620 provides that, depending on the circumstances, the nature, timing and extent of the auditor's procedures will vary with respect to: (1) evaluating the competence, capabilities and objectivity of the auditor's expert; (2) obtaining an understanding of the field of expertise of the auditor's expert; (3) reaching an agreement with the auditor's expert; and (4) evaluating the adequacy of the auditor's expert's work.

⁹¹ AS 1201.06 provides that, to determine the extent of supervision necessary for engagement team members, the engagement partner and other engagement team members performing supervisory activities should take into account, among other things: (1) the nature of the company, including its size and complexity; (2) the nature of the assigned work for each engagement team member; (3) the risks of material misstatement; and (4) the knowledge, skill, and ability of each engagement team member.

In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

Qualifications and Independence of Auditor-Employed Specialists

See AS 1015.06, as amended, and footnote 3A to AS 2101.06b, as amended

PCAOB auditing standards require that personnel be assigned to engagement teams based on their knowledge, skill, and ability.⁹² This requirement applies equally to auditor-employed specialists and other engagement team members. In addition, auditor-employed specialists must be independent of the company.⁹³ Accordingly, the

⁹² See AS 2301.05a and AS 1015.06, as amended.

⁹³ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client" throughout the audit and professional engagement period, meaning that they must satisfy all independence criteria applicable to an engagement. In addition, under Rule 2-01 of Regulation S-X, 17 CFR §210.2-01, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not

requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements apply to auditor-employed specialists.⁹⁴ Rather than add specific requirements for evaluating the qualifications and independence of auditor-employed specialists, the Proposal would have included two paragraphs in Appendix C citing the applicable requirements in existing standards.⁹⁵

Most commenters on this topic advocated for greater acknowledgment of the auditor's ability to use information from the firm's system of quality control when assessing the knowledge, skill, ability, and independence of an auditor-employed specialist. Specifically, some of these commenters recommended the inclusion of references to QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* ("QC 20"), in these requirements. In the view of these commenters, QC 20 more fully encompasses both the considerations related to the appropriate assignment of personnel to an engagement and the requirements related to independence, integrity, and objectivity. One commenter suggested that the standard provide that a firm's system of quality control pursuant to QC 20 would be sufficient to satisfy the requirements relating to the qualifications and independence of auditor-employed specialists. Another commenter stated that the necessary guidance was contained in QC 20 and that the references in the Proposal to applicable requirements in existing standards were duplicative.

independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

⁹⁴ See AS 2101.06b.

⁹⁵ See proposed AS 1201.C3–.C4; see also AS 2301.05a, AS 1015.06, and AS 2101.06b.

The Board considered these comments in adopting the final amendments. The intent of the proposed paragraphs for assigning personnel based on their knowledge, skill, and ability, and for determining compliance with independence and ethics requirements, was to emphasize that auditors' responsibilities for assessing the qualifications and independence of the auditor-employed specialists are the same as for other engagement team members. To avoid any misunderstanding that a different process was expected for assigning auditor-employed specialists and determining their compliance with independence and ethics requirements, the proposed paragraphs do not appear in the final amendments. Also, two related amendments to PCAOB auditing standards are being adopted. First, AS 1015.06 has been amended to clarify that engagement team members, which includes auditor-employed specialists, should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability, and that this requirement is not limited to the assignment and supervision of auditors. Second, in another conforming amendment, a footnote was added to AS 2101.06b to remind auditors of the obligations of registered firms and their associated persons under PCAOB Rule 3520.

Under the final amendments, auditors will continue to have the ability to use information from, and processes in, the firm's quality control system when assessing the knowledge, skill, ability, and independence of auditor-employed specialists. The fact that a system of quality control may have a process for making assignments of specialists does not relieve the engagement partner (with the assistance of appropriate supervisory personnel on the engagement team) of his or her responsibility to determine whether the assigned specialist has the necessary qualifications and independence for the particular audit engagement in accordance with AS 1015.06, as amended, and AS 2101.06, as

amended. The relevant facts and circumstances, including the nature, scope, and objectives of the specialist's work, should be considered when performing this assessment. For example, a valuation specialist may have expertise in valuing oil and gas reserves, but not in valuing coal reserves. In that case, failure to consider the specialist's expertise when assigning the specialist work on an audit engagement in an extractive industry could result in the inappropriate assignment of significant engagement responsibilities.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that the auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities, and objectivity for the auditor's purposes.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

Informing the Specialist of the Work to be Performed

See AS 1201.C3–.C5, as adopted

The Proposal supplemented the requirements in PCAOB standards for informing the engagement team members of their responsibilities to address situations where auditor-employed specialists are performing work in an audit.⁹⁶ Most commenters who commented on the supplemental requirements generally supported the proposed

⁹⁶ AS 1201.05a sets forth requirements for the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform engagement team members of their responsibilities. These matters include: (1) the objectives of the procedures that engagement team members are to perform; (2) the nature, timing, and extent of procedures they are to perform; and (3) matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues.

approach, asserting that it would foster effective communication between the auditor and the auditor's specialist. Some commenters, however, asked for clarification of certain aspects of the proposed requirement to establish and document an understanding with the specialist of the work to be performed. After considering the comments received, the Board is adopting the requirements substantially as proposed.

The final amendments include requirements for the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform the auditor-employed specialist about the work to be performed. These requirements include establishing and documenting an understanding with the specialist regarding the responsibilities of the specialist, the nature of the specialist's work, the specialist's degree of responsibility for testing data and evaluating methods and significant assumptions, and the responsibility of the specialist to provide a report, or equivalent documentation.

Some commenters requested clarification in the final amendments on the form of documentation of the auditor's understanding with the specialist. In addition, some commenters suggested removing the specific reference to the specialist's responsibility to provide a "report, or equivalent documentation" and allowing for more flexibility when the specialist's results are communicated to the auditor. Some of these commenters asserted that the proposed requirement connoted the preparation of a formal, signed report, which could discourage effective two-way communication between the auditor and the specialist. Another commenter suggested that the Board consider whether the auditor's understanding with the specialist should also include matters the specialist should communicate to the auditor, and the nature, timing, and extent of those communications. One commenter also expressed concern that use of the term "degree of

responsibility" could be seen as a means for auditors to abdicate responsibility for audit work to specialists.

The final amendments do not include specific requirements for how to document the auditor's understanding with the auditor's specialist. Instead, the Board contemplates that the understanding with the specialist can be documented in a variety of ways, such as in planning memoranda, separate memoranda, or other related work papers. This approach should provide auditors with flexibility, while still requiring the documentation of the important aspects of the understanding reached by the auditor and the auditor's specialist. This approach also enables the specialist to communicate those matters specific to the work performed and does not limit the specialist's ability to communicate other items to the auditor.

The final amendments also require the auditor to establish and document an understanding with the specialist regarding the degree of responsibility of the specialist for: (1) testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company; (2) evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and (3) evaluating the methods used by the company or the company's specialist, or using his or her own methods. The intent of this requirement is to enhance coordination of the work between the auditor and the auditor's specialist and facilitate supervision of the specialist by the engagement partner and others with supervisory responsibilities. For example, if the auditor's specialist assists the auditor in developing an independent expectation using data, assumptions, or a model provided by the auditor or auditor's specialist, the auditor would establish an understanding with the specialist

regarding the specialist's responsibilities with respect to the data, assumptions, or model.⁹⁷ Regardless of the specialist's degree of responsibility, the engagement partner and, as applicable, other engagement team members performing supervisory activities are responsible for evaluating the specialist's work and report, or equivalent documentation.⁹⁸

In addition, as proposed, the final amendments require establishing and documenting the specialist's responsibility to provide "a report, or equivalent documentation" to the auditor. This requirement should provide flexibility for auditors to obtain the necessary information about the specialist's procedures, findings, and conclusions through the specialist's report, other specialist-provided documentation, or a combination of the two. The requirement should also facilitate the auditor's compliance with other PCAOB auditing standards, such as those on engagement quality review and audit documentation.⁹⁹

The final amendments require establishing and documenting the auditor's understanding with the specialist regarding the "nature of the work that the specialist is to perform or assist in performing." As proposed, this requirement would have also encompassed the "specialist's approach to that work." Two commenters suggested that the Board clarify the difference between the two terms. The nature of the specialist's

⁹⁷ AS 1201.C5, as adopted, provides that the auditor should comply with AS 2501.21–.26, as adopted, when an independent expectation is developed. For example, the auditor's responsibilities with respect to using data or assumptions obtained from a third party are presented in AS 2501.23, as adopted. *See* Estimates Release, *supra* note 20.

⁹⁸ *See* AS 1201.C6-.C7, as adopted.

⁹⁹ *See* AS 1220, *Engagement Quality Review*, and AS 1215, *Audit Documentation*.

work would include, for example, testing data and evaluating the methods and significant assumptions used in developing an estimate when testing the company's process used to develop an accounting estimate or developing an independent expectation of an estimate. The specialist's approach to that work, in turn, might include the procedures the specialist performs to test management's process or develop an independent expectation, such as testing data and evaluating the methods and significant assumptions used in developing an estimate. Since the auditor's obligation to establish and document the specialist's degree of responsibility for performing similar procedures is addressed in other provisions of the final amendments,¹⁰⁰ the phrase "the specialist's approach to that work" has been omitted to avoid potential confusion.

As proposed, the final amendments also provide that, pursuant to AS 1201.05a(3), the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the auditor-employed specialist about matters that could affect the specialist's work.¹⁰¹ This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism. Commenters did not offer suggestions on this provision, although one commenter stated that it concurred with the proposed requirement.

¹⁰⁰ See AS 1201.C3c, as adopted.

¹⁰¹ See AS 1201.C4, as adopted.

The final amendments also provide that the engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion.¹⁰² One commenter requested clarification of the term "measures," as used in this context. The final requirement emphasizes that the auditor is responsible for complying with relevant auditing standards, including, when applicable, AS 2501, as adopted, and Appendix A of AS 1105, as adopted.¹⁰³ This requirement is intended to prompt the auditor to coordinate with the specialist to make sure that the work is performed in accordance with the applicable standards, including the requirement to consider relevant audit evidence, regardless of whether it supports or contradicts the relevant financial statement assertion. For example, in auditing an accounting estimate under AS 2501, as adopted, measures taken by the auditor could include either performing, or supervising the auditor's specialist in performing, the required procedures with respect to testing and evaluating the data, and evaluating the methods and significant assumptions used in developing that estimate.¹⁰⁴

Comparison with Standards of Other Standard Setters

¹⁰² See AS 1201.C5, as adopted.

¹⁰³ See AS 1201.C5, as adopted. In response to comments, this paragraph was revised in the final amendments to provide that, if an auditor's specialist is used to evaluate the work of a company's specialist, measures should be implemented to comply with Appendix A of AS 1105, as adopted, and, for accounting estimates, AS 2501.19, as adopted.

¹⁰⁴ See AS 2501, as adopted, and Estimates Release, *supra* note 20.

Paragraph 11 of ISA 620 provides that the auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

- (a) The nature, scope and objectives of that expert's work;
- (b) The respective roles and responsibilities of the auditor and that expert;
- (c) The nature, timing, and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert;
and
- (d) The need for the auditor's expert to observe confidentiality requirements.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

Evaluating the Work of the Specialist

See AS 1201.C6–.C7, as adopted

The Proposal supplemented, in Appendix C, the requirements in AS 1201.05c for reviewing the work of the engagement team in circumstances in which auditor-employed specialists are used.¹⁰⁵ It provided that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

¹⁰⁵ AS 1201.05c provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities should review the work of engagement team members to evaluate whether: (1) the work was performed and documented; (2) the objectives of the procedures were achieved; and (3) the results of the work support the conclusions reached.

Commenters generally agreed with these requirements, noting that the requirements are appropriate and, in the view of some commenters, would improve audit quality. Two commenters asked for additional guidance on how the auditor should evaluate methods and assumptions used by an auditor-employed specialist. One commenter recommended providing additional guidance on the specific procedures to be performed by auditors to evaluate a specialist's work. After considering the comments, the Board is adopting the requirements substantially as proposed.

The final amendments provide a principles-based framework for reviewing and evaluating the work of the specialist. Under the final amendments, the engagement partner and, as applicable, other engagement team members performing supervisory activities should review the specialist's report or equivalent documentation describing the work performed, the results of the work, and the findings or conclusions reached by the specialist, as provided for under AS 1201.C3d, as adopted.¹⁰⁶

This approach links the scope of the auditor's review to the report or equivalent documentation that the specialist agreed to furnish to the auditor under AS 1201.C3, as adopted. The principles for the necessary extent of supervision, discussed earlier, also apply to evaluating the work of the auditor-employed specialist, including the report or equivalent documentation provided by the specialist. Accordingly, auditors should be familiar with this approach and how to apply this requirement in practice.

The necessary extent of review and evaluation of the auditor-employed specialist's work depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the

¹⁰⁶ See AS 1201.C6, as adopted.

relevant assertion; and (3) the knowledge, skill, and ability of the specialist. In performing the review, the auditor also should evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

AS 1201.C7, as adopted, provides that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue. The final requirement also provides examples of situations in which additional procedures ordinarily would be necessary, including:

- The specialist's work was not performed in accordance with the auditor's instructions;
- The specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work;¹⁰⁷

¹⁰⁷ The auditor's consideration of restrictions, disclaimers, or limitations in a report, or equivalent documentation, provided by an auditor-employed specialist is the same as when such language is contained in a report, or equivalent documentation, provided by an auditor-engaged specialist. *See* below for further discussion of the

- The specialist's findings and conclusions are inconsistent with (1) the results of the work performed by the specialist, (2) other evidence obtained by the auditor, or (3) the auditor's understanding of the company and its environment;
- The specialist lacks a reasonable basis for data or significant assumptions the specialist used; or
- The methods used by the specialist were not appropriate.

These requirements are consistent with existing provisions in paragraphs .06 and .36 of AS 2810, *Evaluating Audit Results*, which provide that, if the auditor concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary (e.g., audit procedures may need to be modified or additional procedures may need to be performed as a result of any changes in the risk assessments). Similarly, if the evidence gathered by the specialist in testing or evaluating data, or evaluating significant assumptions is not adequate, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

One commenter asserted that auditors may not have sufficient knowledge of the specialist's field of expertise to evaluate a specialist's work and effectively challenge methods, assumptions, and data, particularly in relation to highly complex technical areas. The final amendments recognize that the engagement partner and, as applicable,

auditor's consideration of the effect of restrictions, disclaimers, or limitations on the report, or equivalent documentation, provided by the auditor-engaged specialist.

other engagement team members performing supervisory responsibilities may not have in-depth knowledge of the specialist's field. However, under existing PCAOB standards, the auditor is required to have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the nature, timing, and extent of the auditor's work and the effects on the auditor's report.¹⁰⁸ Furthermore, the evaluation of the specialist's work under the final amendments is based on matters that are within the capabilities of the auditor (e.g., whether the specialist followed instructions and whether the results of the work support the specialist's conclusions).

Another commenter asked for clarification of the term "reasonable basis" in the context of assessing whether the specialist lacks a reasonable basis for data or significant assumptions the specialist used. In that context, "reasonable basis" refers to whether the specialist's selection of data or significant assumptions was determined arbitrarily or instead based on consideration of relevant information available to the specialist.

Comparison with Standards of Other Standard Setters

Paragraph 12 of ISA 620 provides that the 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

¹⁰⁸ See AS 2101.17.

- (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.

Paragraph 13 of ISA 620 provides that if the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform additional audit procedures appropriate to the circumstances.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

Amendments to Existing AS 1210 for Using the Work of an Auditor-Engaged Specialist

This section discusses the final requirements in AS 1210, as amended, for audits in which the auditor uses an auditor-engaged specialist. In such circumstances, the objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

Assessing the Knowledge, Skill, Ability, and Objectivity of the Engaged Specialist

As described above, existing AS 1210 requires the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

Similar to the final amendments related to using a company's specialist, the final amendments carry forward the existing requirements with certain modifications described below.

Knowledge, Skill, and Ability

See AS 1210.03–.04, as amended

Requirements in existing AS 1210 related to the auditor's evaluation of a specialist's qualifications were described above with regard to a company's specialist. These requirements are the same for a company's specialist and an auditor-engaged specialist.

The Proposal substantially carried forward the requirement in existing AS 1210. Unlike the existing standard, however, the Proposal expressly provided that the auditor would obtain an understanding of the professional qualifications of both the specialist and the entity that employs the specialist. The Board is adopting this requirement as proposed.

Two commenters concurred with the proposed approach to assessing knowledge, skill, and ability of the auditor-engaged specialist. One commenter suggested allowing auditors to assess the specialist's knowledge, skill, and ability centrally as part of the firm's system of quality control. Another commenter asserted that the proposed requirement was not well-suited to assessing the knowledge, skill, and ability of the entity that employs the specialist.

Under the final amendments, auditors will continue to be able to use information from, and processes in, the firm's quality control system when assessing the knowledge, skill, and ability of auditor-engaged specialists. The fact that a system of quality control may have a firm-level process for screening engaged specialists does not relieve the engagement partner (with the assistance of appropriate supervisory personnel on the engagement team) of his or her responsibility to assess whether the engaged specialist has the necessary knowledge, skill, and ability for the particular audit engagement. The

relevant facts and circumstances, including the nature, scope, and objectives of the specialist's work, should be considered when performing this assessment.

The final requirement retains the concept in existing AS 1210 that a specialist may be an individual or an entity. Outreach to audit firms suggests that firms have policies and procedures for evaluating the qualifications of specialists, whether individuals or entities. Accordingly, auditors should be familiar with assessing the qualifications of entities that are specialists or employ specialists. Therefore, the final requirement is not expected to result in a significant change in practice.

AS 1210, as amended, does not specify steps to perform or information sources to use in assessing the specialist's knowledge, skill, and ability. Potential sources of relevant information, if available, could include the following:

- Information contained within the audit firm related to the professional qualifications and reputation of the specialist and the entity that employs the specialist, if applicable, in the relevant field and experience with previous work of the specialist;
- Professional or industry associations and organizations, which may provide information on: (1) qualification requirements, technical performance standards, and continuing professional education requirements that govern their members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against the specialist;
- Information provided by the specialist about matters regarding the specialist's understanding of the financial reporting framework, experience

in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;

- The specialist's responses to questionnaires about the specialist's professional credentials; and
- Published books or papers written by the specialist.

Requirements applicable to a specialist pursuant to legislation or regulation also could help inform the auditor's assessment of the specialist's knowledge, skill, and ability.

The purpose of the assessment of the auditor-engaged specialist's knowledge, skill, and ability is two-fold: (1) to determine whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform his or her assigned work; and (2) to help determine the necessary extent of the review and evaluation of the specialist's work. AS 1210.04, as amended, emphasizes the importance of engaging a sufficiently qualified auditor's specialist by expressly providing that the auditor should not use the work of an engaged specialist who does not have a sufficient level of knowledge, skill, and ability.

The assessment of the specialist's knowledge, skill, and ability by the engagement partner and, as applicable, other engagement team members performing supervisory activities is also a factor when determining the necessary extent of the review and evaluation of the specialist's work.¹⁰⁹ The auditor's evaluation of the work of a specialist may be more extensive if the specialist generally has sufficient knowledge, skill, and ability in the relevant field of expertise, but less experience in the particular area of specialty within the field. For example, a valuation specialist may possess sufficient

¹⁰⁹ See AS 1210.10, as amended.

knowledge, skill, and ability in business valuation, but may not be well-versed in the application of business valuation for financial reporting purposes.

Objectivity

See AS 1210.05 and .11, as amended

Requirements in existing AS 1210 related to the auditor's evaluation of a specialist's objectivity are described above with regard to a company's specialist. Those requirements are the same for a company's specialist and an auditor-engaged specialist.

The Proposal built on the requirements for assessing objectivity in the existing standard and provided that the engagement partner and, as applicable, other engagement team members performing supervisory activities would assess whether the specialist and the entity that employs the specialist have the necessary objectivity, which includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed.

The proposed requirements differed from the existing requirements in two primary respects. First, they articulated the concept of objectivity for purposes of proposed AS 1210, as referring to the specialist's ability "to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit." Second, they expanded the list of matters that the auditor would consider in assessing objectivity to include financial and business relationships with the company and other conflicts of interest.

Some commenters supported the proposed approach. Other commenters

expressed concern that the proposed requirement implied that the assessment of whether the specialist had the necessary objectivity was a binary decision. These commenters expressed a preference for describing objectivity as an attribute that exists along a spectrum. Some of these commenters asserted that an auditor should not be precluded from using the work of a less objective specialist, as long as the auditor performed additional procedures in those circumstances.

After considering the comments received, the requirement has been revised to allow auditors to assess the specialist's level of objectivity along a spectrum and use the work of a less objective specialist if the auditor performs additional procedures to evaluate the specialist's work. In revising this requirement, the Board took into account the need for auditors to assess the objectivity of auditor-engaged specialists, while allowing auditors, where appropriate, to engage specialists who have certain relationships with a company that may raise questions as to their level of objectivity.

The final amendments also require the auditor to perform procedures that are commensurate with, among other things, an engaged specialist's degree of objectivity.¹¹⁰ Under the final amendments, if the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity, the auditor should (1) perform additional procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing consistent with the understanding established with the specialist pursuant to AS 1210.06, as amended, or (2) engage another specialist. The necessary nature and extent of the

¹¹⁰ See first note to AS 1210.05, as amended. See also AS 1210.10, as amended, for a description of other factors affecting the necessary extent of the auditor's review.

additional procedures would depend on the degree of objectivity of the specialist. As the degree of objectivity increases, the evidence needed from additional procedures decreases.¹¹¹ If the specialist has a low degree of objectivity,¹¹² the auditor should apply the procedures for evaluating the work of a company's specialist.¹¹³ For example, if the specialist's employer has a significant ownership interest in the company, the specialist's ability to exercise objective and impartial judgment might be low and, therefore, the auditor should evaluate the data, significant assumptions, and methods used by the specialist under the requirements in Appendix A of AS 1105, as amended.

Some commenters on the Proposal suggested the Board should provide additional guidance to specify the steps to be performed by auditors to assess the objectivity of an auditor-engaged specialist, as well as what constitutes sufficient appropriate evidence to support this assessment. One commenter asserted that auditors would face challenges in assessing the objectivity of the entity that employs the specialist, as required under the Proposal, and suggested that auditors may be unable to obtain the policies, procedures, and systems, if any, of the entity employing the specialist. This commenter suggested either omitting the requirement to consider the objectivity of the specialist's employer or limiting the requirement to performing inquiry of the specialist.

After considering these comments, the Board has eliminated the assessment of the objectivity of the entity that employs the specialist as a separate requirement under the

¹¹¹ See AS 1210.11, as amended.

¹¹² The concept of a "low degree of objectivity" is used in paragraph .18 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and, therefore, should be familiar to auditors.

¹¹³ See AS 1210.11, as amended.

final requirements. Instead, the auditor is required to evaluate relationships between the company and both the specialist and the specialist's employer to determine whether either has a relationship with the company that may adversely affect the specialist's objectivity.¹¹⁴ This is consistent with existing AS 1210, under which a specialist may be either an individual or an entity. Additionally, outreach to specialist entities and audit firms suggests that audit firms have policies and procedures for evaluating relationships between a specialist entity that they engage and the company. Accordingly, the concept of assessing relationships between a company and an entity that employs specialists should be familiar to auditors.

As under the Proposal, the final amendments do not prescribe the procedures the auditor must perform to obtain information relevant to the auditor's assessment. In response to questions raised by commenters, the Board added a note to clarify that the evidence necessary to assess the specialist's objectivity depends on the significance of the specialist's work and the related risk of material misstatement.¹¹⁵ Under this principles-based approach, as the significance of the specialist's work and the risk of material misstatement increase, the persuasiveness of the evidence the auditor should obtain for this assessment also increases.

In addition, the note includes non-exclusive examples of potential sources of information that could be relevant to the auditor's assessment of the relationship to the

¹¹⁴ See AS 1210.05, as amended. For example, the specialist's employer might have an ownership or other financial interest with respect to the company, or other business relationships that might be relevant to the auditor's assessment of the specialist's ability to exercise objective and impartial judgment.

¹¹⁵ See second note to AS 1210.05, as amended.

company of both the specialist and the specialist's employer.¹¹⁶ These examples include responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company. As with the auditor's assessment of a specialist's knowledge, skill, and ability, certain sources of information may provide more persuasive evidence than others. In situations where more persuasive evidence is required, it may be appropriate to perform procedures to obtain evidence from multiple sources.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that in the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

Informing the Specialist of the Work to be Performed, Determining the Extent of Review, and Evaluating the Work of the Specialist

See AS 1210.06-.12, as amended

As is the case with respect to an auditor-employed specialist, the auditor uses an auditor-engaged specialist to assist the auditor in obtaining and evaluating audit evidence. Given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the final requirements for the auditor-engaged specialist are parallel to the requirements for the auditor-employed specialist when determining the extent of the auditor's review, informing the auditor-engaged specialist of the work to be performed,

¹¹⁶ *Id.* These examples were based on examples set forth in the Proposal, but have been refined to better reflect their application in practice.

and evaluating the work of the auditor-engaged specialist. These final requirements are discussed in additional detail above.

Some commenters on the Proposal commented on the impact of certain proposed changes solely with respect to auditor-engaged specialists. These comments are discussed below.

One commenter on the Proposal expressed concern that the auditor may have limited access to proprietary models used by auditor-engaged specialists. This commenter recommended that the Board include statements made in the Proposal regarding the auditor's access to such models and the impact on the auditor's performance obligations in the final amendments. Similar to the Proposal, the final amendments do not require the auditor to have full access to a specialist's proprietary model or to reperform the work of the specialist, but instead require the auditor to evaluate the work of that specialist in accordance with the final standard. Under AS 1210.10, as amended, the necessary extent of the evaluation of the specialist's work, including a determination of the necessary access to a specialist's model, depends upon (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist. For example, if the specialist used a proprietary model to develop an independent expectation, the auditor would need to obtain information from the specialist to assess whether the specialist's model was in conformity with the applicable financial reporting framework and to evaluate differences between the independent expectation and the company's recorded estimate.

Another commenter recommended including a requirement to inform auditor-engaged specialists of the need to apply professional skepticism, similar to the requirement for auditor-employed specialists in proposed AS 1201.C6. A different commenter recommended that the requirements for informing the specialist of the work to be performed should include communicating the auditor's need to exercise professional skepticism to the auditor-engaged specialist, so that the specialist is aware that relevant information should be passed on to the auditor.

The Board considered these comments and determined to adopt the requirement to inform the specialist of the work to be performed substantially as proposed. Due professional care in the performance of audit procedures requires the auditor to exercise professional skepticism, including a questioning mind and a critical assessment of audit evidence.¹¹⁷ The Board did not propose extending the auditing standard on due professional care to auditor-engaged specialists and, therefore, no change has been made to AS 1210, as amended. While there is no requirement for auditors to make the engaged specialist aware of the auditor's responsibility to exercise professional skepticism, auditors nevertheless may decide to communicate the auditor's responsibility to the auditor-engaged specialist.

Some commenters asserted that the discussion of the auditor's assessment of disclaimers, limitations, and restrictions related to the report of a company's specialist was equally applicable to the report of the auditor-engaged specialist and recommended similar guidance be provided when using the report of an auditor-engaged specialist. Under the final amendments, the auditor's evaluation of the specialist's report or

¹¹⁷ See AS 1015.07.

equivalent documentation includes considering the effect of any restrictions, limitations, or disclaimers in the specialist's report or equivalent documentation on both (1) the relevance and reliability of the audit evidence the specialist's work provides and (2) how the auditor can use the report of the specialist.¹¹⁸ For example, a specialist's report that states "the values in this report are not an indication of the fair value of the underlying assets" generally would not provide sufficient appropriate evidence related to fair value measurements. On the other hand, a specialist's report that indicates that the specialist's calculations were based on information supplied by management may still be appropriate for use by the auditor to support the relevant assertion, since the auditor would be required to test the data that was produced by the company and used in the specialist's calculations

Comparison with Standards of Other Standard Setters

The comparative requirements of the IAASB and the ASB were discussed above.

Other Considerations

The Board proposed to rescind two auditing interpretations.¹¹⁹ The Board has taken commenters' views into account and determined not to rescind these interpretations at this time. The Board is incorporating key elements of each interpretation, however, in the final amendments. These matters are discussed below, along with certain requirements in existing AS 1210 that are not specifically addressed in the final amendments.

¹¹⁸ See note to AS 1210.12, as amended.

¹¹⁹ Auditing interpretations provide guidance the auditor should be aware of and consider related to specific areas of the audit. See paragraph .11 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

Auditing Interpretation AI 11, Using the Work of a Specialist: Auditing Interpretations of AS 1210

The Board proposed to rescind AI 11 in the Proposal. AI 11 provides guidance for auditing transactions involving transfers of financial assets, such as in securitizations that are accounted for under Statement of Financial Accounting Standards No. 140.¹²⁰ The interpretation addresses an auditor's use of a legal opinion obtained from a company's legal counsel on matters that may involve the U.S. Bankruptcy Code, rules of the Federal Deposit Insurance Corporation ("FDIC"),¹²¹ and other federal, state, or foreign law to determine whether "transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership," which affects the accounting for the transaction under FAS No. 140. AI 11 also reiterates certain requirements in generally accepted accounting principles and PCAOB auditing standards. In addition, the interpretation includes illustrative examples of legal isolation letters based on FAS No. 140 and certain provisions of the FDIC's original rule, both of which have been subsequently amended.

A few commenters supported the proposed rescission. A number of other commenters, however, expressed concern about the proposed rescission of AI 11, stating that it continues to provide useful guidance to auditors regarding the necessary audit

¹²⁰ See Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("FAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This standard was subsequently amended by FAS No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and codified into FASB Accounting Standards Codification ("ASC"), Topic 860, *Transfers and Servicing*.

¹²¹ Subsequent to the Board's adoption of AI 11, the FDIC rule regarding the treatment of financial assets transferred by an institution in connection with a securitization or participation was amended in 2010.

evidence to support management's assertion that a transfer of financial assets has met the isolation criterion of ASC 860-10-40, *Transfers and Servicing*. One commenter asserted that companies would struggle to anchor their accounting conclusions to guidance on the existing auditing standards if AI 11 was rescinded.

After considering comments and the continued use of the interpretation in practice, the Board determined not to rescind AI 11 at this time. The final amendments have been revised to include conforming changes to AI 11 to remove outdated references to existing AS 1210, which has been replaced and retitled.

The amended standards for using the work of a company's specialist also incorporate certain principles from AI 11. As discussed in AI 11, legal opinions are sometimes necessary evidence to support an auditor's conclusion about the proper accounting for transfers of financial assets. Accordingly, the final amendments clarify that Appendix A of AS 1105, as adopted, applies in situations when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.¹²² The provision emphasizes the importance of legal opinions as audit evidence in certain contexts and clarifies the requirements the auditor should be applying in such circumstances.

Auditing Interpretation AI 28, Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

¹²² See second note to AS 1105.A1, as adopted.

The Board also proposed to rescind AI 28 in the Proposal. AI 28 provides guidance about matters related to auditing the income tax accounts in a company's financial statements. Topics covered by the interpretation include restrictions on access to the company's books and records related to its income tax calculation, documentation of evidence obtained in auditing the income tax accounts, and use of tax opinions from company legal counsel and tax advisors. The interpretation also reiterates certain requirements from PCAOB auditing standards.

Most commenters did not express a view regarding the proposed rescission of AI 28. A few commenters supported the proposed rescission. Two commenters asserted that AI 28 provides useful guidance to auditors regarding tax specialists and tax working papers and should be retained. The Board has considered these comments and determined not to rescind AI 28 at this time.

The Board recognizes that written advice or opinions of a company's tax advisor or tax legal counsel on material tax matters are sometimes necessary evidence to support the auditor's conclusions on income tax accounts. Accordingly, the Board revised the final amendments to acknowledge such situations and to clarify that, if an auditor plans to use an opinion of legal counsel or the advice of a tax advisor on specific tax issues as audit evidence, it is not appropriate for the auditor to rely solely on that opinion or advice with respect to those tax issues.¹²³ Instead, the auditor needs to evaluate the analysis underlying the tax opinion or tax advice to determine whether it provides relevant and

¹²³ See footnote 1 to AS 1105.A1, as adopted; note to AS 2505.08, as amended.

reliable evidence, taking into account the requirements of the applicable financial reporting framework.

Certain Requirements of Existing AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Final Amendments

Decision to use a specialist. Existing AS 1210 states that an auditor may encounter complex or subjective matters that are potentially material to the financial statements. It further provides that such matters, examples of which are provided, may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter.¹²⁴ The final amendments do not retain this language, as this issue is already addressed in AS 2101. Specifically, AS 2101.16 requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

Reporting requirements. Existing AS 1210 prohibits auditors from making reference to the work or findings of a specialist in the auditor's report, unless such reference will facilitate an understanding of the reason for an explanatory paragraph, a departure from an unqualified opinion, or a critical audit matter ("CAM"). A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.¹²⁵ Depending on the

¹²⁴ See existing AS 1210.06.

¹²⁵ See AS 3101.11–.17.

circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist.

No commenters objected to omitting the prohibition in existing AS 1210 from the proposed amendments. For the reasons discussed above, the Board did not make changes to the final amendments to incorporate these extant requirements.

Other Aspects of the Final Amendments

The Board adopted additional amendments to conform its standards to the final requirements in AS 1105, AS 1201, and AS 1210, as amended. Those conforming amendments to AS 1015, AS 2301, AS 2310, *The Confirmation Process*, AS 2401, *Consideration of Fraud in a Financial Statement Audit*, AS 2610, *Initial Audits – Communications Between Predecessor and Successor Auditors*, AT 601, *Compliance Attestation*, and AT 701, *Management's Discussion and Analysis*, do not change the meaning of existing requirements.

Effective Date

The Board determined that the final amendments take effect, subject to approval by the SEC, for audits of financial statements for fiscal years ending on or after December 15, 2020.

The Board sought comment on the amount of time auditors would need before any amendments would become effective, if adopted by the Board and approved by the SEC. A number of commenters supported an effective date of two years after SEC approval of final amendments, asserting that this would allow firms sufficient time to develop tools, update methodologies, and provide training on the new requirements. A

few commenters also emphasized the importance of having the same effective date for any new standards on using the work of specialists and auditing accounting estimates.

While recognizing other implementation efforts, the effective date determined by the Board is designed to provide auditors with a reasonable period of time to implement the final amendments, without unduly delaying the intended benefits resulting from these improvements to PCAOB standards. The effective date is also aligned with the effective date of the related standards and amendments being adopted in the Estimates Release.

D. Economic Considerations and Application to Audits of Emerging Growth Companies

The Board is mindful of the economic impacts of its standard setting. This economic analysis describes the baseline for evaluating the economic impacts of the final amendments, analyzes the need for the final amendments, and discusses potential economic impacts of the final amendments, including the potential benefits, costs, and unintended consequences. The analysis also discusses alternatives considered.

In the Proposal, the Board had requested input from commenters on their views pertinent to the economic considerations, including the potential benefits and costs, discussed in the Proposal. One commenter stated that it believed the Proposal can be effectively implemented with minimal cost. Several commenters expressed concern, however, that the cost of the Proposal would be relatively greater for smaller audit firms and certain smaller companies. Some commenters also asserted that the Proposal would adversely affect the ability of smaller firms to compete in the audit services market. A number of commenters suggested that the incremental cost of certain aspects of the Proposal would outweigh any increase in audit quality. Finally, some commenters expressed concern that the Proposal could result in a shortage of qualified specialists due

to, for example, a potential increase in the demand for specialists by some audit firms under the proposed requirements.¹²⁶

The Board has considered all comments received, and has made certain changes to the final amendments to reflect those comments, including changes that mitigate some of the concerns expressed above with respect to the Proposal. The Board has also sought to develop an economic analysis that evaluates the potential benefits and costs of the final amendments, as well as facilitates comparisons to alternative Board actions. There are limited data and research findings available to estimate quantitatively the economic impacts of discrete changes to auditing standards in this area, and furthermore, no additional data was identified by commenters that would allow the Board to generally quantify the expected economic impacts (including expected incremental costs related to the Proposal) on audit firms or companies.¹²⁷ Accordingly, the Board's discussion of the economic impact is qualitative in nature.

Baseline

Section C above discusses existing PCAOB requirements for using the work of specialists and existing practice in the application of those requirements. This section addresses from an economic perspective: (1) the prevalence and significance of audits involving specialists; (2) the existing audit requirements that apply to the use of the work

¹²⁶ See below for a discussion of revisions to the proposed requirements in the final amendments to address this concern.

¹²⁷ One commenter provided anecdotal data on certain aspects of the Proposal that was limited to the commenter's experience in one specialized area. The data provided by this commenter, therefore, could not be used to quantify expected economic impacts that would generally apply to the use of the work of specialists.

of specialists; and (3) the quality of audits that involve specialists, based on observations from regulatory oversight and academic literature.

Prevalence and Significance of Audits Involving Specialists

Evidence from PCAOB Inspections Data

The Proposal observed that the PCAOB staff's analysis of inspections data for audits of issuers suggests that larger audit firms extensively use the work of specialists, in particular auditor-employed specialists, while smaller audit firms generally have a lower percentage of audit engagements in which they use the work of a company's specialist or an auditor's specialist.

The conclusion regarding larger audit firms was based on a PCAOB staff analysis of the 274 issuer audits¹²⁸ by U.S. audit firms affiliated with global networks¹²⁹ that were selected for inspection in 2015. This analysis found that auditors used the work of at least one auditor-employed specialist in about 85 percent of those audits. For the 85 percent of those audits that involved the use of auditor-employed specialists, an average of four to five individual specialists performed some work on each audit. In addition, on each of

¹²⁸ This analysis was performed on engagement-level data obtained through PCAOB inspections. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of the work of specialists across a broader population of companies. On average, the engagements selected for inspection are more likely to be complex (and thus more likely to involve the use of the work of a specialist) than the overall population of audit engagements.

¹²⁹ These firms consist of those U.S. audit firms that are registered with the PCAOB and affiliated with one of the six largest global networks, based on information on network affiliations reported by U.S. audit firms on Form 2 in 2017 and identified on the "Global Networks" overview page, available on the Board's website.

those audits, specialists performed work in one to two fields of expertise on average.¹³⁰

The results indicate that such audits typically had more than one specialist performing work in the same area of expertise.

The Proposal further noted that PCAOB inspections data for issuer audits suggested that, in contrast to larger audit firms, smaller U.S. audit firms generally have fewer audit engagements in which they use the work of a company's specialist or an auditor's specialist. Specifically, the PCAOB staff analyzed data from the 361 audits performed by U.S. audit firms not affiliated with one of the global networks that were selected for inspection by the PCAOB in 2015. Of those 361 issuer audits, the PCAOB staff identified: (1) 36 audits (i.e., about 10% of the analyzed audit engagements) in which the auditor used the work of a company's specialist but did not use the work of an auditor's specialist; (2) 24 audits (i.e., about 7% of the analyzed audit engagements) in which the auditor used the work of an auditor's specialist but did not use the work of a company's specialist; (3) 30 audits (i.e., about 8% of the analyzed audit engagements) in which the auditor used the work of a company's specialist and an auditor's specialist; and (4) 271 audits (i.e., about 75% of the analyzed audit engagements) in which the auditor neither used the work of a company's specialist nor used an auditor's specialist.

A PCAOB staff analysis of the 700 issuer audits by audit firms that were selected for inspection in 2017 is broadly consistent with the conclusions in the Proposal

¹³⁰ The data used in this analysis did not indicate how frequently the auditor used the work of an auditor-engaged specialist.

regarding the prevalence and significance of audits involving specialists.¹³¹ The results of this analysis are summarized in the table below:

Figure 5 - Audits performed by U.S. and non-U.S. audit firms that were selected for inspection by the PCAOB in 2017, categorized by use of the work of specialists

	% (number) of audits by larger audit firms (U.S.)	% (number) of audits by smaller audit firms (U.S.)	% (number) of audits by larger audit firms (non-U.S.)	% (number) of audits by smaller audit firms (non-U.S.)
(1) auditor used the work of a <i>company's specialist</i> but did not use the work of an <i>auditor's specialist</i>	8% (26)	10% (28)	8% (7)	6% (1)
(2) auditor used the work of an <i>auditor's specialist</i> but did not use the work of a <i>company's specialist</i>	20% (66)	2% (6)	34% (29)	0% (0)
(3) auditor used the work of both a <i>company's specialist</i> and an <i>auditor's specialist</i>	41% (136)	6% (17)	29% (25)	0% (0)
(4) auditor neither used the work of a <i>company's specialist</i> nor used an <i>auditor's specialist</i> ¹³²	31% (102)	81% (216)	29% (25)	94% (16)

¹³¹ The discussion in note 128 that applies to the 2015 analysis—regarding the selection of inspected audit engagements and how such engagements likely compare to the overall population of audit engagements—likewise applies to this 2017 analysis. Unlike the 2015 analysis, the engagement-level data selected for the analysis of PCAOB inspections performed in 2017 included data on issuer audit engagements conducted by non-U.S. as well as U.S. audit firms. In addition, this engagement-level data was based on specific focus areas, such as recurring audit deficiencies and audit areas that may involve significant management or auditor judgment, for issuer audit engagements selected for inspection. For a more detailed discussion of PCAOB inspection focus areas, see PCAOB, *Staff Inspection Brief: Information about 2017 Inspections*, Vol. 2017/3 (Aug. 2017).

¹³² The audit engagements not included in the preceding three categories were included in the fourth category.

	<i>% (number) of audits by larger audit firms (U.S.)</i>	<i>% (number) of audits by smaller audit firms (U.S.)</i>	<i>% (number) of audits by larger audit firms (non-U.S.)</i>	<i>% (number) of audits by smaller audit firms (non-U.S.)</i>
Total ¹³³	100% (330)	100% (267)	100% (86)	100% (17)

Source: PCAOB

As indicated by Figure 5, auditors used the work of an auditor's specialist in 61% and 63% of the analyzed audit engagements (the sum of categories (2) and (3) above) by larger audit firms—U.S. and non-U.S. firms, respectively—selected for inspection in 2017. Auditors used the work of a company's specialist without also using the work of an auditor's specialist (category (1) above) in only 8% of the analyzed audit engagements of larger audit firms—both U.S. and non-U.S. firms, respectively—selected for inspection in 2017. These results are also consistent with the anecdotal evidence discussed in section C (i.e., that larger audit firms generally require their engagement teams to evaluate the work of a company's specialist, including the specialist's methods and significant assumptions, and often employ specialists to assist their audit personnel in evaluating that work).

The results for smaller audit firms in Figure 5 are also consistent with the analysis in the Proposal and suggest that the work of an auditor's specialist or a company's specialist is used in relatively few audits. Specifically, in 81% and 94% of the audits by smaller audit firms—U.S. and non-U.S. firms, respectively—the auditor neither used the work of a company's specialist nor used an auditor's specialist (category (4) above), possibly because those audits did not involve circumstances that warranted the use of specialists by companies or their auditors. Consistent with the analysis of the issuer audits

¹³³ The total for the values shown in categories (1) through (4) may not add to 100% due to rounding.

selected for inspection in 2015, the results for smaller audit firms in Figure 5 further suggest that, when smaller audit firms use the work of a company's specialist, they often use that work without concurrently using the work of an auditor's specialist. In 62% of the audits by smaller U.S. firms that involved the use of the work of a company's specialist, the audit firm did not concurrently use the work of an auditor's specialist.¹³⁴ An auditor's specialist also was not concurrently involved in the only audit by a smaller non-U.S. firm that involved the use of the work of a company's specialist (category (1) above).

Evidence from the Academic Literature

Consistent with the results of the PCAOB staff analysis, the academic literature suggests that, when a company uses a company's specialist, some larger audit firms also tend to use the work of an auditor's specialist, at least in the context of audits involving challenging fair value measurements.¹³⁵ Furthermore, the academic literature also suggests that the use of valuation specialists is prevalent for at least some audits. One recent study of audits by the four largest firms that involved challenging fair value measurements found that 86% of audit teams used an auditor's specialist, including employed and engaged specialists.¹³⁶ In addition, 60% of the companies in this study

¹³⁴ Specifically, out of the 45 audit engagements of smaller U.S. firms that involved the use of the work of a company's specialists (the sum of categories (1) and (3) in Figure 5), 28 engagements did not concurrently involve the use of the work of an auditor's specialist (category (1) in Figure 5).

¹³⁵ See, e.g., Nathan H. Cannon and Jean C. Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, 92 (4) *The Accounting Review* 81 (2017) (study using an experiential questionnaire involving audit partners and managers of Big 4 firms in audits involving challenging fair value measurements).

¹³⁶ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements:*

used a company's specialist, including employed and engaged specialists.¹³⁷ The audits that were included in this study may not be representative of all audit engagements, because they were selected in order to study engagements that involved material, highly challenging fair value measurements. However, the results suggest that the use of an auditor's specialist is at least prevalent among audits performed by the four largest U.S. firms where a company's specialist is used to assist in the development of highly challenging and material fair value measurements, which may also be audit areas with a high risk of material misstatement and thus a need for greater audit attention.¹³⁸

Furthermore, the academic literature also corroborates the characterizations discussed in section C regarding the current practice of audit firms when using specialists. Academic studies suggest that, at least among the audits that were studied where specialists were used, larger firms were more likely to use the work of auditor-

Evidence From the Field 90. In another study of how auditors use valuation specialists, auditors from seven large U.S. audit firms who were interviewed stated that, on average, 61% of their engagements in the prior year involved a valuation specialist, including auditor-employed and/or auditor-engaged specialists. See Emily E. Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 13 (July 2016) (working paper, available in Social Science Research Network ("SSRN")).

¹³⁷ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field* 90.

¹³⁸ Another recent qualitative study conducted through interviewing audit partners, managers, and seniors also observed that auditors in the six large audit firms in Canada consider factors such as the "client's regulatory environment and other general risk factors," "lack of subject matter expertise within the audit team," and "complexity of the engagement" when determining whether to use a specialist. See J. Efrim Boritz, Natalia Kochetova-Kozloski, Linda A. Robinson, and Christopher Wong, *Auditors' and Specialists' Views About the Use of Specialists During an Audit* 28, 35 (Mar. 2017) (working paper, available in SSRN).

employed specialists than auditor-engaged specialists in their engagements,¹³⁹ while even among the larger firms there are differences in the extent of their use of the work of auditor-engaged specialists.¹⁴⁰

A possible explanation for the tendency of larger firms to use the work of auditor-employed specialists (instead of auditor-engaged specialists) is that larger firms, due to the greater number of their audit engagements or their existing non-auditing practices, have sufficient demand for the services of specialists to warrant hiring specialists who work for them full-time. In contrast, smaller firms may not have many audit engagements where the auditor requires the use of an auditor's specialist, so that engaging an auditor's specialist only as needed may be economically more advantageous. In addition, the tendency of smaller firms to look to the work of a company's specialist without using the

¹³⁹ See, e.g., Steven M. Glover, Mark H. Taylor, and Yi-Jing Wu, *Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy*, 36 (1) *Auditing: A Journal of Practice & Theory* 63, 75 (2017) ("[R]esults indicate that approximately two-thirds (one-third) of our participants reported that they use in-house (third-party) valuation specialists to support the audit work performed for financial FVMs [i.e., fair value measurements]. Moreover, approximately 87 percent (13 percent) of the audit partners indicated that they use in-house (third-party) valuation specialists to support the audit work for nonfinancial FVMs."); see also Emily E. Griffith, Jacqueline S. Hammersley, and Kathryn Kadous, *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice*, 32 *Contemporary Accounting Research* 833, 836 (2015) ("[A]uditors [from the U.S. audit firms affiliated with the six largest global networks] typically enlist audit-firm specialists in auditing estimates because they do not have valuation expertise...").

¹⁴⁰ See Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 58. In this study, all participating auditors from Big 4 audit firms indicated that they used internal valuation specialists (i.e., auditor-employed valuation specialists) and did not use any external valuation specialists (i.e., auditor-engaged valuation specialists). In contrast, only 40% of the auditors from the three other audit firms that participated in the study indicated that they exclusively used internal valuation specialists.

work of an auditor's specialist may reflect the fact that existing AS 1210 enables the auditor to use the work of a company's specialist in a wide range of situations, without imposing obligations on the auditor that might call for the retention of an auditor's specialist.¹⁴¹

PCAOB Auditing Standards Regarding Use of the Work of Specialists

As discussed in more detail in section C, under existing standards, the auditor's primary responsibilities with respect to a company's specialist are set forth in existing AS 1210. That standard also imposes the same responsibilities on auditors with respect to an auditor-engaged specialist, even though an auditor-engaged specialist has a fundamentally different role than a company's specialist. While the auditor's specialist performs work to assist the auditor in obtaining and evaluating audit evidence, the company's specialist performs work that is used by the company in preparing its financial statements and that the auditor may use as audit evidence.

The professional relationships between an auditor and a company's specialist, and between an auditor and an auditor's specialist, differ, among other things, in terms of who is employing or engaging the specialist (i.e., the company in the case of a company's specialist and the auditor in the case of an auditor's specialist). Therefore, the level of control and oversight an auditor is able to exercise over the specialist also differs. Given these differences, which expose a company's specialist and an auditor-engaged specialist to different incentives and biases (e.g., pressure to conform to management bias),¹⁴²

¹⁴¹ Similarly, the final amendments enable the auditor to use the work of a company's specialist in a wide range of situations, without necessarily obligating the auditor to retain an auditor's specialist.

¹⁴² For a discussion of pressures facing a company's specialist, see Divya

requirements would ideally differentiate between the two types of specialists, but existing requirements do not do so.

In contrast, existing PCAOB requirements for using the work of an auditor-employed specialist, who is subject to supervision under AS 1201, differ from the requirements that apply to using the work of an auditor-engaged specialist. Auditor-employed and auditor-engaged specialists may differ in their economic dependency on the auditor and, by extension, could face different incentives to acquiesce to certain auditor decisions, such as a decision by the auditor to downplay or suppress unfavorable information in order to accommodate a conclusion sought by the auditor.¹⁴³ While anecdotal evidence from the academic literature related to a company's specialists suggests that employed specialists may face stronger incentives to do so than engaged specialists,¹⁴⁴ it is difficult to generalize as to whether auditor-employed specialists have

Anantharaman, *The Role of Specialists in Financial Reporting: Evidence from Pension Accounting*, 22 *Review of Accounting Studies* 1261, 1299-300 (2017) (concluding that "client pressure and opinion shopping" affect the work product of actuaries used by company management, which "suggests potentially greater effects for other specialists not subject to the same levels of oversight (e.g., experts in valuing complex financial instruments and other untraded assets)" and that "economically important clients of their actuaries use more aggressive (obligation-reducing) discount rates [than] less important clients of the same actuary").

¹⁴³ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 32 ("[A]udit teams delete extraneous information in specialists' memos when that information contradicts what the audit team has documented in other audit work papers...") and 33 ("Auditors and specialists described several defensive behaviors by auditors that restrict specialists' access to information...Restricting specialists' access to information can influence how specialists do their work, what work they do, and what conclusions they reach.").

¹⁴⁴ See, e.g., J. Richard Dietrich, Mary S. Harris, and Karl A. Muller III, *The Reliability of Investment Property Fair Value Estimates*, 30 *Journal of Accounting and Economics* 125, 155 (2001) ("[O]ur investigation reveals that the reliability of fair value estimates varies according to the relation between the appraiser and the [company]

a greater economic dependency on auditors than auditor-engaged specialists.¹⁴⁵ Any potential bias by auditor-employed and auditor-engaged specialists arising from economic dependency on the auditor may be mitigated by the responsibility imposed directly on the engagement partner under AS 1201 for supervision of the work of engagement team members and compliance with PCAOB standards, including those regarding using the work of specialists. In addition, AS 1220 requires the engagement quality reviewer to "evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report." Such significant judgments may include areas where auditors used the work of an auditor-employed or auditor-engaged specialist.

Furthermore, auditor-employed and auditor-engaged specialists serve similar roles in helping auditors obtain and evaluate audit evidence. Given their similar roles, it seems appropriate that the auditor would follow similar requirements when using both types of specialists, though existing requirements differ for the two types of specialists. A notable difference in the relationship of the auditor with auditor-employed and auditor-engaged specialists, however, relates to the integration of auditor-employed specialists (as compared with auditor-engaged specialists) in an audit firm's or network's quality control

(internal versus external appraiser)...We find evidence that appraisals conducted by external appraisers result in relatively more reliable fair value accounting estimates (i.e., lower conservative bias, greater accuracy and lower managerial manipulation).").

¹⁴⁵ The extent of economic dependency of an auditor-employed specialist on the auditor will depend, for example, on how much of the specialist's work and the specialist's compensation is related to audits (as opposed to non-audit services), which may vary for different auditor-employed specialists. Similarly, the extent of economic dependency of an auditor-engaged specialist on the auditor will depend on how much of the specialist's overall work or income is connected to the particular audit firm, which may vary for different auditor-engaged specialists.

systems, which allows the auditor greater visibility into any relationships that might affect the auditor-employed specialist's independence, as well as greater visibility into the auditor-employed specialist's knowledge, skill, and ability. The final requirements with respect to evaluating the objectivity, as well as knowledge, skill, and ability, of an auditor-engaged specialist, therefore, sought to reflect that difference by providing the auditor with specific requirements to assess whether the auditor-engaged specialist has both the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and the level of knowledge, skill, and ability to perform the specialist's work related to the audit.

As discussed in more detail below, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. However, due to the differences in the auditor's ability to assess the specialist's independence, as well as the specialist's knowledge, skill, and ability, the Board is adopting separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist. It is expected that there would be few differences in the procedures undertaken by the auditor when using an auditor's specialist, whether employed or engaged, with such differences limited to the auditor's assessment of the knowledge, skill, ability, and objectivity of an auditor-engaged specialist (where the auditor may not be able to leverage an audit firm's or network's quality control system to perform these assessments).

Quality of Audits That Involve Specialists

As discussed in section C, PCAOB oversight of audit engagements in which auditors used the work of a company's or an auditor's specialist and SEC enforcement actions have identified instances of noncompliance with PCAOB standards, e.g., situations where auditors did not appropriately evaluate the work of specialists. For issuer audit engagements, PCAOB staff have more recently observed a decline in the number of instances in which auditors at some audit firms did not perform sufficient procedures related to the work of an auditor's specialist. There are some preliminary indications that some, but not all, firms with observed deficiencies have undertaken remedial actions in response to such findings, which may have contributed, at least in part, to improvements in audit quality related to the auditor's use of an auditor's specialist.

Relatively few empirical academic studies have explicitly examined the relationship between the use of specialists and perceptions of audit quality by investors and auditors.¹⁴⁶ This may be because it is difficult, especially for investors, to assess the effect of using specialists on audit quality independently from the effects of other

¹⁴⁶ See, e.g., Brant E. Christensen, Steven M. Glover, Thomas C. Omer, Marjorie K. Shelley, *Understanding Audit Quality: Insights from Audit Professionals and Investors*, 33 *Contemporary Accounting Research* 1648, 1667 (2016) ("Audit professionals [that were surveyed as part of the study] associate the use of both external experts and internal specialists with higher audit quality."). Relatedly, one recent academic study examined the relationship between the use of forensic accountants (described by the authors as "specialists") and the value of their involvement as perceived by the auditor. While forensic accountants are not specialists within the scope of this standard, the authors of the study argued that the findings "likely translate into understanding other specialist domains." The authors suggested that the involvement of forensic accountants is accompanied by the "incremental discovery of ... material misstatements," and further stated that "our results indicate both auditors and forensic specialists recognize the value and additional comfort that come from forensic specialist involvement on audits." See J. Gregory Jenkins, Eric M. Negangard, and Mitchell J. Oler, *Getting Comfortable on Audits: Understanding Firms' Usage of Forensic Specialists*, *Contemporary Accounting Research*, in-press 4 (2017).

relevant factors, such as the quality of the company's financial reporting or internal controls.¹⁴⁷ However, available studies have investigated the relationship between the quality of financial statement estimates, which often are provided with the assistance of a company's specialist, and the usefulness of such estimates to investors. These studies find that less reliable estimates tend to be less useful to investors.¹⁴⁸ Other studies suggest that some estimates are also more likely to be discounted by investors.¹⁴⁹ Because investors' perceptions of the credibility of financial statements are influenced by their perceptions of audit quality, the auditor's appropriate use of the work of specialists should increase the credibility of the accounting estimates included in the financial statements.

Need for the Rulemaking

¹⁴⁷ While not directly assessing the relationship between the use of specialists and perceptions of audit quality, academic literature has investigated factors that influence an auditor's approach to auditing accounting estimates, including the decision whether to use the work of specialists. *See, e.g.,* Jennifer R. Joe, Scott D. Vandervelde, Yi-Jing Wu, *Use of High Quantification Evidence in Fair Value Audits: Do Auditors Stay in their Comfort Zone?*, 92 (5) *The Accounting Review* 89 (2017); Emily E. Griffith, *When Do Auditors Use Specialists' Work to Improve Problem Representations of and Judgments about Complex Estimates?*, 93 (4) *The Accounting Review* 177 (2018).

¹⁴⁸ *See, e.g.,* Scott A. Richardson, Richard G. Sloan, Mark T. Soliman, and Irem Tuna, *Accrual Reliability, Earnings Persistence and Stock Prices*, 39 *Journal of Accounting and Economics* 437, 437-438 (2005) (finding that "less reliable accruals lead to lower earnings persistence ... leading to significant security mispricing").

¹⁴⁹ *See, e.g.,* Chang Joon Song, Wayne B. Thomas, and Han Yi, *Value Relevance of FAS No. 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms*, 85 *The Accounting Review* 1375 (2010). Furthermore, the academic literature notes that auditing estimates with extreme uncertainty can pose significant challenges for auditors. *See, e.g.,* Brant E. Christensen, Steven M. Glover, and David A. Wood, *Extreme Estimation Uncertainty in Fair Value Estimates: Implications for Audit Assurance*, 31 (1) *Auditing: A Journal of Practice & Theory* 127 (2012).

From an economic perspective, the primary cause for market failure¹⁵⁰ that motivates the need for the final amendments is the moral hazard¹⁵¹ affecting the auditor's decisions on how to implement audit procedures related to the use of the work of a specialist, which increases the risk of lower audit quality from the investor's perspective.

As described in the Proposal, the moral hazard problem related to the use of the work of a specialist generally manifests in the auditor not performing appropriate procedures, even though such procedures would improve audit quality by increasing the auditor's attention, because the auditor may not perceive sufficient economic benefit (compared to the corresponding costs¹⁵² and efforts) from such actions. Specifically, when auditors use the work of a company's specialist, moral hazard may take the form of the auditor failing to evaluate data, significant assumptions, and methods used by the

¹⁵⁰ For a discussion of the concept of market failure, *see, e.g.*, Francis M. Bator, *The Anatomy of Market Failure*, 72 *The Quarterly Journal of Economics* 351 (1958); and Steven G. Medema, *The Hesitant Hand: Mill, Sidgwick, and the Evolution of the Theory of Market Failure*, 39 *History of Political Economy* 331 (2007).

¹⁵¹ The moral hazard problem is also referred to as a hidden action, or agency problem, in economics literature. The term "moral hazard" refers to a situation in which an agent could take actions (such as not working hard enough) that are difficult to monitor by the principal and would benefit the agent at the expense of the principal. To mitigate moral hazard problems, the agent's actions need to be better aligned with the interests of the principal. Monitoring is one mechanism to mitigate these problems. *See, e.g.*, Bengt Holmström, *Moral Hazard and Observability*, 10 *The Bell Journal of Economics* 74 (1979).

¹⁵² For a discussion of the effect of cost pressures on audit quality, *compare* James L. Bierstaker and Arnold Wright, *The Effects of Fee Pressure and Partner Pressure on Audit Planning Decisions*, 18 *Advances in Accounting* 25, 40 (2001) (finding, as the result of their experiment, that "auditors significantly reduced budgeted hours ... and planned tests ... in response to fee pressure") *with* Bernard Pierce and Breda Sweeney, *Cost–Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004) (finding, in relation to the Irish market, that "dysfunctional behaviours" are related to time pressure and performance evaluation).

specialist to an extent that would be commensurate with the risk of material misstatement inherent in the specialist's work. Moral hazard in the context of auditors using the work of a company's specialist might also take the form of the auditor failing to appropriately assess relationships between the company's specialist and the company.¹⁵³ In addition, when auditors use the work of an auditor's specialist, moral hazard may, for example, take the form of not performing procedures, or performing insufficient procedures, to communicate and reach an understanding with the specialist regarding the specialist's responsibilities and the objectives of the specialist's work, or insufficiently evaluating that work.¹⁵⁴

In such contexts, moral hazard is made possible by the information asymmetry¹⁵⁵ that exists due to the lack of transparency about the nature of the auditor's work (i.e., between the auditor on the one hand, and investors on the other hand). Investors typically do not know whether an auditor used the work of a specialist and, if so, how the work of the specialist was used. Because of this information asymmetry, the auditor may face little to no scrutiny from investors or others (e.g., audit committees) regarding his or her

¹⁵³ See Anantharaman, *The Role of Specialists in Financial Reporting: Evidence from Pension Accounting*, at 1265 (describing empirical evidence that suggests that auditors "have difficulty in screening out relationships" that might impair the "objectivity" of company specialists).

¹⁵⁴ Alternatively, it is conceivable that, in some situations, moral hazard may take the form of the auditor either influencing the findings or conclusions that specialists reach or modifying the specialist's work after the fact to support the conclusions sought by the auditor. See *supra* note 143.

¹⁵⁵ Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party. For a discussion of the concept of information asymmetry, see, e.g., George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *The Quarterly Journal of Economics* 488 (1970).

audit procedures when using the work of specialists,¹⁵⁶ and may perceive limited economic benefits (e.g., gains in revenue, gains in professional reputation, or a reduction in potential liability) in incurring costs to perform additional audit work. Hence, the moral hazard problem between the auditor and investors may have a detrimental impact on audit quality.¹⁵⁷

Because market forces (e.g., pressure and demands from investors) may not be effective in making the auditor more responsive to investor interests with respect to the use of the work of specialists,¹⁵⁸ from an economic perspective, the situation absent

¹⁵⁶ This is true for other aspects of the audit engagement as well and hence the audit can be thought of providing investors with a credence service. Credence services are difficult for users of the service (such as investors in the context of company audit services) to value because their benefits are difficult to observe and measure. See Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 *Accounting Horizons* 631 (2012). See also Alice Belcher, *Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies*, 18 *Bond Law Review* 1, 5 (2006) (An "audit is a credence service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company.").

¹⁵⁷ Additionally, such situations may occur because the auditor made an error in judgment assessing the audit risk involved when using the work of an auditor's specialist or a company's specialist. In situations in which "objectives and the actions needed to achieve them are complex and multifaceted, it is inevitable that different people...will...interpret...them in different ways..." See John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 *Academy of Management Review* 98, 107–108 (2002). When people are choosing their actions in such situations, Hendry argues that the predicted actions (and hence resulting problems) are more or less the same, whether one assumes that they are unselfish yet "prone to mak[ing] mistakes," or instead are self-interested and opportunistic yet unlikely to make mistakes. *Id.* at 100.

¹⁵⁸ The degree of responsiveness of the auditor to investor interests, such as increasing audit effort in some circumstances when using the work of specialists, may also be related to, among other things, the auditor's ability to pass on cost increases to companies (and, ultimately, to investors) in the form of higher audit fees. See *infra* note 175 for a further discussion of cost pass-through.

standards would be characterized as a form of market failure. While existing standards regarding the use of the work of a company's specialist and an auditor-engaged specialist are intended to address and mitigate potential auditor moral hazard, they could be aligned more closely with the risk assessment standards, which could enhance audit quality. In addition, while auditor-employed specialists are supervised under a risk-based approach, specifying requirements for applying that approach when using an auditor-engaged specialist could promote an improved, more uniform approach to supervision. Additionally, if the work of an auditor's specialist is not properly overseen or evaluated (or the work of a company's specialist is not properly evaluated), there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.

Furthermore, the auditor does not engage or employ a company's specialist and does not supervise the work of a company's specialist. This makes the auditor's use of the work of a company's specialist different from the auditor's use of an auditor's specialist in several important ways. First, because of the different relationships the auditor has with a company's specialist and with an auditor's specialist, the auditor's assessment of the qualifications and relationships of a company's specialist requires greater effort by the auditor compared to the auditor's equivalent procedures with respect to an auditor's specialist. Second, the auditor's consideration of data, significant assumptions, and methods used by the company's specialist may also be more challenging (for example, due to the specialist's use of proprietary data), compared to equivalent procedures performed by the auditor when using a specialist with whom the auditor has an employment or contractual relationship. Third, an auditor is generally more likely to be

familiar with an auditor's specialist than with a company's specialist (e.g., with the professional qualifications, reputation, and work), which reduces the costs associated with the ongoing monitoring of the specialist's work. Given these differences, the standards would ideally differentiate between the two types of specialists, but existing AS 1210 currently does not do so. Accordingly, the potential for moral hazard relating to the auditor's use of the work of a company's specialist is a particular focus of the requirements in the final amendments to AS 1105.

The need to enhance existing standards is further heightened by the fact that it may be particularly challenging for the auditor to evaluate the work of either an auditor's specialist or a company's specialist or to supervise an auditor's specialist. The work of a company's specialist or an auditor's specialist often involves professional judgment, the nature of which the auditor may not fully appreciate when evaluating the work of the specialist. In particular, the specialist's work is highly technical in nature and often is not entirely transparent to the auditor, who may not have complete access to the specialist's work¹⁵⁹ or the same level of knowledge and skill in the specialist's field.¹⁶⁰ Thus, due to the potential that an auditor would incur relatively higher cost to supervise an auditor's

¹⁵⁹ For example, as further discussed in section C, some commenters on the Proposal expressed concern that the auditor may have limited access to proprietary information used by a company's specialist or an auditor-engaged specialist (as compared with information used by an auditor-employed specialist). The final amendments do not require the auditor to obtain such proprietary information, but instead to obtain sufficient information to assess whether the model is in conformity with the applicable financial reporting framework.

¹⁶⁰ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 23 ("[Results] show[] that many auditors review specialists' work for general understanding and sufficiency of the work performed, rather than reviewing in detail as they would in other areas of the audit. They approach the review this way because they cannot fully understand specialists' work.").

specialist or to evaluate the work of a company's or an auditor's specialist, the auditor may have incentives to forego procedures related to the use of the work of specialists that could be beneficial to investors.

The potential negative impact on audit quality of the auditor's incentives to forgo procedures is compounded by the possibility that an auditor's specialist may perceive little benefit (compared to the corresponding costs and efforts) in fully carrying out their responsibilities, including the objectives of the work to be performed.¹⁶¹ Alternatively, the specialist may in some instances believe that he or she faces few negative consequences (such as an increase in potential liability) when performing low quality work or, as one commenter on the Proposal asserted, an auditor's specialist may not set forth conclusions anticipated to be rejected by the auditor. However, any such concerns are at least partially alleviated to the extent specialists are subject to codes of conduct, standards, and disciplinary processes of their own profession or could perceive a risk of reputational damage.¹⁶²

The Proposal stated that enhanced performance standards regarding the use of the work of specialists might improve audit quality and benefit investors. One commenter

¹⁶¹ To the extent that an auditor's specialist has a stronger relationship with the auditor (e.g., repeated business interactions between the specialist and the auditor), the potential for moral hazard arising in the context of the auditor using such an auditor's specialist could be higher. However, a stronger relationship between the auditor and the auditor's specialist may also result in the specialist's work being more commensurate with the risk of material misstatement associated with the financial statement assertion and, therefore, improve audit quality.

¹⁶² See, e.g., Letter from American Academy of Actuaries (Aug. 29, 2017), at 1–2, available on the Board's website in Docket 044 (stating that the Academy's members "are subject to a code of professional conduct, standards of qualification and practice, and a disciplinary process" and that "our profession has a specific standard that defines appropriate practice for actuaries during the course of an audit").

asserted that the Proposal had not articulated a pervasive problem that would be solved by a change in auditing standards. This commenter further stated that it was not persuaded that a change in the audit framework for the auditor's use of specialists was necessary, based on its view that a significant amount of audit work is currently being performed. The Board believes, however, that the changes in the final amendments described in section C are needed (and preferable to other policy-making approaches)¹⁶³ because market forces alone cannot mitigate the moral hazard problem described above.

Strengthening the requirements for evaluating the work of a company's specialist, as well as applying a risk-based supervisory approach when using the work of both auditor-employed and auditor-engaged specialists, will prompt auditors to plan and perform audit procedures commensurate with the risk of material misstatement inherent in the specialist's work, and thereby mitigate the moral hazard problem. The final amendments direct more audit attention and effort, when using the work of specialists, to areas where the specialist's work is more significant to the auditor's conclusion on a financial statement assertion and the risk of material misstatement is higher.

Specifically, as discussed in section C, the final amendments mitigate the moral hazard problem by linking the auditor's responsibilities for determining the necessary evidence when evaluating the work of the company's specialist, including the data, significant assumptions, and methods used by the specialist, to four factors: the risk of material misstatement of the relevant assertion; the significance of the specialist's work to the auditor's conclusion regarding that assertion; the level of knowledge, skill, and ability

¹⁶³ See below for a discussion of why the Board believes that standard setting is preferable to other policy-making approaches.

of the specialist; and the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Further, the final amendments mitigate the moral hazard problem in the context of the use of the work of an auditor's specialists by clarifying the auditor's supervisory responsibilities over auditor-employed specialists and establishing parallel requirements when auditors use the work of auditor-engaged specialists, as discussed in section C. In addition, the necessary extent of supervision under the final amendments depends on factors similar to those that govern the necessary auditor effort in evaluating the work of a company's specialist.

Economic Impacts

The magnitude of the benefits and costs of the final amendments will be affected by the nature of and risks involved in the work performed by specialists, because more complex work and work in areas of greater risk will likely require greater audit effort, holding all else constant. In addition, benefits and costs are likely to be affected by the degree to which auditors have already adopted audit practices and methodologies that are similar to those that the final amendments will require.¹⁶⁴

The remainder of this subsection discusses the potential benefits, costs, and unintended consequences that may result from the final amendments the Board is adopting.

Benefits

¹⁶⁴ Additionally, the new standard and related amendments in the Estimates Release, *supra* note 20, may affect the future prevalence and significance of the use of the work of specialists and, therefore, have an impact on the benefits and costs of the final amendments discussed in this section.

The requirements in the final amendments are expected to benefit investors and auditors by directing auditors to devote more attention to the work of specialists and enhancing the coordination between auditors and their specialists. This should mitigate the problem of auditor moral hazard discussed in the preceding section and contribute to improved audit quality. The final amendments are intended to accomplish this, and increase the likelihood that auditors will detect material misstatements, through requirements that take into account current auditing practices by some larger audit firms and more strongly align auditors' interests with the interests of investors when auditors use the work of specialists. At the same time, by fostering improved audit quality, the final amendments should increase investors' perception of the credibility of a company's financial statements, and help address uncertainty about audit quality and the potential risks associated with the use of the work of company specialists, auditor-employed specialists, and auditor-engaged specialists.

The Board believes that investors will benefit from the final amendments because the application of the requirements should result in more consistently rigorous practices among auditors when using the work of a company's specialist in their audits, as well as a more consistent approach to the supervision of auditor-employed and auditor-engaged specialists. The current divergence in practices related to the auditor's use of the work of specialists, combined with a lack of information about such divergence, could mean that investors are unable to distinguish the quality of each audit separately, which in turn could lead investors to discount the quality of all audits. Conversely, greater consistency in such practices—such as would be promoted by the final amendments—could mitigate those concerns by both enhancing the quality of less rigorous audits and correcting the

inappropriate discounting of more rigorous audits. From an investor's perspective, and as one commenter concurred, the increase in audit quality that should result from the final amendments should contribute to investor protection. Specifically, an increase in audit quality may increase the quality of the information provided in a company's financial statements and decrease the cost of capital for that company,¹⁶⁵ especially if less information is available about the company because it has a shorter financial reporting history.¹⁶⁶

From a broader capital markets perspective, an increase in the information quality of a company's financial statements because of improved audit quality can increase the efficiency of capital allocation decisions. In other words, an increase in the information quality of companies' financial statements can reduce the non-diversifiable risk to

¹⁶⁵ See, e.g., Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 385, 386-7 (2007) ("[A]ccounting information influences a [company's] cost of capital ... where higher quality accounting information ... affects the market participants' assessments of the distribution of future cash flows"); see also Randolph P. Beatty, *Auditor Reputation and the Pricing of Initial Public Offerings*, 64 *The Accounting Review* 693, 696 (1989) ("Since auditing firms that have invested more in reputation capital have greater incentives to reduce application errors, the information disclosed in the accounting reports audited by these firms will be more precise, *ceteris paribus*. This reduction in measurement error will allow uninformed investors to estimate more precisely the distribution of firm value.").

¹⁶⁶ See, e.g., Jeffrey A. Pittman and Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, 37 *Journal of Accounting and Economics* 113, 114 (2004) ("[E]ngaging [an audit firm with] a brand name reputation for supplying higher-quality audit that enhances the credibility of financial statements, enables young [companies] to reduce their borrowing costs...[O]ur research suggests that the economic value of auditor reputation declines with age as [companies] shift toward exploiting their own reputations to reduce information asymmetry.").

investors and generally should result in investment decisions by investors that more accurately reflect the financial position and operating results of each company.¹⁶⁷

In addition to the general benefits to investors and the capital markets described above, the final amendments should result in specific benefits to auditors. In particular, the final amendments should lead to improvements in the ability of auditors to supervise auditor-employed and auditor-engaged specialists and evaluate their work, to the extent that auditors devote more attention to the work of auditor-employed and auditor-engaged specialists and enhance the coordination with those specialists. The final amendments with regard to the use of the work of a company's specialist should also lead to improvements in the auditor's understanding of the data, significant assumptions, and methods used by the company's specialist. As auditors are better able to identify and detect potential risks of material misstatement, this may also spur companies and their specialists over time to improve the quality of financial reporting and their work.

The final amendments may also contribute to the aggregate benefits of the auditing standards (i.e., by enhancing auditors' understanding of, and compliance with, other PCAOB auditing standards), in addition to the other improvements in audit quality described above. For example, the final amendments to evaluate the work of a company's

¹⁶⁷ See, e.g., Lambert et al., *Accounting Information, Disclosure, and the Cost of Capital* 388 (finding that information quality directly influences a company's cost of capital and that improvements in information quality by individual companies unambiguously affect their non-diversifiable risks.); Ahsan Habib, *Information Risk and the Cost of Capital: Review of the Empirical Literature*, 25 *Journal of Accounting Literature* 127, 128 (2006) ("A commitment to increased level [and quality] of disclosure reduces the possibility of information asymmetries and hence should lead to a lower cost of capital effect. ... In addition, high quality auditing ... could provide credible information in the market regarding the future prospect of the [company] and hence could reduce the cost of capital in general, and cost of equity capital in particular." (footnote omitted)).

specialist should result in some auditors developing a better understanding of the company's accounting estimates in significant financial statement accounts and disclosures. In turn, this may also result in improved communications with audit committees.¹⁶⁸

The magnitude of the benefits discussed in this section resulting from improved audit quality will likely vary to the extent that current practices are aligned with the final amendments. Based on observations from the Board's oversight activities, most firms would need to enhance their methodologies, but to varying degrees. In general, both the greatest changes and the greatest benefits are likely to occur with auditors that need to enhance their methodologies the most.

Costs

The Board recognizes that the benefits of the final amendments will come at additional costs to auditors and the companies they audit. As with any changes to existing requirements, it is anticipated that there will be one-time costs for auditors associated with updating audit methodologies and tools, preparing new training materials, and conducting training.¹⁶⁹ The final amendments could also give rise to recurring costs in the form of additional time and effort spent on any individual audit engagement by specialists and engagement team members.

¹⁶⁸ See paragraphs .12c and .13c of AS 1301, *Communications with Audit Committees*, for the auditor's communication requirements related to the company's critical accounting estimates.

¹⁶⁹ The PCAOB has observed that larger firms are likely to update their methodologies using internal resources, whereas smaller firms are more likely to purchase updated methodologies from external vendors.

The most significant impact of the final amendments on costs for auditors is expected to result from the requirements to evaluate the work of a company's specialist. This area of potential impact was also noted by some commenters on the proposed requirements for testing and evaluating the work of a company's specialist.

Compared with the existing requirements,¹⁷⁰ the auditor will be required under the final amendments to evaluate the significant assumptions used by the company's specialist whenever the specialist's work is used, rather than only in certain circumstances,¹⁷¹ as well as the methods used by the specialist. In practice, these requirements may result in auditors performing more work or using an auditor's specialist to assist them in evaluating the work of a company's specialist. This may lead to significant changes in practice for some firms, particularly smaller firms that currently do not employ specialists and follow methodologies solely based on existing AS 1210, even though the final amendments do not require the auditor to use the work of an auditor's specialist.

Compared to the Proposal, however, the final amendments clarify the auditor's responsibility when evaluating the work of the company's specialist and, therefore, should further limit any incremental cost to circumstances where increases in audit quality can be reasonably expected. For example, as detailed in section C, the final

¹⁷⁰ See existing AS 1210.12.

¹⁷¹ In circumstances when an auditor is auditing fair value measurements and disclosures in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurements and disclosures.

amendments reflect changes to the Proposal relating to the auditor's evaluation of the data, significant assumptions, and methods used by the company's specialist. These revisions clarify that the focus of the auditor's evaluation does not require reperforming the specialist's work. Instead, the auditor's responsibility is to evaluate whether the specialist's work provides sufficient appropriate evidence to support a conclusion regarding whether the corresponding accounts or disclosures in the financial statements are in conformity with the applicable financial reporting framework.

In addition, some of the expected cost increases for auditors due to the final amendments are likely to be offset by the implementation of more risk-based audit approaches in practice (e.g., more targeted procedures when using the work of specialists). More risk-based audit approaches reduce the risk to the auditor of failing to detect material misstatement and thus could lead to a reduction in costs resulting from potential liability or reputational loss faced by auditors.

The final amendments' impact on costs for auditors could also vary based on the size and complexity of an audit engagement. Holding all else constant, anticipated costs generally would be higher for larger, more complex audits than for smaller, less complex audits.¹⁷² As discussed above, a smaller portion of audits performed by smaller audit firms tend to involve use of the work of specialists, compared with audits performed by larger audit firms. Accordingly, it is reasonable to infer that relatively fewer audits of smaller firms will be impacted by the final amendments than audits of larger firms.

¹⁷² See Letter from American Academy of Actuaries (July 31, 2015), at 18, available on the Board's website in Docket 044 (stating that "smaller audit firms also tend to have clients that require fewer special needs" and thus implying that audit engagements of smaller audit firms tend to be less complex than audit engagements of larger audit firms).

The impact of the final amendments would also likely vary, however, depending on the extent to which elements of the final amendments have already been incorporated in an audit firm's methodologies or applied in practice by individual engagement teams. For auditors that have already implemented elements of the final amendments, the costs of implementing the final amendments will be lower than for firms that currently perform more limited audit procedures. For example, some firms employ procedures to reach and document their understanding with an auditor's specialist about, among other things, the responsibilities of the auditor's specialist and the nature of the work to be performed. Firms that do not already employ such procedures may incur additional costs under the final amendments.

Similarly, the incremental impact of the final amendments on costs incurred by auditors would likely vary depending on, among other things, how many of an audit firm's engagements involve the use of the work of specialists. Among audit firms that use the work of specialists on their engagements, the anticipated costs would likely be higher for those firms that use the work of specialists more frequently or extensively than for firms that do so less frequently or extensively. Larger audit firms generally perform a larger number of audit engagements, however, and the incremental impact of the final amendments on their costs per engagement should be lower than for smaller firms that generally perform a smaller number of audit engagements. This would be the case regardless of whether the audit engagements of the larger and smaller firms involve the use of the work of specialists, since larger firms, due to their existing economies of

scale¹⁷³ and scope,¹⁷⁴ would tend to be able to distribute the overall cost impact of the final amendments over a larger number of audit engagements.

Some commenters argued that the Proposal could lead, in some instances, to significant (and potentially pervasive) increases in auditing costs, due to increased audit effort that would not necessarily be accompanied by corresponding increases in audit quality. In contrast, one commenter asserted that the requirements could be implemented effectively with minimal costs. In adopting the final amendments, the Board modified certain of the proposed amendments with the intent that the final amendments be risk-based and scalable, and that any cost increases be accompanied by commensurate improvements in audit quality. For example, as discussed earlier in this subsection, the final amendments reflect changes to the Proposal relating to the auditor's evaluation of the data, significant assumptions, and methods used by the company's specialist. These changes clarify that the focus of the auditor's evaluation does not require reperforming

¹⁷³ See *Economies of Scale and Scope*, The Economist, Oct. 20, 2008 (available at <https://www.economist.com/news/2008/10/20/economies-of-scale-and-scope>) ("Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output [i.e., number of audit engagements] increases."). In this context, the average cost would likely fall with the number of audit engagements, because certain costs, such as the cost of employing specialists, are not directly related to the number of audit engagements that an auditor assumes. See also Simon Yu Kit Fung, Ferdinand A. Gul, and Jagan Krishnan, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing* 87 *The Accounting Review* 1281, 1287 (2012) ("For an audit firm, the scale economies can arise from substantial investment in general audit technology (e.g., audit software development or hardware acquisition) and human capital development (e.g., staff training), which are likely to be shared among all of their clients. Once these investments are in place, additional clients can be serviced at a lower marginal cost than the cost of servicing the first few clients.").

¹⁷⁴ See *Economies of Scale and Scope*, The Economist ("[E]conomies of scope [are] factors that make it cheaper to produce a range of products together than to produce each one of them on its own. Such economies can come from businesses sharing centralised functions...").

the specialist's work and thus should limit incremental costs to situations where more auditor involvement is necessary to address the identified risk of material misstatement.

The final amendments might result in additional costs for some companies, compared to costs incurred under current requirements, to the extent that the final amendments lead auditors to raise their audit fees.¹⁷⁵ Such additional costs could vary for the same reasons as described above relating to the final amendments' potential impact on costs incurred by auditors. The final amendments could also give rise to new recurring costs for management, to the extent that the final amendments result in the need for companies to devote more time and resources to respond to auditor inquiries and requests. Some commenters on the Proposal expressed concern about the potential cost to companies, including smaller companies. For example, one commenter suggested that companies might need to provide more support for their discount rate assumptions under the proposed amendments. On the other hand, another commenter suggested that, in the context of the size of the U.S. fixed income market, consistent use of methodologies

¹⁷⁵ It is not clear to what extent the final amendments will result in higher audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees and suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard setters have issued new standards and amended other standards during that period. *See, e.g.,* Audit Analytics, *Audit Fees and Non-Audit Fees: A Fifteen Year Trend* (Dec. 2017). For a general discussion of cost pass-through, *see, e.g.,* James Bierstaker, Rich Houston, Arnold Wright, *The Impact of Competition on Audit Planning, Review, and Performance*, 25 *Journal of Accounting Literature* 1, 12 (2006) (summarizing research on the market for audit services and finding "there is evidence of lower fee premiums when clients switch auditors, suggesting that auditors are less able to pass on the increased costs associated with new audits in a more competitive environment"); and RBB Economics, *Brief 48: The Price Effect of Cost Changes: Passing Through and Here to Stay* 1, 3 (Dec. 2014).

compliant with fair value accounting requirements by companies would be a small cost to bear.

For many companies (and, indirectly, investors), however, the final amendments should not result in significant additional costs or significantly increased audit fees, particularly recurring costs, as their auditors, especially if they are larger audit firms, may have already incorporated many or all elements of the final amendments into their audit methodologies, and individual engagement teams may already be applying many or all of the final amendments in practice. In addition, the changes from the Proposal reflected in the final amendments, which clarify the auditor's responsibility when evaluating the work of the company's specialist, should mitigate some of the potential additional costs suggested by commenters.

Unintended Consequences

In addition to the benefits and costs discussed above, the final amendments could have unintended economic impacts, the possibility of which the Board has taken into account in adopting the final amendments. The discussion below describes the potential unintended consequences that were identified in the Proposal or by commenters, as well as the Board's consideration of such consequences in adopting the final amendments. The discussion also addresses, where applicable, factors that mitigate the potential negative consequences, including revisions to the proposed amendments reflected in the final amendments and the existence of other countervailing factors.

Potential Adverse Impact on the Ability of Smaller Firms to Provide Audit Services

In instances where the final amendments would increase the need of some audit firms to use the work of an auditor's specialist (rather than only use the work of a

company's specialist under existing AS 1210), the final amendments might result in some smaller firms accepting fewer audit engagements that would require the use of an auditor's specialist. Relatedly, in such instances, some smaller firms might be inhibited from expanding their audit services for similar reasons. The Board had acknowledged the possibility of such unintended consequences in the Proposal, and some commenters also expressed the view that the proposed amendments might adversely impact the ability of smaller firms to provide audit services in certain situations.

In particular, to the extent that auditors at smaller audit firms have less experience evaluating the work of a company's specialist than auditors at larger firms, some auditors may have an increased need to use the work of an auditor's specialist for certain engagements. Potentially, such firms would be unable to take advantage of the economies of scale and scope available to larger firms (for example, if they did not employ their own specialists and had to identify and engage qualified specialists), and find it economically less attractive to accept such engagements. In addition, some commenters on the Proposal suggested more broadly that the ability of smaller firms to compete in the audit services market would be adversely affected. The Board acknowledges that the final amendments could have a more significant impact on smaller firms than on larger firms. However, the Board believes that two factors will lessen any such adverse impact of the final amendments on smaller firms.

First, as described earlier in this section, the evidence from PCAOB inspections data indicates that smaller audit firms generally have comparatively few audit engagements in which they use the work of a company's specialist or an auditor's specialist. For example, the results for smaller audit firms in Figure 5 above indicate that

the auditors did not use the work of either a company's specialist or an auditor's specialist in 81% and 94% of the audits of smaller audit firms—U.S. and non-U.S. firms, respectively—inspected in 2017, and that the auditors used the work of a company's specialist without also using the work of an auditor's specialist¹⁷⁶ in only 10% and 6% of the audits of smaller audit firms—U.S. and non-U.S. firms, respectively—inspected in 2017.¹⁷⁷ These results suggest that the number of engagements where smaller firms might be faced with using an auditor's specialist for the first time to evaluate the work of a company's specialist under the final amendments is a relatively small proportion of audits subject to the Board's standards.

Second, there is some evidence that smaller and larger audit firms do not directly compete with one another in some segments of the audit market.¹⁷⁸ To the extent smaller audit firms compete in different segments of the audit market than larger audit firms, the competitive impact of the final amendments on smaller firms would be lessened.

Taking into consideration the factors described above, the final amendments further mitigate the potential adverse impact on the ability of smaller firms to provide audit services involving, or compete for audit engagements that require, the use of the

¹⁷⁶ The fact that the auditor did not use the work of an auditor's specialist does not imply that the auditor should have used the work of an auditor's specialist.

¹⁷⁷ Furthermore, given that the engagements selected for inspection are on average more likely to be complex (and thus more likely to involve the use of the work of a specialist) than the overall population of audit engagements of smaller audit firms, the percentage results shown above for audits involving the use of the work of specialists are likely greater than the actual percentage of the overall population of audit engagements of smaller audit firms.

¹⁷⁸ See, e.g., GAO Report No. GAO-03-864, *Public Accounting Firms: Mandated Study on Consolidation and Competition* (July 2003).

work of specialists. For example, the clarifications in the final amendments for evaluating the work of a company's specialist, such as limiting the use of the term "test" to procedures applied to company-produced information used by the specialist, should alleviate concerns expressed by certain commenters on the Proposal that auditors would be required to reperform the work of a company's specialist. In addition, under the final amendments, auditors are allowed to assess the objectivity of an auditor-engaged specialist along a spectrum, rather than make a binary determination whether they can use the work of an auditor-engaged specialist.¹⁷⁹

Potential Diversion of Auditor Attention from Other Tasks that Warrant Attention

In some audit engagements involving specialists, the final amendments might lead auditors to devote more of their attention and resources to the work of a company's specialists (including the related training of audit personnel) and to enhancing the coordination with an auditor's specialists, and less time and resources to other tasks that warrant greater attention.

The potential impact on overall audit quality might vary as the re-orientation of attention would occur in different ways for each audit engagement. Any potential adverse impact on overall audit quality is mitigated, however, by the risk-based approach in the final amendments to using the work of specialists. To the extent that the re-orientation of the auditor's attention leads to more effort in areas with the greatest risk of material misstatement to the financial statements, overall audit quality would be expected to

¹⁷⁹ Similarly, the final amendments recognize that a company's ability to significantly affect the judgments of a company's specialist may vary and provide for the auditor to evaluate along a spectrum the company's ability to significantly affect those judgments.

increase. Furthermore, if auditors devote more attention to the work of specialists and enhancing the coordination with their specialists, the final amendments will result in some auditors acquiring greater expertise, which could positively affect the quality of audit work performed by such auditors. Such auditor specialization could lead some audit firms to seek fewer audit engagements involving specialists, while other firms might seek more such engagements. In such a market, the competitive effects of increased specialization would likely be highly dependent on the circumstances.

Potential for Unnecessary Effort by the Auditor or the Auditor's Specialist

Under the final amendments, the potential exists that auditors might interpret the final requirements to suggest that they should use the work of an auditor's specialist in situations where the auditor had already obtained sufficient appropriate evidence with respect to a relevant assertion of a significant account or disclosure. The Proposal also identified this potential consequence, and some commenters expressed concern that auditors might feel compelled to do more work than was necessary or optimal under the proposed requirements. This unintended consequence might also arise under the final amendments if an auditor had already evaluated the work of a company's specialist, but decided to employ or engage its own specialist to perform additional procedures. For example, the auditor might ask an auditor's specialist to develop or assist in developing an independent expectation of an estimate in order to further demonstrate his or her diligence or err on the side of caution. In some instances, it is possible that the auditor might do so even though the auditor believes the costs of using the work of an auditor's specialist will outweigh the expected benefits in terms of audit quality.

The final amendments, however, mitigate this risk in several respects. In particular, the final amendments do not require the auditor to use the work of an auditor's specialist. Moreover, the final amendments regarding the nature, timing, and extent of the evaluation of the work of the company's specialist are designed to be risk-based and scalable to companies of varying size and complexity. In addition, as discussed above, the final amendments clarify the requirements for evaluating the work of a company's specialist and assessing the objectivity of an auditor-engaged specialist, which should avoid unnecessary effort by the auditor or auditor's specialist. Accordingly, any increases in effort should be accompanied by improvements in audit quality.

Potential Shift in the Balance Between the Work of a Company's Specialist and the Work of an Auditor's Specialist

In audit engagements involving specialists, the potential exists that the final amendments could affect the balance between the work of a company's specialist and the work of an auditor's specialist. The Proposal also identified this potential consequence, and some commenters expressed concern that companies might, in some instances, choose not to engage or involve a company's specialist if they expected that the auditor would use an auditor's specialist to perform additional procedures.¹⁸⁰

The final amendments do not change management's responsibility for the financial statements or their obligation to maintain effective internal control over financial reporting. Anticipating the use of an auditor's specialist for the audit

¹⁸⁰ See, e.g., Letter from Duff & Phelps (Aug. 30, 2017), at 4, available on the Board's website in Docket 044 ("situations may arise where management may feel compelled to invest less time, costs and effort in supporting certain assertions in the financial statements by not engaging a specialist when one would otherwise be called for—especially given the expectation that the auditor's specialist would perform extensive testing and calculations as part of the audit").

engagement, however, some issuers may decide to use a company's specialist to a lesser extent (or not at all) when preparing financial statements and some company specialists may exhibit a reduced sense of responsibility. In such instances, the auditor's specialist may have to perform more work in order to adequately evaluate potential audit evidence provided by the issuer, including the work of a company's specialist if the issuer continues to use such a specialist. Alternatively the auditor may decide not to use the work of a company's specialist or use that work to a lesser extent. If the situations described above were to occur, audit quality might be reduced, not enhanced, in some instances.

The change in the balance between the work of a company's specialist and the work of an auditor's specialist, however, would likely be limited, as companies control the work of a company's specialist over information to be used in the financial statements, but lack similar control over an auditor's specialist. Companies generally are likely, therefore, to prefer to continue their use of a company's specialist. In addition, the final amendments do not require auditors to use an auditor's specialist when using the work of a company's specialist. Moreover, compared to the Proposal, the final amendments clarify the requirements for evaluating the work of a company's specialist. For example, the final amendments clarify the auditor's responsibilities for evaluating the methods and significant assumptions used by the company's specialist, and limit the use of the term "test" to procedures applied to company-produced information used by the specialist. These clarifications should alleviate concerns expressed by certain commenters.

Potential Reduction in the Availability of Specialists

Some commenters on the Proposal suggested that the proposed amendments, if adopted, would not affect the pool of qualified specialists available to serve as auditors' specialists. Other commenters, however, expressed concern that the proposed amendments might result in a shortage of, or strains on, the pool of qualified auditors' specialists, especially in situations where an audit firm currently uses the work of a company's specialist, but does not concurrently use an auditor's specialist.¹⁸¹ Situations that involved the auditor's use of the work of a company's specialist, but did not concurrently involve the use of an auditor's specialist, comprised a small percentage of audit engagements, ranging from 6% to 10% of the audit engagements of smaller and larger audit firms—U.S. and non-U.S.—that were selected for inspection in 2017 (category (1) of Figure 5 above).

Similar to the proposed amendments, the final amendments do not require auditors to use an auditor's specialist when using the work of a company's specialist. Moreover, in comparison to the proposed amendments, auditors are allowed under the final amendments to assess the objectivity of an auditor-engaged specialist along a spectrum, rather than make a binary determination whether they can use the work of an auditor-engaged specialist.¹⁸² This change should also reduce the possibility of a shortage

¹⁸¹ Commenters did not specify whether such shortages would be permanent, or instead would reflect a temporary disruption to which the market would adjust over time.

¹⁸² Additionally, the final amendments provide for the auditor to evaluate along a spectrum the company's ability to significantly affect the judgments of the company's specialist. Furthermore, as discussed above, the final amendments reflect changes to the Proposal relating to the evaluation of the data, significant assumptions, and methods used by the company's specialist that clarify that the focus of the auditor's evaluation does not require the auditor to reperform the specialist's work.

of qualified auditors' specialists. Accordingly, the Board believes that the final amendments should not result in a shortage of, or strains on, the pool of qualified specialists available to serve as auditors' specialists.

Alternatives Considered, Including Key Policy Choices

The development of the final amendments involved considering a number of alternative approaches to address the problems described above. This subsection explains: (1) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (2) other standard-setting approaches that were considered by the Board; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

Why Standard Setting Is Preferable to Other Policy-Making Approaches

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. One commenter stated that the Board should be proactive and supported the Board's preference for standard setting over other policy tools, while other commenters noted that other policy tools, such as the issuance of staff guidance and inspections activity, should also be considered.

While other policy tools may complement auditing standards, the Board has determined that providing additional guidance or increasing its inspection or enforcement efforts, without also amending the existing requirements regarding the auditor's responsibilities for using the work of specialists, would not be effective corrective mechanisms to address concerns with the evaluation of the work of a company's specialist, the supervision of an auditor's specialists, and the sources of market failure

discussed previously. In addition, while devoting additional resources to such activities might focus auditors' attention on existing requirements, it would not provide the benefits associated with improving the standards discussed above. Thus, the final approach reflects the conclusion that standard setting is needed to fully achieve the benefits resulting from improvement in audits involving specialists. The Board will, however, monitor the implementation of the final amendments by audit firms and, if appropriate, consider the need for additional guidance.

Other Standard-Setting Alternatives Considered

Several alternative standard-setting approaches were also considered, including: (1) retaining the existing framework but requiring the auditor to disclose when the auditor used the work of specialists in the audit; or (2) targeted amendments to existing requirements.

Disclosing When the Work of a Specialist is Used

As an alternative to amending AS 1105 and AS 1201 and replacing existing AS 1210 in its entirety, the Board considered amending existing AS 1210 to remove the current limitations in existing AS 1210.15 on disclosing that a specialist was involved in the audit. Under this approach, the auditor would have been required to disclose this fact. Investors might benefit from such a requirement, since it would inform investors, at a minimum, that the auditor had evaluated the need for specialized skill or knowledge in order to perform an audit in accordance with PCAOB standards. Such disclosures could, in theory, positively affect audit practice, as auditors might face more scrutiny from investors regarding their decisions whether or not to use specialists.

Disclosure alone, however, would be unlikely to achieve the Board's objectives, which includes effecting more consistently rigorous practices among auditors when using the work of a company's specialist in their audits, as well as effecting a more consistent approach to the supervision of auditor-employed and auditor-engaged specialists. For example, with disclosure alone, some auditors might not evaluate the significant assumptions and methods of a company's specialist, even in higher risk audit areas.

Moreover, in a separate rulemaking, the Board has adopted a new auditing standard that requires the auditor to communicate CAMs in the auditor's report. A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.¹⁸³ Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist. While it is not yet clear how frequently the use of the work of specialists will be disclosed in the auditor's report as part of CAMs, these disclosure requirements are complemented by amending AS 1105 and AS 1201 and replacing existing AS 1210 to improve performance requirements over the use of the work of specialists. As discussed above, this should directly mitigate auditor moral hazard and change certain elements of audit practice observed by PCAOB oversight activities that have given rise to concern, such as situations where auditors did not apply appropriate professional skepticism when using the work of specialists.

¹⁸³ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

Targeted Amendments to Existing Requirements for Using the Work of an Auditor's Specialists

The Board considered, but is not adopting, two alternative approaches for an auditor's use of the work of an auditor's specialist, as discussed in further detail in the Proposal. The first alternative was to develop a separate standard for using the work of an auditor's specialist. This approach would have created a new auditing standard for using the work of an auditor's specialist, whether employed or engaged by the auditor, similar to the approach in ISA 620 and AU-C Section 620 (and thereby separating the requirements for using the work of an auditor-engaged specialist from those for using the work of a company's specialist). One commenter on the Proposal supported this approach. The second alternative was to extend the supervisory requirements in AS 1201 to an auditor-engaged specialist. This approach would have amended existing AS 1210 to remove all references to an auditor-engaged specialist and amended AS 1201 to include all arrangements involving auditor-employed and auditor-engaged specialists.

Given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the Board determined that the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. Accordingly, the Board has adopted separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist related to reaching an understanding and evaluating the work to be performed. However, as discussed above, the auditor's relationship to an auditor-employed specialist differs in certain respects from the auditor's relationship to an auditor-engaged specialist, which may affect the auditor's visibility into the specialist's knowledge, skill, and ability, as well as into any relationships that might affect the

specialist's independence or objectivity. Accordingly, the final amendments address these differences by requiring the auditor to perform procedures in AS 1210, as amended, to evaluate the knowledge, skill, ability, and objectivity of auditor-engaged specialists, while recognizing that the auditor evaluates the knowledge, skill, ability, and independence of auditor-employed specialists in accordance with the same requirements that apply to other engagement team members.

Key Policy Choices

Given the preference for creating separate requirements for using a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, the Board considered different approaches to addressing key policy issues.

Scope of the Final Amendments

The Board considered a variety of possible approaches to the scope of the final amendments, including the treatment of persons with specialized skill or knowledge in certain areas of IT and income taxes. *See* section C for a discussion of the Board's considerations. In particular, after considering comments on the Proposal, the Board has clarified the scope and application of the final amendments in the rule text and discussion in its adopting release. The Board, while mindful of advances in technology that could fundamentally impact the audit process (and hence what is understood to be skill and knowledge in specialized areas of accounting and auditing), believes that the final amendments are sufficiently principles-based and flexible to accommodate continued technological advances that could impact audit practice in the future.

Evaluating the Work of a Company's Specialist

The Board considered a variety of possible approaches relating to the auditor's

evaluation of the work of a company's specialist. *See* section C for a discussion of the Board's considerations. In particular, after considering the comments on the Proposal, the Board is retaining the fundamental approach in the Proposal, under which the auditor evaluates the data, significant assumptions, and methods used by the specialist. The final amendments, including the revisions to the proposed requirements described in section C, retain the benefits resulting from the use of a risk-based audit approach, while at the same time directing the auditor to consider the quality of the source of information when determining his or her audit approach.

Evaluating the Qualifications and Independence of the Auditor-Employed Specialist

The Board considered a variety of possible approaches to evaluating the knowledge, skill, ability, and independence of auditor-employed specialists. *See* section C for a discussion of the Board's considerations. In particular, after considering the comments on the Proposal, the Board eliminated from the final amendments certain paragraphs that could have been misinterpreted as suggesting a different process for evaluating the qualifications and independence of auditor-employed specialists than for other engagement team members. Instead, the final amendments acknowledge that an auditor-employed specialist is a member of the engagement team and that existing requirements for assessing the qualifications and independence of engagement team members apply equally to auditor-employed specialists.

Assessing the Qualifications and Objectivity of the Auditor-Engaged Specialist

The Board considered a variety of possible approaches to assessing the knowledge, skill, ability, and objectivity of auditor-engaged specialists. *See* section C for a discussion of the Board's considerations. In particular, after considering the comments,

the Board made revisions in adopting the requirements described in section C to allow auditors to assess the objectivity of auditor-engaged specialists along a spectrum, rather than make a binary determination. The Board believes the final amendments in this area should limit any incremental cost to circumstances where increases in audit quality can be reasonably expected and thereby mitigate any adverse economic impact from potential unintended consequences of the final amendments. For example, requiring the auditor to perform additional procedures to evaluate the data, significant assumptions, and methods used by the specialist when the specialist has a relationship with the company that affects the specialist's objectivity should increase audit quality and reduce the risk that a material misstatement could go undetected.

Special Considerations for Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, rules adopted by the Board subsequent to April 5, 2012, generally do not apply to the audits of EGCs, unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."¹⁸⁴ As a result of the JOBS Act, the rules and related amendments to PCAOB standards the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

¹⁸⁴ See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as added by Section 104 of the JOBS Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The final amendments do not fall within either of these two categories.

The Proposal sought comment on the applicability of the proposed requirements to audits of EGCs. Commenters generally supported applying the proposed requirements to audits of EGCs. These commenters asserted that consistent requirements should apply for similar situations encountered in any audit of a company, whether that company is an EGC or not, as well as that the benefits described in the Proposal would be applicable to EGCs. One commenter suggested "phasing" the implementation of the requirements for such audits to reduce the compliance burden.

The Board also notes that any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs would require auditors to address the differing requirements within their methodologies, which would also create the potential for confusion.

To inform consideration of the application of auditing standards to audits of EGCs, the PCAOB staff has also published a white paper that provides general information about characteristics of EGCs.¹⁸⁵ As of the November 15, 2017 measurement date, the PCAOB staff identified 1,946 companies that had identified themselves as EGCs in at least one SEC filing since 2012 and had filed audited financial statements with the SEC in the 18 months preceding the measurement date.

Overall, the discussion of benefits, costs, and unintended consequences above is generally applicable to audits of EGCs. EGCs generally tend to have shorter financial reporting histories than other exchange-listed companies. As a result, there is less

¹⁸⁵ See PCAOB white paper, *Characteristics of Emerging Growth Companies as of November 15, 2017* (Oct. 11, 2018) ("EGC White Paper"), available on the Board's website.

information available to investors regarding such companies relative to the broader population of public companies.¹⁸⁶

Although the degree of information asymmetry between investors and company management for a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.¹⁸⁷ To the extent that EGCs exhibit one or more of these properties, there may be a greater degree of information asymmetry for EGCs than for the broader population of companies, which increases the importance to investors of the external audit to enhance the credibility of management disclosures.¹⁸⁸ The final amendments relating to the auditor's use of the work of specialists, which are intended to enhance audit quality, could contribute to an increase in the credibility of financial statement disclosures by EGCs.

¹⁸⁶ *Id.*

¹⁸⁷ See, e.g., David Aboody and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *Journal of Finance* 2747 (2002); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995); Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101 (1988); and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 *Journal of Finance* 1041 (1988).

¹⁸⁸ See, e.g., Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185, 189 (2004) ("[Academic studies] provide archival evidence that external assurance from auditors increases disclosure credibility...These archival studies suggest that bankers believe audits enhance the credibility of financial statements...").

When confronted with information asymmetry, investors may require a larger risk premium, and thus increase the cost of capital to companies.¹⁸⁹ Reducing information asymmetry, therefore, can lower the cost of capital to companies, including EGCs, by decreasing the risk premium required by investors.¹⁹⁰

Furthermore, an analysis by PCAOB staff, the results of which are summarized in Figure 6 below, suggests that the prevalence and significance of the use of the work of specialists in audits of EGCs is comparable to the prevalence and significance of the use of the work of specialists in audits of non-EGCs, for audit engagements by both smaller audit firms and larger audit firms.¹⁹¹

¹⁸⁹ See *supra* notes 165 and 167.

¹⁹⁰ For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553 (2004).

¹⁹¹ The staff analysis was based on engagement-level data from the subset of 74 audit engagements of EGCs by U.S. and non-U.S. audit firms that were selected for inspection in 2017 presented above.

Figure 6 - Audits performed by U.S. and non-U.S. audit firms of EGCs that were selected for inspection by the PCAOB in 2017, categorized by use of the work of specialists

	<i>% (number) of audits by larger audit firms (U.S.)</i>	<i>% (number) of audits by smaller audit firms (U.S.)</i>	<i>% (number) of audits by larger audit firms (non-U.S.)</i>	<i>% (number) of audits by smaller audit firms (non-U.S.)</i>
(1) auditor used the work of a <i>company's specialist</i> but did not use the work of an <i>auditor's specialist</i>	0% (0)	9% (3)	11% (1)	13% (1)
(2) auditor used the work of an <i>auditor's specialist</i> but did not use the work of a <i>company's specialist</i>	8% (2)	0% (0)	22% (2)	0% (0)
(3) auditor used the work of both a <i>company's specialist</i> and an <i>auditor's specialist</i>	29% (7)	12% (4)	22% (2)	0% (0)
(4) auditor neither used the work of a <i>company's specialist</i> nor used an <i>auditor's specialist</i> ¹⁹²	63% (15)	79% (26)	44% (4)	88% (7)
Total ¹⁹³	100% (24)	100% (33)	100% (9)	100% (8)

Source: PCAOB

As indicated in Figure 6, the staff analysis observed that 41 (or about 55%) of the audit engagements were performed by U.S. and non-U.S., smaller audit firms. Among those 41 audit engagements, only four (or about 10%) involved the use of the work of a company's specialist but did not concurrently involve the use of the work of an auditor's specialist (category (1) above). In comparison, 33 of the 41 audit engagements (or about 80%) did not involve the use of the work of either a company's specialist or an auditor's

¹⁹² The audit engagements not included in the preceding three categories were included in the fourth category.

¹⁹³ The total for the values shown in categories (1) through (4) may not add to 100% due to rounding.

specialist (category (4) above) and four of the 41 audit engagements (or about 10%) involved the use of both a company's specialist and an auditor's specialist (category (3) above). In none of those 41 audit engagements did the auditor use the work of an auditor's specialist without also concurrently using the work of a company's specialist (category (2) above). Among the 33 audit engagements of EGCs (or about 45%) performed by larger firms, both U.S. and non-U.S. firms, one (or about 3%) involved the use of the work of a company's specialist but did not concurrently involve the use of the work of an auditor's specialist (category (1) above); 19 (or about 58%) did not involve the use of the work of either a company's specialist or an auditor's specialist (category (4) above); nine (or about 27%) involved the use of both a company's specialist and an auditor's specialist (category (3) above); and four (or about 12%) involved the use of the work of an auditor's specialist, but did not concurrently involve the use of work of a company's specialist (category (2) above).

Thus, the Board believes that the need for the final amendments discussed earlier and the associated benefits of the final amendments generally apply also to audits of EGCs.

While for small companies (including EGCs), even a small increase in audit fees could negatively affect their profitability and competitiveness, many EGCs are expected to experience minimal impact from the final amendments. In particular, some EGCs do not use a company's specialist and, for those EGCs that do use a company's specialist, the final amendments relating to the auditor's use of the work of such specialists are risk-based and designed to be scalable to companies of varying size and complexity.

In addition, the analysis presented in the EGC White Paper observed that about 40% of audits of EGCs are performed by firms that provided audit reports for more than 100 issuers and were required to be inspected on an annual basis by the PCAOB.¹⁹⁴ These firms tend to already have practices for using the work of specialists that are consistent with many or all elements of the final amendments. For such audit firms, the costs on a per engagement basis of adopting the final amendments should also be low, for the reasons discussed above.

For the other 60% of audits of EGCs, the PCAOB staff analysis summarized in Figure 6 above suggests that the proportion of EGC audit engagements that involve the use of the work of company specialists, but do not involve the use of the work of an auditor's specialist, is small and comparable to the proportion of similar issuer audit engagements described previously. As discussed above, auditors on such audit engagements may experience the most significant cost impact of the final amendments. However, only a small proportion of audits of EGCs are expected to be significantly affected by the final amendments. In addition, the final amendments clarify the requirements for evaluating the work of a company's specialist and assessing the objectivity of an auditor-engaged specialist, which should avoid unnecessary effort by the auditor or auditor's specialist. Accordingly, any increase in effort should be accompanied by improvements in audit quality.

The Board has provided this analysis to assist the SEC in its consideration of whether it is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and

¹⁹⁴ See EGC White Paper, at 3.

capital formation," to apply the final amendments to audits of EGCs. This information includes data and analysis of EGCs identified by the Board's staff from public sources.

For the reasons explained above, the Board believes that the final amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final amendments should apply to audits of EGCs. Accordingly, the Board recommends that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the final amendments to audits of EGCs. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the Commission's public comment process.

Applicability to Audits of Brokers and Dealers

The Proposal indicated that the proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of the Sarbanes-Oxley Act. The Board solicited comment on any factors specifically related to audits of brokers and dealers that may affect the application of the proposed amendments to those audits. Commenters that addressed the issue agreed that amendments to the standards for the auditor's use of the work of specialists should apply to these audits, citing benefits to users of financial statements of brokers and dealers and the risk of confusion and inconsistency if different methodologies were required under PCAOB standards for audits of different types of entities.

After considering comments, the Board determined that the final amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB

standards, including audits of brokers and dealers. The Board's determination is based on the observation that the information asymmetry between the management of brokers and dealers and their customers about the brokers' and dealers' financial condition may be significant and of particular interest to customers, as a broker or dealer may have custody of customer assets, which could become inaccessible to the customers in the event of the insolvency of the broker or dealer.

In addition, unlike the owners of brokers and dealers, who themselves may be managers and thus be subject to minimal or no information asymmetry, customers of brokers and dealers may, in some instances, be large in number and may not be expert in the management or operation of brokers and dealers. Such information asymmetry between the management and the customers of brokers and dealers makes the role of auditing important to enhance the reliability of financial information.

Accordingly, the discussion above of the need for the final amendments, as well as the costs, benefits, alternatives considered and potential unintended consequences to auditors and the companies they audit, also applies to audits of brokers and dealers. In particular, PCAOB staff analysis of inspections data for audits of brokers and dealers indicates that auditors of brokers and dealers do not frequently use the work of specialists, whether company specialists or an auditor's specialists.¹⁹⁵ Hence, the results suggest that only a small percentage of audits of brokers and dealers will be impacted by

¹⁹⁵ The staff analysis is based on 116 audit engagements of brokers and dealers performed by audit firms that were selected for inspection in 2017. The results of the analysis found that the auditor did not use the work of a specialist in about 90% of the broker or dealer audits. This analysis also found that auditors used the work of at least one auditor's specialist in about 8% of the audits analyzed and used the work of at least one company specialist in about 2% of those audits.

the final amendments. In addition, with respect to the impact of the final amendments on customers of brokers and dealers, the expected improvements in audit quality described previously would benefit such customers, along with investors, capital markets and auditors, while the final requirements are not expected to result in any direct costs or unintended consequences to customers of brokers and dealers.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period not more than an additional 45 days (i) if the Commission determines that such longer period is appropriate and publishes the reasons for such determination or (ii) as to which the Board consents, the Commission will:

- (A) by order approve or disapprove such proposed rules; or
- (B) institute proceedings to determine whether the proposed rules should be

disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form

(<http://www.sec.gov/rules/pcaob.shtml>); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2019-03 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange

Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2019-03. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2019-03 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Vanessa Countryman
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PROPOSED AMENDMENTS TO AUDITING
STANDARDS FOR AUDITOR'S USE OF THE
WORK OF SPECIALISTS

) PCAOB Release No. 2017-003
) June 1, 2017
)
) PCAOB Rulemaking
) Docket Matter No. 044
)
)
)

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing to amend its auditing standards to strengthen the requirements that apply when auditors use the work of specialists in an audit. The amendments are designed to increase audit attention in areas where a specialist is used and to align the applicable requirements with the PCAOB's risk assessment standards.

Public
Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted via e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 044 in the subject or reference line and should be received by the Board no later than August 30, 2017.

Board
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Major Proposed Amendments:

The Board is proposing for public comment to:

(1) Amend:

- AS 1105, *Audit Evidence*; and
- AS 1201, *Supervision of the Audit Engagement*;

(2) Replace:

- AS 1210, *Using the Work of a Specialist*, and retitle the standard *Using the Work of an Auditor-Engaged Specialist*; and

(3) Rescind:

- AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*; and
- AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*.

TABLE OF CONTENTS

I. Executive Summary 1

II. Background and Reasons to Improve Standards..... 4

 A. Current Requirements 5

 B. Current Practice 9

 C. Reasons to Improve Auditing Standards 15

III. Discussion of Proposal..... 20

IV. Economic Considerations 24

 A. Baseline 25

 B. Need for the Proposal 33

 C. Economic Impacts 38

 D. Alternatives Considered 47

V. Special Considerations for Audits of Emerging Growth Companies 56

**VI. Applicability of the Proposed Requirements to Audits of Brokers and
Dealers 59**

VII. Effective Date..... 59

VIII. Appendices 60

IX. Opportunity for Public Comment 60

**APPENDIX 1: Proposed Amendments Relating to the Auditor's Use of the Work of
Specialists.....A1-1**

**APPENDIX 2: Other Related Proposed Amendments to PCAOB Auditing
StandardsA2-1**

APPENDIX 3: Additional Discussion of Proposed Amendments.....A3-1

I. Executive Summary

The Board is proposing amendments to its standards for using the work of specialists, under which two existing standards would be amended and a third existing standard would be retitled and replaced with an updated standard. As discussed in more detail below, in the Board's view the proposed amendments would further investor protection by strengthening the requirements for evaluating the work of a company's employed or engaged specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.

Companies across many industries use specialists¹ to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including, among others, actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors might use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

Accounting estimates are also becoming more prevalent and more significant as financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements.² As a result, the use of the work of specialists continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

Under current PCAOB standards, auditor-employed specialists are subject to supervision under AS 1201, *Supervision of the Audit Engagement*, and auditors' responsibilities with respect to other specialists (employed or engaged by the company or engaged by the auditor) are primarily set forth in AS 1210, *Using the Work of a Specialist*. As a result, requirements that apply to auditor-employed specialists differ

¹ As used in this release, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

² For purposes of this release, a fair value measurement is a form of accounting estimate.

from the requirements that apply to auditor-engaged specialists, though both serve similar roles in helping auditors obtain and evaluate audit evidence. In addition, AS 1210 imposes the same auditor responsibilities with respect to both a company's specialist and an auditor-engaged specialist, even though those specialists have fundamentally different roles (i.e., the company uses the work of its specialist in the preparation of the financial statements).

Observations from PCAOB oversight activities indicate that there is substantial diversity in practice regarding the use of the work of specialists, such as how auditors use employed or engaged specialists and what procedures auditors perform to evaluate the work of companies' specialists. Moreover, PCAOB inspections staff continues to observe deficiencies related to auditors' use of specialists' work, such as failures to evaluate the assumptions of company specialists in fair value measurements or failures to consider contradictory evidence or issues raised by an auditor's specialist.

The PCAOB has also engaged in outreach to explore the views of market participants and others on the potential for improvements to the auditing standards related to using the work of specialists, through the Board's Standing Advisory Group ("SAG")³ and the issuance of and comments on Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*.⁴

The Board is proposing to amend AS 1105, *Audit Evidence*, to add a new appendix that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. The Board also is proposing to amend AS 1201 to add a new appendix on supervising the work of auditor-employed specialists and to replace AS 1210 with proposed AS 1210, which would set forth requirements for using the work of auditor-engaged specialists. The proposal is intended to strengthen PCAOB auditing standards in the following respects:

³ See SAG meeting briefing papers and webcast archives (Nov. 30-Dec. 1, 2016, Nov. 12-13, 2015, June 18, 2015, Oct.14-15, 2009, and Feb. 9, 2006), available on the Board's website.

⁴ See PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015) ("2015 SCP"). The 2015 SCP was issued to solicit comments on various issues, including the potential need for standard setting and key aspects of potential new standards and related requirements.

- Strengthen requirements for evaluating the work of a company's specialist; and
- Apply a risk-based approach to supervising and evaluating the work of both auditor-employed and auditor-engaged specialists.

The Board is seeking comment on the proposed amendments to its standards, alternatives to those proposed amendments, the economic impacts of the proposal, and data on current practices and potential benefits and costs of the proposal. This release contains questions on discrete aspects of these matters for which the Board seeks comment. Readers are encouraged to answer questions in the release, and to comment on any aspect of the release or the proposed amendments not covered by specific questions. Readers are especially encouraged to provide the reasoning to support their views and any relevant data.

The PCAOB has observed that, in many cases, auditors use the work of a specialist to test or assist in testing the company's process to develop an accounting estimate or in developing an independent expectation of an accounting estimate. In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.⁵ In the Estimates Release, the Board is proposing to retitle and replace AS 2501, *Auditing Accounting Estimates*, and supersede AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Proposed AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

⁵ See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017) ("Estimates Release").

II. Background and Reasons to Improve Standards

Companies across many industries use various types of specialists to assist in developing accounting estimates in their financial statements. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors might use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

The use of fair value measurements and other accounting estimates continues to grow in financial reporting with, for example, increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.⁶ If a specialist's work is not properly overseen or evaluated, however, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

In May 2015, the PCAOB issued a staff consultation paper to solicit comments on various issues related to the auditor's use of the work of both a company's specialist and an auditor's specialist. The 2015 SCP described information about a potential need for changes to PCAOB standards and discussed possible approaches to such changes. The 2015 SCP solicited comment on these matters, as well as on current practice and economic considerations. The Board's proposal is informed by comments on the 2015

⁶ See, e.g., Jonathan S. Pyzoha, Mark Taylor, and Yi-Jing Wu, *The Effects of Tone-at-the-Top Messaging and Specialists on Auditors' Judgments during Complex Audit Tasks* 4 (Apr. 2016) (working paper, available in Social Science Research Network ("SSRN")) ("To cope with the escalating complexity of business processes and transactions involved with conducting financial statement audits, management and auditors have increasingly relied on the expertise of specialists..."); see also Karin Barac, Elizabeth Gammie, Bryan Howieson, and Marianne van Staden, *The Capability and Competency Requirements of Auditors in Today's Complex Global Business Environment* 6, 83 (Mar. 2016) (report commissioned by Institute of Chartered Accountants of Scotland and The Financial Reporting Council) ("In terms of the current capabilities, the increasing complexity and globalisation of business, combined with the increasing complexity of financial reporting standards and the opportunities/risks afforded by information technology developments, demands increasing specialisation within the audit team...[T]here was recognition that audit teams now include many more experts than in the past, and for some industries, particularly financial services, this was a welcome development.").



SCP and, where relevant to aspects of the proposal, those comments are discussed throughout this release.

This section discusses current requirements under PCAOB auditing standards for auditors' use of the work of specialists in audits, observations regarding current audit practices, and reasons to improve auditing standards in this area.

A. Current Requirements

The primary standard that applies when auditors use the work of auditor-engaged specialists or company specialists is AS 1210. The primary standard that applies when auditors use the work of auditor-employed specialists in an audit is AS 1201. AS 1210 was adopted by the Board in 2003 shortly after the PCAOB's inception.⁷ AS 1201 was one of eight new risk assessment standards adopted by the Board in 2010.⁸

For purposes of AS 1210, a specialist is "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." AS 1210 also states that income taxes and information technology ("IT") are specialized areas of accounting and auditing, and therefore are outside the scope of the standard.⁹ By its

⁷ See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003). Prior to 2003, the American Institute of Certified Public Accountants ("AICPA"): (1) in 1975, issued Statement on Auditing Standards ("SAS") No. 11, *Using the Work of a Specialist*; (2) in 1976, codified it as AU sec. 336; and (3) in 1994, issued a revised standard, SAS No. 73, *Using the Work of a Specialist* (which remained codified as AU sec. 336), that superseded the previous standard. In 2015, the PCAOB reorganized its standards, at which time AU sec. 336 was renumbered AS 1210. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015).

⁸ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010). Prior to 2010, auditors supervised employed specialists under AU sec. 311, *Planning and Supervision*. Additionally, paragraph .16 of AS 2101, *Audit Planning*, requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

⁹ See footnote 1 of AS 1210.

terms, AS 1210 applies when (1) the company engages or employs a specialist and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions or (2) the auditor engages a specialist and uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.¹⁰

AS 1201 establishes requirements for the supervision of the audit engagement, including supervising the work of engagement team members.¹¹ The auditor supervises a specialist employed by the auditor's firm who participates in the audit under AS 1201.¹² AS 1201 also applies in situations in which an income tax specialist or IT specialist participates in the audit, regardless of whether they are employed or engaged by the auditor's firm.¹³

Figure 1 summarizes the primary PCAOB standards that apply to the use of the work of specialists today.

¹⁰ See AS 1201.03.

¹¹ See AS 1201.01. As an employee of the accounting firm, an auditor-employed specialist is a member of the engagement team and is subject to the requirements in PCAOB auditing standards for assigning personnel based on their knowledge, skill, and ability. See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*. In addition, the requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing the independence of auditor-employed specialists. See AS 2101.06b.

¹² See AS 1210.05.

¹³ See footnote 1 of AS 1210.

Figure 1: Primary PCAOB Standards Applicable When Using the Work of Specialists

	#	Nature of Specialist's Involvement	Primary Audit Requirements
Company's Specialist	1	Specialist employed by the company	Auditor performs the procedures required by AS 1210
	2	Specialist engaged by the company	
Auditor's Specialist	3	Auditor-engaged specialist	Auditor supervises the specialist under AS 1201
	4	Auditor-employed specialist	

Using the work of a company's specialist and auditor-engaged specialist under AS 1210. AS 1210 requires that the auditor perform the following procedures when using the work of a company's specialist or an auditor-engaged specialist:

- Evaluate the professional qualifications of the specialist;¹⁴
- Obtain an understanding of the nature of the specialist's work;¹⁵
- Evaluate the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity;¹⁶ and
- In using the findings of the specialist:¹⁷
 - Obtain an understanding of the methods and assumptions used by the specialist;

¹⁴ See AS 1210.08.

¹⁵ See AS 1210.09.

¹⁶ See AS 1210.10-.11.

¹⁷ See AS 1210.12.

- Make appropriate tests of data provided to the specialist; and
- Evaluate whether the specialist's findings support the financial statement assertions.

AS 1210 also includes certain provisions that could be considered to limit the auditor's responsibilities related to the work of a specialist, including statements that: (1) the appropriateness and reasonableness of methods and assumptions used, and their application, are the responsibility of the specialist; (2) the auditor ordinarily would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.¹⁸

Using the work of a company's specialist when auditing fair value measurements under AS 2502. In circumstances when a company's specialist develops assumptions used in a fair value measurement and the auditor tests the company's process, the auditor is required to evaluate the reasonableness of those assumptions as if the assumptions were developed by the company, as well as to comply with the requirements of AS 1210.¹⁹

Supervising the work of auditor-employed specialists under AS 1201. This standard establishes requirements regarding the auditor's supervision of an audit engagement, including supervising the work of auditor-employed specialists and other members of the engagement team. AS 1201, as it relates to the supervision of auditor-employed specialists, provides that:

- (1) The engagement partner and others who assist the engagement partner in supervising the audit should:
 - Inform engagement team members of their responsibilities;

¹⁸ See AS 1210.12-.13.

¹⁹ Footnote 2 of AS 2502 provides that management's assumptions for developing a fair value measurement include assumptions developed by a specialist engaged or employed by management. The auditor is therefore required to evaluate the reasonableness of assumptions developed by the company's specialist as if they were developed by management.

- Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities; and
 - Review the work of engagement team members to evaluate whether:
 - The work was performed and documented;
 - The objectives of the procedures were achieved; and
 - The results of the work support the conclusions reached.²⁰
- (2) The necessary extent of supervision depends on, for example, the nature of the work performed, the associated risks of material misstatement, and the knowledge, skill, and ability of those being supervised.²¹

B. Current Practice

This section discusses the PCAOB's understanding of current practice based on, among other things, the collective experience of PCAOB staff, observations from oversight activities of the Board, enforcement actions of the Securities and Exchange Commission ("SEC" or "Commission"), comments received on the 2015 SCP,²² and discussions with the SAG, audit firms, and specialist entities. The discussions have included outreach by the PCAOB's staff to audit firms and specialist entities to obtain information on: (1) how auditors evaluate the competence and objectivity of an auditor-engaged specialist and a company's specialist; (2) how auditors evaluate the work performed by an auditor-employed specialist, an auditor-engaged specialist, and a company's specialist; and (3) economic and demographic considerations relating to the

²⁰ See AS 1201.05.

²¹ See AS 1201.06.

²² Most commenters on the 2015 SCP agreed that the information presented therein accurately described current audit practices regarding the use of the work of specialists. Commenters also generally supported the staff's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements.

market for services provided by specialists. The outreach has informed the PCAOB's understanding of current practice at both larger and smaller audit firms.

1. *Overview of Current Practice*

When AS 1210 was originally issued in the early 1970s, the use of the work of specialists was largely confined to pension obligations, insurance reserves, and extractive industry reserves. In recent decades, the use of fair value measurements and other accounting estimates has grown in financial reporting, along with the increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.

Currently, companies across many industries use the work of specialists to: (1) assist them in developing accounting estimates, including fair value measurements presented in the companies' financial statements; (2) interpret laws, regulations, and contracts; or (3) evaluate characteristics of physical assets, as shown in Figure 2 below. In those circumstances, the reliability of a company's financial statements may depend in part on the quality of the work of a company's specialist.

Figure 2: Examples of Activities that Involve the Work of Specialists

Valuation

- Assets acquired and liabilities assumed in business combinations
- Environmental remediation contingencies
- Goodwill impairments
- Insurance reserves
- Intangible assets
- Pension and other post-employment obligations
- Impairment of real estate or other long-term assets
- Stock options
- Fair values of certain other financial instruments

Interpretation of laws, regulations, or contracts

- Legal title to property or interpretation of laws, regulations, or contracts

Evaluation of physical and other characteristics

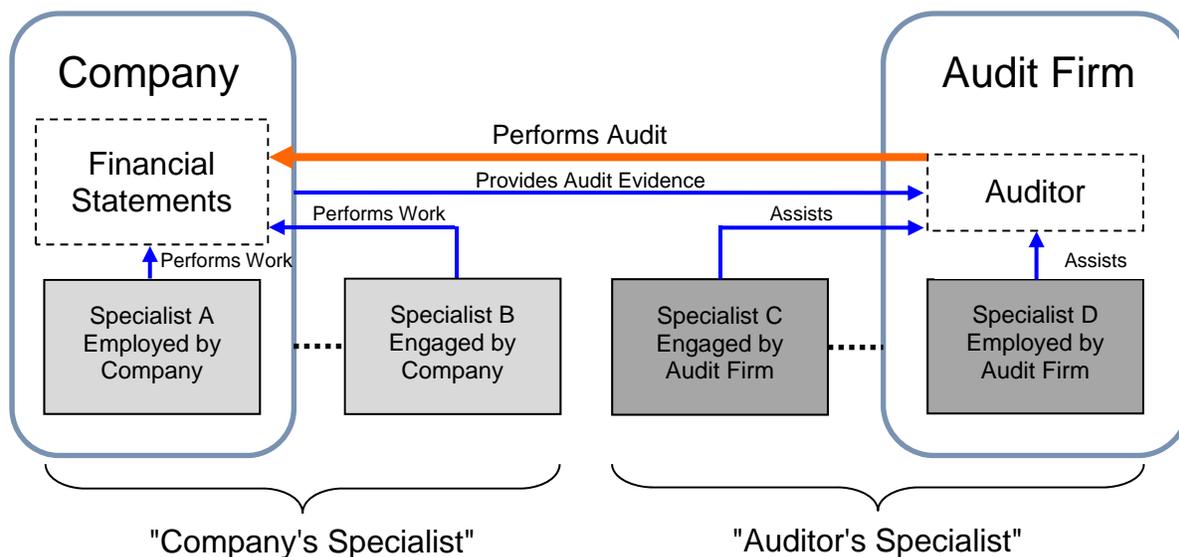
- Materials stored in stockpiles
- Mineral reserves and condition
- Oil and gas reserves
- Property, plant, and equipment useful lives and salvage values

Auditors also increasingly use the work of specialists in their audits to assist in their evaluation of accounting estimates. Auditors may:

- Use the work of a company's specialist—employed or engaged—as audit evidence; or
- Use the work of an auditor's specialist—employed or engaged—to assist the auditor in obtaining and evaluating audit evidence.

Figure 3 illustrates potential ways that auditors use specialists in an audit.

Figure 3: Potential Ways Auditors Use Specialists in an Audit



The company's specialist (A and B above) is employed or engaged by the company to perform work that the company uses with respect to significant accounts and disclosures in the financial statements and that the auditor may use as audit evidence. The auditor's specialist (C and D above) performs work to assist the auditor in obtaining and evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

The PCAOB understands that current practices vary among smaller and larger audit firms. For example, smaller audit firms are more likely to use the work of a company's specialist than to employ or engage their own specialist. Larger audit firms

generally require their engagement teams to evaluate the work of the company's specialist, including the specialist's methods and assumptions, and often employ specialists to assist their audit personnel in evaluating that work.²³ In some respects, the current methodologies of these larger firms with respect to using the work of a company's specialist exceed the existing requirements of AS 1210. The following paragraphs discuss audit practices of smaller firms and larger firms that audit issuers, brokers, and dealers in more detail.

Smaller firm practices. Smaller firm practices generally are based on the required procedures in PCAOB standards, primarily AS 1210. Smaller firms typically evaluate the competence, objectivity, and work of the company's specialist through inquiries of the company's specialist. For example, smaller firms may send a company's specialist a questionnaire to obtain information regarding the specialist's professional qualifications and the existence of relationships with the company that could impair the specialist's objectivity. Smaller firms generally perform the procedures specified in AS 1210, which does not require an auditor to evaluate the appropriateness of specialists' methods. In addition, any evaluation by smaller firms of the assumptions of a company's specialist is generally confined to circumstances when the specialist develops assumptions used in a fair value measurement covered by AS 2502.

In circumstances when smaller firms engage specialists, the auditor-engaged specialists may be used in different ways. Some firms perform the procedures specified in AS 1210 described above when using the auditor-engaged specialist. Other firms perform procedures similar to those in AS 1201 for supervising members of the engagement team. For example, some firms merely evaluate whether the specialist's work supports the financial statement assertions, while other firms go further by also evaluating whether (1) the specialist's work was performed and documented, (2) the objectives of the specialist's procedures were achieved, and (3) the results of the specialist's work support the conclusions reached.

Larger firm practices. As discussed above, although not required by AS 1210, some larger audit firms evaluate the methods and significant assumptions used by company specialists when they test the company's process for developing accounting

²³ An analysis by PCAOB staff indicates that smaller firms predominantly use the work of an auditor's specialist in valuation areas, and seldom use the work of an auditor's specialist in other areas, whereas larger firms tend to use the work of an auditor's specialist in a wider range of audit areas, even though they also primarily use the work of specialists in valuation areas.



estimates. Larger firms often employ their own specialists, who serve on engagement teams and assist with the evaluation of the work of company specialists.

Auditor-employed specialists at larger firms are generally involved early in the audit, usually during planning meetings with other members of the engagement team. Also, in audit planning, auditors and auditor-employed specialists generally reach an understanding, in the form of a planning or scoping memorandum, regarding the scope of work to be performed and the respective responsibilities of the auditor and the specialist. The items covered in that memorandum typically include: (1) the nature, scope, and objectives of the specialist's work;²⁴ (2) the role and responsibilities of the auditor and the specialist;²⁵ and (3) the nature, timing, and extent of communication between the auditor and the specialist.²⁶ The auditor communicates with the specialist as the work progresses to become aware of issues as they arise. When the specialist completes his or her work, the auditor reviews the specialist's work, which is typically documented in a separate report or memorandum.

Sometimes, larger firms do not use the work of an auditor's specialist, particularly when the risk of material misstatement is low or the firm does not employ a specialist with expertise in the particular field. In those situations, larger firms may use the work of a company's specialist without involving an auditor's specialist. Alternatively, although infrequent, larger firms may engage a specialist with expertise in the particular field. When larger firms engage specialists, they may use them in different ways. Some firms perform the procedures specified in AS 1210 described above, while other firms perform procedures that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

²⁴ Examples include whether the specialist is testing (or assisting in testing) the company's process for developing an accounting estimate or developing (or assisting in developing) an independent expectation of the estimate.

²⁵ For example, the documentation might identify the respective responsibilities of the auditor and the specialist for evaluating data and significant assumptions used by the company or the company's specialist.

²⁶ Examples include administrative matters, such as the timing, budget, and other staffing-related issues relevant to the specialist's work, or the protocols for discussing and resolving findings or issues identified by the specialist.

2. *Observations from Audit Inspections and Enforcement Cases*

The Board's understanding of current practice has been informed by observations from PCAOB oversight activities and SEC enforcement actions, including (1) audit deficiencies of both larger and smaller firms, and related remedial actions to address the deficiencies and (2) enforcement actions where the work of a specialist was used in the audit.

Inspections observations. Over the past several years, the observations from PCAOB inspections have indicated that auditors, at times, did not fulfill their responsibilities under existing standards when using the work of an auditor's specialist. These observations included instances in which auditors did not, among other things: (1) adequately communicate clear expectations to the specialist regarding the objectives of the specialist's work; (2) reach an understanding with the specialist regarding his or her responsibilities; (3) adequately evaluate the work performed by the specialist; and (4) consider contradictory evidence identified by the specialist or resolve discrepancies or other concerns that the specialist identified. More recently, PCAOB inspection staff have observed a decline in the number of instances by larger firms in which auditors did not perform sufficient procedures related to the work of an auditor's specialist.

There are some preliminary indications that the largest firms have undertaken remedial actions in response to the findings related to the auditor's use of the work of an auditor's specialist. In most cases, such actions included enhancements to firm methodologies to improve coordination between the auditor and the auditor's specialist through earlier and more frequent communications. These enhancements may have contributed, at least in part, to the decline in findings described above. Not all firms, however, have changed their methodologies, resulting in inconsistent practices in this area.

Over the past several years, the observations from PCAOB inspections have also included instances in which the auditor used the work of a company's specialist without performing the procedures required by AS 1210. These findings were less common than those related to using the work of an auditor's specialist over the same period. More recent findings include instances in which auditors did not, among other things: (1) evaluate the reasonableness of assumptions used by a company's specialist in developing fair value measurements; (2) obtain an understanding of methods or assumptions used by the company's specialist; (3) test the accuracy and completeness of company-provided data used by the company's specialist; and (4) evaluate the professional qualifications of the company's specialist. Unlike the findings related to the auditor's use of the work of an auditor's specialist, inspections staff have not observed a similar change in the frequency of findings related to the auditor's use of the work of a company's specialist.

Enforcement actions. Both the SEC²⁷ and the PCAOB²⁸ have brought enforcement actions involving situations where auditors allegedly failed to comply with current auditing standards when using the work of specialists. For example, such proceedings have involved allegations that auditors failed to (1) perform audit procedures that addressed the risks of material misstatements in a company's financial statements, prepared based on the work of a company's specialist²⁹ and (2) comply with certain requirements of AS 1210 when using the work of a company's specialist (for example, requirements to evaluate the professional qualifications of the specialist, obtain an understanding of the methods and assumptions used by the specialist, evaluate the relationship of the specialist to the company, and apply additional procedures to address a material difference between the specialist's findings and the assertions in the financial statements).³⁰ Several of those proceedings were brought in recent years, suggesting that problems persist in this area.

C. Reasons to Improve Auditing Standards

Financial reporting frameworks are evolving and requiring greater use of accounting estimates, including those based on fair value measurements. Such estimates often require substantial judgment. As a result, the use of the work of

²⁷ See, e.g., *Miller Energy Resources, Inc., Paul W. Boyd, CPA, David M. Hall, and Carlton W. Vogt, III, CPA*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3673 (Aug. 6, 2015); *Troy F. Nilson, CPA*, SEC AAER No. 3264 (Apr. 8, 2011); and *Accounting Consultants, Inc., and Carol L. McAtee, CPA*, SEC AAER No. 2447 (June 27, 2006).

²⁸ See, e.g., *KAP Purwantono, Sungkoro & Surja, Roy Iman Wirahardja, and James Randall Leali*, PCAOB Release No. 105-2017-002 (Feb. 9, 2017); *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045 (Dec. 5, 2016); *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007 (Apr. 1, 2015); and *Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA*, PCAOB Release No. 105-2011-003 (Apr. 8, 2011).

²⁹ See, e.g., *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007.

³⁰ See, e.g., *KAP Purwantono, Sungkoro & Surja*, PCAOB Release No. 105-2017-002; *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045; *Chisholm, Bierwolf, Nilson & Morrill, LLC*, PCAOB Release No. 105-2011-003; and *Miller Energy Resources, Inc.*, SEC AAER No. 3673.



specialists, both by companies and auditors, continues to increase in both frequency and significance.

The Board's existing standards, however, do not clearly reflect the difference between the roles of a company's specialist and an auditor's specialist. AS 1210 imposes the same responsibilities on auditors with respect to both a company's specialist and an auditor-engaged specialist, even though those two types of specialists have fundamentally different roles. In addition, the requirements for auditor-employed specialists in AS 1201 differ from the requirements for auditor-engaged specialists in AS 1210, even though they have similar roles in assisting the auditor in obtaining and evaluating audit evidence. As discussed, an auditor-engaged or auditor-employed specialist performs work to assist the auditor in obtaining and evaluating audit evidence, while the company's specialist performs work used by the company in the preparation of its financial statements.

If a specialist's work is not properly overseen or evaluated, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.³¹ When an auditor uses the work of a company's specialist, current requirements in AS 1210 allow the auditor to plan and perform audit procedures, as described earlier, that may not be commensurate with the risk of material misstatement inherent in the work of the specialist. When an auditor uses an auditor-employed specialist, current requirements in AS 1201, while risk-based and designed to be scalable for companies of varying size and complexity, do not specifically address how to apply the required supervisory procedures to promote effective coordination between an auditor and a specialist. In the case of auditor-engaged specialists, the current requirements in AS 1210 are not risk-based, are identical to the requirements regarding the use of work of a company's specialist, and do not specifically address informing the specialist of matters that could affect the specialist's work or coordination of the work between the auditor and the specialist.

The factors described above suggest that enhancements to PCAOB standards for using the work of specialists are needed. Specifically, investor protection could be improved by increasing audit attention to the work of specialists with respect to significant accounts and disclosures. Enhancing the auditing standards, through further

³¹ For example, one commenter on the 2015 SCP emphasized that "[m]ore rigorous testing of the work of company specialists will reduce the risk of material misstatements." See Letter from American Federation of Labor and Congress of Industrial Organizations (July 29, 2015), at 2.

integration with the risk assessment standards and requirements tailored to the specialists' differing roles, could (1) lead auditors to devote the appropriate audit attention to the work of a company's specialist and (2) prompt more effective coordination between the auditor and an auditor's specialist in obtaining sufficient appropriate audit evidence, as well as the proper evaluation of the evidence obtained.

1. *Results of Outreach on Reasons to Improve Standards*

The reasons to improve auditing standards were informed by the results of outreach, including the 2015 SCP and discussions at various SAG meetings.

Staff Consultation Paper. Of those commenters on the 2015 SCP that provided relevant comments, most supported the staff's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements, while auditing standards related to the use of the work of specialists have not substantively changed since 1994. Many commenters also supported improving or enhancing auditing standards related to using the work of specialists. Some suggested that improvements to the Board's standards on using the work of specialists could result in enhanced audit quality and reduced risk of material misstatement in financial statements, which could provide greater confidence to users of financial statements. A number of commenters also noted that greater specificity and clarity of requirements related to the use of the work of specialists could result in more consistent application of requirements by auditors. Some commenters suggested making targeted improvements to increase the scalability of AS 1210 through principles-based requirements that align with the Board's risk assessment standards. Several commenters suggested the Board should consider aligning any new standards with the standards of the International Auditing and Assurance Standards Board ("IAASB").³²

In comparison, other commenters asserted that the changing business environment and potential needs identified in the 2015 SCP did not warrant changes to current standards. Some of these commenters argued that the inspection findings and enforcement cases cited in the 2015 SCP did not justify changes to current standards. Certain commenters preferred retaining existing requirements and enhancing the Board's oversight or enforcement activities to improve compliance. The Board's consideration of these and other suggested alternatives to standard setting is discussed in Section IV.D.1.

³² See IAASB's International Standard on Auditing ("ISA") 620, *Using the Work of an Auditor's Expert*, and ISA 500, *Audit Evidence*.

Discussions at Standing Advisory Group meetings. The SAG has discussed specialist-related issues at several meetings, including as recently as November 2016.³³ During these meetings, some SAG members have expressed concerns about the adequacy of current PCAOB standards regarding specialists. Many SAG members have expressed support for requiring: (1) better communication between auditors and their specialists; (2) auditors to have similar responsibilities for using the work of an auditor-employed and an auditor-engaged specialist; and (3) greater responsibility for evaluating the work performed by a company's specialist.

Other SAG members have expressed concerns that auditors may not always have the necessary level of expertise to evaluate the work of some specialists and, as a result, may have to rely on the work of specialists. Some other SAG members have argued in response that auditors should have a sufficient understanding of the specialist's area of expertise to be able to evaluate how the specialist's work relates to other audit work, based on the auditor's own knowledge and experience. These SAG members agree that the auditor should not be required to have the same subject-matter expertise as the specialist, but assert that the auditor should nevertheless be sufficiently knowledgeable about the specialist's work in order to opine on the fair presentation of the financial statements.

2. *Areas of Potential Improvement*

Taking into account observations from oversight activities, SAG member input, comment letters in response to the 2015 SCP, activities of other standard setters, and outreach with audit firms and specialist entities, the Board has identified the following areas needing improvement in the current standards relating to the use of the work of specialists:

- *Strengthening the requirements for evaluating the work of a company's specialist.* Strengthening the requirements for evaluating the work of a company's specialist on significant accounts and disclosures could improve the auditor's ability to detect material misstatements in the financial statements and enhance investor protection. This approach would build on improvements adopted in practices of some firms and set forth a uniform, risk-based approach among all audit firms when using the

³³ See SAG meeting briefing papers and webcast archives (Nov. 30-Dec. 1, 2016, Nov. 12-13, 2015, June 18, 2015, Oct. 14-15, 2009, and Feb. 9, 2006), available on the Board's website.

work of a company's specialist as audit evidence. The improvements include (1) strengthening requirements for the auditor's testing and evaluation of data used by the company's specialist and (2) requiring auditor evaluation of significant assumptions and methods used by the company's specialist. These requirements would be aligned with the risk assessment standards and the Board's separate proposal on auditing accounting estimates, including fair value measurements.³⁴

- *Applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.* Enhancing the requirements for applying a risk-based supervisory approach to auditor-employed specialists, and extending those requirements to auditor-engaged specialists could promote an improved, more uniform approach to supervision of an auditor's specialists, reflecting their similar roles and relationships to the auditor. The extent of such supervision would be based on existing supervisory principles in AS 1201 and thus depend upon: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist.

These improvements are intended to direct auditors to devote more attention to the work of a company's specialist and enhance the coordination between an auditor and the auditor's specialist—employed or engaged. The proposed requirements would also align more closely with the Board's risk assessment standards and acknowledge more clearly the differing roles of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist.

Question:

1. Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

³⁴ Estimates Release, PCAOB Release No. 2017-002. Commenters on the 2015 SCP supported aligning any new standards on using the work of specialists with any new standards related to auditing accounting estimates, including fair value measurements.



III. Discussion of Proposal

This proposal is intended to enhance existing requirements in current standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. Specifically, the proposal would: (1) add an appendix to AS 1105 with supplemental requirements for using the work of a company's specialist as audit evidence; (2) add an appendix to AS 1201 with supplemental requirements for supervising an auditor-employed specialist; and (3) replace current AS 1210 with a proposed standard for using the work of an auditor-engaged specialist. Key aspects of the proposal are discussed in this section. The ways in which the proposal would address the need for change from an economic perspective are discussed below in Section IV.B. In addition, Appendix 3 of this release describes the proposed amendments in more detail, drawing upon comments on the 2015 SCP when relevant to the discussion of specific aspects of the proposal.

In brief, the Board's proposal would make the following changes to PCAOB auditing standards:³⁵

- *Amend AS 1105.*
 - Add a new Appendix B to AS 1105 that would supplement the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, related to:
 - (1) Obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls;

³⁵ The proposed amendments would apply to audits of issuers as defined in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7201(a)(7), and to audits of brokers and dealers, as defined in Sections 110(3)–(4) of Sarbanes-Oxley, 15 U.S.C. 7220(3)–(4). As discussed further in this release, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies (see Section V below) and any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits (see Section VI below).

- (2) Obtaining an understanding of and assessing the specialist's knowledge, skill, and ability, as well as the specialist's relationship to the company; and
- (3) Performing procedures to test and evaluate the work of a company's specialist, including: (i) testing and evaluating data used by the specialist and evaluating whether the data was appropriately used by the specialist, (ii) evaluating the appropriateness of methods and reasonableness of significant assumptions used by the specialist, and (iii) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.
 - Align the proposed requirements for using the work of a company's specialist with the risk assessment standards and the Board's separate proposal on auditing accounting estimates, including fair value measurements.³⁶
 - Provide factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.
 - Direct the auditor to the respective standard for auditing accounting estimates to determine the procedures to be applied to test and evaluate data and evaluate methods and significant assumptions used by a company's specialist when auditing accounting estimates, including fair value measurements.
 - Remove requirements for using the work of a company's specialist as audit evidence from the scope of AS 1210.
- *Amend AS 1201.*
 - Add a new Appendix C to AS 1201 that would supplement the requirements for applying the supervisory principles in AS 1201.05-.06 when using the work of an auditor-employed specialist to assist

³⁶ Estimates Release, PCAOB Release No. 2017-002.

the auditor in obtaining or evaluating audit evidence, including proposed requirements related to:

- (1) Determining the necessary extent of the auditor's review of the work of the specialist;
 - (2) Informing the specialist of the work to be performed; and
 - (3) Reviewing and evaluating whether the work of the specialist provides sufficient appropriate audit evidence. Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and that the specialist's findings and conclusions are consistent with, among other things, the results of the work performed by the specialist.
- Provide factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.
 - Leverage the requirements in other PCAOB standards for assigning competent staff and determining compliance with independence and ethics requirements, reflecting the fact that auditor-employed specialists are members of the engagement team, and reference applicable independence and ethics requirements.
 - *Replace existing AS 1210.*
 - Replace existing AS 1210 with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, which would establish requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence.
 - Include proposed requirements for reaching an understanding with the specialist and reviewing and evaluating the specialist's work that parallel the proposed amendments to AS 1201 for auditor-employed specialists.
 - Provide factors for determining the necessary extent of review of the work of the auditor-engaged specialist.

- Amend requirements related to assessing the knowledge, skill, ability, and objectivity³⁷ of the specialist.
- Describe objectivity as the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and expand the list of matters that the auditor would consider when assessing whether the specialist has the necessary objectivity.

The proposed requirements are aligned with the Board's risk assessment standards, so that the necessary audit effort is commensurate with, among other things, the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and the associated risk. The approach has been informed by, among other things: (1) observations from PCAOB oversight activities and SEC enforcement actions; (2) analysis of comment letters on the 2015 SCP; (3) the IAASB's and the AICPA's Auditing Standards Board's ("ASB") auditing standards and IAASB's post-implementation review;³⁸ (4) outreach to audit firms and specialist entities; (5) views expressed by members of the SAG; and (6) academic research.

The proposed approach for an auditor's specialist has some similarities with the approach in ISA 620, but more directly reflects the different relationships of an auditor-employed specialist and an auditor-engaged specialist to the auditor. Specifically, similar to ISA 620, the proposed requirements recognize the common role served by auditor-engaged and auditor-employed specialists. Unlike ISA 620, however, the proposal sets forth in separate standards the auditor's responsibilities with respect to auditor-engaged and auditor-employed specialists. This approach recognizes that certain proposed requirements can be applied similarly to both types of specialists (e.g., reaching an understanding and evaluating work to be performed), while others should differ (e.g., requiring an assessment of objectivity for auditor-engaged specialists, while recognizing that auditor-employed specialists are required to be independent under SEC and PCAOB rules).

³⁷ In the proposal, the term "objectivity" is reserved for the auditor-engaged specialist and not used to describe the relationship to the company of (1) a company's specialist or (2) an auditor-employed specialist. See Section IV.D.3 below and Section IV.B.1 of Appendix 3 for further discussion of objectivity.

³⁸ See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review* 44-45 (July 2013).

The proposal also sets forth requirements for the auditor to evaluate the methods and significant assumptions of a company's specialist when the auditor uses that work as audit evidence. This evaluation is not explicitly required under the Board's existing standards, other than under AS 2502 with respect to the significant assumptions of a company's specialist regarding fair value measurements and disclosures.

In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.³⁹ In the Estimates Release, the Board is proposing to retitle and replace AS 2501 and supersede AS 2502 and AS 2503. Proposed AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

Questions:

2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?
3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

IV. Economic Considerations

The Board is mindful of the economic impacts of its standard setting. The economic analysis describes the baseline for evaluating the economic impacts of the proposal, analyzes the need for the proposal, and discusses potential economic impacts

³⁹ Estimates Release, PCAOB Release No. 2017-002.

of the proposed requirements, including the potential benefits, costs, and unintended consequences. The analysis also discusses alternatives considered. Because there are limited data and research findings available to estimate quantitatively the economic impacts of discrete changes to auditing standards, the Board's economic discussion is qualitative in nature.

A. Baseline

Sections II.A-B above discuss current PCAOB requirements for using the work of specialists and current experience in the application of those requirements. This section addresses from an economic perspective: (1) the prevalence and significance of audits involving specialists; (2) the current audit requirements that apply to the use of the work of specialists; and (3) the quality of audits that involve specialists, based on observations from regulatory oversight and academic literature.

1. Prevalence and Significance of Audits Involving Specialists

Staff analysis of PCAOB inspections data for audits of issuers indicates that larger audit firms extensively use the work of specialists, in particular auditor-employed specialists. This conclusion is based on a staff analysis of the 274 issuer audits⁴⁰ by U.S. audit firms affiliated with global networks that were selected for inspection in 2015. This analysis found that auditors used the work of at least one auditor-employed specialist in about 85 percent of those audits. For the 85 percent of those audits that involved the use of auditor-employed specialists, an average of four to five individual specialists performed some work on each audit, and specialists performed work in an average of one to two fields of expertise on each audit.

The data used in this analysis does not indicate how frequently the auditor used the work of an auditor-engaged specialist. As discussed in Section II.B.1, however, anecdotal evidence suggests that some larger audit firms use the work of auditor-engaged specialists infrequently.

Larger audit firms generally require their engagement teams to evaluate the work of a company's specialist, including the specialist's methods and significant assumptions, and often employ specialists to assist their audit personnel in evaluating

⁴⁰ The analysis was performed on engagement-level data obtained through PCAOB inspections. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of the work of specialists across a broader population of companies.

that work. Furthermore, the academic literature suggests that, when the company uses a company's specialist, some larger audit firms also tend to use the work of an auditor's specialist, at least in the context of audits involving challenging fair value measurements.⁴¹

PCAOB inspections data for issuer audits further suggests that, in contrast to larger audit firms, smaller audit firms generally have fewer audit engagements in which they use the work of a company's specialist or an auditor's specialist. Specifically, the staff analyzed data from the 361 audits performed by U.S. audit firms not affiliated with one of the global networks that were selected for inspection by the PCAOB in 2015. Of those 361 issuer audits, the staff identified: (1) 36 audits (i.e., about 10% of the analyzed audit engagements) in which the auditor used the work of a company's specialist but did not use the work of an auditor's specialist; (2) 24 audits (i.e., about 7% of the analyzed audit engagements) in which the auditor used the work of an auditor's specialist but did not use the work of a company's specialist; (3) 30 audits (i.e., about 8% of the analyzed audit engagements) in which the auditor used the work of a company's specialist and an auditor's specialist; and (4) 271 audits (i.e., about 75% of the analyzed audit engagements) in which the auditor neither used the work of a company's specialist nor used an auditor's specialist.

These results suggest that, when smaller firms use the work of a company's specialist, they often use that work without concurrently using an auditor's specialist to assist the auditor. That is, among the 66 audits (i.e., the sum of categories (1) and (3) above) in which the auditor used the work of a company's specialist, the auditor concurrently used the work of an auditor's specialist in 30 audits (i.e., about 45% of such audits). The results above also suggest that the smaller firms are more likely to use the work of auditor-engaged specialists than auditor-employed specialists.⁴² Among the 54 audits (i.e., the sum of categories (2) and (3) above) in which the auditor used the work of an auditor's specialist, the specialist was an auditor-engaged specialist in 39

⁴¹ See, e.g., Nathan H. Cannon and Jean C. Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, *The Accounting Review*, in-press 3 (2016) (study using an experiential questionnaire involving audit partners and managers of Big 4 firms in audits involving challenging fair value measurements).

⁴² The predominant use of the work of specialists by both larger and smaller audit firms is in the valuation area. See *supra* text accompanying note 23.

audits (i.e., 72% of such audits, or 11% of the audits that were analyzed). This may suggest that many smaller firms do not maintain their own specialists on staff.⁴³

The academic literature also suggests that the use of valuation specialists is prevalent for at least some audits. One recent study of audits by the four largest firms that involved challenging fair value measurements found that, among the audits studied, about 85% of audit teams used auditor-employed specialists, while about 5% of audit teams used auditor-engaged specialists.⁴⁴ In addition, 60% of the companies in this study used their own specialists, who were primarily engaged rather than employed specialists.⁴⁵ The audits that were included in this study may not be representative of all audit engagements, because they were selected in order to study engagements that involved material, highly challenging fair value measurements. However, the results suggest that the use of an auditor's specialist is at least prevalent among audits performed by the four largest U.S. firms where a company's specialist is used to assist in the development of highly challenging and material fair value measurements, which may also be audit areas with a high risk of material misstatement and thus a need for greater audit attention.⁴⁶

⁴³ The fact that the auditor did not use the work of an auditor's specialist does not imply that the auditor should have used the work of an auditor's specialist.

⁴⁴ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, at 22. The percentages stated may include audit engagements in which an auditor used both auditor-employed and auditor-engaged specialists concurrently. The tabulated results in the paper do not provide information about instances where only auditor-employed or only auditor-engaged specialists were used. In another study of how auditors use valuation specialists, auditors from seven larger U.S. audit firms who were interviewed stated that, on average, 61% of their engagements in the past year involved a valuation specialist. See Emily E. Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 13 (July 2016) (working paper, available in SSRN).

⁴⁵ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, at 22.

⁴⁶ Another recent qualitative study conducted through interviewing audit partners, managers, and seniors also observes that auditors in the six larger audit firms consider factors such as the "client's regulatory environment and other risk factors," "lack of subject matter expertise within the audit team," and "complexity of the engagement"

Furthermore, the academic literature also corroborates the characterizations discussed in Section II.B regarding the current practice of audit firms when using specialists. Academic studies suggest that, at least among the audits that were studied where specialists were used, larger firms were more likely to use the work of auditor-employed specialists than auditor-engaged specialists in their engagements,⁴⁷ while smaller firms, relative to larger firms, used the work of auditor-engaged specialists more frequently.⁴⁸

A possible explanation for the tendency of larger firms to use the work of auditor-employed specialists (instead of auditor-engaged specialists) is that larger firms, due to the greater number of their audit engagements or due to a broadening of their non-

when determining whether to use a specialist. See J. Efrim Boritz, Natalia Kochetova-Kozloski, Linda A. Robinson, and Christopher Wong, *Auditors' and Specialists' Views About the Use of Specialists During an Audit* 14-15 (Apr. 2015) (working paper, available in SSRN).

⁴⁷ See, e.g., Steven M. Glover, Mark H. Taylor, and Yi-Jing Wu, *Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy*, 36 *Auditing: A Journal of Practice & Theory* 63, 75 (2017) ("[R]esults indicate that approximately two-thirds (one-third) of our participants reported that they use in-house (third-party) valuation specialists to support the audit work performed for *financial* FVMs [i.e., fair value measurements]. Moreover, approximately 87 percent (13 percent) of the audit partners indicated that they use in-house (third-party) valuation specialists to support the audit work for *nonfinancial* FVMs."); see also Emily E. Griffith, Jacqueline S. Hammersley, and Kathryn Kadous, *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice*, 32 *Contemporary Accounting Research* 833, 836 (2015) ("[A]uditors [from six larger audit firms that were the subject of the study] typically enlist audit-firm specialists in auditing estimates because they do not have valuation expertise...").

⁴⁸ See Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 58. In this study, all participating auditors from Big 4 audit firms indicated that they used internal valuation specialists (i.e., auditor-employed valuation specialists) and did not use any external valuation specialists (i.e., auditor-engaged valuation specialists). In contrast, only 40% of the auditors from the other audit firms that participated in the study indicated that they exclusively used internal valuation specialists.

auditing practices, have sufficient demand for the services of specialists to warrant hiring specialists who work for them full-time. In contrast, smaller firms may currently use the services of an auditor's specialist fairly infrequently,⁴⁹ so that engaging an auditor's specialist as needed may be economically more advantageous. In addition, the tendency of smaller firms to look to the work of a company's specialist without using the work of an auditor's specialist may reflect the fact that AS 1210 enables the auditor to use the work of a company's specialist in a wide range of situations, without imposing obligations on the auditor that might require the retention of an auditor's specialist. Since smaller firms tend not to employ their own specialists, the use of an auditor-engaged specialist could represent a significant incremental cost for those firms, which they may have an incentive to avoid. In contrast, for larger firms, which tend to employ specialists, using a specialist who already works for the firm on an additional audit engagement may entail a lower incremental cost.

2. PCAOB Auditing Standards Regarding Use of the Work of Specialists

As discussed in more detail in Section II.A, under current standards, the auditor's primary responsibilities with respect to a company's specialist are set forth in AS 1210. AS 1210 also imposes the same responsibilities on auditors with respect to an auditor-engaged specialist, even though an auditor-engaged specialist has a fundamentally different role than a company's specialist. While the auditor's specialist performs work to assist the auditor in obtaining and evaluating audit evidence, the company's specialist performs work that is used by the company in preparing its financial statements and that the auditor may use as audit evidence.

The professional relationships between an auditor and a company's specialist and an auditor's specialist differ, among other things, in terms of who is employing or engaging the specialist (i.e., the company in the case of a company's specialist and the auditor in the case of an auditor's specialist) and thus the level of control and oversight an auditor is able to exercise over the specialist. Given these differences, which expose a company's specialist and an auditor-engaged specialist to different incentives and

⁴⁹ However, auditors at smaller firms that primarily audit companies in certain industries for which the involvement of specialists is typically necessary may frequently use specialists, and thus also may have repeated experience supervising an auditor's specialists and evaluating the work of specialists. In such cases, the auditor's capability to supervise an auditor's specialist and evaluate the work of a specialist may improve due to the frequent and repeated experience.

biases (e.g., pressure to conform to management bias), requirements would ideally differentiate between the two types of specialists, but current requirements do not do so.

In contrast, PCAOB requirements for using the work of an auditor-employed specialist, who is subject to supervision under AS 1201, differ from the requirements that apply to using the work of an auditor-engaged specialist. Auditor-employed and auditor-engaged specialists may differ in their economic dependency on the auditor and, by extension, could face different incentives to, for example, acquiesce to auditor decisions to downplay or suppress unfavorable information in order to accommodate a conclusion sought by the auditor.⁵⁰ In the context of a company's specialist, the academic literature provides anecdotal evidence suggesting that employed and engaged specialists may face different incentives when conducting their work.⁵¹ It is difficult to generalize, however, as to whether an auditor-employed specialist has a greater economic dependency on the auditor than an auditor-engaged specialist.⁵² Moreover, any potential bias by auditor-employed and auditor-engaged specialists arising from economic dependency on the auditor may be mitigated by the responsibility

⁵⁰ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 33 ("Auditors and specialists described several defensive behaviors by auditors that restrict specialists' access to information...Restricting specialists' access to information can influence how specialists do their work, what work they do, and what conclusions they reach.") and 32 ("[A]udit teams delete extraneous information in specialists' memos when that information contradicts what the audit team has documented in other audit work papers...").

⁵¹ See, e.g., J. Richard Dietrich, Mary S. Harris, and Karl A. Muller III, *The Reliability of Investment Property Fair Value Estimates*, 30 *Journal of Accounting and Economics* 125, 155 (2001) ("[O]ur investigation reveals that the reliability of fair value estimates varies according to the relation between the appraiser and the [company] (internal versus external appraiser)...We find evidence that appraisals conducted by external appraisers result in relatively more reliable fair value accounting estimates (i.e., lower conservative bias, greater accuracy and lower managerial manipulation).").

⁵² The extent of economic dependency of an auditor-employed specialist on the auditor will depend on how much of the specialist's work is related to audits (as opposed to non-audit services), which may vary for different auditor-employed specialists. Similarly, the extent of economic dependency of an auditor-engaged specialist on the auditor will depend on how much of the specialist's overall work is connected to the particular audit firm, which may vary for different auditor-engaged specialists.

imposed directly on the engagement partner under AS 1201 for supervision of the work of engagement team members and compliance with PCAOB standards, including those regarding using the work of specialists. In addition, AS 1220, *Engagement Quality Review*, requires the engagement quality reviewer to "evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report." Such significant judgments may include areas where auditors used the work of an auditor-employed or auditor-engaged specialist.

Furthermore, auditor-employed and auditor-engaged specialists serve similar roles in helping auditors obtain and evaluate audit evidence. Given the similar relationships of the auditor with auditor-employed and auditor-engaged specialists, it seems appropriate that the auditor would follow similar requirements when using both types of specialists, though current requirements differ for the two types of specialists. A notable difference in the relationship of the auditor with auditor-employed and auditor-engaged specialists, however, relates to the integration of auditor-employed specialists (as compared with auditor-engaged specialists) in an audit firm's quality control systems, which allows the auditor greater visibility into any relationships that might affect the auditor-employed specialist's independence, as well as greater visibility into the auditor-employed specialist's knowledge, skill, and ability. The proposed requirements with respect to evaluating the objectivity, as well as knowledge, skill, and ability, of an auditor-engaged specialist would, therefore, reasonably reflect that difference by providing the auditor with specific requirements to assess whether the auditor-engaged specialist has both the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and the level of knowledge, skill, and ability to perform the specialist's work related to the audit.

3. *Quality of Audits That Involve Specialists*

As discussed in Section II.B, PCAOB oversight of audit engagements in which auditors used the work of a company's or an auditor's specialist and SEC enforcement actions have identified certain concerns. PCAOB oversight activities have also led to inspection findings in this area. For issuer audit engagements, PCAOB staff have more recently observed a decline in the number of instances in which auditors did not perform sufficient procedures related to the work of an auditor's specialist. There are some preliminary indications that some, but not all, firms with observed deficiencies have undertaken remedial actions in response to such findings, which may have contributed, at least in part, to improvements in audit quality related to the auditor's use of an auditor's specialist.

Relatively few empirical academic studies have explicitly examined the relationship between the use of specialists and investors' perception of audit quality. This may be because it is difficult, especially for investors, to assess the effect of using specialists on audit quality independently from the effects of other relevant factors, such as the quality of the company's financial reporting or internal controls. Available studies have focused on the idea that estimates by issuers in financial statements, which often are provided with the help of a company's specialist, are uncertain, which "allows room for management bias"; such studies have also observed that, "as estimates become less reliable they become less useful to capital market participants," including investors.⁵³ Other studies suggest that some estimates are also more likely to be discounted by investors.⁵⁴ Because investors' perceptions of the credibility of financial statements are influenced by their perceptions of audit quality, the auditor's appropriate use of the work of specialists may increase the credibility of the accounting estimates included in the financial statements.

Question:

4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

⁵³ See Griffith et al., *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice* 833.

⁵⁴ See, e.g., Chang Joon Song, Wayne B. Thomas, and Han Yi, *Value Relevance of FAS No. 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms*, 85 *The Accounting Review* 1375 (2010). Furthermore, the academic literature notes that auditing estimates with extreme uncertainty can pose significant challenges for auditors. See, e.g., Brant E. Christensen, Steven M. Glover, and David A. Wood, *Extreme Estimation Uncertainty in Fair Value Estimates: Implications for Audit Assurance*, 31 *Auditing: A Journal of Practice & Theory* 127 (2012).

B. Need for the Proposal

From an economic perspective, the primary cause for market failure⁵⁵ that motivates the need for the proposal is the moral hazard⁵⁶ affecting the auditor's decisions on how to implement audit procedures related to the use of the work of a specialist, which increases the risk of lower audit quality from the investor's perspective.

Generally, the moral hazard problem related to the use of the work of a specialist manifests in the auditor not performing appropriate procedures, even though such procedures would improve audit quality by increasing the auditor's attention, because the auditor may not perceive there to be sufficient economic benefit (compared to the corresponding costs⁵⁷ and efforts) from such actions.

⁵⁵ "Market failure" refers to a situation in which markets fail to function well. One can distinguish between complete and partial market failure. Complete market failure occurs when a market simply does not operate at all, because there are either no willing buyers (but willing producers) or no willing producers (but willing buyers). Partial market failure occurs when a market does function but produces either the wrong quantity of a product, or produces a product at the wrong price, or produces products at the wrong level of quality. For example, a market for public company audits which consistently produces some deficient audits would be considered a market experiencing partial market failure. See, e.g., Francis M. Bator, *The Anatomy of Market Failure*, 72 *The Quarterly Journal of Economics* 351 (1958); and Steven G. Medema, *The Hesitant Hand: Mill, Sidgwick, and the Evolution of the Theory of Market Failure*, 39 *History of Political Economy* 331 (2007).

⁵⁶ The moral hazard problem is also referred to as a hidden action, or agency problem, in economics literature. The term "moral hazard" does not refer to a person's morality, but rather to the incentive an agent may have to take actions (such as not working hard enough) that benefit the agent at the expense of harming the principal. To correct moral hazard problems, the principal must change the incentives the agent faces to better align the agent's actions with the principal's interests. Monitoring the agent's behavior can reinforce these incentives. See, e.g., Bengt Holmström, *Moral Hazard and Observability*, 10 *The Bell Journal of Economics* 74 (1979).

⁵⁷ The general effect of cost pressures on audit quality has been studied in academic literature with varying empirical findings. See, e.g., Bernard Pierce and Breda Sweeney, *Cost-Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004).

Specifically, when auditors use the work of a company's specialist, moral hazard may take the form of planning and performing audit procedures that may not be commensurate with the risk of material misstatement inherent in the work of the company's specialist. When auditors use the work of an auditor's specialist, moral hazard may, for example, take the form of not performing procedures or performing insufficient procedures to communicate and reach an understanding with the specialist regarding the specialist's responsibilities and the objectives of the specialist's work and sufficiently evaluate that work.⁵⁸

Moral hazard is made possible in this context by the information asymmetry⁵⁹ that exists due to the lack of transparency about the nature of the auditor's work (i.e., between the auditor on the one hand, and investors on the other hand). For instance, investors typically do not know whether an auditor used an auditor's specialist and if so, how the auditor's specialist was used. Because of this information asymmetry, the auditor may face little to no scrutiny from investors regarding his or her audit procedures when using the work of specialists,⁶⁰ and may perceive limited economic benefits (e.g., gains in revenue, gains in professional reputation, a reduction in the risk of facing litigation) in incurring costs to perform additional audit work. Hence, the moral hazard

⁵⁸ Alternatively, it is conceivable that, in some situations, moral hazard may take the form of the auditor either influencing the findings or conclusions that specialists reach or modifying the specialist's work after the fact to support the conclusions sought by the auditor. See *supra* text accompanying note 50.

⁵⁹ Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

⁶⁰ This is true for other aspects of the audit engagement as well and hence the audit can be thought of providing investors with a credence service. Credence services (or goods) are difficult for consumers to value because their benefits are difficult to observe and measure. See Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 Accounting Horizons 631 (2012). See also Alice Belcher, *Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies*, 18 Bond Law Review 1, 5 (2006) (An "audit is a credence service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company.").

problem between the auditor and investors may have a detrimental impact on audit quality.⁶¹

Because market forces (e.g., pressure and demands from investors) may not be effective in making the auditor more responsive to investor interests with respect to the use of the work of specialists, from an economic perspective, the situation absent standards would be characterized as a form of market failure. While current standards regarding the use of the work of an auditor-engaged specialist and a company's specialist are intended to address and mitigate potential auditor moral hazard, they could be aligned more closely with the risk assessment standards, which could enhance audit quality. In addition, while auditor-employed specialists are supervised under a risk-based approach, specifying requirements for applying that approach could promote an improved, more uniform approach to supervision of auditor-employed specialists. Additionally, if the work of an auditor's specialist is not properly overseen or evaluated (or the work of a company's specialist is not properly tested or evaluated), there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.⁶²

The auditor does not engage or employ a company's specialist and does not supervise the work of a company's specialist. This makes the auditor's use of the work of a company's specialist different from the auditor's use of an auditor's specialist in several important ways.

First, because of the different relationships the auditor has with a company's specialist and with an auditor's specialist, the auditor's assessment of the qualifications

⁶¹ Additionally, such situations may occur because the auditor made an error in judgment assessing the audit risk involved when using the work of an auditor's specialist or a company's specialist. In situations in which "objectives and the actions needed to achieve them are complex and multifaceted, it is inevitable that different people" will interpret "them in different ways..." See John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 *Academy of Management Review* 98, 107-108 (2002). Whether one assumes that people either are unselfish yet "prone to mak[ing] mistakes" or are self-interested and opportunistic yet unlikely to make mistakes, when choosing their actions in such situations, Hendry argues that the predicted actions (and hence resulting problems) are more or less the same under either assumption. *Id.* at 100.

⁶² See Section II.C, *supra*.

and relationships of a company's specialist requires greater effort by the auditor compared to the auditor's equivalent procedures with respect to an auditor's specialist. Second, the auditor's consideration of significant assumptions and methods used by the company's specialist may also be more challenging, compared to equivalent procedures performed by the auditor when using an auditor's specialist with whom the auditor has an employment or contractual relationship. Third, an auditor is generally more likely to be familiar with an auditor's specialist than with a company's specialist (e.g., with the professional qualifications, reputation, and work), which reduces the costs associated with the ongoing monitoring of the specialist's work.⁶³ Given these differences, the standards would ideally differentiate between the two types of specialists, but AS 1210 currently does not do so.

Accordingly, the potential for moral hazard relating to the auditor's use of the work of a company's specialist is a particular focus of the proposed requirements. Indeed, observations from PCAOB oversight activities described in Section II.B.2 suggest that current standards could be enhanced by providing specific requirements for using the work of a company's specialists that better align with investors' interests.

The need to enhance current standards is further heightened by the fact that it may be particularly challenging for the auditor to supervise an auditor's specialist or to evaluate the work of both an auditor's specialist and a company's specialist. The work of an auditor's or a company's specialist often involves professional judgment, the nature of which the auditor may not fully appreciate when evaluating the work of the specialist. In particular, the specialist's work is highly technical in nature and often is not entirely transparent to the auditor, who may not have complete access to the specialist's work⁶⁴

⁶³ An additional aspect that affects the potential for moral hazard is the possible differences between auditor-engaged and auditor-employed specialists with respect to their business relationships with the auditor. To the extent that one has a stronger business relationship (e.g., repeated business interactions between the specialist and the auditor), the potential for moral hazard, arising in the context of the auditor using such an auditor's specialist, is likely higher.

⁶⁴ As further discussed in Section IV.B.2 of Appendix 3, some commenters on the 2015 SCP expressed concern that the auditor may have limited access to proprietary information used by auditor-engaged specialists (as compared with information used by auditor-employed specialists) and, as a result, would be unable to supervise the auditor-engaged specialist in the same way he or she supervises an auditor-employed specialist. The proposal would not require the auditor to obtain such proprietary

or the same level of knowledge and skill in the specialist's field.⁶⁵ Thus, due to the potential that an auditor would incur relatively higher cost to supervise an auditor's specialist or to test and evaluate the work of a company's specialist, the auditor may have incentives to forego procedures related to the use of the work of specialists that could be beneficial to investors.

The potential negative impact on audit quality of the auditor's incentives to forego procedures is compounded by the possibility that the specialist may, for example, perceive little benefit (compared to the corresponding costs and efforts) in seeking clarification when the auditor and specialist establish the responsibilities of the specialist, including the objectives of the work to be performed; or, the specialist may in some instances believe that he or she faces few negative consequences (such as an increased risk of litigation) when performing low quality work. However, any such concerns are at least partially alleviated to the extent specialists could perceive a risk of reputational damage or are subject to codes of conduct, standards, and disciplinary processes of their own profession.⁶⁶

Accordingly, the Board believes that enhanced performance standards regarding the use of the work of specialists may be beneficial to the quality of the audit and to investors. To address the potential risks discussed above, the proposal would, as discussed in more detail in Section III: (1) strengthen requirements, which are aligned with the risk assessment standards, regarding using the work of a company's specialists as audit evidence; (2) leverage existing supervisory principles to strengthen

information, but rather require the auditor to obtain sufficient information to evaluate the work of that specialist in accordance with the proposed standard.

⁶⁵ See, e.g., Jennifer R. Joe, Yi-Jin Wu, and Aleksandra B. Zimmerman, *Overcoming Communication Challenges: Can Taking the Specialist's Perspective Improve Auditors' Critical Evaluation and Integration of the Specialist's Work?* 7 (Feb. 2017) (working paper, available on SSRN) ("Recent research on auditors' use of specialists focuses on situations where auditors are advice-seekers and lack the knowledge or expertise of the specialists...").

⁶⁶ See, e.g., Letter from American Academy of Actuaries (July 31, 2015), at 18 ("We note that Precept 1 of the actuary's code of conduct mandates performing engagements with integrity: 'An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession.'").

requirements regarding supervision of the work of an auditor-employed specialist; and (3) strengthen requirements when using the work of an auditor-engaged specialist so that those requirements largely parallel the requirements when using an auditor-employed specialist.

Question:

5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

C. Economic Impacts

The magnitude of the benefits and costs of the proposed amendments are likely to be affected by the nature of and risks involved in the work performed by specialists, because more complex work and work in areas of greater risk will likely require greater audit effort, holding all else constant. In addition, benefits and costs are likely to be affected by the degree to which auditors have already adopted audit practices and methodologies that are similar to those that the proposed amendments would require.

The remainder of this section discusses the potential benefits, costs, and unintended consequences that may result from the amendments the Board is proposing.

1. Benefits

The proposal is expected to benefit investors and auditors by directing auditors to devote more attention to the work of specialists and enhancing the coordination between auditors and their specialists. This should mitigate the problem of auditor moral hazard discussed in the preceding section and contribute to improved audit quality. The proposal could accomplish this, and increase the likelihood that auditors will detect material misstatements, through requirements that take into account current auditing practices by some larger audit firms and more strongly align auditors' interests with the interests of investors when auditors use the work of specialists. At the same time, by fostering improved audit quality, the proposed requirements should increase investors' perception of the credibility of a company's financial statements, and help address uncertainty about audit quality and the potential risks associated with the use of the work of company specialists, auditor-employed specialists, and auditor-engaged specialists.

Investors also may benefit from the proposed requirements because the proposed requirements may result in more uniformly rigorous practices among auditors

when using the work of a company's specialist in their audits, as well as a more consistent approach to supervision of auditor-employed and auditor-engaged specialists. The absence of uniformity in the application of practices related to the auditor's use of the work of specialists, combined with a lack of information about such practices, could lead investors to discount the quality of all audits (with the potential effect on the cost of capital of companies) because of investors' inability to distinguish the quality of each audit separately. Conversely, uniformity in such practices could mitigate those concerns. From an investor's perspective, the increase in audit quality that may result if the proposal were adopted by the Board could translate into an increase in the credibility of the information provided in a company's financial statements and a decrease in the cost of capital for that company, especially if relatively less information is available about the company because of its shorter financial reporting history.⁶⁷

From a capital market perspective, an increase in investors' perception of the credibility of information provided in companies' financial statements because of improved audit quality, in the aggregate, can increase the efficiency of capital allocation decisions. In other words, greater reliability of companies' financial statements generally may result in investment decisions by investors that more accurately reflect the financial position and operating results of each company.⁶⁸

⁶⁷ See, e.g., Jeffrey A. Pittman and Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, 37 *Journal of Accounting and Economics* 113, 114 (2004) ("[E]ngaging [an audit firm with] a brand name reputation for supplying higher-quality audit that enhances the credibility of financial statements...enables young [companies] to reduce their borrowing costs...[O]ur research suggests that the economic value of auditor reputation declines with age as [companies] shift toward exploiting their own reputations to reduce information asymmetry.").

⁶⁸ See, e.g., Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 21 (2011) ("[M]arket illiquidity influences the amount of information that is reflected in prices [and] ... reduces investors' average precision and thus raises the cost of capital. Moreover, the degree of information asymmetry in the economy influences the amount of market illiquidity, which also raises the cost of capital."). Professor Leuz is an economic advisor to the PCAOB's Office of Economic and Risk Analysis. This research was published before he joined the PCAOB.

In addition to the general benefits to investors and the capital market described above, the proposed requirements may result in specific benefits to auditors. In particular, the proposed requirements may lead to improvements in the ability of auditors to supervise auditor-employed and auditor-engaged specialists and evaluate their work, to the extent that auditors devote more attention to the work of auditor-employed and auditor-engaged specialists and enhance the coordination with those specialists. The proposed requirements with regard to the use of the work of a company's specialist may lead to improvements in the auditor's understanding of the assumptions and methods used by the company's specialist. In turn, as auditors are better able to identify and detect potential risks of material misstatement, this may also spur companies and their specialists over time to improve the quality of financial reporting and their work.

The proposal may also contribute to the aggregate benefits of the auditing standards (i.e., enhance auditors' understanding of, and compliance with, other PCAOB auditing standards), in addition to the other improvements in audit quality described above. For example, the proposed requirements to test and evaluate the work of a company's specialist may result in some auditors developing a better understanding of the company's critical accounting estimates related to relevant financial statement accounts and disclosures. In turn, this may also result in improved communications with the audit committee.⁶⁹

The magnitude of the benefits discussed in this section resulting from improved audit quality will likely vary to the extent that current practices reflect the proposed requirements. Based on observations from the Board's oversight activities, most firms would need to enhance their methodologies, but to varying degrees. In general, both the greatest changes and the greatest benefits are likely to occur with auditors that need to enhance their methodologies the most.

Question:

6. The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

⁶⁹ See paragraphs .12c and .13c of AS 1301, *Communications with Audit Committees*, for the auditor's communication requirements related to the company's critical accounting estimates.

2. Costs

The Board recognizes that the benefits of the proposal may come at potential additional costs to auditors and the companies they audit.

As with any changes to existing requirements, it is anticipated that there would be one-time costs for auditors associated with updating audit methodologies and tools, preparing new training materials, and conducting training. The proposal could further give rise to recurring costs in the form of additional time and effort spent on any individual audit engagement by specialists and engagement team members.

The most significant impact of the proposal on costs for auditors is expected to result from the proposed requirements to test and evaluate the work of a company's specialist. Compared with the existing requirements,⁷⁰ the auditor will be required in all cases to evaluate the significant assumptions used by the specialist, as currently required by other auditing standards only in certain circumstances,⁷¹ as well as the methods used by the specialist. In practice, these requirements may result in auditors who currently perform limited procedures over the work of a company's specialist engaging or employing an auditor's specialist to assist in performing those procedures. This may lead to significant changes in practice for some firms, particularly smaller firms that currently follow methodologies solely based on AS 1210, even though the proposal does not require the auditor to use the work of an auditor's specialist.

Some of the cost increases for auditors due to the proposal are likely to be offset by the implementation of more efficient, risk-based audit approaches in practice (e.g., more targeted procedures when using the work of specialists). In particular, more efficient, risk-based audit approaches reduce the risk to the auditor of failing to detect material misstatement and thus could lead to a reduction in costs resulting from the risk of litigation, regulatory sanction (including time and effort spent on remediation of deficiencies) or reputational loss faced by auditors.

⁷⁰ See existing AS 1210.12.

⁷¹ In circumstances when an auditor is auditing fair value measurements in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurement.

The proposal's impact on costs for auditors could also vary based on the size and complexity of an audit engagement. Holding all else constant, anticipated costs generally would be higher for larger, more complex audits than for smaller, less complex audits.⁷² The proposal's impact would also likely vary, however, depending on whether any of the proposed requirements have already been incorporated in audit firms' audit methodologies or applied in practice by individual engagement teams. As discussed above, for auditors that have already implemented elements of the proposal, the costs of implementing the proposed requirements may be lower than for firms that currently perform more limited audit procedures. For example, some firms employ procedures to reach and document their understanding with an auditor's specialist about, among other things, the responsibilities of the auditor's specialist and the nature of the work to be performed. Firms that do not already employ such procedures may incur additional costs under the proposal.

Similarly, the proposal's incremental impact on costs incurred by auditors would likely vary depending on, among other things, how many of an audit firm's engagements involve the use of the work of specialists. For audit firms that use the work of specialists in a similar way on their engagements, the anticipated costs would likely be higher for audit firms that perform many audit engagements involving the use of the work of specialists than for audit firms that perform few such audits. For larger audit firms that generally perform a larger number of audit engagements (which may or may not involve the use of the work of specialists), however, the proposal's incremental impact on costs per engagement may be lower than for smaller firms that generally perform a smaller number of audit engagements (which may or may not involve the use of the work of specialists). The reason is that larger firms, due to their existing economies of scale⁷³

⁷² As discussed in Section IV.A.1, a smaller fraction of audits performed by smaller audit firms tend to involve use of the work of specialists, compared with audits performed by larger audit firms. Furthermore, according to the American Academy of Actuaries "smaller audit firms also tend to have clients that require fewer special needs," implying that audit engagements of smaller audit firms tend to also be less complex than audit engagements of larger audit firms. See Letter from American Academy of Actuaries (July 31, 2015), at 18. Hence, it is reasonable to assume that relatively fewer audits of smaller firms will be impacted by the proposal than audits of larger firms.

⁷³ See *Economies of Scale and Scope*, The Economist, Oct. 20, 2008 ("Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output [i.e., number of audit engagements] increases."). In this context, the average cost would likely fall with the number of audit engagements, because certain

and scope,⁷⁴ would tend to be able to distribute the overall cost impact of the proposal over a larger number of audit engagements.

For companies (and, indirectly, investors), the proposal might result in additional costs to the extent that the proposal causes auditors to raise audit fees, which could vary for the same reasons as described above relating to the proposal's potential impact on costs incurred by auditors.⁷⁵ Further, the proposal could give rise to new recurring costs for management to the extent that the proposal results in the need for companies to devote more time and resources to respond to auditor inquiries and requests. For example, when evaluating the work of a company's specialist under the proposal, an auditor may require more of the company's time or more time of the company's specialist.

costs, such as the cost of employing specialists, are not directly related to the number of audit engagements that an auditor assumes; see also Simon Yu Kit Fung, Ferdinand A. Gul, and Jagan Krishnan, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing*, 87 *The Accounting Review* 1281, 1287 (2012) ("For an audit firm, the scale economies can arise from substantial investment in general audit technology (e.g., audit software development or hardware acquisition) and human capital development (e.g., staff training), which are likely to be shared among all of their clients. Once these investments are in place, additional clients can be serviced at a lower marginal cost than the cost of servicing the first few clients.").

⁷⁴ See *Economies of Scale and Scope*, *The Economist*, Oct. 20, 2008. ("[E]conomies of scope [are] factors that make it cheaper to produce a range of products together than to produce each one of them on its own. Such economies can come from businesses sharing centralised functions...").

⁷⁵ It is not clear to what extent the proposed audit performance requirements would result in higher audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard setters have issued new standards during that period. See, e.g., Audit Analytics, *Audit Fees and Non-Audit Fees: A Fourteen Year Trend* (Nov. 2016). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which are not accounted for or priced on a standard-by-standard basis, it is difficult to obtain data that isolate the costs of particular new audit standards and that would be comparable between firms.

Question:

7. The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

3. *Unintended Consequences*

In addition to the benefits and costs discussed above, the proposed amendments could have unintended economic impacts. The following discussion describes potential unintended consequences considered by the Board and, where applicable, factors that mitigate the negative consequences, such as steps the Board has taken or the existence of other countervailing forces.

First, the proposal, to the extent that it increases the need of some audit firms to use the work of an auditor's specialist (rather than only use the work of a company's specialist under existing AS 1210), may result in some smaller firms accepting fewer audit engagements that would require the use of an auditor's specialist. Relatedly, the proposal may inhibit some smaller firms from expanding their audit services for the same reasons.

In particular, the proposal may result in an increased need by some auditors at smaller firms to use the work of an auditor's specialist for certain engagements, to the extent that such auditors have less experience evaluating the work of a company's specialist than auditors at larger firms. Potentially, such firms would be unable to take advantage of economies of scale and scope available to larger firms, and would find it economically less attractive to accept such engagements.

As discussed previously, however,⁷⁶ some auditors at smaller firms that primarily audit companies in industries for which the involvement of specialists is typically necessary may have experience evaluating the work of a company's specialist comparable to auditors at larger firms. For these reasons, the impact on auditors at smaller firms may vary. In addition, as previously discussed in Section IV.A.1, smaller firms tend to have fewer audit engagements than larger firms where a company's specialist or an auditor's specialist is involved. This suggests that any increase in the potential need of smaller firms to use the work of an auditor's specialist may be of limited economic impact for some smaller firms.

⁷⁶ See also *supra* footnote 49.

Second, the proposal may, in some audit engagements involving specialists, lead auditors to devote more of their attention and resources to the work of a company's specialists (including related training of audit personnel) and to enhancing the coordination with an auditor's specialists, and less time and resources to other tasks that warrant greater attention. The impact on overall audit quality might vary as the re-orientation of attention would occur in different ways for each audit engagement. Any potential adverse impact on overall audit quality is mitigated, however, by the proposal's risk-based approach to using the work of specialists. To the extent that the re-orientation of the auditor's attention leads to more effort in areas with the greatest risk of material misstatement to the financial statements, overall audit quality would be expected to increase. Furthermore, if auditors devote more attention to the work of specialists and enhancing the coordination with their specialists, the proposal may result in some auditors acquiring greater expertise, which could positively affect the quality of audit work performed by such auditors.⁷⁷

Third, the potential exists that auditors might interpret the proposal to suggest that they should use the work of an auditor's specialist in situations where the auditor had already obtained sufficient appropriate audit evidence with respect to a relevant assertion of a significant account or disclosure.⁷⁸ This might occur, for example, if an

⁷⁷ Such auditor specialization could lead some audit firms to seek fewer audit engagements involving specialists, while other firms might seek more such engagements. In addition, it could encourage a stronger degree of differentiation among audit firms, providing some firms with more business opportunities and the ability to take advantage of economies of scale and scope resulting from an increased focus on audit engagements involving specialists. As with any market with differentiated product, the competitive effects of increased differentiation are highly dependent on the circumstances. See, e.g., Fung et al, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing* 1287 ("[I]ndustry specialization enables auditors to service a larger number of firms within an industry, as they possess similar client characteristics and service needs, thereby reducing audit costs and simultaneously increasing the 'service value' provided to clients.").

⁷⁸ For example, in commenting on the potential unintended consequence of strengthening the requirements regarding the auditor's use of the work of company's specialists in response to the 2015 SCP, one commenter asserted that "[r]equiring auditors to evaluate evidence provided by a company's specialist in a similar way to any other evidence provided by the company's management generally would require the auditor to employ or engage an auditor's specialist to evaluate the company's specialist's work." See Letter from BKD, LLP (July 24, 2015), at 5.

auditor had already tested and evaluated the work of a company's specialist, but decided to employ or engage its own specialist to perform additional procedures (for example, to develop or assist in developing an independent expectation of an estimate) in order to further demonstrate his or her diligence or err on the side of caution. In some instances, it is possible that the auditor might do so even though the auditor believes the costs of using the work of an auditor's specialist will outweigh the expected benefits in terms of audit quality. This risk is mitigated, however, by the fact that the proposed requirements do not require the auditor to use the work of an auditor's specialist. In addition, the proposed requirements regarding the nature, timing, and extent of the testing and evaluation of the work of the company's specialist are designed to be risk-based and scalable to companies of varying size and complexity and thereby avoid unnecessary effort by the auditor and the auditor's specialist.⁷⁹ Accordingly, the instances described above are expected to be relatively rare.

Finally, in audit engagements involving specialists, the proposal could affect the balance between the work of a company's specialist and the work of an auditor's specialist. Although the proposed standards do not change management's responsibility for the financial statements or their obligation to maintain effective internal control over financial reporting, some issuers and some company specialists, anticipating the use of an auditor's specialist for the audit engagement, may decide to use a company's specialist to a lesser extent when preparing financial statements or exhibit a reduced sense of responsibility, respectively.⁸⁰ In such instances, the auditor's specialist may have to perform more work in order to adequately test and evaluate potential audit evidence provided by the issuer (i.e., the work of the company's specialist), or the auditor may decide not to use the work of the company's specialist or use it to a lesser extent. This could reduce audit quality in some instances. The change in the balance

⁷⁹ See Section III.C of Appendix 3 for examples that illustrate the application of the proposed requirements.

⁸⁰ Some of the commenters on the 2015 SCP articulated similar concerns. See, e.g., Letter from Wilary Winn LLC (July 30, 2015), at 6 ("[I]f audit firms are forced to use a specialist to review the work of the company's engaged specialist, fewer companies would retain their own specialists and would instead rely on the auditor's engaged specialist in order to avoid paying for the same work twice."); and Letter from Illinois CPA Society (July 31, 2015), at 6 ("One potential unintended result of revising the level of auditor evaluation of the independent investigators' [i.e., company specialists'] work...may be that companies are discouraged from seeking outside expertise in this important area...").

between the work of a company's specialist and the work of an auditor's specialist, however, would likely be limited, as companies control the work of a company's specialist over information to be used in the financial statements, but lack similar control over an auditor's specialist. Companies generally are likely, therefore, to prefer to continue their use of a company's specialist.

Questions:

8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?
9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

D. Alternatives Considered

The development of the proposal involved considering a number of alternative approaches to address the problems described above. This section explains: (1) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (2) other standard-setting approaches that were considered by the Board; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

1. Why Standard Setting Is Preferable to Other Policy-Making Approaches

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. The Board considered whether providing guidance or increasing inspection or enforcement efforts would be effective corrective mechanisms to address concerns with the testing and evaluation of the work of a company's specialists, the supervision of an auditor's specialists, and the sources of market failure discussed in Section IV.B.

Interpretive guidance, inspections, or enforcement actions alone without amending auditing standards would be unlikely to achieve the Board's objectives, as described in Section II.C.2. Interpretive guidance inherently provides additional

information about existing standards. Inspection and enforcement actions take place after insufficient audit performance (and potential investor harm) has occurred. Devoting additional resources to guidance, inspections, or enforcement activities, without improving the relevant performance requirements for auditors, would at best focus auditors' performance on existing standards and would not provide the benefits associated with improving the standards. The proposed approach reflects the conclusion that standard setting is needed to fully achieve the benefits resulting from improvement in audits involving specialists.

2. *Other Standard-Setting Alternatives Considered*

Several alternative standard-setting approaches were also considered, including: (1) retaining the existing framework but requiring the auditor to disclose when the auditor used the work of specialists in the audit; or (2) targeted amendments to existing requirements.

(a) *Disclosing When the Work of a Specialist is Used*

As an alternative to amending AS 1105 and AS 1201 and replacing AS 1210 in its entirety, the Board considered amending AS 1210 to remove the current prohibition in AS 1210.15 on disclosing that a specialist was involved in the audit. Instead, under this approach, the auditor would be required to disclose this fact. Investors might benefit from such a requirement, since it would inform investors, at a minimum, that the auditor had evaluated the need for specialized skill or knowledge in order to perform an audit in accordance with PCAOB standards. Such disclosures could, in theory, positively affect audit practice, as auditors might face more scrutiny from investors regarding their decisions whether or not to use specialists.

Disclosure alone, however, would be unlikely to achieve the Board's objectives. In a separate rulemaking, the Board is considering adoption of a new auditing standard that would require the auditor to communicate in the auditor's report critical audit matters ("CAMs") arising from the audit that involved especially challenging, subjective, or complex auditor judgment. Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist if the work or findings related to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.⁸¹ While it

⁸¹ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

is uncertain how frequently the use of the work of specialists would be disclosed in the auditor's report as part of a CAM, the disclosure requirements would be complemented by amending AS 1105 and AS 1201 and replacing AS 1210 to improve performance requirements over the use of the work of specialists. As discussed in Section IV.B, this would directly mitigate auditor moral hazard and change certain elements of audit practice observed by PCAOB oversight activities, described in Section II.B, that have given rise to concern.

(b) Amending Existing Requirements for Using the Work of an Auditor's Specialists

The Board considered, but is not proposing, two alternative approaches for an auditor's use of the work of an auditor's specialist. The staff sought comment on these approaches in the 2015 SCP. Each approach involved new requirements for: (1) evaluating the knowledge, skill, and objectivity of an auditor's specialist; (2) informing the specialist of his or her responsibilities; and (3) reviewing the specialist's work and conclusions.

The first alternative was to develop a separate standard for using the work of an auditor's specialist. This approach would have created a new auditing standard for using the work of an auditor's specialist, whether employed or engaged by the auditor, similar to the approach in ISA 620 and AU-C Section 620 (and thereby separating the requirements for using the work of an auditor-engaged specialist from those for using the work of a company's specialist). The approach would have applied the supervisory principles set forth in AS 1201 to both auditor-employed and auditor-engaged specialists in a separate standard. This approach also would have required the auditor to continue applying AS 1201 when using the work of an auditor-employed specialist.

The second alternative was to extend the supervisory requirements in AS 1201 to an auditor-engaged specialist. This approach would have amended AS 1210 to remove all references to an auditor-engaged specialist and amended AS 1201 to include all arrangements involving auditor-employed and auditor-engaged specialists. Similar to developing a separate standard, this approach would apply the supervisory principles set forth in AS 1201 to both auditor-employed and auditor-engaged specialists. This approach would be familiar to auditors who employ specialists, since AS 1201 already applies to an auditor-employed specialist.

Many commenters on the 2015 SCP opposed including an auditor-engaged specialist within the scope of AS 1201, and thereby treating such specialist as a member of the engagement team subject to the firm's system of quality control. Many of these commenters asserted that it would not be practical to apply important aspects of an audit firm's system of quality control to an auditor-engaged specialist. Other commenters, however, expressed support for having similar requirements for supervising

an auditor-employed specialist and an auditor-engaged specialist. Some commenters recommended that any new requirements should be principles-based and allow auditors to exercise judgment in overseeing the work of an auditor's specialists. Many of these commenters also supported aligning current requirements with those in ISA 620. A few commenters did not support changing the current requirements for using the work of an auditor's specialist.

The Board determined that, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. After considering the comments on certain elements of the two alternatives discussed in the 2015 SCP, the Board determined instead to propose separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist related to reaching an understanding and evaluating the work to be performed. The proposed approach acknowledges that, unlike auditor-employed specialists, auditor-engaged specialists are not subject to certain elements of a firm's system of quality control, such as independence, personnel management, and ongoing monitoring.⁸² Requiring the auditor or the auditor-engaged specialist to create and maintain a system of quality control for independence, personnel management, and ongoing monitoring that would apply to the auditor-engaged specialist would pose an undue cost burden on the auditor and auditor-engaged specialist relative to the potential benefits of the two alternatives described above.⁸³ Accordingly, under the proposal, the auditor would perform different procedures when assessing the knowledge, skill, ability, and objectivity of auditor-engaged specialists than when assessing the knowledge, skill, ability, and independence of auditor-employed specialists.

⁸² See, e.g., paragraphs .09-.10 of QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (describing the independence, integrity, and objectivity element of a firm's system of quality control); paragraphs .11-.13 of QC 20 (describing the personnel management element of a firm's system of quality control); paragraph .20 of QC 20 (describing the monitoring element of a firm's system of quality control); and QC 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

⁸³ See also Section IV.D.3 for additional discussion regarding the objectivity of the auditor-engaged specialist.

3. *Key Policy Choices*

Given the preference for creating separate requirements for using a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, the Board considered different approaches to addressing key policy issues.

(a) *Testing and Evaluating the Work of a Company's Specialist*

The Board is proposing to amend AS 1105 to enhance the requirements for testing and evaluating the work of a company's specialist. Including these requirements in an appendix to the Board's standard on audit evidence underscores that the auditor may use the work of a company's specialist as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure. The proposal is intended to be risk-based and to focus the auditor's attention on information from a company's specialist that pertains to accounts or financial statement disclosures that are significant or have a higher risk of material misstatement, while allowing the auditor to take the knowledge, skill, and ability of the specialist into account in determining the necessary evidence from the auditor's testing and evaluation of the specialist's work.

The Board considered, but is not proposing, an alternative approach discussed in the 2015 SCP for an auditor's use of the work of a company's specialist. This approach suggested the possibility of amending the requirements in AS 1210 to remove certain provisions that might be considered to limit the auditor's responsibilities to evaluate the work of a company's specialist.⁸⁴ While this approach would have required limited changes to existing AS 1210, it does not respond to the risk of material misstatement that may be associated with the financial statement accounts or disclosures with which the work of a company's specialist is involved. In comparison, the Board's proposal, while eliminating the provisions that might be considered to limit the auditor's responsibilities, directs the auditor to focus on areas of greater significance with higher risks of material misstatements.

⁸⁴ For example, this alternative discussed eliminating language in AS 1210.12-.13 that states that: (1) the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist; (2) the auditor would ordinarily use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.

The Board also considered, as a second alternative, rescinding AS 1210 without issuing new requirements for the auditor's use of the work of a company's specialist. Under this approach, also discussed in the 2015 SCP, information provided by a company's specialist would be evaluated similarly to any other information provided by the company. This approach might respond better to the risks of material misstatement associated with the work of a company's specialist than current requirements, as well as result in increased testing by some auditors who currently "rely" on the work of a company's specialist without performing additional procedures. However, this approach would not specifically acknowledge the role of a company's specialist in performing work that is used by the company in preparing its financial statements and that the auditor may use as audit evidence. It also would fail to direct an auditor to consider the knowledge, skill, and ability of the specialist in determining the necessary evidence from the auditor's testing and evaluation of the specialist's work.

The Board considered the views of commenters on the two alternatives discussed in the 2015 SCP. Some commenters supported amending AS 1210 to remove certain language that could be considered to limit the auditor's responsibility, or retaining the current requirements with, at most, minor enhancements. A few commenters supported rescinding AS 1210 entirely and instead treating the work of a company's specialist the same as other information provided by the company. Other commenters expressed support for amending the existing requirements to align the requirements with the PCAOB's risk assessment standards or ISA 500 the IAASB's standard on audit evidence.

Certain commenters, however, expressed concern that rescinding AS 1210 and elevating the requirements for using the work of a company's specialist would suggest that an auditor is required to have the same level of expertise as a specialist. A few commenters also asserted that such changes would result in the auditor being required to use the work of an auditor-employed or auditor-engaged specialist when evaluating the work of a company's specialist. Some commenters also recommended that the Board distinguish between the work of a company's employed specialists and the work of a company's engaged specialists, as company management may be able to exert greater influence over a specialist employed by the company, while other commenters urged the Board to consider the impact on the nature, timing, and extent of audit procedures related to internal control over financial reporting when a company uses a specialist.

After considering the views expressed by commenters, the Board determined that the proposed approach appropriately recognizes the purpose of the work of a company's specialist and aligns the requirements for using the work of a company's specialist with the risk assessment standards. The proposal would require auditors to focus their attention on information pertaining to financial statement accounts or disclosures that are significant or considered to have a higher risk of material misstatement, as well as the

source of that information. This approach would retain the benefits of a risk-based audit approach, while at the same time providing the auditor with the ability to take the quality of the source of the information into consideration when determining his or her audit approach.

(b) *Objectivity of the Auditor-Engaged Specialist*

The Board's proposal sets forth a framework for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist. The proposed approach directs the auditor to assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. It further assists the auditor in making that assessment by identifying the types of relationships and interests that the auditor should consider, in addition to evaluating whether the specialist has any other conflicts of interest relevant to the work to be performed.

The Board considered, but is not proposing, two approaches for assessing the level of objectivity of the auditor-engaged specialist. The staff sought comment on these approaches in the 2015 SCP. Each would have required a more rigorous evaluation of business, employment, and financial relationships that may impair the objectivity of the specialist than is presently required.

The first approach would extend the PCAOB and SEC auditor independence rules⁸⁵ to auditor-engaged specialists. Under this potential approach, an auditor-engaged specialist could be subject to the independence restrictions that apply to a "covered person in the [accounting] firm" under Rule 2-01 of the Commission's Regulation S-X.⁸⁶ This approach would result in the same independence requirements for auditor-engaged specialists as for auditor-employed specialists, who also assist

⁸⁵ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client," meaning that they must satisfy all independence criteria applicable to an engagement. Under Rule 2-01 of Regulation S-X, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

⁸⁶ See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. 210.2-01(f)(11).

auditors in obtaining and evaluating audit evidence.

Most commenters on the 2015 SCP who addressed this approach opposed applying the requirements of the PCAOB's independence rules to an auditor-engaged specialist.⁸⁷ These commenters, who were accounting firms, associations of accountants, or specialists, generally argued such an approach would be impracticable because the majority of specialists do not currently have the quality control systems needed to monitor compliance with the independence rules. They argued that creating and maintaining the necessary quality control and ongoing monitoring systems would result in significant incremental costs to third-party specialists. These commenters asserted that third-party specialists may not be willing to undertake these additional costs and efforts, which would result in a decreased pool of otherwise qualified specialists available to assist auditors.

The second approach—referred to as an "enhanced objectivity approach" in the 2015 SCP—would incorporate a "reasonable investor" test as an overarching principle in evaluating the objectivity of an auditor-engaged specialist, while also identifying certain relationships and interests that might impair a specialist's objectivity. In addition, this alternative would specify how an auditor should obtain information regarding such relationships and interests from the specialist and the company.

Some commenters on the 2015 SCP supported enhancing the requirements for evaluating the objectivity of an auditor-engaged specialist, including clarifying when the specialist's objectivity may be impaired. They asserted, however, that aspects of the "enhanced objectivity approach," as described, were unduly prescriptive (for example, requiring the auditor to obtain a written description from the specialist regarding, among other things, the process used by the specialist to respond to the auditor's inquiries).

Some commenters on the 2015 SCP also suggested that the Board consider the application and explanatory material in ISA 620 and AU-C Section 620 regarding evaluating the significance of threats to the specialist's objectivity and determining

⁸⁷ Two commenters on the 2015 SCP asserted that the independence requirements should be extended to auditor-engaged specialists. Another commenter, a specialist firm, asserted that this approach would be consistent with its current practices regarding independence and objectivity, while a fourth commenter suggested a different approach whereby all specialists would be required to be independent of both the company and the auditor.

whether there are safeguards to reduce them.⁸⁸ This proposal sets forth a framework, similar to that currently in ISA 620 and AU-C Section 620, for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist. While the proposal would not expressly require an evaluation of safeguards against threats to the specialist's objectivity, it does include a similar assessment of relationships to the company and other conflicts of interest that may affect the specialist's objectivity.

In the Board's view, the proposed approach is preferable to the two more prescriptive approaches described in the 2015 SCP. Specifically, the proposal provides that the auditor should assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. This includes evaluating whether the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed. While an auditor typically would request information from the specialist as part of the auditor's evaluation, the proposal does not specify how the auditor should request information from the specialist or how the specialist should respond to such requests. If the specialist lacks the necessary objectivity, the proposal provides that the auditor would not use that specialist.⁸⁹ This approach is intended to achieve the objective of ensuring that auditors engage specialists who can exercise impartial judgment on all relevant issues related to the audit, without imposing unnecessary costs.

Questions:

10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

⁸⁸ See generally ISA 620.A19 and paragraph .A20 of AU-C Section 620, *Using the Work of an Auditor's Specialist*.

⁸⁹ See Section IV.B.1 of Appendix 3 for discussion of the application of this potential requirement and sources of information that the auditor might consider when performing this assessment.

11. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

V. Special Considerations for Audits of Emerging Growth Companies

The proposed amendments would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley. As discussed below, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Securities and Exchange Act of 1934 ("Exchange Act").

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."⁹⁰ As a result of the JOBS Act, the rules and related amendments to PCAOB standards the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

General data on EGCs⁹¹ indicate that, among other things, a majority of EGCs are smaller public companies that are relatively new to the SEC reporting process. As a result, there is less information available to investors regarding such companies relative to the broader population of public companies. Academic research finds that, on average, investors are less informed about companies that are smaller and that these

⁹⁰ See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The proposed amendments do not fall within either of these two categories.

⁹¹ See *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's website.

companies are followed by fewer analysts.⁹² To the extent that EGCs exhibit one or more of these properties, investors are likely to have less information available about EGCs relative to the broader population of public companies. Accordingly, EGCs are likely to have a greater relative degree of information asymmetry between management and investors, which increases the importance to investors of the external audit to enhance the credibility of management disclosures.⁹³ The proposed requirements relating to the auditor's use of the work of specialists, which are intended to enhance audit quality, could contribute to an increase in the credibility of financial statement disclosures by EGCs.

When confronted with information asymmetry, investors may require a larger risk premium, and thus increase the cost of capital to companies.⁹⁴ Reducing information asymmetry, therefore, can lower the cost of capital to companies, including EGCs, by decreasing the risk premium required by investors.⁹⁵

Compared to the broader population of public companies that use specialists and whose auditors use specialists, there is no evidence that EGCs—a majority of which are smaller companies—are more or less likely to use the work of a company's specialists in preparing their financial statements than non-EGCs of comparable size, though specialists might be used more frequently in some industries than others. Furthermore, there is no evidence that the prevalence and significance of the use of the work of

⁹² See, e.g., V. V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101 (1988); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995).

⁹³ See, e.g., Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185, 189 (2004) ("[Academic studies] provide archival evidence that external assurance from auditors increases disclosure credibility...These archival studies suggest that bankers believe audits enhance the credibility of financial statements...").

⁹⁴ See *supra* footnote 68.

⁹⁵ For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553 (2004).

specialists in audits of EGCs or the quality of audits of EGCs differs systematically from audits of non-EGCs. Thus, the need for the proposal discussed earlier in Section IV.B and the associated benefits of the proposal are believed to generally apply also to audits of EGCs.

While for small companies (including EGCs), even a small increase in audit fees could negatively affect their profitability and competitiveness, many EGCs are expected to experience minimal to no impact from the proposed requirements. In particular, some EGCs presumably do not use a company's specialist and, for those EGCs that do use a company's specialist, the proposed requirements relating to the auditor's use of the work of such specialists are risk-based and designed to be scalable to companies of varying size and complexity. Furthermore, auditors of EGCs who currently do not use the work of auditor's specialists (because, for example, the use of the work of an auditor's specialist for their engagements is not warranted) are expected to experience no to minimal impact from the proposed requirements for using the work of an auditor's specialist, which are also risk-based and scalable. Also, for firms that have already established practices of using their own specialists, the costs on a per engagement basis of adopting the proposed new requirements also may be low. In instances where the proposed requirements will lead to an increase in auditor effort (related to the use of the work of specialists) in audits of EGCs, the increase in auditor effort is expected to be accompanied by a commensurate increase in the quality of such audits. Accordingly, the discussion of benefits, costs and unintended consequences in Section IV.C is generally applicable to audits of EGCs.

Any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs will require auditors to differentiate requirements between clients and develop different methodologies. In this situation, there would be the potential for confusion, as the current PCAOB standards would remain in effect for EGCs and firms potentially would have to maintain two different methodologies in this area.

Question:

12. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

VI. Applicability of the Proposed Requirements to Audits of Brokers and Dealers

The proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes-Oxley. The information asymmetry between the management of brokers and dealers and their customers about the brokers' and dealers' financial condition may be significant and of particular interest to customers, as a broker or dealer may have custody of customer assets, which could become inaccessible to the customers in the event of the insolvency of the broker or dealer. In addition, unlike the owners of brokers and dealers, who themselves may be managers and thus be subject to minimal or no information asymmetry, customers of brokers and dealers may, in some instances, be large in number and may not be expert in the management or operation of brokers and dealers. Such information asymmetry between the management and the customers of brokers and dealers makes the role of auditing important to enhance the reliability of financial information.

Accordingly, the discussion in Section IV of the need for the proposal, as well as the costs, benefits, alternatives considered and potential unintended consequences to auditors and the companies they audit, also applies to audits of brokers and dealers. In addition, with respect to the impact of the proposal on customers of brokers and dealers, the expected improvements in audit quality described in Section IV.C.1 would benefit such customers, along with investors, capital markets and auditors, while the proposed requirements are not expected to result in any direct costs or unintended consequences to customers of brokers and dealers. The Board is seeking comment on any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits.

Question:

13. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

VII. Effective Date

The Board seeks comment on the amount of time auditors would need before the proposed amendments would become effective, if adopted by the Board and approved by the SEC. Specifically, the Board is considering whether compliance with adopted amendments and a new auditing standard should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if SEC approval occurs in the fourth quarter of a calendar year).

Questions:

14. How much time following SEC approval would audit firms need to implement the proposed requirements?
15. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

VIII. Appendices

This proposal includes this release and its appendices:

- Appendix 1—Proposed Amendments Relating to the Auditor's Use of the Work of Specialists
- Appendix 2—Other Related Proposed Amendments to PCAOB Auditing Standards
- Appendix 3—Additional Discussion of Proposed Amendments

IX. Opportunity for Public Comment

The Board is seeking comments on all aspects of its proposal, as well as specific comments on the proposed amendments and proposed new standard. Among other things, the Board is seeking comment on the economic analysis relating to its proposal, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the proposed amendments and standard.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 044 in the subject or reference line and should be received by the Board no later than August 30, 2017. Written comments on the proposed requirements in the companion release on auditing accounting estimates, including fair value measurements, should refer to PCAOB Rulemaking Docket Matter No. 043 in the subject or reference line.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take



PCAOB Release No. 2017-003
June 1, 2017
Page 61

effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

* * *

On the 1st day of June, in the year 2017, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

June 1, 2017

APPENDIX 1

Proposed Amendments Relating to the Auditor's Use of the Work of Specialists

This appendix proposes amendments to AS 1105, *Audit Evidence*, AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of a Specialist*. Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. References to proposed amendments to existing standards presented in the Board's separate companion release on auditing accounting estimates, including fair value measurements, appear in [brackets]. The presentation of the proposed amendments by showing deletions and additions to existing sentences, paragraphs, and footnotes is intended to assist readers in comprehending the proposed changes to the auditing standard. The proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of the auditing standard, as amended by this proposal.¹

¹ Several of the Board's pending rulemaking projects include proposals that would supersede, amend, or delete paragraphs of PCAOB auditing standards for which proposed amendments are included in this appendix. These projects include *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit With Another Accounting Firm*, PCAOB Release No. 2016-002 (Apr. 12, 2016), and *Proposed Auditing Standard—Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017). If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the proposed amendments in this release, the Board may make conforming changes to these proposed amendments.

Auditing Standards Proposed to be Amended²

PCAOB Standard	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
Audit Evidence				
AS 1105, <i>Audit Evidence</i>	.08	Relevance and Reliability	Add a note to paragraph .08	p. A1-4
AS 1105, <i>Audit Evidence</i>	.10	Using Information Produced by the Company	Make conforming amendment	p. A1-5
AS 1105, <i>Audit Evidence</i>	Appendix B	Using the Work of a Company's Specialist as Audit Evidence	Add	p.A1- 10
Supervision of the Audit Engagement				
AS 1201, <i>Supervision of the Audit Engagement</i>	.03	Responsibility of the Engagement Partner for Supervision	Amend	p. A1-14
AS 1201, <i>Supervision of the Audit Engagement</i>	Appendix C	Supervision of the Work of an Auditor-Employed Specialist	Add	p. A1-17
Using the Work of A Specialist				
AS 1210, <i>Using the Work of a Specialist</i>	Title	Using the Work of a Specialist	Amend AS 1210.01-.17 and retitle standard "Using the Work of an Auditor-Engaged Specialist"	p. A1-20

² This table is a reference tool for the proposed amendments that follow. "Add" refers to a new paragraph, appendix, or other text to be added to existing PCAOB standards. "Amend" refers to substantive changes to existing PCAOB standards. "Make conforming amendment" refers to technical changes to existing PCAOB standards, such as changes to cross-references and defined terms.

Auditing Interpretations Proposed to be Rescinded

Auditing Interpretation
AI 11, <i>Using the Work of a Specialist: Auditing Interpretation of AS 1210</i>
AI 28, <i>Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations</i>

AS 1105, *Audit Evidence*

Introduction

.01 This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

.02 Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

.03 The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.¹

¹ AS 2810, *Evaluating Audit Results*, establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. AS 1215, *Audit Documentation*, establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

.04 The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

.05 Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

- *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should

obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.²

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

² Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

.06 Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Relevance and Reliability

.07 *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

- a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and
- b. The timing of the audit procedure used to test the assertion or control.

.08 *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

Note: See Appendix B, *Using the Work of a Company's Specialist as Audit Evidence*, for requirements related to the evaluation of evidence from a company's specialist.

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

.09 The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

.10 When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:³

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

³ When using the work of a company's specialist engaged or employed by management, see Appendix B of this standard~~AS 1210, *Using the Work of a Specialist*~~. When using information produced by a service organization or a service auditor's report as audit evidence, see AS 2601, *Consideration of an Entity's Use of a Service Organization*, and for integrated audits, see AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Financial Statement Assertions

.11 In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence*—Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

- *Completeness*—All transactions and accounts that should be presented in the financial statements are so included.
- *Valuation or allocation*—Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.
- *Rights and obligations*—The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- *Presentation and disclosure*—The components of the financial statements are properly classified, described, and disclosed.

.12 The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility⁴ of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.⁵

⁴ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

⁵ For an integrated audit, also see AS 2201.28.

Audit Procedures for Obtaining Audit Evidence

.13 Audit procedures can be classified into the following categories:

- a. Risk assessment procedures,⁶ and
- b. Further audit procedures,⁷ which consist of:
 - (1) Tests of controls, and
 - (2) Substantive procedures, including tests of details and substantive analytical procedures.

⁶ AS 2110.

⁷ AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

.14 Paragraphs .15-.21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

.15 Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

.16 Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.⁸

⁸ AS 2510, *Auditing Inventories*, establishes requirements regarding observation of the counting of inventory.

Inquiry

.17 Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.⁹

Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

⁹ AS 2805, *Management Representations*, establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

Confirmation

.18 A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.¹⁰

¹⁰ AS 2310, *The Confirmation Process*.

Recalculation

.19 Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

.20 Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

.21 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.¹¹

¹¹ AS 2305, *Substantive Analytical Procedures*, establishes requirements on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

.22 Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

.23 The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the

control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

.24 Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

.25 Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

.26 The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

.27 The application of audit procedures to items that are selected as described in paragraphs .25-.26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.¹²

¹² If misstatements are identified in the selected items, see AS 2810.12-.13 and AS 2810.17-.19.

Audit Sampling

.28 Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.¹³

¹³ AS 2315, *Audit Sampling*, establishes requirements regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

.29 If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

Appendix A – Reserved

Appendix B – Using the Work of a Company's Specialist as Audit Evidence

.B1 This appendix describes the auditor's responsibilities with respect to the work of a specialist,¹ employed or engaged by the company ("company's specialist"), including procedures to be applied in conjunction with obtaining an understanding of the company's information system relevant to financial reporting (.B2) and procedures to be performed when using the work as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure (.B3-.B10). The requirements in this appendix supplement the requirements of this standard.

¹ For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply when the auditor uses the work of an income tax specialist or information technology specialist as audit evidence.

.B2 The auditor should, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting,² obtain an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, which includes:

- a. The nature and purpose of the specialist's work;
- b. Whether the specialist's work is based on data produced by the company, data obtained from external sources, or both; and

- c. The company's process for selecting and using the work of specialists.

² See paragraphs .28-.32 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

.B3 The auditor should obtain an understanding of the professional qualifications of the company's specialist in the particular field, and the entity that employs the specialist (if other than the company), and assess the level of knowledge, skill, and ability of the specialist in the particular field. Factors that are relevant to the assessment of the specialist's knowledge, skill, and ability include the following:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work performed, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

.B4 The auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise).

.B5 The necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company in paragraphs .B3–.B4 depend on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.

Testing and Evaluating the Work of the Company's Specialist

.B6 Testing and evaluating the work of a company's specialist involves:

- a. Testing and evaluating the data used by the specialist and evaluating whether the data was appropriately used by the specialist;

- b. Evaluating the methods and significant assumptions used by the specialist; and
- c. Evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.

Note: Paragraphs .16-.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed to plan or perform audit procedures or to evaluate audit results. This includes determining whether an auditor's specialist is needed to test and evaluate the work of a company's specialist.

.B7 The necessary evidence from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on:

- a. The significance of the specialist's work to the auditor's conclusion regarding the relevant assertion;
- b. The risk of material misstatement of the relevant assertion;
- c. The level of knowledge, skill, and ability of the specialist; and
- d. The ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Note: The persuasiveness of the evidence the auditor should obtain through testing and evaluation of the specialist's work increases as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist in the particular field decreases.

.B8 The auditor should (1) test the accuracy and completeness of company-produced data used by the specialist, (2) evaluate the relevance and reliability of data obtained from external sources and used by the specialists, and (3) evaluate whether the data was appropriately used by the specialist. The auditor also should evaluate whether the methods used by the specialist are appropriate and the significant assumptions used by the specialist are reasonable.

Note: If the company's specialist assisted the company in developing an accounting estimate, the auditor should also comply with the requirements in [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB

Release No. 2017-002)] when testing and evaluating data and evaluating methods and significant assumptions.

.B9 The auditor should evaluate the relevance and reliability of the specialist's work and whether the specialist's findings support or contradict the relevant assertion. Factors that affect the relevance and reliability of the specialist's work include:

- a. The results of the auditor's procedures over data, methods, and significant assumptions performed pursuant to paragraph .B8;
- b. The nature of restrictions, disclaimers, or limitations in the specialist's report, if any; and
- c. The consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

.B10 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the auditor should perform additional procedures, as necessary, to address the matter.

Note: Examples of situations in which additional procedures ordinarily are necessary include (1) the specialist's findings and conclusions are inconsistent with (i) other information in the specialist's report, if any, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (2) the specialist's report contains restrictions, disclaimers, or limitations regarding the auditor's use of the report; (3) exceptions were identified in performing the procedures described in paragraph .B8 above to data, methods, or significant assumptions; (4) the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments; or (5) the specialist has a conflict of interest relevant to the specialist's work.

* * *

AS 1201, Supervision of the Audit Engagement

Introduction

.01 This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

Objective

.02 The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

.03 The **engagement partner**¹ is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,² other auditors,³ internal auditors,⁴ and others who are involved in testing controls.⁵ Paragraphs .05-.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.⁶

¹ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

² AS 1210, *Using the Work of an Auditor-Engaged Specialist*; Appendix C, *Supervision of the Work of Auditor-Employed Specialists*; and Appendix B of AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, establish requirements for an auditor using the work of an auditor-engaged specialist, auditor-employed specialist, and a company's specialist, respectively, in performing an audit of financial statements.

³ AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

⁴ AS 2605, *Consideration of the Internal Audit Function*.

⁵ Paragraphs .16-.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

⁶ See also paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

.04 The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

- a. Inform engagement team members of their responsibilities,⁷ including:
 - (1) The objectives of the procedures that they are to perform;
 - (2) The nature, timing, and extent of procedures they are to perform; and
 - (3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,⁸ and possible accounting and auditing issues;
- b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;⁹

Note: In applying due professional care in accordance with AS 1015, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

- c. Review the work of engagement team members to evaluate whether:
 - (1) The work was performed and documented;
 - (2) The objectives of the procedures were achieved; and
 - (3) The results of the work support the conclusions reached.¹⁰

⁷ AS 1015.06 and paragraph .05 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements regarding the appropriate assignment of engagement team members.

⁸ AS 2110, *Identifying and Assessing Risks of Material Misstatement*, describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

⁹ See, e.g., paragraph .15 of AS 2101, *Audit Planning*, AS 2110.74, and paragraphs .20-.23 and .35-.36 of AS 2810, *Evaluating Audit Results*.

¹⁰ AS 2810 describes the auditor's responsibilities for evaluating the results of the audit, and AS 1215, *Audit Documentation*, establishes requirements regarding audit documentation.

.06 To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

- a. The nature of the company, including its size and complexity;¹¹
- b. The nature of the assigned work for each engagement team member, including:
 - (1) The procedures to be performed, and
 - (2) The controls or accounts and disclosures to be tested;
- c. The risks of material misstatement; and
- d. The knowledge, skill, and ability of each engagement team member.¹²

Note: In accordance with the requirements of AS 2301.05, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.¹³

¹¹ AS 2110.10.

¹² See also AS 2301.05a and AS 1015.06.

¹³ AS 2301.05b indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

Appendix A – Definition

.A1 For purposes of this standard, the term listed below is defined as follows:

.A2 Engagement partner - The member of the engagement team with primary responsibility for the audit.

Appendix B – Reserved

Appendix C – Supervision of the Work of Auditor-Employed Specialists

.C1 For engagements in which auditor-employed specialists¹ assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure, this appendix describes supervisory activities to be performed in conjunction with supervising the work of a specialist employed by the auditor's firm ("auditor-employed specialist") in an audit. The requirements in this appendix supplement the requirements in paragraphs .05-.06 of this standard.

¹ For purposes of this standard, a specialist is a person possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Paragraphs .03-.06 of this standard apply in those situations.

.C2 The necessary extent of supervision of an auditor-employed specialist depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the auditor-employed specialist.

Qualifications and Independence of Auditor-Employed Specialists

.C3 The requirements in PCAOB auditing standards for assigning personnel based on their knowledge, skill, and ability are applicable to assigning auditor-employed specialists.²

² See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

.C4 The requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing compliance with the independence requirements applicable to auditor-employed specialists.³

³ See paragraph .06b of AS 2101, *Audit Planning*.

Informing the Auditor-Employed Specialist of Work to be Performed

.C5 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate), and the specialist's approach to that work;
- c. The degree of responsibility of the auditor's specialist for:
 - (1) Testing data produced by the company, or evaluating the relevance and reliability of data from external sources;
 - (2) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
 - (3) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions;
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.C6 Pursuant to paragraph .05a(3) of this standard, the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the auditor-employed specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.⁴

⁴ See AS 1015.07-.09.

.C7 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with [paragraphs .21-.26 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)];
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)]; or
- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix B to AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, and, for accounting estimates, [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)].

Evaluating the Work of the Auditor-Employed Specialist

.C8 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .C5d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, if applicable, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.C9 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing

supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report contains restrictions, disclaimers, or limitations that affect the auditor's use of the report; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

* * *

AS 1210, ~~Using the Work of a Specialist~~ Using the Work of an Auditor-Engaged Specialist

Introduction

.01 This standard establishes requirements regarding the use of a specialist engaged by the auditor's firm ("auditor-engaged specialist") to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.¹

¹ For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this standard does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. AS 1201, *Supervision of the Audit Engagement*, applies in those situations.

Objective

.02 The objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

Assessing the Knowledge, Skill, Ability, and Objectivity of the Auditor-Engaged Specialist

.03 The engagement partner and, as applicable, other engagement team members performing supervisory activities should assess the specialist's knowledge, skill, and

ability in the particular field for the type of work under consideration. This includes obtaining an understanding of the following with respect to the specialist and the entity that employs the specialist:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work under consideration, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

Note: The auditor's assessment of the specialist's knowledge, skill, and ability affects the auditor's determination of: (1) whether the auditor-engaged specialist possesses a sufficient level of knowledge, skill, and ability to perform the type of work under consideration (paragraph .05); and (2) the necessary extent of the review and evaluation of the specialist's work (paragraph .10).

.04 The engagement partner and, as applicable, other engagement team members performing supervisory activities should assess whether the specialist and the entity that employs the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. This includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed.

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities should not use a specialist who does not have a sufficient level of knowledge, skill, and ability or lacks the necessary objectivity.

Informing the Auditor-Engaged Specialist of the Work to be Performed

.06 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding between the engagement team and the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop

an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate), and the specialist's approach to that work;

- c. The degree of responsibility of the auditor's specialist for:
- (1) Testing data produced by the company, or evaluating the relevance and reliability of data from external sources;
 - (2) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
 - (3) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions.
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.07 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, and possible accounting and auditing issues.

.08 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with [paragraphs .21-.26 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)];
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with

[paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements (See PCAOB Release No. 2017-002)*]; or

- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix B to AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, and, for accounting estimates, [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements (See PCAOB Release No. 2017-002)*].

Evaluating the Work of the Auditor-Engaged Specialist

.09 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .06d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, if applicable, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.10 The necessary extent of the review depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, (2) the risk of material misstatement of the relevant assertion, and (3) the knowledge, skill, and ability of the specialist.

.11 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report contains restrictions, disclaimers, or limitations that affect the auditor's use of the report; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the

company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

* * *

AI 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*

AI 11, "Using the Work of a Specialist: Auditing Interpretation of AS 1210", as amended, is rescinded.

* * *

AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*

AI 28, "Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations", as amended, is rescinded.

APPENDIX 2

Other Related Proposed Amendments to PCAOB Auditing Standards

In connection with the proposed amendments to AS 1105, *Audit Evidence*, AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of a Specialist*, the Board is proposing other related amendments, including conforming amendments, to several of its auditing standards ("other proposed amendments").¹

Language that would be deleted by the other proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the other proposed amendments by showing deletions and additions to existing sentences, paragraphs and footnotes is intended to assist readers in easily comprehending the Board's proposed changes to auditing standards. The Board's other proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of a standard that may be amended.

The Board is requesting comments on all aspects of the proposed amendments.

¹ Several of the Board's pending rulemaking projects include proposals that would supersede, amend, or delete paragraphs of PCAOB auditing standards for which other proposed amendments are included in this appendix. These projects include *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit With Another Accounting Firm*, PCAOB Release No. 2016-002, (Apr. 12, 2016), and *Proposed Auditing Standard—Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017). If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the other proposed amendments in this release, the Board may make conforming changes to these other proposed amendments.

Auditing Standards Proposed to be Amended²

PCAOB Standard	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
AS 2301, <i>The Auditor's Responses to the Risks of Material Misstatement</i>	.07	Overall Responses	Add footnote 5A	p. A2-3
AS 2310, <i>The Confirmation Process</i>	.03	Introduction and Applicability	Make conforming amendment	p. A2-3
AS 2401, <i>Consideration of Fraud in a Financial Statement Audit</i>	.54	Responding to Assessed Fraud Risks: Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting	Make conforming amendment	p. A2-4
AS 2610, <i>Initial Audits—Communications Between Predecessor and Successor Auditors</i>	.16	Audits of Financial Statements That Have Been Previously Audited	Make conforming amendment	p. A2-5

² This table is a reference tool for the proposed amendments that follow. "Add" refers to a new paragraph, appendix, or other text to be added to existing PCAOB standards. "Amend" refers to substantive changes to existing PCAOB standards. "Make conforming amendment" refers to technical changes to existing PCAOB standards, such as changes to cross-references and defined terms.

AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*

* * *

Overall Responses

* * *

.07 Due professional care requires the auditor to exercise professional skepticism.⁴ Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.⁵ Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor,^{5A} or examination of documentation from independent sources.

⁴ AS 1015.07-.09.

⁵ AS 2401.13.

^{5A} Refer to AS 1210, *Using the Work of an Auditor-Engaged Specialist*, and Appendix C of AS 1201, *Supervision of the Work of Auditor-Employed Specialists*, which establish requirements for an auditor using the work of an auditor-engaged specialist and an auditor-employed specialist, respectively, in performing an audit of the financial statements.

* * *

AS 2310, *The Confirmation Process*

* * *

Introduction and Applicability

* * *

.03 In addition, this section does not address matters described in ~~AS 1210, *Using the Work of a Specialist*~~, or in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

* * *

AS 2401, *Consideration of Fraud in a Financial Statement Audit*

* * *

Responding to Assessed Fraud Risks

* * *

Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting

* * *

.54

* * *

It also may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.²² Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

* * *

In addressing an identified fraud risk involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see AS 2501.09 through .14). In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of an intangible asset derivative), it may be appropriate to engage use the work of an auditor-employed specialist or an auditor-engaged specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgments and assumptions.

* * *

²² Appendix C of AS 1201, *Supervision of the Work of Auditor-Employed Specialists*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*, ~~AS 1210, *Using the Work of a Specialist*~~, establishes requirements for an auditor who using the work of an auditor-employed specialist and an auditor-engaged the work of a specialist, respectively, in performing an audit of financial statements.

* * *

AS 2610, Initial Audits—Communications Between Predecessor and Successor Auditors

* * *

Audits of Financial Statements That Have Been Previously Audited

* * *

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in AS 1205. Furthermore, the predecessor auditor is not an auditor's specialist as defined in AS 1210, *Using the Work of a Specialist*, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16-.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

APPENDIX 3

Additional Discussion of Proposed Amendments

Contents of This Appendix

I. Introduction.....	A3-2
A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board	A3-3
B. Requests for Comment	A3-5
II. Scope of this Proposal.....	A3-5
III. Proposed Amendments Related to Using the Work of a Company's Specialist.....	A3-7
A. Obtaining an Understanding of the Work of the Company's Specialist	A3-8
B. Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company	A3-10
C. Testing and Evaluating the Work of a Company's Specialist	A3-15
IV. Proposed Amendments Related to Supervising or Using the Work of an Auditor's Specialist	A3-25
A. Proposed Amendments to AS 1201 for Supervising the Work of an Auditor-Employed Specialist	A3-26
B. Proposed Amendments to AS 1210 for Using the Work of an Auditor-Engaged Specialist	A3-36
V. Other Considerations	A3-44
A. Proposal to Rescind Auditing Interpretation 11, <i>Using the Work of a Specialist: Auditing Interpretation of AS 1210</i>	A3-45
B. Proposal to Rescind Auditing Interpretation 28, <i>Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations</i>	A3-46
C. Certain Existing Requirements of AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Proposed Amendments.....	A3-47
VI. Additional Questions Regarding Certain Aspects of the Proposal.....	A3-48

I. Introduction

This proposal is intended to tailor the requirements for using the work of specialists to the differing roles that specialists have in an audit and thereby improve the quality of audits that involve using the work of specialists employed or engaged by a company ("company's specialist"), employed by the auditor's firm ("auditor-employed specialist"), or engaged by the auditor's firm ("auditor-engaged specialist"). This appendix discusses in more detail amendments to existing auditing standards proposed by the Public Company Accounting Oversight Board ("PCAOB" or "Board") relating to the use of the work of a company's specialist and the use of the work of an auditor-employed specialist, as well as a new standard for using the work of an auditor-engaged specialist that replaces a current Board standard (collectively, the "proposal" or "Board's proposal").

In brief, the Board is proposing to:

- (1) Amend:
 - AS 1105, *Audit Evidence*; and
 - AS 1201, *Supervision of the Audit Engagement*,
- (2) Replace:
 - AS 1210, *Using the Work of a Specialist*, and retitle the standard *Using the Work of an Auditor-Engaged Specialist*, and
- (3) Rescind:
 - AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*; and
 - AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*.

The proposal would add an appendix to AS 1105, *Audit Evidence*, with supplemental requirements, aligned with the Board's risk assessment standards,¹ for using the work of a company's specialist as audit evidence. It would also add an appendix to AS 1201, *Supervision of the Audit Engagement*, with supplemental requirements for applying the supervisory principles in AS 1201 when using the work an auditor-employed specialist (for example, in reaching an understanding with the

¹ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

specialist about the specialist's work and reviewing and evaluating the specialist's work). The proposal would also replace AS 1210, *Using the Work of a Specialist*, with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, which would set forth tailored requirements for assessing the competence and objectivity of an auditor-engaged specialist and requirements that parallel the proposed amendments to AS 1201 for reaching an understanding with the specialist and reviewing and evaluating the specialist's work.

The PCAOB has observed that, in many cases, auditors use the work of a specialist to test or assist in testing the company's process to develop an accounting estimate or in developing an independent expectation of an accounting estimate. In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.² In the Estimates Release, the Board is proposing to retitle and replace AS 2501, *Auditing Accounting Estimates*, and supersede AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Proposed Auditing Standard AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board

This appendix includes a comparison of the proposed requirements with the analogous requirements of the following standards issued by the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). The following IAASB and ASB standards are included in the comparison:

IAASB Standards

² See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017) ("Estimates Release").

- International Standard on Auditing 500, *Audit Evidence* ("ISA 500"); and
- International Standard on Auditing 620, *Using the Work of an Auditor's Expert* ("ISA 620").

ASB Standards

- AU-C Section 500, *Audit Evidence* ("AU-C Section 500"); and
- AU-C Section 620, *Using the Work of an Auditor's Specialist* ("AU-C Section 620").

The comparison included in the appendix may not represent the views of the IAASB or ASB regarding the interpretation of their standards. The information presented in this appendix does not cover the application and explanatory material in the IAASB standards or ASB standards.³

The approach in this proposal has some similarity to the analogous IAASB and ASB standards, such as addressing the auditor's responsibilities for evaluating the work of a company's specialist in the audit evidence standard (ISA 500 and AS 1105, respectively), and separately addressing the auditor's responsibilities with respect to the auditor's specialist. However, there are some important differences. In particular, ISA 620 and AU-C 620 set forth requirements for both an "auditor's internal expert" and an "auditor's external expert" in the same standard, whereas the Board's proposal retains the existing approach for supervision of the auditor-employed specialist under AS 1201, with some additional direction, and sets forth the auditor's responsibilities with respect to auditor-engaged specialists in a separate standard that would replace existing AS 1210. Additionally, the Board's proposal sets forth specific factors for scaling the audit effort in this area.

³ Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement" but "is relevant to the proper application of the requirements of an ISA." Paragraph .A64 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that, although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

B. Requests for Comment

The Board requests comments on the specific questions that are included in this appendix, as well as on the proposal in general.

II. Scope of this Proposal

The scope of this proposal hinges largely on the meaning of the term "specialist." Consistent with AS 1210, this proposal addresses auditors' primary responsibilities with respect to persons or firms with specialized skill or knowledge in a particular field other than accounting or auditing. Furthermore, this proposal retains the principle in existing PCAOB standards that income taxes and information technology ("IT") are specialized areas of accounting and auditing and are therefore outside the scope of the standard.⁴

In its Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015) ("2015 SCP"), the staff solicited comment on a potential definition of the term "specialist" that was consistent with the existing meaning of the term "specialist" in AS 1210 and is consistent with the approach in this proposal. Most commenters who commented on this issue supported retaining the current meaning of the term "specialist," indicating that the term as currently used is adequate. Many of these commenters also asserted that, while income taxes and IT may have increased in complexity over the years, they remain areas of accounting and auditing for which audit firms currently have, and need to maintain, sufficient supervisory processes.

Some commenters, however, suggested changes to the existing meaning of the term "specialist." In particular, two commenters asserted that persons with specialized expertise in certain areas of income taxes and IT, such as foreign income taxes or cybersecurity, should be included within the definition of a "specialist." These commenters argued that the work performed by such persons is often complex and outside the traditional expertise of auditors, and that it would be appropriate to treat persons with such specialized skill or knowledge as specialists. These commenters also asserted that this approach would be more closely aligned with ISA 620, which does not exclude persons with specialized skill or knowledge in income taxes or IT from its definition of an "expert." Other commenters argued that the focus should be on whether the person's field of expertise requires professional accreditation, rather than on whether the skill or knowledge is in a field other than accounting or auditing.

⁴ See footnote 1 of existing AS 1210.

In addition, while not suggesting changes to the existing meaning of the term "specialist," a number of commenters recommended that the Board provide additional guidance as to what constitutes a "specialized area of accounting and auditing," in part to promote greater consistency in practice. A number of commenters also noted that they do not currently view persons with expertise in certain areas (e.g., regulatory compliance) as "specialists" under current AS 1210, and recommended that the Board expressly treat expertise in such areas as a "specialized area of accounting and auditing."

After considering the comments received, this proposal retains the existing meaning of the term "specialist." The term as used today is generally understood by auditors, and observations from PCAOB oversight activities do not indicate that there is significant confusion over the terms "specialist" and "specialized area of accounting and auditing," as currently used in the standards. Further, under this proposal, specialists would continue to include those involved in the activities similar to those shown in Figure 2 of Section II.B of the release. For example, consistent with existing AS 1210.02, specialists would include attorneys engaged by the company as specialists in situations other than to provide services to a client concerning litigation, claims, or assessments⁵ (e.g., attorneys engaged by the company to interpret contractual terms or provide a legal opinion).

Some commenters on the 2015 SCP also suggested that the Board address when a third-party source of pricing information should be considered a "specialist." The Estimates Release addresses the auditor's responsibilities with respect to using pricing information from third parties as audit evidence, including the circumstances in which auditors would look to the requirements of this proposal when using information from a pricing service.⁶ Specifically, the requirements of this proposal on using the work of specialists would apply when a pricing service is engaged by a company or an auditor to individually develop a price for a specific financial instrument not routinely priced for its subscribers.⁷

⁵ AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, applies when attorneys are engaged by the company to provide services concerning litigation, claims, or assessments.

⁶ Estimates Release, PCAOB Release No. 2017-002.

⁷ See paragraph .A3 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, Estimates Release, PCAOB Release No. 2017-002.

Comparison with Standards of Other Standard Setters

ISA 620 uses the terms "auditor's expert" and "management's expert" in a manner analogous to the term "specialist" in this proposal, although ISA 620 does not provide that income taxes and IT are specialized areas of accounting and auditing.⁸ The meaning of the terms is the same in AU-C Section 620 although that standard uses the word "specialist" instead of "expert."

Questions:

16. Is it appropriate to retain the existing meaning of the term "specialist" in current auditing standards? Do auditors understand the existing meaning of the term and when a person (or firm) is a specialist? If not, what changes are necessary?
17. Are the other terms used in the proposal—"company's specialist," "auditor-employed specialist," and "auditor-engaged specialist"—clear and appropriate for purposes of the Board's proposal? Do these terms align with the role of each of these specialists in the audit?

III. Proposed Amendments Related to Using the Work of a Company's Specialist

The proposal would add an appendix to AS 1105 with supplemental requirements for using the work of the company's specialist as audit evidence. The proposed requirements would be aligned with the Board's risk assessment standards and the Estimates Release.⁹ The proposed amendments to AS 1105 relate to:

- Obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls;
- Obtaining an understanding of and assessing the specialist's knowledge, skill, and ability, and the specialist's relationship to the company; and
- Performing procedures to assess the work of a company's specialist, including: (1) testing and evaluating the data used by the specialist and

⁸ The term "management's expert" is also defined in ISA 500.

⁹ Estimates Release, PCAOB Release No. 2017-002.

evaluating whether the data was appropriately used by the specialist; (2) evaluating the methods and significant assumptions used by the specialist; and (3) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.

The proposed appendix would supplement the existing general requirements in AS 1105 for circumstances when the auditor uses the work of a company's specialist as audit evidence. The proposed approach is informed by, among other things, the views of commenters on the 2015 SCP, other outreach activities, and observations from oversight activities.

A. Obtaining an Understanding of the Work of the Company's Specialist

See proposed paragraph .B2 of AS 1105

AS 2110, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of the company's information system, including the related business processes, relevant to financial reporting. This includes, among other things, obtaining information related to: (1) the classes of transactions in the company's operations that are significant to the financial statements; (2) the procedures by which those transactions are initiated, authorized, processed, recorded, and reported; (3) the related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions; (4) how the information system captures events and conditions, other than transactions, that are significant to the financial statements; and (5) the period-end financial reporting process.¹⁰

In addition, existing AS 1210.09 requires that the auditor obtain an understanding of the nature of the work performed or to be performed by the specialist, which includes, among other things: (1) the objectives and scope of the specialist's work; (2) the methods or assumptions used; (3) the appropriateness of using the specialist's work for the intended purpose; and (4) the form and content of the specialist's findings. The existing requirements, however, are not fully aligned with the risk assessment standards. Specifically, they do not require the procedures in AS 1210.09 to be performed in conjunction with obtaining an understanding of the company's information system, nor do they describe the necessary level of audit effort to be devoted to obtaining that understanding.

¹⁰ See AS 2110.28-.32.

The proposed requirement in AS 1105.B2 is more closely aligned with the risk assessment requirements in AS 2110. It specifies that obtaining an understanding of the company's information system relevant to financial reporting encompasses the work and report(s) of the company's specialist(s) and related company processes and controls. This would include obtaining an understanding of: (1) the nature and purpose of the specialist's work; (2) whether the specialist's work is based on data produced by the company, data obtained from external sources, or both; and (3) the company's process for selecting and using the work of specialists. Because the auditor's understanding is linked to understanding the information system relevant to financial reporting, the necessary effort to obtain such understanding would be subject to the general requirements in AS 2110 for obtaining a sufficient understanding of the company's internal control over financial reporting.¹¹ While the proposed requirement likely would not represent a major change in practice, particularly for those firms whose practices already go beyond existing PCAOB standards, it should prompt auditors to appropriately consider the interaction of the specialist's work and the company's processes in assessing and responding to risk in the related accounts and disclosures, especially when the specialist's work is more significant to the auditor's conclusion regarding the relevant assertion and the accounts or disclosures have higher risk.

Comparison with Standards of Other Standard Setters

The requirements in ISA 500 and AU-C 500 have some commonality with the proposed requirements. Paragraph 8(b) of ISA 500 states that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, obtain an understanding of the work of that expert.

¹¹ See AS 2110.18, which provides that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to: (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design further audit procedures. See also AS 2110.19, which further provides that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

B. Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

See proposed paragraphs .B3–.B5 of AS 1105

AS 1210.08, .10-.11 currently require the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

This proposal sets forth similar requirements, along with additional direction regarding the necessary audit effort in this area. Specifically, proposed AS 1105.B5 provides that the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and the risk of material misstatement increases, the persuasiveness of the evidence the auditor would obtain for those assessments also increases.

Knowledge, Skill, and Ability

AS 1210.08 currently provides that the auditor should consider certain information in evaluating the professional qualifications of the specialist to determine that the specialist possesses the necessary skill or knowledge in the particular field. The information to be considered in that evaluation is: (1) the professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate; (2) the reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance; and (3) the specialist's experience in the type of work under consideration.

Proposed AS 1105.B3 has a similar requirement to that in AS 1210.08 and generally would provide the same factors for the auditor's assessment of the specialist's knowledge, skill, and ability. However, the proposed requirement differs from the current requirement in certain respects. First, the proposed requirement expressly extends the required understanding to include the entity that employs the specialist, if the specialist is not employed by the company. A strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, a poor reputation, or little expertise, of the employer in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted. Second, the requirement in the proposal refers to the level of knowledge, skill, and ability. As with competence under AS 2605, *Consideration of the Internal Audit Function*, this recognizes that knowledge, skill, and ability exist on a spectrum, rather than as a binary attribute. Third, the proposal provides that the

necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. The persuasiveness of the evidence the auditor would need to obtain increases as the significance of the specialist's work to the auditor's conclusion or the risk of material misstatement of the relevant assertion increases.¹²

Proposed AS 1105.B3 does not prescribe specific steps to perform or information sources to use in assessing the specialist's knowledge, skill, and ability. Potential sources of relevant information could include the following:

- Information contained within the auditor's firm related to the professional qualifications and reputation of the specialist in the relevant field and experience with previous work of the specialist;
- Professional or industry associations and organizations, which may provide information regarding: (1) qualification requirements, technical performance standards, and continuing professional education requirements standards that govern its members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against, the specialist;
- Discussions with the specialist, through the company, about matters such as the specialist's understanding of the financial reporting framework, experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- Information obtained as part of audit planning, when obtaining an understanding of the company's processes and identifying controls for testing;
- Information included in the specialist's report about the specialist's professional qualifications (e.g., biography or resume);
- Responses to questionnaires provided to the specialist regarding the specialist's professional credentials; and

¹² See Section III.C for illustrative examples on the application of these factors when testing and evaluating the work of a company's specialist.

- Published books or papers written by the specialist.

Under this proposal, the auditor would perform procedures to obtain the necessary evidence for evaluating the specialist's knowledge, skill, and ability, commensurate with the significance of the work and related risk of material misstatement. Some of the sources of information listed above provide more persuasive evidence than others. For example, relevant information from sources not affiliated with the company or specialist and the auditor's experience with previous work of the specialist generally would provide more persuasive evidence than the specialist's representations about his or her professional credentials. Further, in situations where more persuasive evidence is required, it may be necessary to obtain information from multiple sources.

Relationship to the Company

AS 1210.10-.11 currently require the auditor to evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability—through employment, ownership, contractual right, family relationship, or otherwise—to directly or indirectly control or significantly influence the specialist.

AS 1210.11 provides that when a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. When such a relationship is present, the standard requires the auditor to assess the risk that the specialist's objectivity might be impaired; if so, 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 engage another specialist for that purpose.

Proposed AS 1105.B4 contains requirements similar to those in existing AS 1210.10. The proposal provides that the auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise). This expands the list of matters that the auditor should consider to include financial and business relationships with the company.

Two commenters on the 2015 SCP suggested that the PCAOB consider the requirements to evaluate the objectivity of the company's internal audit function¹³ when developing requirements for evaluating the relationships between the company's specialist and the company. These commenters suggested that using the work of a company's internal audit function is analogous to using the work of a company's specialist. This approach was considered, but is not being proposed, because the work of a company's internal audit function and the work of a company's specialist differ in their nature and objectives. The internal audit function performs an objective evaluation of a subject matter (e.g., the effectiveness of company's controls), whereas a company's specialist assists in developing information that generally serves as source material for one or more financial statement accounts or disclosures.

The proposal did not retain the requirement in AS 1210.11 for performing additional procedures because it is encompassed by other procedures that would be required under the proposal.¹⁴

Proposed AS 1105.B4 also does not prescribe specific steps to perform or information sources to use in assessing the specialist's relationship to the company. Potential sources of information that could be relevant to the auditor's evaluation include:

- Engagement contracts between the company and the company's specialist, or the specialist's employer;
- Requirements related to relationships with clients promulgated by the specialist's profession or by legislation or regulation governing the specialist, if applicable;
- Responses to questionnaires provided to the specialist regarding the relationships between the specialist, or specialist's employer, and the company; and

¹³ AS 2605.10 provides requirements for the auditor to, among other things, obtain or update information from prior years about factors such as (1) the organizational status of the internal auditor responsible for the internal audit function and (2) policies to maintain internal auditors' objectivity about the areas audited.

¹⁴ See proposed AS 1105.B7-.B10.

- Information provided by the employer of a company's specialist regarding relationships with the company.

As with the assessment of knowledge, skill, and ability, some of the sources of information listed above provide more persuasive evidence than others. In situations where more persuasive evidence is required under this proposal, it may be necessary to perform a mix of procedures to obtain evidence from multiple sources.

In assessing whether the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings for purposes of proposed AS 1105.B4, the auditor might consider a range of relationships, examples of which include, but are not limited to:

- The reporting relationship of a company-employed specialist within the company;
- Compensation of a company's specialist based, in part, on the outcome of the work performed;
- Relationships a company-engaged specialist has with entities acting as an agent of the company;
- Personal relationships, including family relationships, between the company's specialist and others within company management;
- Financial interests, including stock holdings, company specialists have in the company; and
- Ownership, business relationships, or other financial interests the employer of a company-engaged specialist has with respect to the company.

Notably, the proposal does not use the term "objectivity" in the context of the company's specialist. That term is reserved in this proposal for auditor-engaged specialists, who would be expected to exercise impartial judgment in their work for the auditor. In contrast, the work of a company's specialist, regardless of any relationships between the specialist and the company, generally serves as source material for one or more financial statement accounts or disclosures and thus is different in nature from the work of an auditor's specialist.

The 2015 SCP suggested that any proposed revisions to Board standards should differentiate company-employed and company-engaged specialists. Some commenters agreed that such a distinction would be appropriate because a company-employed specialist could be viewed as inherently less objective and therefore more susceptible to

control or influence than a company-engaged specialist. Some commenters also stated that evaluating the work of a company-employed specialist should require more rigorous testing than the work of a company-engaged specialist. The Board is not proposing to expressly differentiate between company-employed and company-engaged specialists, because the proposed requirement to evaluate the relationship between the company and its specialist inherently takes these considerations into account. For example, under proposed AS 1105.B7d, the necessary evidence needed from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion would, in part, depend on the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Comparison with Standards of Other Standard Setters

Paragraph 8(a) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the competence, capabilities and objectivity of that expert.

AU-C Section 500 contains requirements that are substantively the same as those in ISA 500.

C. Testing and Evaluating the Work of a Company's Specialist

See proposed paragraphs .B6–.B10 of AS 1105

AS 1210.12 currently requires the auditor to, among other things: (1) obtain an understanding of the methods and assumptions used by the specialist; (2) make appropriate tests of data provided to the specialist; (3) evaluate whether the specialist's findings support the related assertions in the financial statements; and (4) if the auditor believes the findings are unreasonable, apply additional procedures, which may include obtaining the opinion of another specialist.

The proposed requirements would enhance the current requirements for testing and evaluating the work of a company's specialist. Among other things, the proposed requirements provide for the auditor to independently test and evaluate the work of a company's specialist that is used as audit evidence. Specifically, proposed AS 1105.B6 provides that testing and evaluating the work of a company's specialist involves: (1) testing and evaluating the data used by the specialist and evaluating whether the data was appropriately used by the specialist; (2) evaluating the methods and significant assumptions used by the specialist; and (3) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion. The proposal also refers the auditor to applicable requirements in other auditing standards (proposed AS 1105.B8), while providing for scalability (i.e., a risk-based approach) in the evidence that

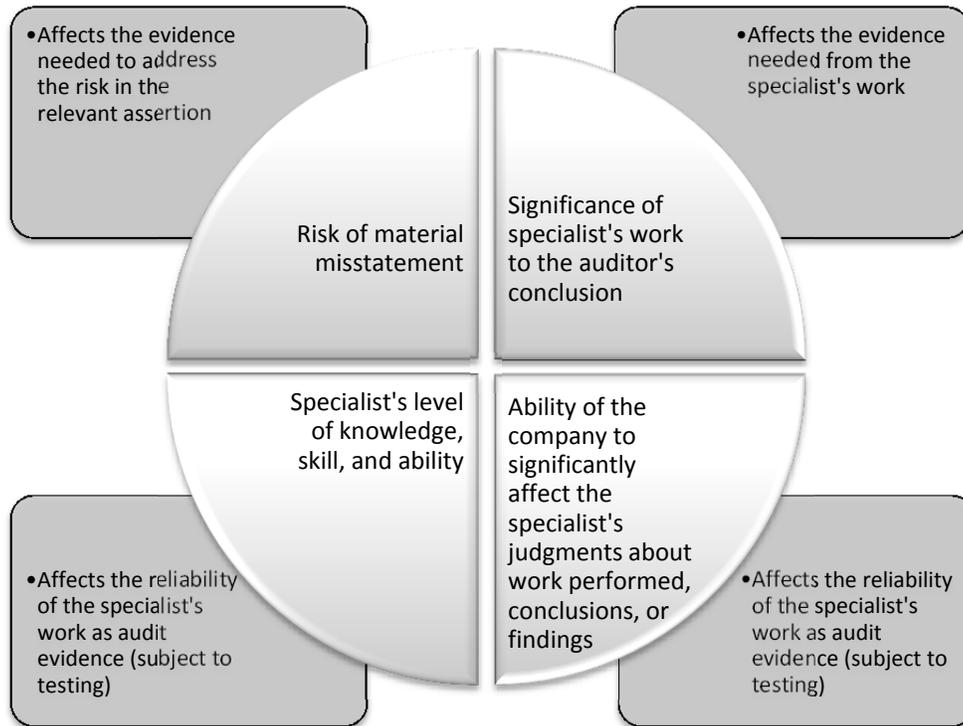
is necessary from the auditor's testing and evaluation of the specialist's work (proposed AS 1105.B7).

In addition, a note to proposed AS 1105.B6 emphasizes that paragraphs .16-.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed to plan or perform audit procedures or to evaluate audit results.¹⁵ This includes determining whether an auditor's specialist is needed to test and evaluate the work of a company's specialist.

Necessary evidence from the auditor's testing and evaluation of the specialist's work. The current requirements in AS 1210 do not explicitly provide for a scalable approach when the auditor assesses the work of a company's specialist. Proposed AS 1105.B7, however, states that the necessary evidence from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on the: (1) significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) risk of material misstatement of the relevant assertion; (3) level of knowledge, skill, and ability of the specialist; and (4) the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings. These factors are illustrated in Figure 1 below.

¹⁵ An auditor also should determine if an auditor's specialist is needed to perform appropriate risk assessments. See AS 2101.16.

**Figure 1: Factors that Affect the Necessary Evidence
From the Auditor's Testing and Evaluation of the Specialist's Work**



Under the proposed amendments, the first two factors, in combination, relate to the persuasiveness of the evidence needed from the work of the company's specialist to support a conclusion on the relevant assertion, and the amount of audit effort necessary to evaluate the last two factors:

- **Risk of Material Misstatement.** Consistent with the risk assessment standards, under the proposed amendments, the risk of material misstatement affects the persuasiveness of the evidence needed to address the risk in the relevant assertion. The higher the risk of material misstatement for an assertion, the more persuasive the evidence needed to support a conclusion about that assertion.¹⁶

¹⁶ See paragraph .09a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

- Significance of the Specialist's Work. The significance of the specialist's work refers to the degree to which the auditor would use the work of the company's specialist to support the auditor's conclusions about the assertion. Generally, the greater the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, the more persuasive the evidence from the specialist's work needs to be. The significance of the specialist's work stems from:
 - *The extent to which the specialist's work affects significant accounts and disclosures in the financial statements.* In some situations, the specialist's work might be used only as a secondary check for a significant account or disclosure, while in other situations, that work might be a primary determinant in one or more significant accounts and disclosures in the financial statements.
 - *The auditor's approach to testing the relevant assertion.* When a company's accounting estimate is determined principally based on the work of a company's specialist, an auditor testing the company's process for developing the accounting estimate would plan to use the work of the company's specialist for evidence regarding the estimate. On the other hand, if the auditor tests an assertion by developing an independent expectation, the auditor would give less consideration to the work of the company's specialist.

The next two factors—the specialist's level of knowledge, skill, and ability, and the ability of the company to significantly affect the specialist's judgments—relate to the degree of reliability of the specialist's work as audit evidence (i.e., the extent to which the specialist's work could provide persuasive evidence, if relevant and found to be satisfactory after the auditor's testing).

Under the proposal, the auditor would need to consider the four factors to determine the necessary audit effort for testing and evaluating the work of the company's specialist. In general, the required audit effort when testing and evaluating the work of a company's specialist would be greatest when the risk of material misstatement is high; the specialist's work is critical to the auditor's conclusion; the specialist has a lower level of knowledge, skill, and ability in the particular field; and the company has the ability to significantly affect the specialist's judgments.

In some situations, if the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments, the auditor might choose not to use the work of the company's specialist, instead of more rigorously testing the specialist's work. This proposal would not preclude the auditor from pursuing other alternatives to using that specialist's work. Such alternatives might include

developing an independent expectation of the related accounting estimate or seeking to use the work of another company's specialist.

The following examples illustrate various ways in which the factors discussed above can affect the necessary audit effort in testing and evaluating the work of a company's specialist under this proposal. The examples have been provided for illustrative purposes only, and similar situations in practice, accompanied by additional information, could lead to different conclusions. The examples assume that the auditor will test and evaluate, as appropriate, the data used by the specialist, evaluate the methods and the significant assumptions used by the specialist, and evaluate the relevance and reliability of the work of the company's specialist.

Example 1 – An oil and gas production company employs an experienced reserve engineer to assist in developing the estimated proven reserves that are used in multiple financial statement areas, including: (1) the company's impairment analysis; (2) depreciation, depletion and amortization calculations; and (3) related financial statement disclosures. The auditor concludes that the risk of material misstatement of the valuation of oil and gas properties is high, and the reserve engineer's work is significant to that assertion. Thus, the auditor would need to extensively test and evaluate the work of the company's specialist to obtain sufficient appropriate evidence, perhaps with the assistance of an auditor's specialist.¹⁷

Example 2 – A financial services company specializes in residential mortgage and commercial mortgage loans, which are either sold or held in its portfolio. During the financial statement audit, the auditor may inspect appraisals prepared by the company's specialists for the real estate collateralizing loans for a variety of reasons, including in conjunction with testing the valuation of loans and the related allowance for loan losses. Under these circumstances, the persuasiveness of the evidence needed from and the necessary degree of audit attention devoted to an individual appraisal would depend, among other things, on the importance of the individual appraisal to the auditor's conclusion about the related financial statement assertion. In general, more audit attention would be needed for appraisals used in testing the valuation of individually large loans that

¹⁷ The proposal would not preclude the auditor (with or without the assistance of an auditor's specialist) from developing an independent expectation instead of testing and evaluating the specialist's work and using that expectation as the primary evidence to support the auditor's conclusion on the assertion. However, for a variety of reasons, that alternative may not be practical in this example or similar situations.

are valued principally based on their collateral than for appraisals inspected in loan file reviews for a portfolio of smaller loans with a low risk of default and a low loan-to-value ratio.

Example 3 – A manufacturing company engages an actuary to calculate the projected pension benefit obligation ("PBO") for its pension plan, which is used to determine the related amounts and disclosures in the financial statements. The auditor has assessed the risk of material misstatement for the valuation of the PBO as high and concluded that the actuary's work is significant to the auditor's conclusion. The actuary has extensive experience and is employed by a highly regarded actuarial firm. The actuary and actuarial firm have no relationships with the company other than performing the actuarial pension plan calculations for the company's financial statements. Under these circumstances, the necessary level of audit testing and evaluation is less than it otherwise would be for a situation where a specialist has a lower level of knowledge, skill and ability, or the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings. In the latter case, more audit attention might need to be devoted to those aspects of the specialist's work that could be affected by the issues related to the specialist's knowledge, skill, and ability or by the company's ability to significantly affect the specialist's judgments.

Testing and evaluating data and evaluating methods and significant assumptions. AS 1210.12, among other things, currently requires the auditor to make appropriate tests of data provided to the specialist. The proposal expands this requirement to require the auditor to also: (1) test the accuracy and completeness of company-produced data used by the specialist; (2) evaluate the relevance and reliability of data obtained from external sources and used by the specialist; and (3) evaluate whether the data was appropriately used by the specialist.¹⁸ The proposal would also elevate the current obligation of the auditor to "obtain an understanding" of the methods and significant assumptions used by the specialist to "evaluate" whether the methods used by the specialist are appropriate and significant assumptions used by the specialist are reasonable.¹⁹ Accordingly, merely obtaining an understanding of the

¹⁸ See proposed AS 1105.B8.

¹⁹ See *id.* In circumstances when the auditor is auditing fair value measurements in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the

methods and significant assumptions used by the specialist would not be sufficient. This could represent a significant change in practice for some auditors. As previously discussed in Section IV.B of the release, the change in practice may be most significant for smaller audit firms that use the work of company specialists, as PCAOB staff have observed that, unlike larger audit firms, smaller firms tend to perform only the specified procedures required by AS 1210.²⁰ On the other hand, although not currently required, some larger firms have been observed to evaluate the methods and significant assumptions used by the company's specialist when testing the company's process for developing accounting estimates, often using an auditor's specialist.

The proposed requirements are intended to increase audit attention to the work of a company's specialist, particularly when that work is significant in areas of higher risk, to increase the likelihood that the auditor would detect material misstatements in that area. Some commenters on the 2015 SCP and some SAG members argued that an auditor's responsibility for evaluating the work of a company's specialist should be elevated from current requirements. Others expressed concerns about elevating the requirements to evaluate the work of a company's specialist. As previously discussed in Section IV.D of the release, the proposed approach employs a risk-based approach that takes into account the views expressed by commenters.

Under proposed AS 1105.B8, when the auditor is testing and evaluating data, methods, and significant assumptions used by a company's specialist who assists the company in developing an accounting estimate, the auditor would be required to comply with Proposed Appendix B and Proposed Auditing Standard AS 2501.²¹ The Board's separate proposal on accounting estimates, including fair value measurements, addresses the proposed requirements for testing company-generated data, evaluating data obtained from external sources, and evaluating methods and significant assumptions used to develop the accounting estimate.²² In determining, the nature,

reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurement.

²⁰ Some accounting firm commenters on the 2015 SCP asserted that some firms "rely" on the work of a company's specialists and that changes to the requirements for using the work of company's specialists would preclude this practice.

²¹ See note to proposed AS 1105.B8 and Estimates Release, PCAOB Release No. 2017-002.

²² Estimates Release, PCAOB Release No. 2017-002. Specifically, the estimates proposal includes requirements, among other things, for: (1) testing the accuracy and

timing, and extent of these procedures, the auditor would take into account the four factors in proposed AS 1105.B7. The approach presented in this proposal would align the requirements for using the work of a company's specialist with those for testing the company's process for developing accounting estimates, avoiding potential redundancy in the requirements and providing direction to auditors in this area.

Evaluating relevance and reliability of the specialist's work. AS 1210.12 currently requires the auditor to evaluate whether the specialist's findings support the related assertions in the financial statements. Proposed AS 1105.B9 would build upon this requirement, with revisions to align the proposed requirement with the risk assessment standards for evaluating the relevance and reliability of audit evidence.

Under the proposal, factors that affect the relevance and reliability of the specialist's work would include: (1) the results of the auditor's procedures over data, methods, and significant assumptions that would be performed pursuant to proposed AS 1105.B8; (2) the nature of restrictions, limitations, or disclaimers in the specialist's report, if any; and (3) the consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

AS 1210.12 currently provides that the auditor may perform additional procedures if he or she believes the specialist's findings are unreasonable under the circumstances. It does not specify, however, what might lead an auditor to conclude that he or she should perform additional procedures or obtain the opinion of another specialist. Proposed AS 1105.B10 has a similar requirement to existing AS 1210.12 and an accompanying note providing examples of situations in which additional procedures ordinarily are necessary, including:

- The specialist's findings and conclusions are inconsistent with (1) other information in the specialist's report, if any, (2) other evidence obtained by the auditor, or (3) the auditor's understanding of the company and its environment;
- The specialist's report contains restrictions, disclaimers, or limitations regarding the auditor's use of the report;

completeness of company-provided information; (2) evaluating the relevance and reliability of data from an external source; (3) evaluating whether the data was appropriately used by the company; (4) evaluating the methods used to develop the estimate; and (5) evaluating the reasonableness of significant assumptions.

- Exceptions were identified in performing the procedures described in proposed AS 1105.B8 to data, methods, or significant assumptions;
- The auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments; or
- The specialist has a conflict of interest relevant to the specialist's work.

A specialist's report may contain restrictions, disclaimers, or limitations that cast doubt about the relevance and reliability of the information contained in the specialist's report and affect how the auditor can use the report of the specialist. For example, a specialist's report that states "the values in this report are not an indication of the fair value of the underlying assets" generally would not provide sufficient appropriate audit evidence related to fair value measurements. On the other hand, a specialist's report that indicates that the specialist's calculations were based on information supplied by management may still be appropriate for use by the auditor to support the relevant assertion, since the auditor would be required to test and evaluate the data used in the specialist's calculations.

The proposal does not require the auditor to perform procedures specifically to search for potential conflicts of interest that a company's specialist might have other than those resulting from the specialist's relationship with the company. However, the auditor may become aware of conflicts of interest arising from relationships with parties outside the company, e.g., through obtaining information about the specialist's professional reputation and standing, reading the specialist's report, or performing procedures in other audit areas. For example, in reviewing an appraisal of the collateral for a material loan receivable, the auditor may become aware that the appraiser has a substantial financial interest in the collateral. If the auditor becomes aware of a conflict of interest relevant to the specialist's work, the auditor would need to consider the effect of that conflict on the reliability of the specialist's work, and perform additional procedures if necessary to obtain sufficient appropriate evidence regarding the relevant financial statement assertion.

Comparison with Standards of Other Standard Setters

Paragraph 8(c) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

AU-C Section 500 contains requirements that are substantively the same as those in ISA 500.

The IAASB and ASB do not have analogous requirements to test and evaluate data provided to the company's specialist or evaluate methods and significant assumptions used by the company's specialist.

Questions:

18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?
19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?
20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.
21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?
22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?
23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?
24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

IV. Proposed Amendments Related to Supervising or Using the Work of an Auditor's Specialist

If the work of an auditor's specialist is not properly overseen or evaluated, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures, including significant accounting estimates. This proposal sets forth enhanced requirements and additional direction to prompt auditors to more effectively oversee and coordinate with their employed and engaged specialists.

Current PCAOB requirements for using the work of an auditor-engaged specialist differ significantly from the risk-based supervisory requirements that apply when using the work of an auditor-employed specialist, even though, in both situations, the auditor's specialist assists the auditor in obtaining and evaluating audit evidence. Specifically, the use of the work of an auditor-engaged specialist is primarily addressed by the same standard as for the use of the work of a company's specialist, while the auditor-employed specialist is required to be supervised in accordance with AS 1201. This proposal establishes a uniform risk-based approach for determining the scope of the specialist's work and evaluating the specialist's work, while taking into account differences in the auditor's relationship with employed specialists and engaged specialists.

Auditor-employed specialists. Currently, AS 1201 sets forth the general framework for supervision of engagement team members, including the nature and extent of supervisory activities, and this framework applies to the supervision of auditor-employed specialists. This proposal would add an appendix to AS 1201, described in Section IV.A below, that would supplement the existing requirements in AS 1201 and provide more specific direction on applying the general supervisory principles to the supervision of the work of auditor-employed specialists. Additionally, the proposed appendix leverages existing principles in other PCAOB standards for assigning competent staff and determining compliance with independence and ethics requirements.

Auditor-engaged specialists. The proposal would replace current AS 1210, *Using the Work of a Specialist*, with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, described in Section IV.B below, which sets forth requirements for situations in which the auditor uses an auditor-engaged specialist. Proposed AS 1210 includes requirements for assessing the knowledge, skill, ability, and objectivity²³ of the

²³ As noted in Section III.B, this proposal reserves the term "objectivity" for the auditor-engaged specialist.

specialist. It also includes requirements for establishing and documenting an understanding with the specialist and reviewing and evaluating the specialist's work that parallel the proposed amendments to AS 1201 for auditor-employed specialists.

This proposal is informed by observations of oversight activities, other outreach activities, and views of commenters on the 2015 SCP.

A. Proposed Amendments to AS 1201 for Supervising the Work of an Auditor-Employed Specialist

This section discusses the proposed requirements in Appendix C to AS 1201 for audits in which the auditor uses an auditor-employed specialist who performs work to assist the auditor in obtaining or evaluating audit evidence in accordance with AS 1201, as amended.

1. Determining the Extent of Supervision

See proposed paragraph .C2 of AS 1201

AS 1201.06 currently provides that, to determine the extent of supervision necessary for engagement team members, the engagement partner and other engagement team members performing supervisory activities should take into account, among other things: (1) the nature of the company, including its size and complexity; (2) the nature of the assigned work for each engagement team member; (3) the risks of material misstatement; and (4) the knowledge, skill, and ability of each engagement team member.

Proposed AS 1201.C2 adapts the factors set forth in AS 1201.06 to the relevant circumstances when using the work of an auditor-employed specialist. Specifically, it provides that the necessary extent of supervision would depend on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the auditor-employed specialist.

A few commenters on the 2015 SCP suggested that the PCAOB consider the involvement of more experienced specialists who supervise the work of less experienced specialists when the engagement partner is determining the extent of supervision needed over the auditor's specialist. Under the proposal, an assessment of knowledge, skill, and ability is one factor in determining the extent of supervision needed. This assessment of knowledge, skill, and ability may be influenced by the composition of the specialist team involved in the audit, including whether or not more experienced specialists participate in supervising the work of less experienced specialists.

AS 1201.04 currently provides that the engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her supervisory responsibilities, which could include involving a more experienced auditor-employed specialist. However, those responsible for supervising the work of an auditor's specialist should also include the engagement partner and, as applicable, other engagement team members with the necessary knowledge, skill, and ability in accounting and auditing and knowledge of the audit engagement to, among other things, determine whether the specialist's procedures meet the auditor's objectives and evaluate how the specialist's work relates to the auditor's conclusions about the assertions subject to testing.²⁴

Comparison with Standards of Other Standard Setters

Paragraph 8 of ISA 620 provides that, depending on the circumstances, the nature, timing and extent of the auditor's procedures will vary with respect to: (1) evaluating the competence, capabilities and objectivity of the auditor's expert; (2) obtaining an understanding of the field of expertise of the auditor's expert; (3) reaching an agreement with the auditor's expert; and (4) evaluating the adequacy of the auditor's expert's work. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

²⁴ See AS 2101.17 and AS 1201.05.

2. *Qualifications and Independence of Auditor-Employed Specialists*

See proposed paragraphs .C3–.C4 of AS 1201

Existing PCAOB auditing standards require that personnel be assigned to engagement teams based on their knowledge, skill, and ability,²⁵ and this applies to auditor-employed specialists. Additionally, auditor-employed specialists must be independent of the company.²⁶ The requirements in existing PCAOB auditing standards for determining compliance with independence and ethics requirements apply to auditor-employed specialists.²⁷

Thus, rather than add specific requirements for evaluating the qualifications and independence of auditor-employed specialists, proposed AS 1201.C3-.C4 cites the applicable requirements in existing standards.

Some commenters on the 2015 SCP suggested that any enhancements to requirements for evaluating the knowledge, skill, and ability of an auditor-employed specialist should permit engagement teams to rely on an audit firm's system of quality control. Under the proposal, the auditor would be able to use information from and processes in the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor-employed specialists.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that the auditor shall evaluate whether the

²⁵ See AS 2301.05a and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

²⁶ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client," meaning that they must satisfy all independence criteria applicable to an engagement. Under Rule 2-01 of Regulation S-X, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

²⁷ See AS 2101.06b.

auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

3. *Informing the Specialist of the Work to be Performed*

See proposed paragraphs .C5–.C7 of AS 1201

AS 1201.05a currently sets forth requirements for the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform engagement team members of their responsibilities. These matters include: (1) the objectives of the procedures that engagement team members are to perform; (2) the nature, timing, and extent of procedures they are to perform; and (3) matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues.

The proposed requirements in AS 1201.C5-.C7 are intended to prompt the engagement partner and, as applicable, other engagement team members performing supervisory activities to properly supervise the specialist and achieve a proper coordination between the auditor and the specialist in obtaining and evaluating audit evidence.

Proposed AS 1201.C5 includes additional requirements to inform the auditor-employed specialist about the work to be performed, which includes establishing and documenting an understanding with the specialist regarding:

- The responsibilities of the specialist, including the objectives of the work to be performed.
- The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate), and the specialist's approach to that work.
- The degree of responsibility of the auditor's specialist for:
 - Testing data produced by the company, or evaluating the relevance and reliability of data from external sources;
 - Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and

- Evaluating the significant assumptions used by the company, or the company's specialist, or developing his or her own assumptions.
- The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

Proposed AS 1201.C6 also provides that, pursuant to AS 1201.05a(3), the engagement partner and, as applicable, other engagement team members performing supervisory activities would inform the auditor-employed specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.

In addition, proposed AS 1201.C7 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities would implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This proposed requirement emphasizes that the auditor is responsible for complying with relevant auditing standards, including Proposed Auditing Standard AS 2501 and Proposed Appendix B to AS 1105, as applicable.²⁸ This requirement is intended to prompt the auditor to coordinate with the specialist to make sure that the work is performed in accordance with the applicable standards. For example, in auditing an accounting estimate under Proposed Auditing Standard AS 2501, the auditor would either perform, or supervise the auditor's specialist in performing, the required procedures with respect to testing and evaluating the data, and evaluating the methods, and significant assumptions used in developing that estimate.²⁹

The proposed requirements were informed, in part, by observations from the

²⁸ See Proposed AS 1201.C7; Estimates Release, PCAOB Release No. 2017-002; and Proposed Appendix B to AS 1105.

²⁹ See Proposed Auditing Standard AS 2501, Estimates Release, PCAOB Release No. 2017-002.

PCAOB's oversight activities, which indicated that some auditors did not adequately inform specialists of their responsibilities or failed to evaluate contrary evidence developed by specialists.

The 2015 SCP suggested expanding on current requirements by providing specific requirements for the auditor when informing an auditor's employed specialist of his or her responsibilities pursuant to AS 1201.05a. Many commenters on the 2015 SCP agreed that clear communication between the auditor and the specialist regarding relevant responsibilities and terms of the work to be performed is important. One commenter suggested that the agreement include communication of the auditor's risk assessment. Another commenter suggested including the following additional items in the list of required communications: (1) expectations regarding objectivity or independence; (2) the process for resolving findings; and (3) expectations on the content and completeness of the specialist's work for inclusion in audit documentation. Other commenters generally supported requirements for the auditor to communicate the nature, scope, and objectives of an employed specialist's work to the specialist, but asserted that a less detailed list of items to be agreed upon than set forth in the 2015 SCP would be appropriate. Proposed AS 1201.C5-.C7 describes the requirements for establishing an understanding with the specialist in more general terms, as compared to the detailed requirements in the 2015 SCP. While the Board is not proposing to require auditors to communicate all the items that commenters on the 2015 SCP recommended, auditors nevertheless may decide to establish an understanding with their employed specialists regarding such matters, either pursuant to the more general requirements of proposed AS 1201.C5-.C7 or voluntarily.

In addition, some commenters on the 2015 SCP suggested that requirements should address how to evidence the agreement between the auditor and the auditor's specialist. These commenters agreed with a suggestion in the 2015 SCP that evidence of the agreement between the auditor and the auditor's specialist might be included in different work papers prepared by the auditor. Proposed AS 1201.C5 does not include specific requirements for how to document the auditor's understanding with the auditor's specialist. Instead, the Board contemplates that the understanding with the specialist can be documented, at the auditor's discretion, in planning memoranda, separate memoranda, audit programs, or other related work papers. This approach provides auditors with flexibility, while still requiring the documentation of the important aspects of the understanding reached by the auditor and the auditor's specialist.

Based on the PCAOB's observations of current practice and firm methodologies, the proposed requirements would have the greatest impact on smaller audit firms that employ specialists. In general, the larger firms, and some smaller firms, already have processes to: (1) involve specialists in planning meetings; (2) prepare a written agreement or memo describing the specialist's and the audit team's responsibilities; (3) determine that issues and discrepancies are communicated and investigated throughout

the audit; and (4) prepare a summary report or memo in which any remaining issues or concerns are communicated. Firms that do not currently employ similar practices with respect to their employed specialists will likely need to adjust their practices if proposed AS 1201.C5-.C7 were adopted.

Comparison with Standards of Other Standard Setters

Paragraph 11 of ISA 620 provides that the auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

- (a) The nature, scope and objectives of that expert's work;
- (b) The respective roles and responsibilities of the auditor and that expert;
- (c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and
- (d) The need for the auditor's expert to observe confidentiality requirements.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

4. Evaluating the Work of the Specialist

See proposed paragraphs .C8-.C9 of AS 1201

AS 1201.05c currently provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities should review the work of engagement team members to evaluate whether: (1) the work was performed and documented; (2) the objectives of the procedures were achieved; and (3) the results of the work support the conclusions reached.

Proposed AS 1201.C8 adapts the requirements in AS 1201.05c for circumstances in which auditor-employed specialists are used. Under the proposed requirements, the engagement partner and, as applicable, other engagement team members performing supervisory activities would review the specialist's report or equivalent documentation describing the work performed, the results of the work, and the findings or conclusions reached by the specialist provided under proposed AS 1201.C5d. The proposed requirement links the scope of the auditor's review to the report or equivalent documentation that the specialist agreed to furnish to the auditor under Proposed AS 1201.C5. The principles in Proposed AS 1201.C2 for the necessary extent of supervision also would apply to reviewing the report or equivalent documentation and evaluating the work of the auditor-employed specialist. Accordingly, the necessary extent of review and evaluation of the auditor-employed specialist's work

depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist. In performing the review, the auditor also would evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- The specialist's work and report, or equivalent documentation, if applicable, are in accordance with the auditor's understanding with the specialist; and
- The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

Under this proposal, when the specialist's work relates to testing the company's process to develop an accounting estimate, the auditor's evaluation of the specialist's work would include, for example, evaluating the results of the specialist's testing and evaluation of data and evaluating methods and significant assumptions, as well as any restrictions, limitations, or disclaimers in the specialist's report or equivalent documentation that are not consistent with the auditor's understanding with the specialist.³⁰

The 2015 SCP suggested potential detailed requirements for the auditor to evaluate the work of an auditor's specialist depending on whether the auditor's specialist evaluated management's process or developed an independent expectation of the estimate. Commenters generally agreed with providing requirements or guidance regarding the auditor's review of the specialist's work. Some commenters, however, suggested: (1) taking a more principles-based approach by allowing the auditor to evaluate a specialist's conclusions as opposed to determining whether the specialist's methods and significant assumptions were appropriate (regardless of whether the specialist develops an independent expectation or evaluates the company's process); or (2) issuing staff guidance rather than new standards on evaluating the work of the auditor's specialist. Other commenters recommended that the Board align its requirements with those in ISA 620.

The approach in the Board's proposal provides requirements for reviewing the work of auditor-employed specialists that are less detailed than the potential

³⁰ See Proposed AS 2501.09-.18; Estimates Release, PCAOB Release No. 2017-002.

requirements described in the 2015 SCP. The proposed requirements to evaluate the specialist's findings and conclusions are similar to requirements in ISA 620. ISA 620 specifically provides for the auditor to evaluate significant assumptions, methods, and data used by the auditor's specialist. The Board's proposal would require the auditor to make sure that the specialist's work and report, or equivalent documentation, were in accordance with the auditor's understanding established at the outset. This understanding would include, among other things, responsibilities for testing data produced by the company or evaluating data from external sources used by the specialist and evaluating significant assumptions and methods used by the specialist, the company, or the company's specialist.

Proposed AS 1201.C9 provides that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities would perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue. The proposal also provides examples of situations in which additional procedures ordinarily would be considered necessary, including:

- The specialist's work was not performed in accordance with the auditor's instructions;
- The specialist's report contains restrictions, disclaimers, or limitations that affect the auditor's use of the report;
- The specialist's findings and conclusions are inconsistent with (1) the results of the work performed by the specialist, (2) other evidence obtained by the auditor, or (3) the auditor's understanding of the company and its environment;
- The specialist lacks a reasonable basis for data or significant assumptions the specialist used; or
- The methods used by the specialist were not appropriate.

These requirements are consistent with existing provisions in paragraphs .06 and .36 of AS 2810, *Evaluating Audit Results*, which provide that, if the auditor concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary (e.g., audit procedures may need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments).

Some commenters on the 2015 SCP expressed concern that the potential requirements for evaluating the work of an auditor's specialist could be construed as

requiring the auditor to reperform the work of the specialist. This proposal does not require the auditor to reperform the work of the specialist. The proposal recognizes that the engagement partner and, as applicable, other engagement team members performing supervisory responsibilities may not have sufficient knowledge of the specialist's field to reperform the work of a specialist. However, the auditor should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the nature, timing, and extent of the auditor's work and the effects on the auditor's report.³¹

Comparison with Standards of Other Standard Setters

Paragraph 12 of ISA 620 provides that the 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.

Paragraph 13 of ISA 620 provides that if the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform additional audit procedures appropriate to the circumstances.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

³¹ See AS 2101.17.

Questions:

25. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?
26. Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?
27. Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?
28. Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?
29. To what extent would the proposed requirement for establishing and documenting the understanding with the specialist represent a change in current practice? If so, what is that change?
30. Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?
31. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-employed specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

B. Proposed Amendments to AS 1210 for Using the Work of an Auditor-Engaged Specialist

This section discusses the proposed amendments to AS 1210 for audits in which the auditor uses an auditor-engaged specialist. In such circumstances, the objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

1. *Assessing the Knowledge, Skill, Ability, and Objectivity of the Engaged Specialist*

As described in Section III.B above, AS 1210 currently requires the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

Similar to the proposed requirements related to using a company's specialist, the proposal carries forward the current requirements with certain modifications described below.

Knowledge, Skill, and Ability

See proposed paragraphs .03 and .05 of AS 1210

Current requirements related to the auditor's evaluation of a specialist's qualifications were described in Section III.B above. These requirements are the same for a company's specialist and an auditor-engaged specialist.

Proposed AS 1210.03 substantially retains the requirement in existing AS 1210.08. Unlike the current requirements, the proposal expressly provides that the auditor would obtain an understanding of the professional qualifications of the specialist and the entity that employs the specialist. A strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, a poor reputation, or little expertise, of the employer in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted.

Proposed AS 1210 does not specify steps to perform or information sources to use in assessing the specialist's knowledge, skill, and ability. Potential sources of relevant information could include the following:

- Information contained within the auditor's firm related to the professional qualifications and reputation of the specialist in the relevant field and experience with previous work of the specialist;
- Professional or industry associations and organizations, which may provide information regarding: (1) qualification requirements, technical performance standards, and continuing professional education requirements standards that govern its members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against the specialist;

- Information provided by the specialist about matters regarding the specialist's understanding of the financial reporting framework, experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- Responses to questionnaires provided to the specialist regarding the specialist's professional credentials; and
- Published books or papers written by the specialist.

The proposed requirement for assessing the knowledge, skill, and ability of the auditor-engaged specialist is generally consistent with the suggested approach in the 2015 SCP. The approach in the 2015 SCP largely retained the current requirement in AS 1210. Most commenters on the 2015 SCP who provided relevant comments agreed with the potential requirements for evaluating the knowledge, skill, and ability of an auditor-engaged specialist. Two of these commenters, however, expressed concerns about using the word "determine" to describe the auditor's role in considering the specialist's knowledge, skill, and ability. These commenters suggested that the staff consider the word "assess" or "evaluate" to better describe the auditor's responsibility. In addition, while largely supporting the suggested approach in the 2015 SCP, some commenters recommended revising existing provisions based on requirements in ISA 620. Other commenters emphasized the importance of considering the qualifications and credentials of a specialist when assessing his or her competence.

Taking these comments into account, the proposal would require the auditor to "assess," rather than "determine," the knowledge, skill, and ability of the auditor-engaged specialist. The proposed requirement also provides that the auditor would obtain an understanding of the qualifications and professional credentials of a specialist when performing this assessment.

The purpose of the assessment of the auditor-engaged specialist's knowledge, skill, and ability is two-fold: (1) to determine whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform his or her assigned work; and (2) to help determine the necessary extent of the review and evaluation of the specialist's work. Proposed AS 1210.05 emphasizes the importance of engaging a sufficiently qualified auditor's specialist by expressly providing that the auditor would not engage a specialist who does not have a sufficient level of knowledge, skill, and ability. Additionally, the assessment of the specialist's knowledge, skill, and ability by the engagement partner and, as applicable, other engagement team members performing supervisory activities is a factor when determining the necessary extent of the review

and evaluation of the specialist's work.³² For example, a valuation specialist may possess sufficient knowledge, skill, and ability in business valuation, but may not be well-versed in the application of his or her work to financial reporting. Similarly, the auditor's evaluation of the work of a specialist may be more extensive if the specialist has sufficient knowledge, skill, and ability, in the field but less experience in the particular area of specialty within the field.

Objectivity

See proposed paragraphs .04–.05 of AS 1210

Current requirements in PCAOB standards related to the auditor's evaluation of a specialist's objectivity were described in Section III.B above. Those requirements are the same for a company's specialist and an auditor-engaged specialist.

With respect to objectivity, the auditor's primary interest regarding a specialist that the auditor may potentially engage is whether the specialist can be sufficiently objective to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Proposed AS 1210.05 provides that the auditor would not use a specialist who lacks the necessary objectivity.

Building on the current requirements for assessing objectivity in existing AS 1210.10-.11, proposed AS 1210.04 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities would assess whether the specialist and the entity that employs the specialist has the necessary objectivity, which includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed. Thus, the auditor would be required to evaluate relationships between the company and both the specialist and the specialist's employer to determine whether either has a relationship with the company that may impair the specialist's objectivity.

Proposed AS 1210.04 differs from the existing requirements in two respects. First, it articulates the concept of objectivity for purposes of proposed AS 1210: objectivity refers to the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Second, it expands the list of matters that the auditor would consider to include financial and business relationships

³² See proposed AS 1210.10.

with the company and other conflicts of interest.

Although the auditor would consider the same types of relationships between the specialist and company, the auditor's assessment of the objectivity of the auditor-engaged specialist differs from the assessment of the relationship between the company and the company's specialist. Under proposed AS 1210, there is an expectation for the auditor-engaged specialist to have the necessary objectivity. Specifically, the auditor would evaluate whether the auditor-engaged specialist or the entity that employs the specialist has relationships or conflicts of interest that would prevent the specialist from exercising impartial judgment on all issues encompassed by the specialist's work; whereas, with the company's specialist, the auditor would assess whether the relationship to the company could enable the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Proposed AS 1210.04 does not prescribe the sources that the auditor would use to evaluate the specialist's relationship to the company. Sources of information that could be relevant to the auditor's evaluation include:

- Engagement contracts between the company and the auditor-engaged specialist, or the specialist's employer;
- Requirements regarding relationships with clients promulgated by the specialist's profession (e.g., a professional code of conduct) or by legislation or regulation governing the specialist, if applicable;
- Responses to questionnaires provided to the specialist regarding the relationships between the specialist, or specialist's employer, and the company;
- Written representations from the specialist concerning its relationships with the company; and
- Information from the specialist's employer regarding relationships with the company.

The proposal further provides that, when evaluating relationships between the auditor-engaged specialist and the company, the auditor should evaluate the relationship between the entity that employs the specialist and the company. Instances could exist in which the specialist performing the work does not have a relationship with the company, but the entity that employs the specialist has a relationship. For example, the specialist's employer might have an ownership or other financial interest with respect to the company, or other business relationships that might be relevant to the auditor's assessment of the specialist's ability to exercise objective and impartial judgment.

The proposal has been informed by comments on the 2015 SCP, in which the staff identified two potential approaches for how the auditor would evaluate the relationship between an auditor-engaged specialist and the company. Both approaches suggested a more rigorous evaluation of business, employment, and financial relationships that may impair the objectivity of the specialist than is presently required.

The first of the two approaches in the 2015 SCP described a potential extension of the PCAOB's independence rules,³³ which currently apply to auditor-employed specialists, to also encompass auditor-engaged specialists. For example, under this approach, an auditor-engaged specialist might be subject to all the independence restrictions that apply to a "covered person in the [accounting] firm" under Rule 2-01 of the Securities and Exchange Commission's Regulation S-X.³⁴ The second approach—referred to as an "enhanced objectivity approach"—described a framework that incorporated a "reasonable investor" test as an overarching principle in evaluating the objectivity of an auditor-engaged specialist. That approach also identified certain relationships and interests that might impair a specialist's objectivity and specified how an auditor would obtain information from the specialist and the company regarding such relationships and interests.

Most commenters on the 2015 SCP who provided comments on this topic were accounting firms, associations of accountants, or specialists. These commenters opposed applying the requirements of the PCAOB's independence rules to an auditor-engaged specialist.³⁵ These commenters generally argued such an approach would: (1) be impracticable; (2) increase costs to third-party specialists; and (3) decrease the pool of specialists available to assist auditors. Many commenters, however, did support enhancing the requirements for evaluating the objectivity of an auditor-engaged specialist. Many of these commenters expressed concern that the "enhanced objectivity approach" as described in the 2015 SCP was too prescriptive. Some of these commenters also did not favor requiring the auditor to obtain a written description from

³³ See PCAOB Rule 3520. See *also* Regulation S-X Rule 2-01, 17 C.F.R. 210.2-01.

³⁴ See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. 210.2-01(f)(11).

³⁵ Two commenters on the 2015 SCP asserted that the independence requirements should be extended to auditor-engaged specialists. Another commenter, a specialist firm, asserted that this approach would be consistent with its current practices regarding independence and objectivity, while a fourth commenter suggested a different approach whereby all specialists would be required to be independent of both the company and the auditor.

the specialist regarding its process to respond to the auditor's request for information bearing on the specialist's objectivity. The views of many of these commenters were also expressed by several members of the SAG.

The proposed approach in AS 1210.04 takes into account the comments on the two potential approaches described in the 2015 SCP and the approaches suggested by commenters.³⁶ It sets forth a framework, similar to that currently in ISA 620, for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist, while still identifying the types of relationships and interests that the auditor would consider and which might impair the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that in the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

2. Informing the Specialist of the Work to be Performed, Determining the Extent of Review, and Evaluating the Work of the Specialist

See proposed paragraphs .06–.11 of AS 1210

As is the case with respect to an auditor-employed specialist, the auditor uses an auditor-engaged specialist to assist the auditor in obtaining and evaluating audit evidence. As described in Section IV.D of the release, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the proposed requirements for the auditor-engaged specialist are parallel to the requirements for the auditor-employed specialist when determining the extent of the auditor's review, informing the auditor-engaged specialist of the work to be performed, and evaluating the work of the auditor-engaged specialist. Sections IV.A.1, IV.A.3, and IV.A.4 of this Appendix discuss these proposed requirements in additional detail.

Some commenters on the 2015 SCP expressed concern that the auditor may have limited access to proprietary information, such as models, used by auditor-engaged specialists and, as a result, would be unable to supervise the auditor-engaged

³⁶ See Section IV.D.3(b) of the release for further discussion of these approaches.

specialist in the same way he or she supervises an auditor-employed specialist. As described in Section IV.A.4, the auditor should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the auditor's work and audit report. The proposal does not require the auditor to have full access to a specialist's proprietary model or reperform the work of the specialist, but instead to evaluate the work of that specialist in accordance with the proposed standard.

One commenter raised a concern related to the auditor's ability to exercise supervisory responsibilities over an auditor-engaged specialist or his or her work.³⁷ This commenter noted that a specialist entity may not wish to relinquish control of its employees to an audit firm, while retaining the legal risk associated with those employees. The commenter suggested this concern could be mitigated if the auditor includes a requirement in the engagement letter that the engaged specialist provide the audit firm with copies of work papers and access to the preparers as appropriate. The proposal includes a proposed requirement similar to this commenter's suggestion. Specifically, proposed AS 1210.06 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities should establish and document an understanding with the auditor-engaged specialist as to the work to be performed and documentation to be provided by the specialist.³⁸

Comparison with Standards of Other Standard Setters

Sections IV.A.1, IV.A.3, and IV.A.4 of this Appendix discuss the comparative requirements of the IAASB and the ASB.

Questions:

32. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?
33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any

³⁷ See Letter from American Academy of Actuaries (July 31, 2015), at 3.

³⁸ See *also* Section IV.A.3 for a discussion of the similar requirement under proposed AS 1201.C5.

additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?
35. Does the proposed requirement to assess the objectivity of the auditor-engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?
36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?
37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?
38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?
39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

V. Other Considerations

This proposal, if adopted, would rescind AI 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*, and AI 28, *Evidential Matter Relating to Income Tax*

*Accruals: Auditing Interpretations.*³⁹ These interpretations were originally adopted by the Board in 2003 with its interim auditing standards, but are no longer considered necessary for the reasons discussed below.

A. Proposal to Rescind Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*

AI 11 provides guidance for auditing transactions involving transfers of financial assets, such as in securitizations, that are accounted for under Statement of Financial Accounting Standard No. 140.⁴⁰ The interpretation addresses an auditor's use of a legal opinion obtained from a company's legal counsel on matters that may involve the U.S. Bankruptcy Code, rules of the Federal Deposit Insurance Corporation ("FDIC"),⁴¹ and other federal, state, or foreign law to determine whether "transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership," which affects the accounting for the transaction under FAS No. 140. AI 11 also reiterates requirements in generally accepted accounting principles ("GAAP") and PCAOB auditing standards. The interpretation also includes illustrative examples of legal isolation letters based on FAS No. 140 and certain provisions of the FDIC's original rule, both of which were subsequently amended.

The Board is proposing to rescind AI 11 because the interpretation is based on outdated accounting requirements and banking regulations, and the proposed amendments set forth the necessary requirements for evaluating the work of legal

³⁹ Auditing interpretations provide guidance the auditor should be aware of and consider related to specific areas of the audit. See paragraph .11 of AS 1001, *Responsibilities and Functions of the Independent Auditor*. As with other PCAOB guidance, auditing interpretations are not rules or standards of the Board.

⁴⁰ See Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("FAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This standard was subsequently amended by FAS No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and codified into FASB Accounting Standards Codification ("ASC"), Topic 860, *Transfers and Servicing*.

⁴¹ Subsequent to the Board's adoption of AI 11, the FDIC rule regarding the treatment of financial assets transferred by an institution in connection with a securitization or participation was amended in 2010.

specialists when auditing financial asset transfers. For example, under this proposal, the auditor would continue to use the work of legal specialists when necessary to evaluate the accounting for these transactions. Additionally, the proposed amendments establish requirements for matters covered in AI 11, such as evaluating the knowledge, skill, and ability of a company's specialist and evaluating the effects of restrictions, disclaimers, or limitations in the specialist's report. Additionally, the requirement in the proposed amendments for the auditor to evaluate the relevance of the work of the company's specialist would apply when considering the need for updates to the specialist's report.

While two commenters on the 2015 SCP recommended that the Board consider updating the interpretation, the Board has not identified any relevant guidance in AI 11 that would warrant retaining it. Accordingly, the Board is proposing to rescind AI 11 and is seeking comment on the implications of such change to the auditing interpretation.

Question:

40. Is rescinding AI 11 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

B. Proposal to Rescind Auditing Interpretation 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*

AI 28 provides guidance about matters related to auditing the income tax accounts in a company's financial statements. Topics covered by the interpretation include restrictions on access to the company's books and records related to its income tax calculation, documentation of evidence obtained in auditing the income tax accounts, and use of tax opinions from company legal counsel and tax advisors. The interpretation also reiterates requirements from PCAOB auditing standards.

The Board is proposing to rescind AI 28 because the proposed amendments and other existing PCAOB standards already set forth the necessary requirements with respect to auditing income tax accounts and documenting that work. For example:

- AS 1105 requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion, and both AS 2810, *Evaluating Audit Results*, and AS 3101, *Reports on Audited Financial Statements*, require the auditor to qualify or disclaim an opinion on the financial statements if the auditor is

unable to obtain sufficient appropriate evidence.⁴² These requirements would apply to situations in which the company restricts the auditor's access to the company's books and records related to its income tax calculation.

- AS 1215, *Audit Documentation*, establishes requirements for the nature and extent of the auditor's documentation, including the auditor's responsibility to document the procedures performed, evidence obtained, and conclusions reached for each relevant assertion.⁴³ These documentation requirements apply when auditing income tax accounts.

The proposed amendments retain the concept under existing AS 1210 that income tax is a specialized area of accounting and auditing, so the requirements in the proposed amendments to AS 1210 would not apply to the opinions of legal counsel or tax advisors on income tax matters.⁴⁴ As under existing standards, if the auditor planned to use a tax opinion as audit evidence, the auditor would need to evaluate the analysis underlying the tax opinion to determine whether it provided relevant and reliable evidence, taking into account the requirements of the applicable financial reporting framework.⁴⁵

Question:

41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

C. Certain Existing Requirements of AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Proposed Amendments

Decision to use a specialist. Currently, AS 1210.06 states that an auditor may encounter complex or subjective matters potentially material to the financial statements. It further provides that such matters, examples of which are provided in AS 1210.07,

⁴² See AS 2810.35 and AS 3101.24.

⁴³ See AS 1215.04-.13.

⁴⁴ See existing AS 1210.01. See also AI 28.17-.23.

⁴⁵ See generally AS 1105, AS 2301, and AS 2810.

may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter. The proposed new requirements do not retain these paragraphs, as this issue is already addressed in AS 2101. Specifically, AS 2101.16 requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

Reporting requirements. Currently, AS 1210.15-.16 prohibit auditors from making reference to the work or findings of a specialist in the auditor's report, unless such reference will facilitate an understanding of the reason for an explanatory paragraph or a departure from an unqualified opinion. AS 1210.15 states that such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

The proposal does not retain this prohibition, as a separate rulemaking would require the auditor to communicate in the auditor's report critical audit matters ("CAMs") arising from the audit that involved especially challenging, subjective, or complex auditor judgment.⁴⁶ Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist if the work related to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.

VI. Additional Questions Regarding Certain Aspects of the Proposal

Appendix 2 contains additional amendments that the Board is proposing to conform its standards to the proposed amendments to AS 1105 and AS 1201, and the proposed replacement of AS 1210. The proposed conforming amendments to AS 2301, AS 2310, AS 2401, and AS 2610 are not intended to change the meaning of existing requirements. The Board invites comments on the amendments in Appendix 2. The following are specific questions on the proposed amendments included in Appendix 2 and more general questions on the overall proposal:

⁴⁶ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

Questions:

42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?
43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210?

STAFF CONSULTATION PAPER NO. 2015-01
THE AUDITOR'S USE OF THE WORK OF SPECIALISTS
MAY 28, 2015

This staff consultation paper was developed by staff of the Office of the Chief Auditor ("staff") of the Public Company Accounting Oversight Board ("Board" or "PCAOB"). It is not a statement of the Board, has not been approved by the Board, and does not necessarily reflect the views of the Board or its members.

This staff consultation paper discusses certain matters related to the auditor's use of the work of specialists. It describes information obtained by the staff about a potential need for changes to PCAOB standards and discusses possible alternatives regarding the potential need for such changes. This staff consultation paper requests comment on these matters.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the PCAOB's website at: www.pcaobus.org. All comments should refer to Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*, on the subject or reference line and should be submitted no later than July 31, 2015.

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Contents

I.	Introduction.....	3
II.	Background	5
	A. The Use of the Work of Specialists in Audits	5
	B. Supervision and the Evaluation of Audit Evidence.....	8
III.	Current Requirements and Current Practice	11
	A. PCAOB Standards That Apply to the Use of the Work of Specialists	11
	B. Key Requirements Governing the Auditor's Use of the Work of Specialists.....	12
	C. Current Practice.....	15
IV.	Potential Need for Improvement.....	19
	A. Issues Related to the Standards.....	20
	B. Observations from Board Oversight Activities.....	23
	C. Views Expressed by the Board's Standing Advisory Group.....	24
	D. Comments from the Estimates and Fair Value Consultation Paper	24
V.	Alternative Regulatory Approaches	26
	A. Consideration of Alternatives to Standard Setting	26
	B. Alternatives for Revising Standards – Auditor's Specialist.....	26
	C. Alternatives for Revising Objectivity Requirements – Auditor's Specialist	30
	D. Alternatives for Revising Standards – Company's Specialist.....	30
VI.	Potential Amendments – Definitions.....	33
VII.	Potential Amendments – Auditor's Employed or Engaged Specialist	35
	A. Amend the Requirements for Using the Work of an Auditor's Specialist	35
	B. Amend the Requirements for Evaluating the Objectivity of an Auditor's Specialist.....	42
VIII.	Questions Related to Economic Impacts and Implications	52

I. Introduction

The staff of the PCAOB's Office of the Chief Auditor is considering ways to improve the standards that apply to the auditor's use of the work of a specialist. PCAOB standards describe a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing."¹ The use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions. This complexity may contribute to increased risks of material misstatement in financial statements. Auditors of many companies now use the work of specialists, such as valuation specialists, appraisers, and actuaries, to bring necessary expertise to bear on audits. The use of the work 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.

This staff consultation paper seeks information to help the staff address the potential need for improvement of PCAOB standards governing the use of the work of specialists:

- Despite the increasing complexity of business transactions and the resulting increase in auditors' use of the work of specialists, relevant PCAOB standards have not been updated. When the Board adopted the risk assessment standards in 2010, it acknowledged that there may be a need to change Auditing Standard No. 10, *Supervision of the Audit Engagement*, to address the use of specialists.²
- PCAOB standards contain different requirements for an auditor's use of the work of a specialist employed by the auditor ("auditor's employed specialist") and the work of a third-party specialist contracted by the accounting firm ("auditor's engaged specialist"), even though these specialists often perform the same work.
- An auditor's employed specialist is required to be independent of the company being audited ("company"), while an auditor's engaged specialist is not required to be independent of the company. Instead, the auditor is required to evaluate the relationship of an auditor's engaged specialist to the

¹ See paragraph .01 of AU section ("AU sec.") 336, *Using the Work of a Specialist*.

² See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (August 5, 2010), at A10-19 ("[T]he Board has separate standards-setting projects regarding specialists ... which will include [a] comprehensive [review] of AU sec. 336 ... in light of, among other things, observations from the Board's inspection activities. [This project] will likely result in changes to the auditor's responsibilities regarding the auditor's use of specialists ... and, in turn, may result in changes to Auditing Standard No. 10.").

company, including circumstances that might impair the specialist's objectivity.

- The standard that applies to an auditor's use of the work of an auditor's engaged specialist is the same standard that applies to the auditor's use of the work of a specialist employed or contracted by the company being audited ("company's specialist"), even though an auditor's engaged specialist performs work for the auditor and a company's specialist performs work for the company.
- The standard that applies to an auditor's evaluation of information provided by a company's specialist may allow the auditor to use that information after performing the specified procedures in that standard, rather than performing the more rigorous procedures that other standards would require if the information were provided by others in the company.³ In this regard, AU sec. 336 also may not be sufficiently aligned with the risk assessment standards.
- The standard that contains requirements for supervision of the audit engagement does not provide specific requirements for how to apply that standard to the work of an auditor's employed specialist.

The staff is seeking additional information on current practice, on the potential need for changes, and on possible alternatives to address the issues discussed in this staff consultation paper. Some of these alternatives may have a significant effect on smaller accounting firms or firms that audit companies in specialized industries. Before the staff makes any recommendation to the Board for a specific standard-setting proposal, it is conducting outreach. As part of this outreach, the Board is hosting a Standing Advisory Group ("SAG") meeting on June 18, 2015, in Washington, DC, that will include a discussion of matters addressed in this paper.

This staff consultation paper has been informed by, among other things, current accounting firm practices, findings from the Board's oversight activities, discussions with the Board's inspections and enforcement staff and the Board's advisory groups, and comment letters submitted to the Board on other matters. This staff consultation paper solicits views from investors, accounting firms of all sizes, specialists, companies, and others. The staff also is seeking relevant information about the potential economic impacts of standard setting, including data to inform the PCAOB's economic analysis associated with this project.

In August 2014, the PCAOB issued a staff consultation paper to obtain public input on issues related to auditing accounting estimates and fair value measurements ("Estimates and Fair Value Consultation Paper"). That staff consultation paper

³ In this context, this staff consultation paper often refers to the procedures in AU sec. 336 as "specified procedures." See Section III.B.2 for a description of the specified procedures.

requested comment on potential revisions to PCAOB standards related to accounting estimates and fair value measurements, including how a potential new standard might address the varying circumstances when auditors obtain information from third parties, including specialists. The Estimates and Fair Value Consultation Paper also sought comment on how standards might address an auditor's use of the work of a company's specialist. The staff has analyzed the comment letters on that paper that are relevant to the auditor's use of the work of specialists and seeks further comment on certain related matters.

II. Background

A. The Use of the Work of Specialists in Audits

The use of the work of specialists was once largely limited to companies in specialized industries, such as financial services and oil and gas. In recent decades, accounting for business transactions has become more complicated due to elaborate business structures and complex transactions that are difficult to measure.⁴ Financial reporting standards have changed in response to the increased complexity. Since 1995, the Financial Accounting Standards Board ("FASB") has issued standards that increasingly require the use of estimates such as fair value measurements.⁵ As a result of these changes, the use of the work of specialists has increased.

Today, companies across many industries use the work of specialists to assist them in developing accounting estimates, including fair value measurements, and in providing expert assistance in the preparation of their financial statements.⁶ For example, companies use actuaries to determine employee benefit obligations,

⁴ See, e.g., J. Efrim Boritz, Linda A. Robinson, Christopher Wong, and Natalia Kochetova-Kozloski, *Auditors' and Specialists' Views about the Use of Specialists during an Audit* (November 29, 2014) (working paper available at Social Science Research Network ("SSRN")), at 2 ("Use of specialists ... has increased considerably due to the increasing complexity of client business processes, transactions and technologies."). See also Larry E. Rittenberg, Karla M. Johnstone, and Audrey A. Gramling, *Auditing: A Business Risk Approach 2* (8th ed., 2012) ("Accounting transactions are becoming increasingly complicated as companies engage in more elaborate structures as well as in transactions that are difficult to measure.").

⁵ See, e.g., FASB, Statement of Financial Accounting Standards ("SFAS") No. 142: *Goodwill and Other Intangible Assets* (June 2001), paragraph B39 ("[FASB] affirmed that an asset acquisition should be measured on the basis of the values exchanged ... based on the fair value of the consideration given or the fair value of the net assets acquired, whichever is more reliably measurable."). See also FASB, SFAS No. 159: *The Fair Value Option for Financial Assets and Financial Liabilities* (February 2007), and FASB, Accounting Standards Update 2014-09: *Revenue from Contracts with Customers* (Topic 606) (May 2014).

⁶ The issues discussed in this paper are intended to apply to all uses of the work of specialists in audits, although many examples focus on the use of the work of specialists in accounting estimates.

engineers to determine obligations regarding environmental remediation, or valuation specialists or appraisers to determine the value of intangible assets or real estate.⁷ In circumstances when such estimates comprise a large part of a company's financial statements, the reliability of those financial statements may depend in part on the quality of the work of a company's specialist. Auditors increasingly use the work of specialists to assist in their evaluation of accounting estimates and fair value measurements when auditing companies' financial statements.⁸

PCAOB inspections data indicate that the largest accounting firms extensively use the work of specialists. The staff analyzed a sample of audits⁹ by large, global accounting firms selected for inspection in 2014 and found that auditors used the work of at least one specialist in about 90 percent of those audits. Of the 90 percent of audits, an average of 5 individual specialists performed some work on each audit, and specialists performed work in an average of 2 fields of expertise on each audit. Substantially all the specialists in the sample were employed by the auditor. The staff also analyzed audits¹⁰ by smaller firms selected for inspection in 2014 and found that auditors used the work of (i) a company's specialist in approximately 14 percent of those audits and (ii) an auditor's specialist in approximately 5 percent of those audits, 80 percent of whom were engaged by the auditor. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of the work of specialists across a broader population of companies.

⁷ See Steven Gottlieb, Robert Meulmeester, and Matthew Bohlin, *Financial Reporting for Real Estate: Will FASB 157 Achieve a Higher and Better Use?*, *Journal of Accountancy* 50, 53 (January 2009) ("[A] real estate valuation specialist ... may be needed to confirm that a company's real property assets are properly valued, and those valuations comply with the new standard."). See also Richard I. Johnson, Edward K. Atwood, and Larry Walther, *Incorporating Highest and Best Use into Accounting Standards Expands Opportunities for Appraisers*, 78 *Appraisal Journal* 150, 151 – 52 (2010) ("The measurement process to assess highest and best use to a typical market participant ... is outside of an accountant's area of expertise, but solidly within the domain of the work of real estate appraisers.").

⁸ See, e.g., Emily E. Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?* (March 1, 2015) (working paper available at SSRN), at 3 ("Auditors' use of valuation specialists to audit fair values has increased in response to the proliferation of fair values in financial statements."). See also Roger D. Martin, Jay S. Rich, and T. Jeffrey Wilks, *Auditing Fair Value Measurements: A Synthesis of Relevant Research*, 20 *Accounting Horizons* 287, 293 (2006) (noting "the movement toward more specialization on audit teams to respond to the demands of the fair value standards").

⁹ The staff analyzed data from a sample of 50 audits, performed by large global accounting firms, that were inspected by the PCAOB in 2014.

¹⁰ The staff analyzed data from 318 audits, performed by smaller domestic accounting firms, that were inspected by the PCAOB in 2014. The staff identified (i) 45 audits in which the auditor used the work of a company's specialist and (ii) 15 audits in which the auditor used the work of an auditor's specialist (3 employed and 12 engaged).

Figure 1 gives examples of activities for which companies and their auditors frequently use the work of specialists.

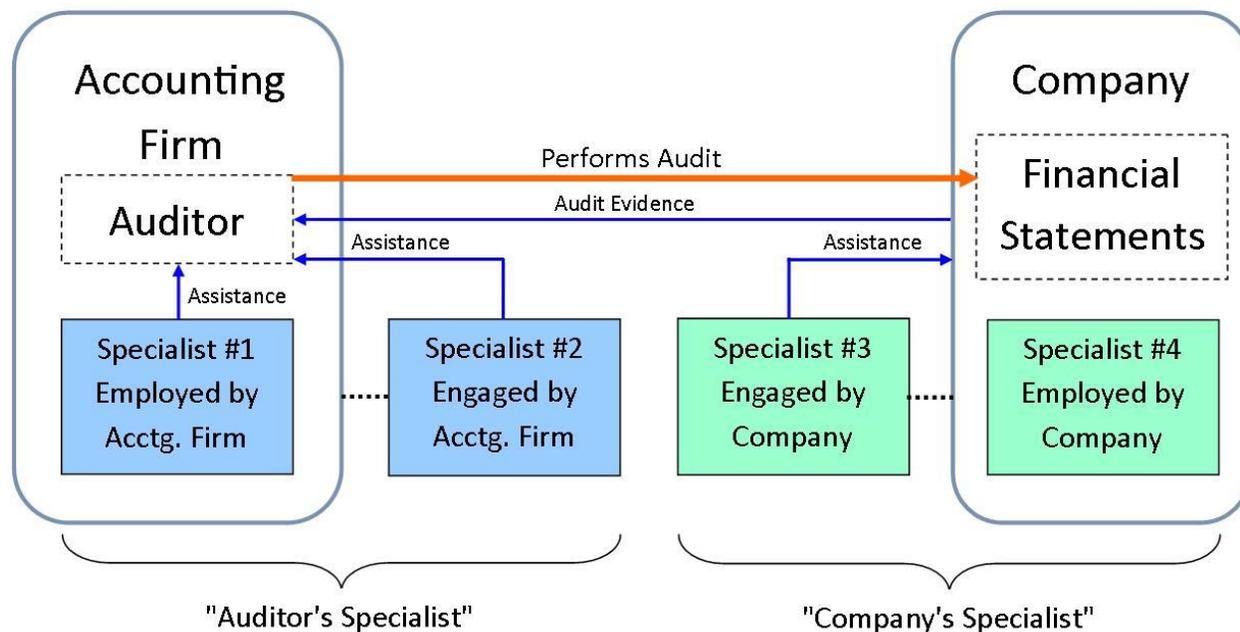
Figure 1: Examples of Activities that Involve the Work of Specialists

Activities	Types of Specialists
Valuation	
Assets acquired and liabilities assumed in business combinations	Valuation specialist / appraiser
Complex financial instruments	Valuation specialist
Environmental remediation contingencies	Engineer
Goodwill impairments	Valuation specialist
Insurance reserves	Actuary
Intangible assets	Valuation specialist
Jewelry and art	Appraiser
Pension and other post-employment obligations	Actuary
Real estate	Appraiser
Stock options	Valuation specialist
Evaluation of physical and other characteristics	
Materials stored in stockpiles	Geologist
Mineral reserves and condition	Geologist
Oil and gas reserves	Geologist
Property, plant, and equipment useful lives and salvage values	Valuation specialist / appraiser
Interpretation of laws, regulations, or contracts	
Legal title to property or interpretation of laws, regulations, or contracts	Lawyer

The staff's understanding, as discussed in Section III.C, is that many larger accounting firms employ their own specialists to assist in audits while other firms may use the work of a third-party specialist for this purpose or use the work of a company's employed or engaged specialist. Figure 2 shows the basic ways that auditors typically involve specialists in an audit:

- Employing a specialist;
- Engaging a third-party specialist; and
- Using the work of a specialist who is either engaged or employed by the company.

Figure 2: Relationships of Specialists with an Auditor



In Figure 2, Specialists #1 and #2 (*i.e.*, the auditor's specialists) perform work to assist the auditor. The results of their work provide audit evidence, frequently about the reasonableness of a company's accounting estimates. Specialists #3 and #4 (*i.e.*, the company's specialists) are engaged or employed by the company and generally perform work that is used by the company in preparing its accounting estimates and that also may be used by the auditor as audit evidence.

B. Supervision and the Evaluation of Audit Evidence

Two important concepts in the conduct of audits are central to the themes discussed in this staff consultation paper: (i) supervision by auditors of persons who perform work on the audit and (ii) the evaluation of evidence obtained during the audit. Other standard setters, such as the Government Accountability Office ("GAO"), the International Auditing and Assurance Standards Board ("IAASB"), and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"), also include these concepts in their auditing standards.¹¹

¹¹ See, *e.g.*, paragraph 6.54 of GAO, GAO-12-331G, *Government Auditing Standards, 2011 Revision* (December 2011) ("Audit supervision involves providing sufficient guidance and direction to staff assigned to the audit to address the audit objectives and follow applicable requirements, while staying informed about significant problems encountered, reviewing the work performed, and providing effective on-the-job training."); paragraph A15 of International Standard on Auditing ("ISA") 220, *Quality Control for an Audit of Financial Statements* (supervision includes matters such as tracking the progress of the audit, considering the

1. **Supervision**

The concept of supervision has existed in auditing standards for several decades. Auditing Standard No. 10, which the Board adopted in 2010,¹² builds on concepts of supervision that date back at least to the Committee on Auditing Procedure of the American Institute of Accountants, which established the first standard of audit fieldwork in 1963 and stated, "The work is to be adequately planned and assistants, if any, are to be properly supervised."¹³ Statement on Auditing Standards No. 22, *Planning and Supervision* (codified as AU sec. 311, *Planning and Supervision*), which became effective in 1978, established standards in this area.¹⁴

Auditing Standard No. 10 requires that, to supervise the work of engagement team members, the engagement partner and, as applicable, other engagement team members performing supervisory activities:

- a. Inform engagement team members of their responsibilities, including:
 - The objectives of the procedures they are to perform;
 - The nature, timing, and extent of the procedures they are to perform; and
 - Matters that could affect the procedures to be performed or the evaluation of the results of those procedures;
- b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities;¹⁵ and
- c. Review the work of engagement team members to evaluate whether:
 - The work was performed and documented;

(footnote continued)

competence and capabilities of individual members of the engagement team, addressing significant matters arising during the audit, and identifying matters for consultation or consideration by more experienced engagement team members); and paragraph .A14 of Clarified Statement on Auditing Standards ("AU-C") Section 220, *Quality Control for an Engagement* (similar).

¹² In 2010, the PCAOB adopted eight new standards related to the auditor's assessment of, and response to, risk in an audit, including Auditing Standard No. 10. See PCAOB Release No. 2010-004. Prior to 2010, auditors supervised the work of employed specialists under AU sec. 311.

¹³ See Statement on Auditing Procedure No. 33, *Auditing Standards and Procedures*, AICPA, Committee on Auditing Procedure (1963), at 18.

¹⁴ AU sec. 311 was superseded by the risk assessment standards.

¹⁵ See also note to paragraph 5.b of Auditing Standard No. 10.

- The objectives of the procedures were achieved; and
- The results of the work support the conclusions reached.¹⁶

2. Evaluation of Audit Evidence

The concept of sufficient appropriate audit evidence also has existed for decades in auditing standards, including those adopted by various standard setters.¹⁷ Under PCAOB standards, an auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.¹⁸ The auditor also must 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.¹⁹ Although reasonable assurance is not absolute assurance, it is a high level of assurance.²⁰

Audit evidence is all of the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.²¹

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.²² It requires, among other things, that the auditor consider the competency and sufficiency of the evidence and that the auditor not be satisfied with less than persuasive evidence.²³ Professional skepticism is important in all areas of the audit, including those that are more susceptible to management bias and risks of material misstatement, such as accounting estimates and fair value measurements, where the work of specialists is typically used.²⁴

¹⁶ See paragraph 5 of Auditing Standard No. 10.

¹⁷ See, e.g., paragraph 4 of ISA 500, *Audit Evidence*.

¹⁸ See paragraph 4 of Auditing Standard No. 15, *Audit Evidence*.

¹⁹ See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

²⁰ See paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

²¹ See paragraph 2 of Auditing Standard No. 15.

²² See paragraph 7 of Auditing Standard No. 13, *The Auditor's Response to the Risks of Material Misstatement*. See also AU sec. 230.07.

²³ See AU sec. 230.07 – .09.

²⁴ See, e.g., paragraph .54 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs 24 – 27 of Auditing Standard No. 14, *Evaluating Audit Results*.

III. Current Requirements and Current Practice

When auditing accounting estimates or fair value measurements, auditors should look to the requirements in AU sec. 342, *Auditing Accounting Estimates*, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, or AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, as applicable. In the audit areas covered by these standards and in certain other audit areas, the auditor may, at times, require specialized knowledge or skill in a field of expertise other than accounting or auditing in connection with performing the audit in accordance with PCAOB standards. Auditing Standard No. 9, *Audit Planning*, requires the auditor to determine whether such specialized knowledge or skill is needed.²⁵ This section addresses PCAOB standards and related requirements that apply when the auditor uses the work of a specialist in performing an audit and discusses observations regarding current practice.

A. PCAOB Standards That Apply to the Use of the Work of Specialists

The primary PCAOB standards that apply today to the auditor's use of the work of specialists in the scenarios outlined in Figure 2 are:

- For a specialist whom the auditor employs (Specialist #1), the auditor *supervises* the specialist on the audit engagement. The PCAOB standard that applies to this relationship is Auditing Standard No. 10. The specialist also must be independent of the company being audited.
- For a specialist whom the auditor engages to perform work in the audit (Specialist #2), the auditor applies the procedures of AU sec. 336.²⁶
- For a specialist whom the company engages or employs (Specialists #3 and #4) and the auditor uses the work of that specialist, the auditor also applies the procedures of AU sec. 336.

Figure 3 summarizes the standards that apply to the use of the work of specialists.

²⁵ See paragraph 16 of Auditing Standard No. 9, which applies to a person with specialized knowledge or skill, including a specialist.

²⁶ In 2003, shortly after its inception, the PCAOB adopted the auditing standards of the accounting profession in existence at that time, on an interim basis. See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (April 18, 2003). Prior to 2003, the AICPA: (i) in 1975, issued Statement on Auditing Standards No. 11, *Using the Work of a Specialist*; (ii) in 1976, codified it as AU sec. 336; and (iii) in 1994, issued a revised standard, Statement on Auditing Standards No. 73, *Using the Work of a Specialist* (which remained codified as AU sec. 336), that superseded the previous standard. Paragraph 3 of Auditing Standard No. 10 provides that the engagement partner is responsible for compliance with AU sec. 336.

Figure 3: PCAOB Standards That Govern the Use of the Work of Specialists

	#	Nature of Specialist's Involvement	Current Audit Requirements
Auditor's Specialist	1	Specialist employed by the auditor	<i>Supervision:</i> Auditor supervises the specialist under Auditing Standard No. 10. Specialist must be independent.
	2	Specialist engaged by the auditor	<i>Specified procedures:</i> Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist
Company's Specialist	3	Specialist engaged by the company	<i>Specified procedures:</i> Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist
	4	Specialist employed by the company	<i>Specified procedures:</i> Auditor performs the procedures required by AU sec. 336 and evaluates objectivity of the specialist

B. Key Requirements Governing the Auditor's Use of the Work of Specialists

1. Definition of a Specialist

AU sec. 336 defines a specialist, for purposes of that standard, as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." Paragraph .05 states: "This section does not apply to situations in which a specialist employed by the auditor's firm participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement*, applies in those situations." Footnote 1 states: "Because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, *Supervision of the Audit Engagement*, applies in those situations."

2. Auditor's Specialist

PCAOB standards require the auditor to have knowledge relevant to the work of employed or engaged specialists. Under Auditing Standard No. 9, if a person with specialized knowledge or skill, including a specialist, participates in the audit, the auditor is required to have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to (i) communicate the objectives of that person's work,

(ii) determine whether that person's work meets the auditor's objectives, and
(iii) evaluate the results of that person's work.²⁷

PCAOB standards also require that the engagement partner:

- Be knowledgeable about the client;²⁸ and
- Possess an understanding of the industry in which a client operates. This understanding includes an industry's organization and operating characteristics sufficient to (i) identify areas of high or unusual risk associated with an engagement and (ii) evaluate the reasonableness of industry specific estimates.²⁹

i. Supervising an Auditor's Employed Specialist Under Auditing Standard No. 10 – Specialist #1

Auditing Standard No. 10 provides scalable, overarching principles for supervision (see Section II.B). The necessary extent of supervision depends on, for example, the nature of the work performed, the associated risks of material misstatement, and the knowledge, skill, and ability of those being supervised.³⁰

It is important to note that the supervision of a specialist does not require the auditor to have the same degree of expertise as the specialist. An auditor typically would not have the knowledge or skill necessary to engage in a profession or occupation related to that expertise (e.g. the expertise to create a model to value a complex financial instrument). However, the auditor should have sufficient knowledge in that field to meet the requirements set forth in Auditing Standard No. 9.

ii. Using the Work of an Auditor's Engaged Specialist Under AU sec. 336 – Specialist #2

Using the work of a specialist under AU sec. 336 requires that the auditor perform the following procedures:

- Evaluate the professional qualifications of the specialist;
- Obtain an understanding of the nature of the specialist's work;

²⁷ See paragraph 17 of Auditing Standard No. 9. These requirements apply to any person with specialized knowledge and skill, whether employed or engaged by the auditor.

²⁸ See AU sec. 230.06.

²⁹ See paragraph .08 of Quality Control Section ("QC sec.") 40, *The Personnel Management Element of a Firm's System of Quality Control – Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

³⁰ See paragraph 6 of Auditing Standard No. 10.

- Evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity; and
- In using the findings of a specialist:
 - Obtain an understanding of the methods and assumptions used by the specialist;
 - Make appropriate tests of data provided to the specialist; and
 - Evaluate whether the specialist's findings support the financial statement assertions.

Also, AU sec. 336 provides that the appropriateness and reasonableness of methods and assumptions used, and their application, are the responsibility of the specialist. The standard also provides that the auditor ordinarily would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.³¹ Further, if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.³² In addition, if the auditor believes a relationship of the specialist with the company might impair the specialist's objectivity, the standard permits the auditor to use the work of the specialist after performing additional procedures to determine that the findings are not unreasonable.³³

3. *Company's Engaged or Employed Specialist: Using the Work of a Specialist Under AU sec. 336 – Specialists #3 and #4*

The requirements for using the work of a company's employed or engaged specialist are the same as those for using the work of an auditor's engaged specialist described in the preceding subsection. However, when a company's specialist develops assumptions used in a fair value measurement and the auditor tests the company's process,³⁴ the auditor is required to evaluate the reasonableness of those assumptions.

³¹ See AU sec. 336.12.

³² See AU sec. 336.13.

³³ See AU sec. 336.11.

³⁴ One of three acceptable approaches for auditing fair value measurements is to test the company's significant assumptions, valuation model, and underlying data ("company's process"). Under this approach, footnote 2 of AU sec. 328 provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is required to evaluate the reasonableness of assumptions developed by the company's specialist in accordance with AU sec. 328.

C. Current Practice

This section discusses the staff's understanding of current practice based on, among other things, collective experience of PCAOB staff, observations from the Board's oversight activities, review of academic research, and discussions with the Board's SAG. The staff seeks additional feedback, as outlined in the questions for this subsection, to supplement its understanding of current practice.

Auditor's Specialist. Many of the larger accounting firms use the work of *employed specialists*³⁵ and consider them members of the engagement team.³⁶ These firms may involve their employed specialists early in the audit, usually during planning.³⁷ During planning, auditors and their employed specialists may agree on the specialists' responsibilities, often in the form of a planning or scoping memorandum. Items agreed upon may include the timing of the specialist's work, the specialist's deliverable, and which items the auditor or specialist, or both, will test, such as underlying data and certain assumptions.

The auditor may communicate with the employed specialist as the work progresses to become aware of issues as they arise. When the specialist completes his or her work, the auditor reviews the specialist's work,³⁸ which may be documented in a separate report. In reviewing that work, the auditor often focuses on the specialist's use of significant assumptions used in an accounting estimate. The auditor also may

³⁵ See Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?*, at 11 ("[T]he predominant arrangement is for auditors to use internal, rather than external, specialists."). The paper is based on interviews of 28 audit partners and managers from the Big Four and from two national firms with extensive experience using valuation specialists. See also footnote 8.

³⁶ See Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, at 11 (it was "predicted that auditing would evolve from a rather independent approach to one where multidisciplinary teams became the norm and specialists began to be treated as an integral part of the audit team To some extent, the prediction has increasingly become reality However, to date, it still appears unclear under what circumstances exactly a specialist should be considered part of the audit team"). The paper is based on interviews with 40 practitioners from the largest six accounting firms, of whom 18 were auditors (partners, managers, seniors) and 22 specialists.

³⁷ Specialists employed by the auditor may participate in the fraud brainstorming meetings required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*. However, one study showed discrepancies between auditors' and specialists' views about how involved specialists are in the planning process. See Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, at 11, 15 ("Auditors typically tended to emphasize that specialists are instrumental in the planning stages of an audit ... [but] only 33% of valuations specialists stated that they were routinely involved in planning and risk assessment.").

³⁸ This is consistent with the requirements in paragraph 5.c of Auditing Standard No. 10.

discuss with the employed specialist the basis for his or her conclusions about the reasonableness of significant assumptions and the appropriateness of methods.

Practice varies in circumstances when auditors *engage* specialists. Auditors may perform the procedures specified in AU sec. 336 and use the reports that the specialists prepare as audit evidence. Alternatively, auditors may perform procedures similar to the procedures the larger firms perform when supervising the work of their employed specialists.³⁹

Issues may arise when the auditor does not (i) reach an agreement with the auditor's specialist regarding the work the specialist is to perform, (ii) adequately evaluate the specialist's work, or (iii) resolve discrepancies or differences the specialist identified. These are sometimes referred to as "hand-off issues."⁴⁰

Company's Specialist. As noted earlier, in the sample of inspected audits analyzed by the staff, larger accounting firms used the work of an auditor's specialist in most cases, while smaller firms were more likely to use the work of a company's specialist. Although AU sec. 336 does not require it (except as discussed in footnote 34), in some cases, these firms perform additional procedures for evaluating the reasonableness of assumptions and the appropriateness of methods used by the company's specialist.

Standards Issued by Other Standard Setters. Current practice is also influenced by standards of the IAASB and the ASB because many accounting firms apply standards issued by the IAASB and the ASB in their audits of companies to which PCAOB standards do not apply. ISA 620, *Using the Work of an Auditor's Expert*, and AU-C Section 620, *Using the Work of an Auditor's Specialist*, contain the same requirements and apply to an auditor's employed or engaged specialist.⁴¹ Those standards also contain requirements that are generally consistent with the elements of

³⁹ See Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, at 9, 10 ("[A]uditor-hired [engaged] specialists occasionally worked closely enough with the auditors to be considered part of the audit team. In such cases, careful precautions were taken to document the relationship within an engagement letter which bound the expert to standards of professionalism similar to those the auditor was subject to").

⁴⁰ See *id.* at 4 ("Our key findings are that there is a high level of reliance by auditors on specialists and a high level of trust in their work."). Other research indicates that auditors may make the specialist's work conform to their views. See Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?*, at 44 ("I also identify a tendency among auditors to make valuation specialists' work conform to the audit team's pre-existing view of a fair value, which undermines the purpose of using a specialist and consequently endangers audit quality. This tendency manifests throughout the audit process in the form of auditors filtering information between specialists and clients, editing specialists' work, deleting information deemed unnecessary to include as evidence, and ignoring specialist-identified issues as insignificant.").

⁴¹ See paragraph 6 of ISA 620 and paragraph .06 of AU-C Section 620.

supervision in Auditing Standard No. 10. They require the auditor to reach an agreement with the specialist about the nature, scope, and objectives of the specialist's work and to evaluate the specialist's work, including the:

- Relevance and reasonableness of the specialist's findings or conclusions and their consistency with other audit evidence;
- Relevance and reasonableness of significant assumptions and methods; and
- Relevance, completeness, and accuracy of source data.⁴²

In 2013, the IAASB published findings from a post-implementation review of its standards, including ISA 620. The review indicated "concern about the inconsistency in the procedures that auditors are performing in relation to the expert's [*i.e.*, specialist's] work, including:

- Insufficient understanding of the expert's methods and assumptions, and whether they are generally accepted in the expert's field;
- Work performed by the expert with little involvement from the auditor;
- Inconsistent follow-up on the findings and recommendations of the experts;
- Insufficient testing of the source data used by the experts; and
- Over-reliance on the qualifications of the expert with no further consideration as to their appropriateness."⁴³

The IAASB and the ASB also issued standards that require the auditor to evaluate the work of a company's specialist: ISA 500 and AU-C Section 500, *Audit Evidence*.⁴⁴ Those standards require the auditor, to the extent necessary, having regard to the significance of that work for the auditor's purposes, to evaluate the competence, capabilities, and objectivity of the specialist, to obtain an understanding of the work of that specialist, and to evaluate the appropriateness of the work as audit evidence for the relevant assertion.

Questions:

1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?

⁴² See paragraph 12 of ISA 620 and paragraph .12 of AU-C Section 620.

⁴³ See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review* 44 – 45 (July 2013).

⁴⁴ See paragraph 8 of ISA 500 and paragraph .08 of AU-C Section 500.

2. Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?
3. For accounting firms that use the work of an auditor's specialist:
 - a. Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit.
 - b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?
 - c. What type of work do the specialists perform? Does the type of work vary depending on whether the firm employs or engages the specialist? Does the type of work vary depending on the specialist's field of expertise?
 - d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate? Why?
4. For accounting firms that use the work of an auditor's employed specialist:
 - a. Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?
 - b. How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?
 - c. Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?
 - d. How would the evaluation change if the firm engaged the specialist?
 - e. What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist? How does that assistance affect the auditor's supervision of the work of the employed specialist?
5. For accounting firms that use the work of an auditor's engaged specialist:
 - a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?
 - b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Auditing

- Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?
- c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?
 - d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?
6. For accounting firms that use the work of a company's specialist:
- a. What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.
 - b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?
 - c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?
 - d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?
 - e. Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?

IV. Potential Need for Improvement

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.⁴⁵ This section identifies issues that may indicate a need to improve the standards that apply to the auditor's use of the work of a specialist in an audit. These issues are based on information from an analysis of PCAOB standards, observations from Board oversight activities, and input from the SAG. This staff consultation paper also has been informed by commenters to the Estimates and Fair Value Consultation Paper.

A. Issues Related to the Standards

1. Auditor's Specialist

Oversight.⁴⁶ Auditing Standard No. 10 sets out principles for supervising an audit engagement and applies to the supervision of engagement team members, including a specialist employed by the auditor. It requires the auditor to, among other things: (i) inform the specialist of his or her responsibilities, including the objectives of the procedures he or she is to perform and the nature, timing, and extent of those procedures; (ii) direct the specialist to bring issues to the attention of the auditor so the auditor can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards; and (iii) review the specialist's work to *evaluate* whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached.

⁴⁵ The auditor's use of the work of a company's specialist, in the staff's view, may have contributed to material misstatements, whether due to error or fraud, not being detected by the auditor. Securities and Exchange Commission ("SEC" or "Commission") enforcement cases provide examples 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. See SEC, *In the Matter of Harlan & Boettger, LLP, William C. Boettger, CPA, and P. Robert Wilkinson, CPA, Respondents*, Securities Exchange Act of 1934 Release No. 44817, Accounting and Auditing Enforcement Release No. 1452 (September 19, 2001); SEC, *In the Matter of Accounting Consultants, Inc., and Carol L. McAtee, CPA, Respondents*, Securities Exchange Act of 1934 Release No. 54048, Accounting and Auditing Enforcement Release No. 2447 (June 27, 2006); and SEC, *In the Matter of Troy F. Nilson, CPA, Respondent*, Securities Exchange Act of 1934 Release No. 64277, Accounting and Auditing Enforcement Release No. 3264 (April 8, 2011).

Further, the ZZZZ Best fraud, uncovered in 1987, involved collusion between the company and its specialist (an appraiser) in producing fictitious appraisals. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994); see also Michael C. Knapp, *ZZZZ Best Company, Inc., in Contemporary Auditing: Real Issues and Cases* 109 (8th ed. 2006).

⁴⁶ For purposes of this staff consultation paper, the staff uses the term "oversight" to describe the auditor's ability to direct the work of the auditor's employed and engaged specialists under the two applicable frameworks (*i.e.*, the supervisory framework of Auditing Standard No. 10 as it relates to employed specialists and the framework of AU sec. 336 as it relates to engaged specialists).

By contrast, AU sec. 336 mandates, in the staff's view, a less rigorous level of oversight of specialists whom the auditor engages, even though those specialists often perform the same work on the audit as employed specialists perform. For example, AU sec. 336 provides that the auditor should obtain an understanding of the nature of the work performed, including the objectives and scope of the specialist's work. The standard also provides that, among other things: (i) the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist; (ii) the auditor should obtain an understanding of the methods and assumptions used by the specialist; and (iii) ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.⁴⁷ Further, if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.⁴⁸

Although the staff considers Auditing Standard No. 10 to be a more rigorous standard for the oversight of the work of an auditor's specialist than AU sec. 336, it is exploring whether additional specificity is needed to the principles-based requirements in Auditing Standard No. 10.⁴⁹ Auditing Standard No. 10 does not specifically address how to supervise the work of a specialist, which may be different from supervising those in the field of accounting and auditing. For example, specialists generally do not have training as auditors, including applying professional skepticism. In addition, auditors are required to have sufficient knowledge of the subject matter to use the work of an auditor's specialist,⁵⁰ but typically do not have the level of expertise required to practice in the specialist's field.

Objectivity of an Auditor's Engaged Specialist. An auditor's employed specialist is subject to the independence requirements of the PCAOB and the SEC, as

⁴⁷ See AU sec. 336.12.

⁴⁸ See AU sec. 336.13.

⁴⁹ Providing additional, specific requirements for the auditor's use of the work of an auditor's specialist (as described in Section VII.A) might address concerns about insufficient guidance related to the use of the work of specialists. See, e.g., Boritz et al. *Auditors' and Specialists' Views about the Use of Specialists during an Audit* at 4, 41 ("Existing literature on the use of specialists in an audit engagement provides limited systematic inference on *how* auditors make use of *various types* of specialists"; "Many audit team members have limited knowledge and experience in the specialty areas covered by our study – IT, Tax, Valuation and Forensics – and an increasing number of specialists are not auditors or have limited audit knowledge and experience, whereas audit team members have limited knowledge and experience in the specialty areas covered by our study.").

⁵⁰ See, e.g., paragraph 17 of Auditing Standard No. 9.

discussed further in Section VII.B.1. In contrast, AU sec. 336 requires the auditor to evaluate the relationship of an auditor's engaged specialist to the client, including circumstances that might impair the specialist's objectivity, but it does not provide specific requirements for how to perform the evaluation. It also permits the auditor, even if he or she determines that the objectivity of the engaged specialist might be impaired, to use the work of the specialist after performing additional procedures to determine that the findings are not unreasonable or engaging another specialist for that purpose.⁵¹

The staff is considering whether the requirement in AU sec. 336 to evaluate the objectivity of an auditor's engaged specialist should be strengthened to reduce the risk that an auditor uses the work of a specialist whose objectivity might be impaired.

2. Company's Specialist

AU sec. 336 generally allows an auditor to use the work and conclusions of a company's employed or engaged specialist after performing the procedures specified in that standard, unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. In addition, AU sec. 336.12 requires the auditor to *obtain an understanding* of the methods and assumptions of the specialist, and it provides that the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist.⁵² AU sec. 336.12 further requires the auditor to make appropriate tests of data provided to the specialist. AU sec. 336.13 provides that, if the auditor determines that the specialist's findings support the related assertions, the auditor may conclude that sufficient appropriate audit evidence has been obtained.

In the staff's view, the specified procedures of AU sec. 336 may not be rigorous enough to address the risks of material misstatement associated with many accounting estimates, given the increased importance of specialists as discussed earlier. Those provisions raise questions because a company's specialist (especially a specialist employed by the company) may perform work to assist a company in developing accounting estimates and provide expert assistance in the preparation of the company's financial statements. 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. Thus, the staff is exploring whether the auditor should evaluate the work of a company's specialist in the same manner as other information produced by the company is evaluated.

⁵¹ See AU secs. 336.10 – .11.

⁵² As discussed in Section III.B.3, when the auditor audits a fair value measurement by testing the company's process, management's assumptions include assumptions developed by a specialist engaged or employed by management. See footnote 2 of AU sec. 328.

B. Observations from Board Oversight Activities

Observations from the Board's oversight activities also have informed the staff's views about current practice and the potential need for guidance or changes to the standards. These observations indicate that auditors, at times, may not have fulfilled their responsibilities under existing standards when they used the work of an auditor's specialist (described in Section III.C as hand-off issues between the auditor and an auditor's specialist). These issues include instances⁵³ in which auditors did not:

- Adequately communicate clear expectations to the employed specialist regarding the objectives of the specialist's work;
- Reach an understanding with the employed specialist regarding the responsibilities of the auditor and the specialist;
- Adequately evaluate the employed specialist's basis for determining the reasonableness of significant assumptions;
- Perform sufficient audit procedures to test assumptions underlying accounting estimates in cases when the employed specialist did not test those assumptions;
- Consider contradictory evidence identified by the employed specialist or resolve discrepancies, differences, or other concerns that the specialist identified;⁵⁴ and
- Perform the procedures required by AU sec. 336 when using the work of an engaged specialist.

The Board's inspections also have found instances in which auditors used the work of a company's specialist without performing the procedures required by AU sec. 336. In addition to observations from inspections, SEC and PCAOB enforcement cases provide examples in which: (i) companies materially misstated financial statements, in part with the involvement of companies' specialists; and (ii) auditors did not comply with existing standards.⁵⁵

⁵³ Academic research also identifies similar issues. For example, see Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, at 19, 42; and Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?*, at 31, 40.

⁵⁴ Auditors also may have similar issues regarding the failure to consider contradictory evidence identified by persons with specialized knowledge or skill in accounting or auditing (*i.e.*, not a specialist under current definition in AU sec. 336). See, *e.g.*, *In the Matter of Randall A. Stone, CPA*, PCAOB Release No. 105-2014-007 (July 7, 2014), at 24 – 25.

⁵⁵ See footnote 45. In addition, a recent PCAOB enforcement case involved the auditor's failure to comply with AU sec. 336 regarding the use of the work of a company's specialist. See *In the Matter of Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007 (April 1, 2015).

The staff has drawn two preliminary conclusions from these observations and cases. First, the observations related to the supervision of an auditor's employed specialist under Auditing Standard No. 10 suggest that auditors might benefit from more specificity about how to supervise an auditor's specialist than the principles-based Auditing Standard No. 10 provides. The staff is considering whether potential requirements or other guidance might provide more specific direction related to the auditor's communication of audit objectives to an auditor's specialist and the review of the specialist's work. Second, the inspections findings with regard to AU sec. 336 show that at least some auditors are not performing procedures required by AU sec. 336 – a standard that, in the staff's view as discussed above, may not be rigorous enough to address the risks of material misstatement.

C. Views Expressed by the Board's Standing Advisory Group

The alternatives the staff is considering have been informed by the views of members of the SAG, who have expressed concerns about the robustness of PCAOB standards regarding specialists.⁵⁶ Many SAG members, in discussions related to AU sec. 336, generally expressed support for requiring auditors to have (i) similar responsibilities for overseeing an auditor's employed or engaged specialist, (ii) greater responsibility for evaluating the methods and assumptions used by an auditor's specialist, and (iii) responsibility for evaluating the reasonableness of methods and assumptions used by a company's specialist. As noted in Section I, the staff plans to seek feedback on the issues raised by this staff consultation paper at the SAG meeting on June 18, 2015.

D. Comments from the Estimates and Fair Value Consultation Paper

The Estimates and Fair Value Consultation Paper did not comprehensively explore issues related to an auditor's use of the work of a company's specialist because it necessarily focused on broader issues related to auditing accounting estimates and fair value measurements. The general discussion included the staff's view that a potential new standard might require that, when the company uses the work of an employed or engaged specialist to develop an accounting estimate, the auditor should test information provided by the specialist as if it were produced by the company.

Over half of the commenters to the Estimates and Fair Value Consultation Paper provided comments that are relevant to the topic of the auditor's evaluation of the work of a company's specialist. Of these, some commenters generally supported testing information provided by a company's specialist as if it were developed by company

⁵⁶ The SAG discussed specialist-related issues at two of its meetings. Briefing papers and webcast archives for these meetings (February 9, 2006 and October 14-15, 2009) are available on the Board's website. These meetings occurred before the Board adopted the risk assessment standards. See footnote 12.

management.⁵⁷ Many other commenters generally recommended maintaining the current approach in AU sec. 336 for using the work of a company's specialist. Several of those commenters supported the idea of enhancing that standard. Commenters had varied views about potential enhancements. Their views included recommendations that the PCAOB consider:

- Using ISA 500 and AU-C Section 500 as a model for enhancements;⁵⁸
- Requiring that an auditor test information that a company's *employed* specialist provides as if the company itself provided the information; and
- Allowing the auditor to consider the competence and objectivity of a company's specialist when assessing risks.⁵⁹

Also, some commenters on the Estimates and Fair Value Consultation Paper expressed concerns about whether the auditor could be expected to evaluate the appropriateness of a proprietary model used by a company's specialist, in accordance with AU sec. 328, if the company's specialist does not provide the auditor access to that model. The staff is seeking comment on how an auditor can determine the appropriateness of a proprietary method or model used by a company's specialist in such circumstances.

Questions:

7. This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?
8. When an auditor obtains an understanding of the methods used by the company's specialist:
 - a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?

⁵⁷ For example, the two smaller accounting firms that provided comments supported requiring that the auditor test the information provided by the company's specialist as if it were produced by the company.

⁵⁸ The staff has considered the standards of the IAASB and ASB in developing its alternative approaches and will continue to consider their standards as it evaluates ways to improve PCAOB standards.

⁵⁹ The auditor's evaluation of the knowledge, skill, and objectivity of a company's specialist may affect the auditor's assessment of the risks of material misstatement, as described in Section V.D.

- b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

V. Alternative Regulatory Approaches

The staff has identified a number of alternatives to address the issues related to the use of the work of specialists. The staff is interested in commenters' views regarding these alternatives, which are summarized below.

A. Consideration of Alternatives to Standard Setting

The staff has considered alternatives to standard setting. Additional staff guidance⁶⁰ may provide targeted information to auditors on the application of PCAOB standards. Alternatively, additional resources could be devoted to inspections and enforcement of existing standards. These alternatives may increase compliance with those standards, likely resulting in incremental improvement in auditors' use of the work of specialists. However, in the staff's view, these alternatives would not solve the underlying issues with the standards.

Question:

9. Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

B. Alternatives for Revising Standards – Auditor's Specialist

The staff is exploring whether consistent requirements should apply to an auditor's employed and engaged specialist. These requirements would be scalable and provide more specific direction. More specific direction might be especially important for the auditor's use of the work of an auditor's engaged specialist who is not subject to the accounting firm's training, resources, and quality control ("QC") system under current PCAOB standards. For example, an auditor's engaged specialist may have limited familiarity with the auditor's methodology and may not be trained to apply professional skepticism. An auditor's employed specialist, on the other hand, may have experience working with the auditor and is subject to the firm's QC system.

This section provides an overview of alternatives the staff is considering for

⁶⁰ The PCAOB has issued staff guidance that addresses topics related to specialists. See, e.g., *Auditing the Fair Value of Share Options Granted to Employees*, Staff Questions and Answers (October 17, 2006); *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, Staff Audit Practice Alert No. 2 (December 10, 2007); and *Audit Considerations in the Current Economic Environment*, Staff Audit Practice Alert No. 3 (December 5, 2008).

revising standards related to the auditor's evaluation of the work of an auditor's specialist. Although both alternatives would provide substantially the same requirements for an auditor's employed and engaged specialists, the alternatives differ in the way the requirements would be set forth in PCAOB standards. Under both alternatives new requirements would be established, as discussed in Section VII, for: (i) evaluating the knowledge, skill, and objectivity of an auditor's specialist; (ii) informing the specialist of his or her responsibilities; and (iii) reviewing the specialist's work and conclusions.⁶¹ The staff is continuing to consider alternatives and is seeking commenters' views.

1. Develop a Separate Standard for Using the Work of an Auditor's Specialist

This alternative would develop a separate standard for using the work of an auditor's specialist that would apply to a specialist employed or engaged by the auditor, similar to the approach used by the IAASB in ISA 620 and the ASB in AU-C Section 620. The standard would include the potential new requirements, described in the preceding paragraph, that would apply to both an auditor's employed specialist and an auditor's engaged specialist. The principles of supervision set forth in Auditing Standard No. 10 would continue to apply when the auditor uses the work of an employed specialist, and the potential new standard would provide specific requirements for how an auditor applies those principles when supervising an auditor's employed specialist. These specific requirements also would apply to the auditor's use of the work of an engaged specialist.

i. Benefits

Under this alternative, the potential standard would:

- Be scalable and result in substantially the same requirements for evaluating the work of employed and engaged specialists, which would create consistency in practice among accounting firms of all sizes; and
- Take into account differences between an engaged specialist and an employed specialist that may make it difficult to bring an auditor's engaged specialist into the scope of Auditing Standard No. 10 (e.g., unlike an employed specialist, an engaged specialist is not currently subject to the accounting firm's QC system).

ii. Concerns

The potential standard:

- Would require the auditor to consult two standards that govern the supervision of the work of an auditor's employed specialist; and

⁶¹ Section VII discusses the potential requirements in more detail.

- May create the misconception that an auditor's employed specialist is not a member of the engagement team.

2. Extend the Supervision Requirements in Auditing Standard No. 10 to an Auditor's Engaged Specialist

This alternative would extend the supervision requirements in Auditing Standard No. 10 to cover all arrangements involving an auditor's employed and engaged specialist. It would be scalable and familiar to auditors who employ specialists because Auditing Standard No. 10 already applies to an auditor's employed specialist. PCAOB standards also require that an auditor supervise the work of persons who are not subject to the accounting firm's QC system, such as internal auditors who provide direct assistance⁶² to the auditor and persons with specialized knowledge and skill in income tax and information technology ("IT") that are engaged by the auditor.⁶³ This alternative would integrate the engaged specialists into the engagement team, and would provide requirements for evaluating the work of an auditor's engaged specialist that are the same as the auditor's responsibilities for supervising the work of employed specialists.⁶⁴ Like the separate standard alternative, this alternative also would incorporate the potential requirements for evaluating the knowledge, skill, and objectivity of an auditor's specialist, for informing the specialist of his or her responsibilities, and for reviewing the specialist's work and conclusions.⁶⁵

⁶² See paragraph .27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

⁶³ See footnote 1 to AU sec. 336.01. See also PCAOB Release No. 2010-004 at A10-18 ("Paragraphs 5 – 6 of Auditing Standard No. 10 describe the nature and extent of the supervisory activities necessary for proper supervision of a person with specialized skill or knowledge who participates in the audit and is ... engaged by the auditor to provide services in a specialized area of accounting or auditing").

⁶⁴ See Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, at 42 ("When asked how the use of specialists could be improved, 44% of auditors (67% of audit partners) stated that specialists should be more integrated with the audit team, but only 14% of specialists stated this as a recommendation. This suggests that auditors' and specialists' perceptions of the value of integration differ and that specialists may be reluctant to become more fully integrated into the work of audit teams, potentially affecting the quality of the audit."). A different view is provided at 44, 45 ("Some of our respondents describe a practice of not involving certain specialists in the primary audit planning meeting; but rather, holding a separate meeting with them. This cost-saving practice may be subject to future regulatory/litigation criticism, since the specialists excluded from the primary planning meeting may be unaware of other/broader issues that might impact their work, e.g., fraud/forensic specialists might identify additional fraud risk factors or red flags.").

⁶⁵ Section VII discusses the potential requirements in more detail.

i. Benefits

Under this alternative, the potential amendments to apply the supervision requirements in Auditing Standard No. 10 to an auditor's engaged specialist would:

- Be scalable and result in the same requirements for evaluating the work of employed and engaged specialists, which would create consistency in practice among accounting firms of all sizes; and
- Use the same supervision framework for an auditor's engaged specialist as that used for other members of the engagement team, including an auditor's employed specialist (*i.e.*, Auditing Standard No. 10), which is familiar to auditors.

ii. Concerns

The potential amendments to apply the supervision requirements in Auditing Standard No. 10 may:

- Not sufficiently recognize that an engaged specialist is different from an employed specialist; for example, unlike an employed specialist, an engaged specialist: (i) would not be subject to the accounting firm's training, resources, and QC system; and (ii) would be subject to supervision requirements that the specialist's policies and procedures (including those of his or her employer) may not be able to address without triggering significant changes; and
- Require changes to an accounting firm's methodology or QC system if the firm does not already have policies and procedures for supervising a specialist.

Questions:

10. Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?
11. Are there other considerations related to the alternatives presented that the staff should be aware of?
12. Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.
13. Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

C. Alternatives for Revising Objectivity Requirements – Auditor's Specialist

Alternatives for addressing differences in how the auditor evaluates the objectivity of an auditor's specialist are discussed in Section VII.B.

D. Alternatives for Revising Standards – Company's Specialist

Below are two alternatives the staff is considering for revising performance requirements for the auditor's use of the work of a company's specialist. Both alternatives would require more rigorous procedures than AU sec. 336 requires. The staff believes more rigor may be appropriate given the risks of material misstatement often associated with accounting estimates. In cases when the auditor does not possess the specialized knowledge or skill to perform those more rigorous procedures, the auditor might need to employ or engage his or her own specialist. Several commenters to the Estimates and Fair Value Consultation Paper indicated that a potential requirement to test information provided by a company's specialist as if it were prepared by the company would result in additional effort by the auditor.

Both alternatives would recognize that the company's use of the work of a competent and objective specialist to assist in developing an accounting estimate may reduce the risks of material misstatement related to the accounting estimate. Therefore, the auditor would evaluate the knowledge, skill, and objectivity of a company's specialist under each alternative. The results of the auditor's evaluation may affect the auditor's assessment of the risks of material misstatement and the nature, timing, and extent of the auditor's procedures to respond to such risks in areas in which a company's specialist has performed work. For example, a competent specialist may have expertise in applying a complex valuation technique that is consistent with current or new accounting principles within the applicable financial reporting framework. The staff envisions that criteria for evaluating the knowledge and skill of the company's specialist would be the same as those for the auditor's specialist. The staff is continuing to consider alternatives and is seeking commenters' views.

1. Amend the Requirements in AU sec. 336 for Evaluating the Work of a Company's Specialist

This alternative would amend the requirements in AU sec. 336 by removing certain provisions that may be considered to limit the auditor's responsibilities to evaluate the work of a company's specialist.⁶⁶ For example, it would eliminate language in AU sec. 336 that states that the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist because such language may be considered to limit the extent of testing of the specialist's work

⁶⁶ Under this alternative approach, the standard would be renamed and would apply solely to a company's specialist.

that is needed to obtain sufficient appropriate audit evidence. Similarly, the approach would eliminate the provisions that (i) "ordinarily the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances" and (ii) "[i]f the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained."⁶⁷

In addition, other requirements in AU sec. 336 would be clarified in the amended standard. For example, AU sec. 336 requires auditors to obtain an understanding of methods and assumptions used by a company's specialist.⁶⁸ In the staff's view, that requirement is less rigorous than standards that apply to the auditor's evaluation of information when the company does not use a specialist. Also, in the staff's view, the general nature of the AU sec. 336 requirement may result in a variety of practices and inconsistent application. Thus, the staff is exploring whether the standard should require auditors to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist in the same manner as the auditor evaluates information produced by others in the company. Any potential requirements would be designed to align with the risk assessment standards.

i. Benefits

Under this alternative, amending the requirements of AU sec. 336 for evaluating the work of a company's specialist would:

- Retain certain requirements for the auditor related to the work of a company's specialist that are already familiar to auditors. This might be especially helpful for smaller accounting firms that apply the specified procedures in AU sec. 336; and
- Eliminate certain provisions of AU sec. 336 that may limit the auditor's responsibilities to evaluate the work of a company's specialist, and align the requirements with the risk assessment standards.

ii. Concerns

Amending the requirements of AU sec. 336 may:

- Result in the auditor continuing to test information provided by a company's specialist differently from how the auditor tests information provided by others

⁶⁷ See AU secs. 336.12 – .13.

⁶⁸ The amended standard may retain the requirements of AU sec. 336 that the auditor (i) make appropriate tests of data provided to the specialist and (ii) evaluate whether the specialist's findings support the related assertions in the financial statements.

- in the company;⁶⁹ and
- Be challenging for some firms to implement more rigorous procedures.

2. Rescind AU sec. 336

This alternative would rescind AU sec. 336 without issuing new requirements for the auditor's use of the work of a company's specialist. Under this alternative, auditors would look to other applicable PCAOB standards, including AU sec. 328 and AU sec. 342, when the work of a company's specialist is used. Under this approach, evidence provided by a company's specialist would be evaluated similarly to any other evidence provided by the company to the auditor. This alternative may better respond to the risks of material misstatement than does the current approach. Overall, rescinding AU sec. 336 likely would result in increased testing by some auditors who use the work of a company's specialist in auditing accounting estimates, but this increased testing may be appropriate given the risks of material misstatement often associated with accounting estimates.

i. Benefits

Under this alternative, rescinding AU sec. 336 would:

- Clarify that the auditor would evaluate information provided by a company's specialist in accordance with standards that would apply if the company did not use the work of a specialist; and
- Align the requirements for the auditor's evaluation of the work of a company's specialist with the risk assessment standards.

ii. Concerns

Rescinding AU sec. 336 may:

- Cause difficulties, especially at the outset, for accounting firms that have previously used the work of a company's specialist after performing the specified procedures in AU sec. 336 because there would be less specific direction for an auditor about which standard applies (e.g., AU sec. 342); and
- Result in some inconsistent practice because, in the absence of specific requirements, it may not always be clear how to apply other PCAOB standards, including the risk assessment standards, when the company uses the work of a specialist.

⁶⁹ As noted in Section V.D.1, the staff is considering whether auditors should be required to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist.

Questions:

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?
15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?
16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?
17. Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?
18. Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

VI. Potential Amendments – Definitions

The staff believes that definitions would be required under any of the alternatives described in Section V related to an auditor's use of the work of an auditor's specialist or a company's specialist. The staff is considering whether the definition of a specialist in AU sec. 336 should be retained. The current definition of a specialist in AU sec. 336 does not distinguish between an auditor's engaged specialist and a company's specialist. Such a distinction is important because the auditor's specialist performs work to assist the auditor while the company's specialist performs work to assist the company in preparing the financial statements being audited.

The potential definition below would retain the concept in AU sec. 336 that a person who has specialized knowledge or skill in areas of accounting or auditing is *not* considered a specialist for purposes of that standard. Specifically, AU sec. 336 provides that income taxes and IT are specialized areas of accounting and auditing and are

therefore outside the scope of the standard.⁷⁰ Potential definitions are as follows:

Specialist – A person¹ with specialized knowledge or skill in a field of expertise other than accounting or auditing.²

Auditor's specialist – A specialist who performs work to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's specialist may be either employed by the auditor ("auditor's employed specialist") or a third party engaged by the auditor ("auditor's engaged specialist").

Company's specialist – A specialist who performs work to assist the company in its preparation of the financial statements. A company's specialist may be either employed by the company ("company's employed specialist") or a third party engaged by the company ("company's engaged specialist").

¹ As defined by PCAOB Rule 1001 (p)(iv), the term "person" means any natural person or any business, legal or governmental entity or association.

² Because income taxes and information technology, as they relate to the audit, are specialized areas of accounting and auditing, this definition does not apply to a person with specialized knowledge or skill in those areas.

The staff is interested in commenters' views about whether specialized knowledge or skill in a field of expertise other than accounting or auditing should continue to exclude income taxes and IT, or whether the definition should remove this exclusion to respond to increased complexities in income taxes and IT. These complexities include matters such as the interpretation of income tax law in foreign jurisdictions and data mining techniques for performing analytical procedures.

The definition of an auditor's specialist would not include all third parties that an auditor might use. When an auditor uses the work of a third party in areas outside of accounting and auditing, in the staff's view, determining whether that third party is an auditor's engaged specialist would depend on whether the third party is performing work to assist the auditor in obtaining sufficient appropriate audit evidence, as opposed to providing information that is routinely and commercially available for a fee. For example, in the staff's view, a third party that provides prices of financial instruments to the auditor that it routinely makes available for a fee would generally not be considered an auditor's engaged specialist.⁷¹

On the other hand, if an auditor engages a third party to develop fair value

⁷⁰ See footnote 1 of AU sec. 336.

⁷¹ The Estimates and Fair Value Consultation Paper also sought comment on the use of third parties in an audit. Most commenters agreed that a third party that provides prices available to the public for a fee is not an auditor's specialist. Also, the characterization of when a third party is a specialist in this staff consultation paper is consistent with the characterization provided in the Estimates and Fair Value Consultation Paper.

measurements for certain complex financial instruments and the measurements are not routinely and commercially available from the third party for a fee, the third party would be performing work specifically to assist the auditor in developing an independent estimate. In that circumstance, the third party would be considered an auditor's engaged specialist and therefore covered by the potential amendments.

Questions:

19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?
20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?
21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

VII. Potential Amendments – Auditor's Employed or Engaged Specialist

A. Amend the Requirements for Using the Work of an Auditor's Specialist

Under either alternative in Section V.B (*i.e.*, develop a separate standard for an auditor's specialist or extend the supervision requirements of Auditing Standard No. 10 to an auditor's engaged specialist), in the staff's view, it would be necessary to provide more specific requirements for using the work of an auditor's specialist. Among other things, these specific requirements would address the hand-off issues (described in Sections III.C and IV.B) and would include enhanced requirements for:

- Evaluating the knowledge, skill, and objectivity⁷² of an auditor's specialist;
- Informing an auditor's specialist of his or her responsibilities; and
- Evaluating the work of an auditor's specialist.

⁷²

See Section VII.B.

1. *Evaluating the Knowledge and Skill of an Auditor's Specialist*

The staff is considering whether specific requirements are needed to improve the auditor's evaluation of whether an auditor's specialist has the necessary knowledge and skill to perform the assigned tasks on the audit.

Similar to the requirements in AU sec. 336.08 for determining whether the specialist has the necessary knowledge or skill,⁷³ under the potential requirements the auditor would evaluate the professional qualifications, experience, and reputation and standing of an auditor's specialist. The auditor obtains information from a variety of sources, such as (i) experience with previous work of the specialist, (ii) discussions with the specialist and others who have used the specialist, and (iii) published papers or books written by the specialist. The staff is considering the following potential requirements:

The auditor should determine the knowledge and skill of an auditor's specialist by evaluating the specialist's:

- a. Professional qualifications, including whether the work of the auditor's specialist is subject to any technical performance standards or other professional or industry requirements, including ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation;
- b. Experience in the type of work under consideration, including any areas of specialty within the field of the auditor's specialist; and
- c. Reputation and standing in the views of peers and others familiar with the capability or performance of the auditor's specialist.

In the staff's view, although the objectives of an evaluation are the same whether the specialist is employed or engaged by the auditor, the manner in which the auditor obtains the information may differ. For example, for an employed specialist, the auditor may take into account information available from the accounting firm (e.g., information contained in the firm's QC system, results of internal and external inspections, and results of the firm's performance reviews) to assist him or her in making that evaluation. The auditor also may hold discussions with the specialist, his or her supervisor, and other firm personnel about the number and types of engagements in which the specialist performed work, the role he or she played in the engagements, and the quality of his or her performance.

⁷³ The potential requirements are also consistent with those in ISA 620 and AU-C Section 620.

Question:

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

2. *Informing an Auditor's Specialist of His or Her Responsibilities*

Paragraph 5.a of Auditing Standard No. 10 requires the engagement partner and other engagement team members who perform supervisory activities to inform engagement team members of their responsibilities. The staff is considering the need for specific requirements for informing an auditor's specialist of the specialist's responsibilities on the engagement, consistent with the requirements in paragraph 5.a. These potential requirements were guided, in part, by observations from the Board's oversight activities in which auditing deficiencies appeared to result at least to some extent from inadequate instructions from the auditor. The staff is considering the following potential requirements, either as requirements in a separate standard or as additional requirements under Auditing Standard No. 10:

The auditor should reach an agreement with the auditor's specialist, evidenced in writing, regarding the following matters:

- a. The responsibilities of the auditor's specialist, including:
 - (1) The objectives of the work that the specialist is to perform;
 - (2) The nature, timing, and extent of the work that the specialist is to perform; and
 - (3) Matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues related to areas in which the auditor uses the work of the specialist;
- b. When the work of the auditor's specialist relates to an accounting estimate, including a fair value measurement, whether the work of the specialist will assist the auditor in:
 - (1) Developing an independent estimate, including how the specialist's work will use methods (which may include models) or significant assumptions; or
 - (2) Testing the methods and significant assumptions used by the company;
- c. The nature of company-provided or third-party information to be used by the auditor's specialist, including the source of the information and whether the specialist is responsible for performing work to assist the auditor in evaluating the:

- (1) Accuracy and completeness of company-provided information;¹ and
- (2) Relevance and reliability of third-party information;²
- d. Requirements in the applicable financial reporting framework that are relevant to the work of the auditor's specialist;
- e. The nature and extent of audit documentation the auditor's specialist will provide and, if applicable, the form of report to be issued by the auditor's specialist;
- f. The nature, timing, and extent of communications between the engagement partner or other engagement team members performing supervisory activities and the auditor's specialist, including any changes in the scope of the work of the specialist or any other changes to the matters addressed in the agreement; and
- g. The importance of professional skepticism³ in an audit and the need to consider contradictory information.

¹ Paragraph 10 of Auditing Standard No. 15, *Audit Evidence*, paragraph .39 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, and paragraph .11 of AU sec. 342, *Auditing Accounting Estimates*, provide requirements for testing the accuracy and completeness of data.

² Paragraphs 7 and 8 of Auditing Standard No. 15 describe the concepts of relevance and reliability.

³ Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. See paragraphs .07 – .09 of AU sec. 230, *Due Professional Care in the Performance of Work*.

The objective of reaching an agreement evidenced in writing⁷⁴ is to help ensure that the auditor and the auditor's specialist agree about (i) the scope of the work to be performed, (ii) the documentation the specialist is to provide to the auditor, and (iii) the necessary communications between the auditor and the specialist. In the staff's view, such a requirement might help foster effective two-way communication between the auditor and the auditor's specialist, help prevent misunderstandings about the auditor's and the specialist's responsibilities, and reduce the risk that either the auditor or the specialist will misinterpret the needs or expectations of the other party.⁷⁵ For example, it

⁷⁴ Evidence of the agreement between the auditor and the auditor's specialist might be in the planning memoranda, separate memoranda, audit programs, or other related work papers.

⁷⁵ An academic working paper discusses the issues that may result from the auditor and specialist not reaching an agreement about their responsibilities. See Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?*, at 3 ("Interviewees identified problems arising from the division of labor between auditors and valuation specialists that include coordination issues between auditors and specialists, differences in perspectives between these two parties, and uncertainty about the respective responsibilities of auditors and specialists. These problems can cause auditors to discount specialists' conclusions or caveats, fail to

is critical that the auditor and the specialist reach an understanding that an accounting estimate, or fair value measurement, to be developed by the specialist is in accordance with the applicable financial reporting framework.⁷⁶

Questions:

23. Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?
24. Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?
25. Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?
26. How do accounting firms determine what information an auditor's specialist should provide to the auditor? Are there circumstances in which auditors may not retain all audit evidence obtained from the specialist?

3. Evaluating the Work of an Auditor's Specialist

Paragraph 5.c of Auditing Standard No. 10 requires the engagement partner to review the work of engagement team members. The staff is considering the need for specific requirements for the auditor's review of the work of an auditor's specialist in accordance with the requirements of paragraph 5.c.

The staff believes it is important for an auditor who reviews the work of an auditor's specialist to focus on the risks associated with assumptions and methods – two key drivers of most accounting estimates. Observations from the Board's oversight activities and input from SAG members have underscored the need to strengthen the auditor's responsibilities for evaluating the assumptions and methods used by an auditor's specialist.

(footnote continued)

recognize the importance of issues raised by specialists, and fail to follow up on specialists' work when necessary").

⁷⁶ See Johnson et al., *Incorporating Highest and Best Use into Accounting Standards Expands Opportunities for Appraisers*, at 157 ("[A]ppraisers will increasingly be called upon to develop fair value measures for financial reporting purposes and ... the definition of *fair value* is close to the traditional definition of *market value* used by real estate appraisers. The definitions, however, are not synonymous.").

Two ways in which an auditor's specialist may perform work related to evaluating accounting estimates are (i) developing an independent estimate and (ii) testing the methods and significant assumptions used by the company.⁷⁷ In the first instance, when an auditor's specialist develops an independent estimate, the staff is considering whether it would be beneficial for the auditor to evaluate whether the methods used by the specialist are appropriate and whether the significant assumptions used by the specialist are reasonable. In the second instance, when an auditor's specialist tests the methods and significant assumptions used by the company, the staff is considering whether the auditor should be required to evaluate the specialist's conclusions about the appropriateness of the company's methods and the reasonableness of the company's significant assumptions. For example, potential requirements related to estimates might provide that:

Evaluating the work of an auditor's specialist should include:

- a. When the auditor's specialist develops an independent estimate, determining whether:
 - (1) The methods (which may include models) used by the specialist are appropriate, including whether those methods are (1) in conformity with the applicable financial reporting framework, (2) generally accepted within the specialist's field of expertise, and (3) applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company; and
 - (2) The significant assumptions used by the specialist are reasonable, taking into account information presented in the report or documentation of the specialist, in view of the auditor's understanding of the company, its environment, and other evidence available to the auditor.
- b. When the auditor's specialist tests the methods and significant assumptions used by the company, evaluating the conclusions of the specialist about:
 - (1) The appropriateness of the company's methods including whether those methods are (1) in conformity with the applicable financial reporting framework, (2) generally accepted within the specialist's field of expertise, and (3) applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company;
 - (2) The reasonableness of the company's significant assumptions, taking into account information presented in the report or documentation of the specialist, in view of the auditor's

⁷⁷ In addition, the auditor may test accounting estimates and fair value measurements by reviewing subsequent events or transactions. See, e.g., AU secs. 328.23, .41 – .42.

understanding of the company, its environment, and other evidence available to the auditor; and

- (3) The company's basis for selecting the methods and assumptions used in developing the estimate, including whether the company considered alternative methods and assumptions.

c. Determining whether the results and conclusions of the specialist's work:

- (1) Support and corroborate or contradict the relevant financial statement assertions or conclusions regarding the design or operating effectiveness of the company's controls; and
- (2) Are consistent or inconsistent with evidence obtained from other audit procedures performed.

Note: The auditor should evaluate the effect of any restrictions, limitations, or caveats in the report of the specialist on the appropriateness of the specialist's work for the auditor's purposes.

Depending on the area of expertise of the specialist, the auditor's understanding of the specialist's subject matter may vary (e.g., the auditor may have a better understanding of methods and assumptions used in the valuation of financial instruments than of those used in a highly specialized area, such as in the valuation of an environmental remediation contingency). Nevertheless, PCAOB standards require the auditor to have knowledge of the industry, subject matter, and requirements of the applicable financial reporting framework.⁷⁸ This knowledge should inform the auditor's evaluation of the work of the specialist under the potential requirements described above.⁷⁹ The staff is interested in commenters' views about whether these potential requirements are consistent with current practice, including audits conducted in accordance with ISA 620 and AU-C Section 620.⁸⁰

The potential requirements for evaluating the results and conclusions of the specialist are intended to address issues related to the failure of the auditor to consider

⁷⁸ See AU sec. 230.06, QC sec. 40.08, paragraphs 9 and 17 of Auditing Standard No. 9, and paragraph 5.a of Auditing Standard No. 13.

⁷⁹ For example, an auditor's knowledge of the company and the company's industry might provide the auditor a better understanding of the projected growth rates a company used in its goodwill impairment analysis. See, e.g., Griffith, *How Do Auditors Use Valuation Specialists When Auditing Fair Values?*, at 18 – 19 ("However, specialists do not evaluate all of the assumptions because some assumptions require client-specific knowledge that auditors have but specialists lack."; "Audit teams primarily evaluate assumptions about clients' projected financial information such as clients' forecasted revenues, expenses, cash flows, EBITDA, and changes in margins").

⁸⁰ Paragraph 12 of ISA 620 and paragraph .12 of AU-C Section 620 require the auditor to evaluate the relevance and reasonableness of significant assumptions and methods.

contradictory evidence or to resolve discrepancies, differences, or other concerns that the specialist identified.

Questions:

27. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?
28. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?
29. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?
30. Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?
31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

B. Amend the Requirements for Evaluating the Objectivity of an Auditor's Specialist

There are currently differences between the requirements that apply to the auditor's evaluation of the relationships between (i) an auditor's employed specialist and the company and (ii) an auditor's engaged specialist and the company. An auditor's employed specialist must be independent of the company.⁸¹ The auditor should evaluate the relationship between an auditor's engaged specialist and the company, including circumstances that might impair the specialist's objectivity.⁸² The staff is

⁸¹ See PCAOB Rule 3520, *Auditor Independence*, which provides that a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period. A note to the rule clarifies that it applies only to those associated persons that are required to be independent of the firm's audit client by standards, rules, or regulations of the SEC (or other applicable independence criteria).

⁸² See AU sec. 336.10.

seeking comments on whether to revise the requirements that apply to an auditor's determination of whether an engaged specialist is capable of exercising objective and impartial judgment in his or her work.

1. Background: Existing Requirements

i. Auditor's Engaged Specialist: AU sec. 336

AU sec. 336 requires the auditor to evaluate the relationship between an auditor's engaged specialist and the company, including circumstances that might impair the specialist's objectivity. Specifically, AU sec. 336.09 provides that the auditor should obtain an understanding of the specialist's relationship to the company. When obtaining such an understanding, the auditor is required to evaluate that relationship,⁸³ including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the company has the ability (through employment, ownership, contractual right, family relationship, or otherwise) to directly or indirectly control or significantly influence the specialist.⁸⁴

If the specialist has a relationship with the company, the auditor should assess the risk that the specialist's objectivity might be impaired.⁸⁵ If the auditor believes 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.⁸⁶

Given the increased use of complex accounting estimates in financial statements and the increased use of the work of specialists by auditors, the staff is exploring whether stronger and more robust requirements than those in AU sec. 336 may be necessary for evaluating the relationship of an auditor's engaged specialist to the company being audited. The requirements in AU sec. 336 may not be rigorous enough given the risks of material misstatement often associated with areas in which companies use the work of specialists. In the staff's view, maintaining those requirements may not adequately protect investors because it allows an auditor to use the work of a specialist even if the auditor believes the relationship might impair the specialist's objectivity.

⁸³ Footnote 6 of AU sec. 336 indicates that the term *relationship* includes, but is not limited to, those situations meeting the definition of "related parties" contained in the financial reporting framework applicable to the company under audit.

⁸⁴ See AU sec. 336.10.

⁸⁵ See AU sec. 336.11.

⁸⁶ *Id.*

ii. Auditor's Employed Specialist: Independence Rule

PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client"⁸⁷ within the meaning of all applicable requirements. For purposes of Regulation S-X Rule 2-01⁸⁸ ("Independence Rule" or "Rule 2-01") adopted by the SEC, the staff understands that the SEC applies its definition of "audit engagement team" in Rule 2-01⁸⁹ to include a specialist employed by a registered public "accounting firm" as defined in Rule 2-01 (which includes associated entities).⁹⁰ The effect is that an accounting firm is not independent if it uses the work of a specialist, employed by the firm or employed by an associated entity, who does not meet the independence requirement of Rule 2-01.

The Independence Rule requires auditors to be independent of their audit clients both in fact and in appearance. The rule provides a general standard of auditor independence and specifies circumstances in which an auditor's independence is impaired. The general standard of auditor independence ("reasonable investor test") in paragraph (b) of the Independence Rule states that:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

The Independence Rule specifies circumstances that are inconsistent with the general standard. Circumstances not specified by the rule, however, may also violate the general standard.

The circumstances specified by the Independence Rule set forth specific restrictions. For example, Rule 2-01(c) restrictions include:

⁸⁷ For purposes of the auditor independence rules, the term "audit client" means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client. See paragraph (a)(iv) of PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*.

⁸⁸ See Regulation S-X Rule 2-01, *Qualifications of Accountants*, 17 CFR 210.2-01.

⁸⁹ See Regulation S-X Rule 2-01(f)(7)(i).

⁹⁰ See Regulation S-X Rule 2-01(f)(2).

- Certain financial relationships with the audit client;⁹¹
- Certain employment relationships with the audit client;⁹²
- Certain business relationships with the audit client;⁹³
- Providing certain non-audit services to an audit client,⁹⁴ and
- Entering into contingent fee arrangements.⁹⁵

The Independence Rule also interacts with an accounting firm's QC system. Under PCAOB standards, an accounting firm is required to have QC policies and procedures⁹⁶ to provide reasonable assurance that personnel maintain independence in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.⁹⁷

iii. Other Standard Setters

ISA 620 and AU-C Section 620 contain consistent requirements for the auditor to evaluate whether an auditor's specialist has the necessary objectivity for the auditor's purposes.⁹⁸ For an auditor's external (engaged) specialist, these standards require the evaluation of objectivity to include inquiry regarding interests and relationships that may create a threat to that specialist's objectivity. These standards also provide application guidance on identifying and evaluating threats to objectivity. That application guidance also permits the auditor to consider information from the accounting firm's QC system when evaluating the objectivity of an auditor's internal (employed) specialist.

2. Alternative Regulatory Approaches

The staff is considering two alternative regulatory approaches for how the auditor evaluates the relationship between an auditor's specialist and the company. Both alternatives would require a more rigorous evaluation of the business, employment, and financial relationships that may impair the objectivity of an auditor's specialist. The staff

⁹¹ See Regulation S-X Rule 2-01(c)(1), *Financial Relationships*.

⁹² See Regulation S-X Rule 2-01(c)(2), *Employment Relationships*.

⁹³ See Regulation S-X Rule 2-01(c)(3), *Business Relationships*.

⁹⁴ See Regulation S-X Rule 2-01(c)(4), *Non-Audit Services*.

⁹⁵ See Regulation S-X Rule 2-01(c)(5), *Contingent Fees*.

⁹⁶ PCAOB QC standards describe the policies and procedures the firm should establish to provide the firm with reasonable assurance that its personnel possess the necessary competence through recruitment and training. See QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

⁹⁷ See QC sec. 20.09.

⁹⁸ See, e.g., paragraph 9 of ISA 620.

is seeking comment on both alternatives:

- Applying the requirements of the Independence Rule in PCAOB standards to engaged specialists; and
- Applying an approach for an auditor's engaged specialist that would incorporate some but not all elements of the Independence Rule.

The staff is continuing to consider alternatives and is seeking commenters' views.

i. Apply the Requirements of Rule 2-01 of Regulation S-X

This alternative would apply requirements similar to those in the Independence Rule to an auditor's engaged specialist. For an individual specialist, a possible approach might be to treat the engaged specialist similarly to how a "covered person in the [accounting] firm"⁹⁹ is treated under Rule 2-01, for purposes of the PCAOB rules. Under this approach, the engaged specialist would be subject to all the requirements and restrictions that apply to covered persons in the accounting firm under Rule 2-01. For a specialist's employer, an approach might be to treat the engaged specialist's employer similarly to how Rule 2-01 treats an "accounting firm"¹⁰⁰ and subject the employer to all the requirements and restrictions that apply to accounting firms under Rule 2-01, such as restrictions related to persons in the specialist's "chain of command."¹⁰¹

⁹⁹ "Covered persons in the firm" is a term defined in Regulation S-X Rule 2-01(f)(11) to mean the following partners, principals, shareholders, and employees of an accounting firm: (i) the "audit engagement team"; (ii) the "chain of command"; (iii) any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and (iv) any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

¹⁰⁰ "Accounting firm" is defined in Regulation S-X Rule 2-01(f)(2) to mean an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.

¹⁰¹ "Chain of command" is defined in Regulation S-X Rule 2-01(f)(8) to mean all persons who: (i) supervise or have direct management responsibility for the audit, including at all successively senior levels through an accounting firm's chief executive; (ii) evaluate the performance or recommend the compensation of the audit engagement partner; or (iii) provide quality control or other oversight of the audit.

a. Benefits

Under this alternative, applying the requirements of Rule 2-01 of Regulation S-X would:

- Result in the same independence requirements for an auditor's engaged specialist, as for an auditor's employed specialist; and
- Result in the auditor being prohibited from using the work of an auditor's engaged specialist if that specialist is not independent.

b. Concerns

Applying the requirements of Rule 2-01 may be difficult because:

- Rule 2-01 was written primarily for accounting firms and not for other organizations, such as specialist entities, that are not structured similarly, and specialist entities and individual specialists may have considerable challenges in complying with the rule; and
- If there is no QC system at the specialist's employer to monitor compliance with the Independence Rule, it would present considerable challenges for an accounting firm to obtain reasonable assurance that an engaged specialist, including the specialist's employer, has implemented and complied with the detailed independence requirements.

ii. Apply an Enhanced Objectivity Approach

This alternative would incorporate certain relevant elements of the Independence Rule and reflect the unique circumstances of an auditor's engaged specialist. This potential "enhanced objectivity approach" would incorporate the reasonable investor test as an overarching principle and, similar to Rule 2-01, it would identify certain relationships that might impair a specialist's objectivity (i) business relationships, (ii) employment relationships, and (iii) financial relationships.

Unlike AU sec. 336, the enhanced objectivity alternative would require the auditor to determine whether an auditor's specialist has the necessary objectivity. The auditor would be required to make this determination by: (i) obtaining information, from the specialist and the company, regarding business, employment, and financial relationships between the specialist and the company; (ii) evaluating that information; and (iii) determining whether any relationships impair the specialist's objectivity. Further, unlike AU sec. 336, if the specialist's objectivity is impaired under the potential enhanced objectivity approach, the auditor should not use the work of that specialist. The staff has developed potential requirements for evaluating whether an auditor's specialist has the necessary objectivity regarding the company (see Section VII.B.3).

a. Benefits

Under this alternative, applying the enhanced objectivity approach would result in:

- More rigorous requirements for evaluating the objectivity of an auditor's engaged specialist than those in AU sec. 336; and
- Requirements for evaluating the objectivity of an auditor's engaged specialist that are based on those for evaluating the independence of an auditor's employed specialist.

b. Concerns

Applying the enhanced objectivity alternative may:

- Result in slightly different evaluations of the objectivity of an auditor's employed or engaged specialist because the principles-based enhanced objectivity approach may, based on the auditor's judgment, result in different outcomes; and
- If there is no system at the specialist's employer to maintain information regarding business, employment, and financial relationships between the auditor's specialist and the company, it would present considerable challenges for an accounting firm to obtain reasonable assurance about the objectivity of an engaged specialist, including the specialist's employer.

3. *Enhanced Requirements for Evaluating the Objectivity of an Auditor's Specialist*

To obtain more targeted feedback about the enhanced objectivity approach, the staff has developed potential requirements described below for evaluating whether an auditor's specialist has the necessary objectivity regarding the company. Those potential requirements are based on the principles in the Independence Rule.

The enhanced objectivity approach would apply equally to an auditor's employed and engaged specialists. However, an auditor's employed specialist already is required to meet the independence criteria of Rule 2-01 of Regulation S-X. If the auditor's employed specialist meets those independence criteria, then the specialist would meet the requirements of the enhanced objectivity approach described in this subsection. Therefore, the remainder of this subsection explores how an auditor may evaluate the objectivity of an auditor's engaged specialist under the enhanced objectivity approach.

The enhanced objectivity approach would establish a framework that incorporates the reasonable investor test and includes requirements for the auditor to obtain and evaluate information regarding relationships or interests that an auditor's engaged specialist has with the company that might impair the specialist's objectivity. The approach also would provide that the auditor should not use the work of a specialist

if the auditor determines that the objectivity of that specialist is impaired.¹⁰²

The intent of the enhanced objectivity approach is to focus the auditor's attention on the relationships between the auditor's engaged specialist and the company because those relationships may impair the specialist's objectivity. The potential amendments are intended to help the auditor establish a basis for evaluating those relationships and determining whether the specialist's objectivity is impaired. For example, potential requirements might provide that:

The auditor should evaluate the objectivity of an auditor's specialist with regard to the company by considering whether a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the specialist is capable of exercising objective and impartial judgment on all issues encompassed within the specialist's assignment on an audit. In making this determination, the auditor should:

- a. Obtain information regarding business, employment, and financial relationships between the auditor's specialist and the company; and
- b. Determine, based on an evaluation of that information, whether the objectivity of the auditor's specialist is impaired.

Note: For an auditor's employed specialist, if, based on information contained in the firm's quality control system,¹ the auditor determines that the specialist is independent regarding the company, then the auditor may consider that specialist to meet the objectivity requirement.

¹ PCAOB quality control standards describe the policies and procedures the firm should establish to provide the firm with reasonable assurance that its personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities. See QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

Under these requirements, the auditor would be required to obtain information regarding business, employment, and financial relationships between the auditor's engaged specialist and the company. For example, potential requirements might provide that:

The auditor should obtain information regarding (1) any business relationships between an auditor's engaged specialist and the company, (2) any employment relationships between the auditor's engaged specialist

¹⁰² Employed specialists would still be required to be independent of the firm's audit clients, in accordance with the Independence Rule.

and the company, (3) any financial relationships between the auditor's engaged specialist and the company, and (4) any business or financial relationships between the employer of the auditor's engaged specialist and the company. The auditor should obtain information regarding such relationships and interests by:

- a. Inquiring of the company regarding any business, employment, or financial relationships described above; and
- b. Obtaining a written description from the specialist regarding (i) any business, employment, or financial relationships described above, and (ii) the process used by the specialist to formulate the responses to (i).

Business and employment relationships may include relationships between the auditor's engaged specialist and persons in a financial reporting oversight role¹⁰³ at the company. For example, employment relationships may exist when a specialist's family member is in a financial reporting oversight role at the company. Further, financial relationships may include, among other things, the specialist's ownership of securities issued by the company.

The potential amendments would also require the auditor to obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's request for information. This is intended to improve the auditor's understanding of how the specialist reached any conclusions about the relationships that the specialist reports to the auditor. For example, to identify business relationships, the specialist's process may include searching for the names of the company and its subsidiaries in the specialist's vendor or supplier files.

The evaluation of business, employment, and financial relationships would require a determination based on the facts and circumstances. The auditor would evaluate each business or employment relationship to determine whether they individually or in combination might impair the objectivity of the auditor's engaged specialist and enable the company to control or influence the specialist. The auditor also would evaluate whether there are any financial relationships between the specialist (including his or her employer) and the company that would, or reasonably could, affect the judgment of the specialist in the views of a reasonable investor.

The following are examples of business, employment, and financial relationships

¹⁰³ See PCAOB Rule 3501(f)(i), which mirrors the SEC's definition and states that the term "financial reporting oversight role" means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

between the auditor's engaged specialist and the company that would, in the staff's view, impair objectivity:

- The auditor engaged the same specialist to evaluate the company's pension costs and obligations that the company used to develop its estimate of the pension costs and obligations;
- A specialist is employed by a financial institution that is involved in selling or structuring financial instruments issued by the company; and
- The spouse of a specialist has a financial reporting oversight role at the company.

In addition, the employer of an auditor's engaged specialist may have a significant business or financial relationship with the company. Under the potential amendment, the auditor would evaluate each relationship of the specialist's employer.

The potential amendments also would require the auditor to determine, based on an evaluation of the information obtained, whether the objectivity of an auditor's engaged specialist is impaired. For example, a potential requirement might provide that:

The auditor's determination of whether the objectivity of an auditor's engaged specialist is impaired should be based on the evaluation of the information obtained. The objectivity of the specialist is impaired if, based on the evaluation of information obtained, (1) the company is able to control or influence the specialist, or (2) the specialist's business, employment, or financial relationships with the company make the specialist incapable of exercising objective and impartial judgment. If the auditor determines that the objectivity of the specialist is impaired, the auditor should not use the work of that specialist.

Note: If the auditor is unable to make a determination regarding the objectivity of a specialist, the auditor should not use the work of that specialist.

Questions:

32. How does the auditor evaluate relationships between an auditor's engaged specialist and a company under AU sec. 336?
33. Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?
34. Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

35. Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor's specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist's firm?
36. Are the potential requirements for the auditor to evaluate the objectivity of an auditor's specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account "threats" to objectivity and "safeguards" to reduce the threats, as provided in ISA 620?
37. Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor's engaged specialist will not be influenced by business, employment, or financial relationships?
38. Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?
39. Does the specialist (or his or her employer) typically have a system in place capable of tracking the information to respond to the auditor's request? If not, could a system feasibly be created?

VIII. Questions Related to Economic Impacts and Implications

As the staff continues to explore appropriate alternatives, it is interested in information and views regarding economic implications of the concepts, including the alternatives described throughout this staff consultation paper. The staff is seeking data and other information on current practice and potential regulatory alternatives to help inform its analysis. This includes information on the likely benefits and costs of a potential new set of requirements and of alternative approaches.

Potential requirements being considered by the staff related to the auditor's use of the work of an auditor's specialist or testing of the work of a company's specialist might represent a change in practice for accounting firms and additional costs, especially for accounting firms that are not already performing similar procedures. However, in the staff's view, the potential requirements under consideration should improve audit quality and result in all firms performing consistent procedures.

The staff believes the following information is important to inform an analysis of the potential economic impacts of the alternatives discussed in this staff consultation paper. The staff acknowledges that certain information may be difficult to accumulate

and provide, but encourages commenters to provide it to the best of their ability, including through the use of estimates, examples, and aggregated data.

Questions:

40. For accounting firms that use the work of an auditor's or a company's specialist for public company audits:
 - a. In how many (e.g., what percentage) of those audits is the work of specialists used? Provide details within the following categories:
 - (i) Auditor's employed specialists;
 - (ii) Auditor's engaged specialists;
 - (iii) Company's employed specialists; and
 - (iv) Company's engaged specialists.
 - b. For the auditor's specialists described in a.(i) and a.(ii), what is the ratio of specialist hours to total audit hours?
 - c. How are the auditor's engaged specialists compensated?
41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?
42. To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies, and fraud?
43. Would any of the potential alternatives lead to increased cost? If so, what are the estimated (i) number of audits affected and impact on audit hours and cost and (ii) effects on companies' costs?
44. Do the incremental costs associated with any of the potential alternatives decline as an accounting firm uses specialists more frequently?
45. Are the costs of the potential alternatives likely to be reduced in years after the year of initial implementation?
46. Are the economic impacts of the potential alternatives likely to be different for audits involving (i) emerging growth companies, (ii) brokers and dealers, (iii) companies in specialized industries, (iv) companies in certain stages of their life cycles (e.g., development stage), and (v) the use of the work of specialists in specific fields of expertise? If so, provide relevant details.
47. Are the economic impacts of the potential alternatives likely to affect accounting firms of different sizes differently? If so, provide relevant details. Are there other alternatives that might address the need for improvement noted in this staff consultation paper at lower cost or greater

efficiency?

48. As part of considering the need for change, the staff is analyzing academic literature that relates to the auditor's use of the work of a specialist.¹⁰⁴ Is there ongoing research or other information, other than that identified in this staff consultation paper, that the staff should consider in evaluating the economic aspects of changes in standards for the auditor's use of the work of a specialist?

* * *

¹⁰⁴ See, e.g., Griffith, *How Do Auditors Use Valuation Specialists when Auditing Fair Values?*; Johnson et al., *Incorporating Highest and Best Use into Accounting Standards Expands Opportunities for Appraisers*; Boritz et al., *Auditors' and Specialists' Views about the Use of Specialists during an Audit*, and Martin et al., *Auditing Fair Value Measurements: A Synthesis of Relevant Research*.



Exhibit 2(a)(C)

**Alphabetical List of Commenters on the Proposal in
PCAOB Release No. 2017-003**

1	Accountancy Europe
2	American Academy of Actuaries
3	Baker Tilly Virchow Krause, LLP
4	BDO USA, LLP
5	BKD LLP
6	California Society of Certified Public Accountants
7	California State Teachers' Retirement System
8	Center for Audit Quality (2 Letters)
9	Council of Institutional Investors
10	Crowe Horwath LLP
11	Deloitte & Touche LLP
12	Duff & Phelps, LLC
13	Environmental Risk Communications, Inc.
14	Ernst & Young LLP
15	Federal Deposit Insurance Corporation; Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency
16	Financial Executives International
17	Grant Thornton LLP
18	Harvest Investments, Ltd.
19	Illinois CPA Society

Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2017-003	
20	Institut der Wirtschaftsprüfer
21	Institute of Management Accountants
22	KPMG LLP
23	Mazars USA LLP
24	National Association of Real Estate Investment Trusts
25	National Association of State Boards of Accountancy
26	National Venture Capital Association
27	Oak Advising & Consulting, Inc.
28	PricewaterhouseCoopers LLP
29	RSM US LLP
30	Ryder Scott Company, L.P.
31	Texas Society of Certified Public Accountants
32	The Institute of Chartered Accountants in England and Wales
33	U. S. Chamber of Commerce, Center for Capital Markets Competitiveness
34	U.S. Government Accountability Office



Office of the Secretary
PCAOB

Sent by email:
comments@pcaobus.org

Brussels, 23 August 2017

Subject: Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

Dear Sir or Madam,

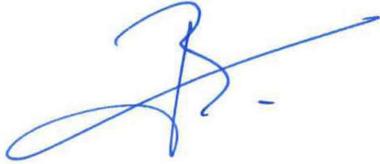
- (1) Accountancy Europe (previously known as FEE, the Federation of European Accountants) welcomes the opportunity to comment on the PCAOB Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists. Our main comments are summarised hereafter.

GENERAL COMMENTS

- (2) Given the increasing complexity of business processes and transactions, and the heightened risk of material misstatements in financial statements, the use of specialists has become imperative both for auditors and their respective clients. We welcome the PCAOB's initiative to address the need for improvements in this area and have provided answers to the questions included in the proposal in an Appendix to this letter.
- (3) We think it is instrumental that the revised PCAOB standard remains on the same line as the IAASB standard ISA 620, Using the Work of an Auditor's Experts. In general, we need to find the right balance between applying principles and requiring auditors to undertake certain detailed procedures. The priority should be that both standards remain consistent with each other. We advocate for the alignment of auditing standards globally to the maximum extent possible, which enhances both the quality of audits and the acceptance of audit work globally.
- (4) We agree with the PCAOB that a risk-based approach is essential in dealing with the work of specialists – either engaged/employed by the auditor or the audited entity. We favour a scaled approach in line with ISA 620, Using the Work of an Auditor's Expert, whereby evidence provided by a specialist employed/engaged by the client ('management's specialist') is treated differently than the one obtained by an independent expert or an expert engaged or otherwise employed by the audit firm ('auditor's specialist'). This is based on the fact that a specialist who is engaged or otherwise employed by the client is working on behalf of the client.

- (5) Our detailed responses to the questions included in the PCAOB proposal are set out below. For further information, please contact my colleagues Hilde Blomme at hilde@accountancyeurope.eu or Noémi Robert at noemi@accountancyeurope.eu.

Sincerely,



Olivier Boutellis-Taft
Chief Executive

ABOUT ACCOUNTANCY EUROPE

Accountancy Europe unites 50 professional organisations from 37 countries that represent close to **1 million** professional accountants, auditors, and advisors. They make numbers work for people. Accountancy Europe translates their daily experience to inform the public policy debate in Europe and beyond.

Accountancy Europe is in the EU Transparency Register (No 4713568401-18)

APPENDIX: RESPONSES TO QUESTIONS

Questions 1-3: Current Practice

- (6) The information included in the proposal satisfactorily reflects the current practice in audit firms. We agree with the PCAOB that in the areas covered by the PCAOB standards relating to Auditing Accounting Estimates, Auditing Fair Value Measurements and Disclosures, and Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, the use of specialist knowledge or skill in relevant areas has increased in recent years.
- (7) In line with ISA 620, Using the Work of an Auditor's Expert, we support an approach whereby evidence provided by a specialist employed/engaged by the client ('management's specialist') is treated differently than the one obtained by an independent expert or an expert engaged or otherwise employed by the audit firm ('auditor's specialist'). This is based on the fact that a specialist who is engaged or otherwise employed by the client is working on behalf of the client.

Question 4-11: Economic Considerations

- (8) Nothing to report

Question 12: Special Considerations for Audits of Emerging Growth Companies

- (9) Nothing to report

Question 13: Applicability of the Proposed Requirements to Audits of Brokers and Dealers

- (10) Nothing to report

Questions 14-15: Effective Date

- (11) Nothing to report

Questions 16-17: Scope of this Proposal

- (12) We support the PCAOB view that the Board should be proactive in addressing auditors' dealings with specialists by means of its standard setting activities as an alternative to devoting additional resources to inspections and enforcement of existing standards. In terms of investor protection, action to prevent weaknesses occurring in the conduct of the audit is far more appropriate than the retrospective identification of weaknesses that have already occurred. However, this does not imply that every issue is susceptible to resolution through auditing standards.
- (13) With regards to auditor's specialists, we support an approach that would be similar to the approach used by the IAASB in ISA 620. We see the benefit of a scalable approach, taking into account practical differences between an engaged specialist and an employed specialist. In our view, a principle-based approach recognising practical differences, but setting a common objective, is appropriate.

Questions 18-24: Proposed Amendments Related to Using the Work of a Company's Specialist

- (14) With regards to company's specialists, we agree with the Board approach in rescinding the parts of AU sec 336 that relate to company specialists, and then mirror the approach taken in ISA 500, Audit Evidence. We think that the auditor's risk assessment in assessing the objectivity and competence of a company's specialist should determine the need for, and nature of, further audit procedures. Even if it is standard practice for auditors to perform specific procedures to evaluate the work of specialists, requirements need to be drafted in a way that allows flexibility to accommodate individual audit circumstances.

Questions 25-31: Proposed Amendments Related to Supervising or Using the Work of an Auditor's Specialist

- (15) We agree that any revisions to the PCAOB standards should continue to require the auditor to evaluate the knowledge, skill and objectivity of an auditor's specialist; inform the specialist of his or her responsibilities; and evaluate the specialist's work and conclusions. As per ISA 620, the auditor needs to assess the extent of the procedures against a number of factors using professional judgment. We favour this approach.

Questions 32-39: Proposed Amendments to AS 1210 for Using the Work of an Auditor Engaged Specialist

- (16) Further consideration is needed from the PCAOB with regards to the differences between employed and engaged specialists so as not to disadvantage audit firms which do not employ specialists, which are likely to be smaller audit firms in particular.
- (17) The Board should adopt a principles-based "enhanced objectivity approach". We note that the potential requirements set forth in the proposal are far more prescriptive than the requirements of ISA 620, and in many cases, mirror the application material in that standard. It should be noted that in some jurisdictions and/or fields of expertise, there may be a limited number of specialists; the balance between professionalism and inconsequential threats to objectivity should therefore be better balanced.
- (18) When dealing with the degree and level of evaluation of the specialist's work required by the auditor, costs need to be considered for a proportionate and realistic approach. The degree and level of evaluation of the specialists' work required by the auditor should not be prescribed to the extent that the increased costs outweigh the incremental increase in audit quality.
- (19) There also needs to be due consideration of the impact to smaller audit firms, as the currently stated practice as described in the proposal holds true predominantly for larger network firms. In some jurisdictions and in specific areas, there may be a limited number of suitable specialists for auditors to employ or engage.

Questions 40-43: Other Considerations

- (20) Nothing to report



AMERICAN ACADEMY of ACTUARIES

Objective. Independent. Effective.™

August 29, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803
Submitted via email to: comments@pcaobus.org

RE: *Rulemaking Docket Matter No. 044—Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*

To Whom It May Concern:

On behalf of the Financial Reporting Committee of the American Academy of Actuaries,¹ I appreciate the opportunity to provide comments to the PCAOB related to *Rulemaking Docket Matter No. 044—Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*.

The current version of the document has incorporated many of the [comments](#) that we made to the document “Staff Consultation Paper No.2015-01: The Auditor’s Use of the Work of Specialists” issued May 28, 2015. We particularly appreciate the reference to specialists, who, like the members of the Academy and other U.S. actuarial organizations, are subject to a code of professional conduct, standards of qualification and practice, and a disciplinary process. We support the direction that you have moved in articulating the need for objectivity of auditors’ specialists and for an auditor to obtain an understanding of the approach taken by a specialist of the entity being audited.

In the process of an auditor’s evaluation of the methods and assumptions used by a specialist, the auditor will not have the same type or depth of expertise as the specialist, unless employing or engaging its own specialist. The description of what it means for the auditor to perform this evaluation should make clear the intent of the auditor’s evaluation. One interpretation of the intent of the auditor’s evaluation could be that the methods and assumptions used are reasonable for the particular facts and circumstances involved. Another interpretation is to help ensure that the explanation provided by the specialist is consistent with common practice as noted by both the specialist and the observations of the auditor, as well as to appropriately apply analytics on the results of the specialist’s work, as appropriate.

¹ The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policy makers by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

We continue to value the opportunity to work with auditors either on behalf of the auditor or for the entity being audited. We emphasize the importance of actuaries working in a professional manner in these circumstances—our profession has a specific standard that defines appropriate practice for actuaries during the course of an audit. Actuarial Standard of Practice No. 21, *Responding to or Assisting Auditors or Examiners in Connection with Financial Audits, Financial Reviews, and Financial Examinations*, describes the guidance which the Actuarial Standards Board has provided to actuaries who are responding to an auditor or assisting an auditor. This actuarial standard of practice emphasizes many of the same considerations that are described within Docket No. 44—i.e., planning, scoping, data, and discussions related to methods and assumptions.

Thank you for this opportunity to provide our views on the PCAOB’s *Rulemaking Docket Matter No. 044—Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*. If you have any questions or would like to discuss this letter in more detail, please contact Nikhail Nigam, the Academy’s policy analyst for risk management and financial reporting matters, at nigam@actuary.org or 202-785-7851.

Sincerely,

Gareth Kennedy, MAAA, ACAS
Chairperson, Financial Reporting Committee
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August 28, 2017

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Re: PCAOB Rulemaking Docket Matter No. 043: *Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements*

PCAOB Rulemaking Docket Matter No. 044: *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

Dear Madam Secretary:

We are pleased to provide comment to the Public Company Accounting Oversight Board (PCAOB or Board) and the staff of the Office of the Chief Auditor (the Staff) regarding the recently issued proposed auditing standard related to auditing estimates, including fair value measurements (Release No. 2017-002), and the related proposed amendments to auditing standards related to the auditor's use of the work of specialists (Release No. 2017-003). As noted in each of these proposals, the standards are closely related and auditors will need to consider both in planning and executing audits where these issues arise. As such we believe it is most efficient for us to comment with one letter addressing our observations in both proposals.

We commend the Staff's efforts in these two areas and believe the final adoption of these standards should improve audit quality. Providing enhanced clarity to the public company auditors enables them to apply their judgment in a reasonable and consistent manner, based on risk assessments and clear guidance. We also are appreciative of the deliberative approach that the Staff undertook in drafting these two standards. The opportunities afforded to stakeholders in the financial reporting process to provide feedback was unprecedented and we believe this model should become the norm for any future standard setting.

Baker Tilly Virchow Krause, LLP (Baker Tilly), is a large regional accounting firm operating primarily in the Midwest and Mid-Atlantic regions. We have approximately 2,700 total staff and 300 partners. We have fewer than 100 issuer audit clients and are a triennially inspected firm. Our issuer practice consists primarily of smaller, non-accelerated filers in various industries, including financial institutions as well as a substantial complement of 11-K audits. Although we are a top 15 ranked firm, our organization is substantially different from a "big four" firm.

Our comments will be in the form of general and specific observations rather than answering the questions posed in the proposals.

Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements*

We agree with the Staff's approach in simplifying the current AS structure, by replacing AS 2501, 2502, and 2503 with one new auditing standard addressing the issues. The existence of three related standards made it difficult for auditors to navigate among the standards to be certain that all the requirements were met. We also appreciate that this proposal finally provides guidance for how the use of pricing services articulates within the two standards. For a smaller firm with a larger financial institution practice, this guidance is very important. Specific comments:

- Appendix 1: Proposed Auditing Standard AS 2501: *Auditing Accounting Estimates, Including Fair Value Measurements*
 - 09: We believe the phrase "free from bias," to be overly broad and appears to be absolutism. Audits are designed to determine whether the financial statements as whole are free from material misstatement, as noted in paragraph .24 of AS 2810. This phrase seems to elevate the concept into a particular measurement(s) in the financial statements. We recommend clarifying this is meant solely in the context of the financial statements as a whole.
 - 10 b: We wonder if this is too narrow a requirement. We agree that the auditor should consider industry practices, when available. But, there may be circumstances where use of another approach may be more appropriate for the issuer. In those cases the auditor should document management's rationale for the departure and consider as part of the risk assessment related to the estimate.
 - 30 b, c: Each of these sub-paragraphs could be interpreted as a presumption that bias always exists in accounting estimates. We recommend inserting the word "potential" before each reference to bias in these sub-paragraphs. We believe these changes are consistent with other PCAOB auditing standards, including AS 1015.09 and the proposed amendment to AS 1015.11. We believe this change is also consistent with the footnote references to AS 2810.24 through .27. Specifically:
 - Sub-paragraph .30b states "...including bias in management's judgments..." with a footnote reference to AS 2810.24 – .26. AS 2810.24 references "potential bias" in the context of the "financial statements as a whole." Similarly, the description of bias in AS 2810.26 is preceded by the word "if."
 - Sub-paragraph .30c states "Evaluating bias in account estimates" with a footnote reference to AS 2810.27. However, AS 2810 includes the words "potential" and "possible" in describing the auditor's evaluation of the presence of bias.

While we have no disagreement with the performance requirements of AS 2810, we recommend the proposed standard in AS 2501 uses consistent language and does not inadvertently extend the auditor's responsibility to determining whether actual bias exists. Determining actual bias requires insight into the intentions of management, which is beyond the scope of auditing. While auditors can assess the appearance of or potential for bias, definitively determining whether bias actually exists could require a forensic examination or behavioral analysis that is beyond the scope of an audit. We believe AS 1015.09 appropriately describes role of the auditor in exercising professional skepticism in an audit.

- Appendix 2: Proposed Amendments to AS 1105, *Audit Evidence*, Appendix A—*Audit Evidence Regarding Valuation of Investments Based on Investee Financial Condition or Operating Results*
 - A2 d: We object to this requirement as it appears to imply that audits conducted in accordance with US GAAS or IAASB audit standards are somehow inferior to PCAOB audits. For many investees this is irrelevant.
 - A4-.A5: Some of the requirements in these paragraphs imply an ability by the investor to obtain direct access to the investee auditor or in some cases the actual books and records of the investee. This in turn implies a level of control being exercised by the investor that may not be the case. We urge the Board to reconsider these requirements.

Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

In our previous letter to the Staff commenting on the related Staff Consultation Paper (Comment Letter No. 11), we stated the following, which we continue to believe should be the cornerstone of any new standard addressing the use of specialists:

- Baker Tilly welcomes the Staff Consultation Paper (CP) on AU 336. We agree that the use of specialists has become more prevalent as a result of the need for more complex estimates and fair value measurements in preparing financial statements. We encourage the Staff to carefully consider enhancements to AU 336 but do not agree with rescinding the standard. AU 336 and the principles therein have been a cornerstone of the auditing profession for many years, in particular, the concept contained in paragraph .06 *"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."* When applied properly, AU 336 enables smaller auditing firms to conduct high quality audits that may include complex measurements and estimates. Therefore any revisions to AU 336 should be made in a way that is operational, sustainable, and scalable for smaller auditing firms. We believe retaining this flexibility in the auditing standard should be an important public policy consideration when the Staff is developing any potential new standard.

Specific comments:

- Proposed Amendments to AS 1105, *Audit Evidence*
 - 08: We strongly agree with the statement in the second bullet about the impact of management's controls on the reliability of evidence generated internally and with the aid of a company's specialist. We recommend that this concept should be directly linked into the risk assessment standards when considering risk related to estimates. A cross reference may be helpful.
 - Appendix B – *Using the Work of a Company's Specialist as Audit Evidence*
 - B4: While we understand this requirement is addressing the objectivity of the company specialist, we believe there are practical limitations as to what exactly an auditor can do beyond inquiry and maintaining an awareness of observing potential indicators as to the lack of objectivity. We also believe that this might be an area where representations by management may be useful and should be required.
 - B5: We also believe there is a practical limit on obtaining evidence related to the company-engaged specialist's competence and objectivity regardless of the importance of the estimate. We suggest that if this is the Board's intent, then some practical guidance on what the auditor could actually do to increase scrutiny in this area should be provided in the proposed auditing standard.



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August 30, 2017

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Re: PCAOB Rulemaking Docket Matter No. 044: *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

Dear Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting Oversight Board's (the PCAOB or the Board) *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (the Proposal). Consistent with the views expressed in our letter dated July 31, 2015 on the PCAOB Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*, we are supportive of strengthening the requirements for evaluating the work of a company's employed or engaged specialist, including the application of a risk based supervisory approach to the use of specialists. As the use of the work of specialists has grown, in large part due to the increase in the use of fair value measurements in financial reporting frameworks, the importance of assessing the work of specialists has become an essential component in many audits.

Our comments focus on the following more significant topics within the Proposal as follows:

1. Amendments to AS 1105, *Audit Evidence*
2. Supervision of the Work of Auditor-Employed Specialists - Amendments to AS 1201, *Supervision of the Audit Engagement*
3. Using the Work of an Auditor-Engaged Specialist - Replacement of Extant AS 1210, *Using the Work of a Specialist*
4. Other Matters

1. Amendments to AS 1105, *Audit Evidence*

We note that the proposed amendment to AS 1105, *Audit Evidence* (AS 1105), would supplement the requirements in AS 1105 to address circumstances where the auditor uses the work of the company's specialist as audit evidence. We support the inclusion of a separate section within AS 1105 to address the audit considerations in such circumstances; however, we have provided suggestions below that we believe will enhance auditor performance and improve audit quality.



Office of the Secretary
 Public Company Accounting Oversight Board
 Page 2 of 5

Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

Paragraph .B4 of the Proposed Appendix to AS 1105 states:

The auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company) - specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgment about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise).

We note that the proposed paragraph uses the phrase 'relationship to the company' rather than the term 'objectivity' in describing the auditor's responsibility to assess whether the company has the ability to significantly affect the specialist's judgment. We are concerned that the phrase 'relationship to the company' may be narrowly focused on the relationship between the specialist and the company and not focused more broadly on the 'possible effects that bias, conflict of interest or the influence of others, including the company, may have on the professional or business judgment of management's expert.'¹ For this reason we suggest replacing the phrase 'relationship to the company' with the term 'objectivity.'

Furthermore, we believe that the following factors may be helpful to auditors in assessing the objectivity of the specialist and therefore suggest including these within the Proposal:

- The nature, scope, and objectives of the work of the company's specialist
- The extent to which management can exercise control or influence the work of the company's specialist
- Whether the company's specialist is subject to professional ethical or independence standards
- Threats to the specialist's objectivity from both within and outside the company

The Work of the Company's Specialist

Management Use of an External Specialist

Paragraph .B1 of proposed Appendix B to AS 1105 explains that this appendix applies with respect to both the work of an employed or engaged specialist. However, we are concerned that this approach may result in duplication of work by the auditor's specialist in circumstances where the company engages their own external specialist with appropriate knowledge, skills, and objectivity, without a corresponding increase in audit quality. In such a situation, the company would incur not only the costs of engaging a specialist to develop the accounting estimate but the auditor's costs to engage or employ a separate specialist to develop an independent estimate as well. Accordingly, we suggest that the nature and extent of

¹ ISA 500, *Audit Evidence*, paragraph A37.



Office of the Secretary
Public Company Accounting Oversight Board
Page 3 of 5

procedures to obtain sufficient appropriate evidence when the company engages its own external specialists should differ from when an external specialist is not employed by the company.

Use of Restrictions, Disclaimers, and Limitations

The use of restrictions, disclaimers, and limitations in specialist's reports results in challenges for the auditor in considering the results of the work of the specialist as part of audit evidence. Accordingly, we support the addition of guidance in paragraph .B9 of the proposed Appendix B to AS 1105 that explains the factors that affect the relevance and reliability of the company's specialist's work, which include the nature of restrictions, disclaimers, or limitations in the specialist's report since it is not infrequent that these reports include such language. Moreover, in practice, the use of restrictions, disclaimers, and limitations is not solely an issue relating to the work of company specialists and, therefore, we suggest including similar guidance relating to the auditor's engaged specialist's report.

2. Supervision of the Work of Auditor-Employed Specialists - Amendments to AS 1201, *Supervision of the Audit Engagement*

We support the addition of an appendix to AS 1201, *Supervision of the Audit Engagement* (AS 1201), to specifically address the application of a risk based supervisory approach in the circumstance when an auditor employs a specialist. Moreover, we agree that the extent of supervision should be based on the significance of the specialist's work to the auditor's conclusion on the relevant assertion, the risk of material misstatement, and the knowledge, skill, and ability of the specialist.

A Firm's System of Quality Control

QC Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC 20), provides guidance regarding quality control procedures to ensure that a firm's services are competently delivered and adequately supervised. This includes personnel management policies which encompasses hiring, assigning personnel, professional development, and advancement activities, among other matters. While paragraph .C3 of Proposed Appendix C to AS 1201 states that 'The requirements in PCAOB auditing standards for assigning personnel based on their knowledge, skill, and ability are applicable to assigning auditor-employed specialists, we believe QC 20 more fully encompasses the considerations relating to the appropriate assignment of personnel and therefore suggest reference to QC 20 within AS 1201.

Furthermore, with respect to the requirement in paragraph .C4 relating to PCAOB independence and ethics requirements, similar to our comment above, we believe reference to QC 20 more fully describes the independence, integrity, and objectivity requirements. For example, paragraph .09 of QC 20 explains that policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.



Office of the Secretary
Public Company Accounting Oversight Board
Page 4 of 5

3. Using the Work of an Auditor-Engaged Specialist - Replacement of Extant AS 1210, *Using the Work of a Specialist*

Paragraph .05 of proposed AS 1210 states 'The engagement partner and, as applicable, other engagement team members performing supervisory activities should not use a specialist who does not have a sufficient level of knowledge, skill, and ability or lacks the necessary objectivity.' While we agree with this statement, we believe additional explanation is needed to promote consistent application across firms and engagement teams. For example, as described previously on page 2, we believe inclusion of the following factors would be helpful in assessing objectivity.

- The nature, scope and objectives of the work of the specialist
- The extent to which management can exercise control or influence the work of the specialist
- Whether the specialist is subject to professional ethical or independence standards
- Threats to the specialist's objectivity from both within and outside the company

Moreover, the degree of objectivity should not be characterized as an 'on - off' switch; either the specialist is objective or not. Rather, we believe auditors should consider objectivity as a continuum such that the less objective the auditor's engaged specialist, the greater the safeguards needed to address any threats. Additionally, we suggest that the auditor would perform further procedures in focused areas of higher assessed risk. However, if the auditor determined that the objectivity of the auditor's engaged specialist is impaired, the auditor would not use the work of that auditor's engaged specialist.

4. Other Matters

Applicability

We support application of the proposed amendments to emerging growth companies (EGCs) and brokers and dealers that are required to be conducted in accordance with PCAOB standards, since we believe the proposed guidance would benefit users of financial information of these entities.

Effective Date

To ensure audit firms have the necessary time to update firm methodologies, develop and implement training, and ensure effective quality control process to support implementation, similar to our suggestion within our comment letter relating to Rulemaking Docket Matter No. 043, we suggest providing for an effective date for audits of fiscal years beginning two years after the Securities and Exchange Commission approves the final standard.

* * * *



Office of the Secretary
Public Company Accounting Oversight Board
Page 5 of 5

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Christopher Tower, National Managing Partner - Audit Quality and Professional Practice at 714-668-7320 (ctower@bdo.com), Phillip Austin, National Managing Partner - Auditing at 317-730-1273 (paustin@bdo.com), or Patricia Bottomly, Partner - National Assurance at 310-557-8538 (pbottomly@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP



August 31, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter 044 – Release No. 2017-003: *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*

Dear Office of the Secretary:

BKD, LLP is pleased to provide our comments on the Public Company Accounting Oversight Board’s (PCAOB or Board) *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists* (the Proposal).

BKD, LLP (BKD) is the 12th largest public accounting firm in the United States, with over 2,600 personnel serving clients from 35 offices in 16 states. We have been registered with the PCAOB since its inception and serve as the independent registered public accounting firm for approximately 75 public companies. Our comments come from our perspective as a medium-sized accounting firm and the middle-market clients we serve.

We support the PCAOB’s desire to strengthen the requirements that apply when auditors use the work of specialists in an audit and agree with the PCAOB’s assessment that the use and importance of specialists has increased in recent years, due to additional fair-value requirements and the complexity of business transactions. BKD advocates targeted improvements that would be both operational and scalable for all accounting firms.

Regarding the Board’s proposed amendments, we have several relatively minor concerns but generally are supportive of the amendments as proposed to AS 1201, *Supervision of the Audit Engagement*, and the replacement of AS 1210, *Using the Work of an Auditor-Engaged Specialist*. We have some significant concerns, however, relating to the proposed amendments to AS 1105, *Audit Evidence*. In order to keep the focus on our most substantial concerns, we are limiting our detailed comments to those items in the Proposal where our views most significantly diverge from the Board.

While we are encouraged by the Board’s efforts to implement a risk-based approach when using the work of specialists, we believe the proposed standards as written may result in quite the opposite. That is, a more formulaic and rules-based approach that diminishes the value of

Office of the Secretary
Public Company Accounting Oversight Board
Page 2
August 31, 2017

auditor judgment and risk assessment. Based on the discussion in the Proposal accompanying the proposed changes, we do not believe this is the PCAOB's intent and suggest the Board further evaluate how the proposed standards would be operationalized in order to fully appreciate the consequences.

Using the Work of a Company's Specialist as Audit Evidence

Testing and Evaluating the Work of the Company's Specialists

We note the Board's assertion that "(t)he proposed requirements are aligned with the Board's risk assessment standards, so that the necessary audit effort is commensurate with, among other things, the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and the associated risk."¹ However, our experience with interpretations of PCAOB auditing standards informs us that a literal read of each paragraph in a given standard is required. Based on this perspective of interpreting standards, it seems possible and even likely that certain paragraphs in the proposed Appendix B to AS 1105 will create a de facto requirement for auditors to employ or engage specialists whenever an audit client uses a specialist to provide audit evidence.

Our concern on this point is the result of considering the proposed language in AS 1105 paragraphs .B6 and .B8. By definition, "a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing."² While auditors are required to have skills and knowledge in the fields of accounting and auditing in order to apply due professional care in performing their audit engagements, in general, auditors are not expected to have similar special skills or knowledge in areas other than accounting or auditing, where specialists are used.

Specifically in proposed paragraphs 1105.B6a and 1105.B8(3), the Proposal indicates the auditor's procedures to test and evaluate the work of a company's specialist involves "evaluating whether the data was appropriately used by the specialist." Given that auditors cannot be expected to have the special skill or knowledge that the specialist has, it appears that a rebuttable presumption exists in the proposed standards that the auditor would not be able to accomplish these procedures without engaging or employing their own specialist to appropriately make such evaluations.

Further, proposed paragraph 1105.B8 provides "(t)he auditor also should evaluate whether the methods used by the specialist are appropriate and the significant assumptions used by the specialist are reasonable." Again, it is unclear how an audit professional without the expertise or training in the specialist's field or occupation would be qualified to evaluate and conclude on the appropriateness of the methods and assumptions used by the specialist. Rather, we believe there

¹ See page 23 of the Proposal.

² Proposed AS 1105.B1, Footnote 1.

Office of the Secretary
Public Company Accounting Oversight Board
Page 3
August 31, 2017

are many situations when evaluating the qualifications and work of specialists under existing standards provides an appropriate audit response to address the risk of material misstatement. The language in the proposed standards leads us to conclude in situations where an auditor may possess such special skill or knowledge, or determine not to use an auditor's specialist for any reason, it may be difficult to establish and justify the decision not to use an auditor's specialist in the circumstances.

We recommend the Proposal keep the principles of extant AS 1210 on this topic, which explicitly acknowledges that auditors' are "not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation."³

Company Employed vs. Engaged Specialists

We note the Board makes no distinction in the nature and extent of procedures to be performed regardless of whether a company's specialist is employed or engaged. Considering the requirement to evaluate aspects of the specialist's work as noted above, as well as the requirement to comply in certain circumstances with the more detailed procedures in the *Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements*, we believe there are differences that should be considered when determining the appropriate audit procedures in situations where a company engages (rather than employs) a specialist.

While AS 1105.08 provides that "evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources," it is unclear why the Board believes this is not the case when it comes to audit evidence from a specialist. We suggest the guidance in AS 1105.08 should generally remain applicable to audit evidence obtained from specialists. In addition, we believe the proprietary nature of external specialists' models will create significant difficulties in applying the proposed procedures.

The consequences in this instance could create a further need for the auditor to engage another specialist in order to develop an independent estimate, instead of testing the estimate developed by the company. This would result in companies essentially paying for two specialists to create two separate estimates, with potentially no comfort that either estimate would be more appropriate than the other. Additionally, smaller public companies may bear an increased burden in this situation, as they and their accounting firms are more likely to need to engage external specialists for specific situations where they do not have the economies of scale and scope to economically employ relevant specialists.

³ Extant AS 1210.06.

Office of the Secretary
Public Company Accounting Oversight Board
Page 4
August 31, 2017

BKD supports the PCAOB's endeavors to further audit quality. Additional specificity and clarity around the use of specialists benefits the profession given their increasing importance. However, we believe the interpretation and implementation challenges of the Proposal may result in a de facto requirement for auditors to employ or engage specialists in all situations where a company also employs or engages its own specialist. Further, smaller firms' limited resources and scale make it impossible to retain the variety of in-house specialists needed for multiple types of complex business transactions, and thus they and their middle-market clients will bear a disproportionate burden. The scalability of enhancements to auditing guidance is critical to ensuring a sustainable playing field for all public accounting firms without compromising audit quality. In addition to considering standard-setting updates, we encourage the PCAOB to continue to issue additional guidance when the inspection process reveals consistent departures from the current guidance on the use of specialists.

We appreciate the opportunity to express our views for the Board's consideration. If you have any questions or would like to discuss these matters further, please contact Doug Bennett at 417.831.7283 or by email at dbennett@bkd.com or Peter Kern at 417.831.7283 or by email at pkern@bkd.com.

Sincerely,

Handwritten signature of BKD, LLP in black ink.

BKD, LLP



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August 23, 2017

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PCAOB Release No. 2017-003
Proposed Amendments to Auditing Standards
For Auditor's Use of the Work of Specialists

The California Society of CPA's ("CalCPA") Accounting Principles and Assurance Services Committee (the "Committee") is the senior technical committee of CalCPA. CalCPA has approximately 43,500 members. The Committee consists of 55 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee has provided responses to the specific questions set forth in the Release below.

Question:

1. Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

The Committee believes the information accurately reflects the state of current practice for both large and smaller CPA firms and represents a reasonable starting point for an evaluation of the relevant PCAOB auditing standards. The Committee also notes the Board has developed a more measured response in response to the issues previously identified in PCAOB Staff Consultation Paper No. 2015-01 ("2015-01"). The Committee was critical of the PCAOB staff's initial response to the issues, as communicated in our comment letter on 2015-01 submitted in July 2015.

2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?

The Committee believes the Board has appropriately addressed the reasons to improve the current standards and agrees that separating the standards by company specialist, auditor-employed specialist and auditor-engaged specialist will hopefully facilitate better application in practice, especially with smaller CPA firms.

3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

The Committee is not aware of other areas of practice involving the use of specialists that ought to be addressed by the Board at this time.

4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

The Committee, which is composed of members from a wide range of CPA firms of all sizes, believes the Board's current proposal can be effectively implemented through enhanced training and development of internal guidance at minimal cost to the CPA firm and its clients. The Committee is not aware of any external studies regarding the economic impacts of the proposal.

5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

See our response to Question 4.

6. The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

None that are not already reflected as the basis for the Board's proposal.

7. The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

See our response to Question 4.

8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?

The Committee believes the Board's proposed responses to the issues raised in the proposal are well founded and should not have any significant unintended consequences. While it is likely smaller CPA firms might not have the economic resources to have employed specialists in several specialized fields, the availability of engaged specialists should minimize the overall economic costs to the firm's clients requiring such services.

9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

As we have stated in our responses to several of the previous questions, the Committee believes the Board's proposal can be effectively implemented with minimal cost to the CPA firms and their clients, and the Committee is not aware of any unintended consequences arising from the new standard's implementation.

10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

The Committee believes the Board's current approach to the use of specialists is the most effective and preferable means to achieve the intended objectives. The auditor's ability to assess the objectivity of the auditor-engaged specialist is an important element under the proposed standard.

11. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

None that the Committee is aware of.

12. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

The Committee is not aware of any reason to support the differential application of the proposed auditing standard, or any PCAOB audit standard, to the audit of an EGC. Consistency in the

application of PCAOB audit standards to similar situations encountered in any audit should be at the forefront of any of the Board's standard setting efforts. The Committee also sees no need for a different effective date for an audit of an EGC.

13. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

None that the Committee is aware of.

14. How much time following SEC approval would audit firms need to implement the proposed requirements?

Assuming the Board were able to finalize the proposal and obtain SEC approval by the 4th quarter of 2017, application for audits of entities with fiscal years ending on or after December 15, 2018 would allow sufficient time for implementation. The Committee does not see the need for a two-year deferral as suggested in the proposal.

15. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

No. See the Committee's response to Question 14.

16. Is it appropriate to retain the existing meaning of the term "specialist" in current auditing standards? Do auditors understand the existing meaning of the term and when a person (or firm) is a specialist? If not, what changes are necessary?

The Committee believes the general term "specialist" is understood as currently set forth in the PCAOB auditing standards, and as set forth in paragraph B1(note 1) of proposed Appendix B of AS 1105, *Audit Evidence*. However, the proposal's emphasis on the three specialist categories, and how the proposed standard would be applied to each category, is a welcome addition as clarity of the auditor's responsibilities in each situation is needed.

17. Are the other terms used in the proposal—"company's specialist," "auditor- employed specialist," and "auditor-engaged specialist"—clear and appropriate for purposes of the Board's proposal? Do these terms align with the role of each of these specialists in the audit?

The Committee believes the three categories are clearly defined in the proposal and are aligned with the role of each in the audit.

18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?

The Committee is not aware of any challenges associated with a specific industry that would require additional guidance in the proposed standard.

19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?

The Committee believes the proposed requirements are scalable based on the auditor's assessment of the risks associated with the use of the specialist's work and do not present any specific challenge to its adoption.

20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.

The procedures set forth in proposed Appendix B of AS 1105, *Audit Evidence*, will require more time to complete by smaller CPA firms, and will likely require the use of specific audit program or template to insure the required elements have been met. However, the members of the Committee from larger firms believe the enhancements can be implemented in a cost effective manner.

21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?

The Committee supports the inclusion of procedures to evaluate the company's underlying internal control processes for using the work of company specialists as integral to the auditor's overall understanding of the information system relevant to financial reporting.

22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?

The Committee believes the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company are clear and very appropriate. The Committee believes that the clarification of the auditor's responsibilities may require more effort by smaller CPA firms that infrequently encounter the use of a company specialist than CPA firms with more experience in the use of company specialists.

23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?

The examples of situations requiring tailoring the nature, timing and extent of procedures applied to the work of a specialist in response to the auditor's risk assessments are useful. The Committee believes the proposed guidance is sufficient without the need for additional examples.

24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

The Committee believes the proposed requirements to evaluate the relevance and reliability of the company specialist's work are clear and appropriate.

25. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

The Committee does not see the proposed approach to evaluating the work of the company's specialist to be unusually challenging.

26. Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?

The proposed clarified requirements for determining the extent of supervision of the auditor's employed specialist in an appendix to AS 1201 *Supervision of the Audit Engagement*, and the proposed replacement of AS 1210 *Using the Work of a Specialist* with a proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist* suitably highlights the differences in approach required in each situation.

27. Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?

The Committees considers the proposed requirements scalable based on the auditor's risk assessments and the significance of the work of the specialist to the financial reporting process.

28. Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?

The Committee believes the proposed requirements for establishing and documenting the understanding with the specialist are sufficiently clear and appropriate, and should assist in fostering effective two-way communication.

29. To what extent would the proposed requirement for establishing and documenting the understanding with the specialist represent a change in current practice? If so, what is that change?

The Committee believes that smaller CPA firms would experience the greatest challenges to compliance with the proposed requirements but these challenges can be overcome through the use of practice aids that will be developed by various third party vendors.

30. Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

The Committee believes the proposed guidance is sufficiently clear to facilitate a clear link between the understanding and the evaluation of the specialist's work product.

31. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-employed specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

The Committee believes the proposed guidance is sufficiently comprehensive to facilitate the intended objectives of the Board. Further refinements that might arise in the initial implementation of the new standard can be evaluated through the PCAOB's inspection program.

32. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

At this point, the Committee believes the Board's proposed approach is sufficiently detailed to facilitate implementation by both large and smaller CPA firms without causing undue challenges.

33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

The Board has taken pains to differentiate the approach to be taken in evaluating the independence/objectiveness of the auditor-employed and auditor-engaged specialist, which is an important outcome of the revision to AS 1210. The Committee does not see the need to establish any additional requirements at this time.

34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?

The Committee believes the greatest challenge in using the work of the company's employed or retained specialist is establishing the true objectivity of a company's employed specialist. In that regard, the Committee believes there was some validity in the expressed view that the work product of a client's employed or retained specialist be looked upon no differently as any other piece of client supplied information. To some extent, that view impacts current practice today. The Board's proposed guidance for assessing the objectivity of an auditor-engaged specialist is sufficiently clear.

35. Does the proposed requirement to assess the objectivity of the auditor-engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?

The Committee believes the process of assessing the objectivity of the auditor-engaged specialist was reasonably developed in current practice. Therefore, the current proposal should not create any special challenges.

36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?

The Committee believes the proposed requirements are sufficiently clear and appropriate.

37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?

As stated in the Committee's response to Questions 35 and 36 above, we do not see any specific challenges developing regarding the implementation of the proposed standard for establishing an understanding with an auditor-retained specialist. The principal change would be in more clearly documenting the objectivity of the auditor-retained specialist and the communications regarding the scope of services for the intended work product.

38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

The Committee believes the proposed standards for evaluating the work of the auditor-engaged specialist are sufficiently clear and suitably linked.

39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

At this point, the Committee believes the proposed standard is sufficiently comprehensive and does not require additional guidance.

40. Is rescinding AI 11 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

The Committee concurs with the Board's plan to delete the Auditing Interpretation regarding the use of a legal opinion in this very fact specific situation.

41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

The Committee concurs with the Board's plan to delete the Auditing Interpretation regarding income tax accruals and use of tax opinions from company legal counsel and tax advisors.

42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?

The Committee does not see any need to change any of the proposed amendments.

43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210?

The Committee is not aware of the need for further amendments at this time.

The Committee would be glad to discuss our responses further should the Staff have any questions or require additional information.

Very truly yours,



Matthew J. Lombardi
Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants



California State Teachers'
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September 6, 2017

Via Email: comments@pcaobus.org

Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 044 – Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists

Dear Secretary Brown:

I am writing on behalf of the California State Teachers’ Retirement System (CalSTRS) in response to the Public Company Accounting Oversight Board’s (PCAOB, Board) request for written comments to the proposed amendments to auditing standards for auditor’s use of the work of specialists, Release No. 2017-003, Docket Matter No. 044. CalSTRS appreciates the work of the PCAOB and its efforts in proposing these amendments to further investor protection by strengthening the requirements for evaluating the work of a company’s employed or engaged specialist. We support the need to apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.

CalSTRS is the largest educator only pension fund in the world, with a global investment portfolio valued at approximately \$213.5 billion as of July 31, 2017.¹ CalSTRS’ mission is to secure the financial future and sustain the trust of California’s educators. We serve the investment and retirement interests of approximately 914,000 plan participants and their beneficiaries. It is important to us with long-term nature of CalSTRS liabilities, the composition of our portfolio with more than fifty six percent (~\$119.7 billion) of our current fund’s assets being invested in the public equity market; that rules and regulations continue to evolve, especially since the Board observed substantial diversity in practice regarding the use of the work of specialists. CalSTRS has a vested interest in ensuring the integrity, stability and efficiency of the capital markets to pay out benefits to CalSTRS’ beneficiaries, California teachers.

Just as CalSTRS employs and contracts with specialists, it is essential to clearly articulate the scope of work and adequately evaluate the work of specialists. Especially, since the “PCAOB

¹ CalSTRS Current Investment Portfolio for the period ending July 31, 2017.
<http://www.calstrs.com/current-investment-portfolio>

Phoebe W. Brown, Secretary
9/6/2017
Page 2 of 2

inspection staff continues to observe deficiencies related to auditors' use of specialists' work, and with these deficiency factors that enhancements to PCAOB standards on using the work of specialists are needed."

CalSTRS commends the Board in its efforts to strengthen the requirements for evaluating the work of a company's specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists. We agree these proposed amendments will promote an improved, more uniform approach to supervision of an auditor's specialists. CalSTRS is optimistic that improving the audit requirements in using the work of specialists may also enhance the reliability of the auditor's opinion.

CalSTRS supports amending the audit standards to strengthen the requirements for auditor's use of the work of specialists. If you have any questions or would like to discuss this letter further, please do not hesitate to contact me at 916-414-7410, ASheehan@calstrs.com or Mary Hartman Morris, Investment Officer at 916-414-7412, MMorris@CalSTRS.com.

Sincerely,



Anne Sheehan
Director of Corporate Governance
California State Teachers' Retirement System



**CENTER
FOR AUDIT
QUALITY**

Serving Investors, Public Company Auditors & the Markets

August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

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Re: PCAOB Rulemaking Docket Matter No. 044: *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs (AICPA). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to share our views and provide input on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (the Proposal).

Similar to views previously expressed on this topic, which includes our framework,¹ the CAQ applauds the PCAOB's efforts to consider ways to further investor protection by strengthening the requirements for evaluating the work of a company's employed or engaged specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.²

We have organized our detailed observations and suggestions on the Proposal as follows:

- I. General Views
- II. Amendments to PCAOB Auditing Standard 1105, *Audit Evidence* (AS 1105)
- III. Amendments to PCAOB Auditing Standard 1201, *Supervision of the Audit Engagement* (AS 1201)
- IV. Amendments to PCAOB Auditing Standard 1210, *Using the Work of a Specialist* (AS 1210)
- V. Applicability
- VI. Effective Date
- VII. Conclusion

I. General Views

As noted within the Proposal³ there are companies across many industries using specialists to assist in developing accounting estimates, interpreting laws, contracts, evaluating characteristics of certain physical assets, in addition to other areas. Our letter will focus on the following areas where we believe additional clarity could be provided for the roles of specialists in the audit. First, we support using the term "objectivity" versus the phrase "relationship to the company." Second, we continue to believe in the core principle that the auditor is not expected to have the expertise of another profession as interpreted from paragraph 12 of AS 1210. Third, a requirement for auditors to apply the same auditing procedures to accounting estimates regardless of whether or not management uses an external specialist could have unintended consequences. Fourth, we would encourage multiple options in the acceptable forms of communications with specialists on work to be performed and those acceptable forms of communication should be explicitly stated within the Proposal. Lastly, we are concerned about the potential consequences of rescinding Audit Interpretation (AI) 11 which deals with the use of legal opinions as audit evidence.

II. Amendments to PCAOB Auditing Standard 1105, *Audit Evidence* (AS 1105)

Assessing the knowledge, skill and ability of the company specialist and the specialist's relationship to the company

We support using the term "objectivity" versus the phrase "relationship to the company" for company specialists (employed or engaged) analogous to the Proposal for auditor-engaged specialists.⁴ When evaluated appropriately, a specialist's relationship to the company would be considered within the assessment of a specialist's objectivity. Evaluating the degree of objectivity of a company's specialist should

¹ See the comment letter from the CAQ on this topic dated July 31, 2015, <http://www.thecaq.org/pcaob-auditor%E2%80%99s-use-work-specialists>, and *Auditing Accounting Estimates and Fair Value Measurements: A Framework*. Both can be found in the Appendix of the CAQ's comment letter submitted to the PCAOB and publicly available on the [PCAOB's Docket 043](#).

² See page 1 of the Proposal.

³ See page 1 of the Proposal.

⁴ See page A1-20 of the Proposal.

be viewed as a continuum that affects the nature, timing, and extent of audit procedures. An auditor may consider, among other things:

- a) Any interests and relationships that create threats to the specialist's objectivity, such as threats relating to self-interest, advocacy, familiarity, self-review, and intimidation, as well as any applicable safeguards, including any professional requirements that apply to the specialist, and evaluation of whether such safeguards are adequate;
- b) Threats to a specialist's objectivity posed by an employment relationship and whether there is any direct reporting by the specialist;
- c) The terms of the agreement to engage the specialist, including whether, and if so, how, the payment structure is tied to a particular outcome;
- d) Whether management has the ability to dictate revisions to the specialist's results before finalization (with or without the agreement of the specialist);
- e) The significance of the relationship between the engaged specialist and management (i.e., whether the specialist has an extensive relationship with management, and whether the fees charged by the specialist are material to the specialist); and
- f) The nature of other services provided by the specialist to the company.

It is our view that while evaluating objectivity, the auditor would evaluate the specialist's relationship with the company and use knowledge of the risks related to the accounting estimate to determine whether additional procedures should be performed with respect to some or all of the specialist's assumptions, methods, or conclusions, including whether the auditor should consider using an auditor's specialist for that purpose.

Using the work of the company's specialists as audit evidence

Paragraph .B2 of the Proposal states that "the auditor should, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, obtain an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls." Unless clarified, this could be interpreted that auditors need to evaluate, not just understand, the design of controls in this area in all circumstances even when not relying on those controls. We suggest the phrase "and controls" be deleted and a footnote be included to highlight that this is intended to build upon the requirement in paragraph .28 of PCAOB Auditing Standard 2110, *Identifying and Assessing Risks of Material Misstatement*.

Further, paragraph .B2c indicates that the auditor should understand "the company's process for selecting and using the work of specialists." It is not clear what is meant by "selecting" in this sentence. The statement appears to be referring to the process by which the company chooses one specialist over another. If the specialist selected is objective and competent, explicitly requiring an understanding of the selection process seems unnecessarily prescriptive.

Testing and evaluating the work of the company's specialists

The proposed amendments to paragraphs .B6a and .B8(3) of AS 1105 seem to suggest that the auditor would need to evaluate whether the data was "appropriately" used by the specialist. It is unclear whether this requirement is intended to be similar to paragraph .14 of *Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements* (Estimates Proposal). 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

and based on auditor judgment, may encounter matters that require such specialized skill. The additional proposed requirements in .B8 that “the auditor should evaluate whether the methods used by the specialists are appropriate and the significant assumptions used by the specialists are reasonable” would require an elevated level of knowledge by the auditor.

The Note to paragraph .B8 indicates that the auditor should also comply with the requirements in paragraphs .09 - .18 of the Estimates Proposal, if the company's specialist assisted the company in developing an accounting estimate. We suggest that the nature and extent of procedures should not be the same when a company employed specialist develops an accounting estimate themselves as opposed to when management uses a company-engaged specialist (i.e., an external specialist) that is competent and objective. Furthermore, certain of these procedures may not be practicable given the proprietary nature of certain specialist models or the auditor’s lack of sufficient knowledge of the specialist’s field to perform all the procedures in these paragraphs. We recommend the Proposal keep the principles of extant AS 1210 in regards to this topic.

A requirement for auditors to apply the same auditing procedures to accounting estimates regardless of whether or not management uses an external specialist could have unintended consequences. For instance, if auditors are not able to obtain access to the specialist’s proprietary models, the auditor might need to engage another specialist to develop an independent estimate rather than test the estimate developed by the company’s specialist. Consequently, the company would incur both the costs of engaging a specialist to develop the accounting estimate and the auditor’s costs to engage or employ a separate specialist to develop an independent estimate, with an uncertain increase in audit quality, while placing a significant and possibly disproportionate burden on accounting firms that do not have employed specialists on staff. Those firms may determine that they are unable to engage specialists necessary to their audits that enable them to comply with these requirements, which would limit their ability to continue to audit public companies.

The Proposal⁵ provides examples illustrating the necessary audit effort in testing and evaluating the work of specialists. We note that the Oil and Gas impairment analysis, the Allowance for Loan Losses, and the Pension Benefit Obligations examples are often recognized as significant risks already prompting the auditor to do more procedures to gain evidence around the estimates. It is unclear what incremental work would be required to be performed by the auditor as opposed to what is required in extant AS 1105. Providing lower risk examples for contrast would be helpful for the auditor to understand the requirements of the Proposal.

The potential incremental testing outlined above, when coupled with the potential consequences of the suggested requirements in the Proposal regarding the evaluation of an engaged specialist’s relationship to the company could require significant effort, especially in situations where the auditor may not possess the required knowledge or skills related to certain matters encountered in the audit.

III. Amendments to PCAOB Auditing Standard 1201, *Supervision of the Audit Engagement* (AS 1201)

Informing the auditor-employed specialist of work to be performed

We support the Proposal’s requirement to “inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist...”⁶ The language within the Staff Consultation Paper No. 2015-01: *The Auditor’s Use of the Work of Specialists* (Consultation Paper), which does

⁵ See page A3-19 of the Proposal.

⁶ See page A1-18 of the Proposal.

not appear to be included in the potential amended standard, suggests that “evidence of the agreement between the auditor and the auditor’s specialist might be in the planning memorandum, separate memorandum, audit programs, or other related workpapers.”⁷ We believe this provides an appropriate amount of flexibility to the auditor and should be explicitly stated within AS 1201.

Use of restrictions, disclaimers, and limitations

We believe the discussion of restrictions, disclaimers, and limitations in company specialist’s reports (page A3-22 of the Proposal) are equally applicable to situations involving auditor-engaged specialists. Thus, we suggest providing clarity that these same factors may be used by auditors in assessing restrictions, disclaimers, and limitations in auditor’s specialists reports.

IV. Amendments to PCAOB Auditing Standard 1210, *Using the Work of a Specialist* (AS 1210)

Assessing the knowledge, skill, ability, and objectivity of the auditor-engaged specialist

The proposed amendments to paragraph .04 of AS 1210 specify the need for the auditor to evaluate an auditor-engaged specialist’s “relationship to the company.” As noted within our discussion of the proposed amendments to AS 1105, a specialist’s relationship to the company would already be considered within the evaluation of the specialist’s objectivity.

An auditor’s engaged specialist is not part of the accounting firm’s training, resource monitoring, or overall system of quality control. Accordingly, in evaluating the objectivity of an auditor’s engaged specialist, the auditor views objectivity as a continuum that, based on the auditor’s judgment, affects the nature, timing, and extent of the auditor’s procedures and the reliability of the specialist’s work as audit evidence. In evaluating the objectivity of an auditor’s engaged specialist, the auditor may:

- a) Obtain information regarding business, employment, and financial relationships between the auditor’s specialist and the company;
- b) Determine, based on an evaluation of that information, whether there are threats to the specialist’s objectivity (e.g., due to an identified relationship between the specialist and the company); and
- c) If threats to the specialist’s objectivity are identified, evaluate the impact of the relationship on the nature, timing, and extent of the audit procedures, taking into consideration whether the relationship has a significant bearing on the ability of the specialist to perform his or her work objectively.

The proposed amendments to paragraph .05 of AS 1210 suggests that the auditor “should not use a specialist who does not have a sufficient level of knowledge, skill, and ability or lacks the necessary objectivity.”⁸ Our view is that objectivity should be viewed as a continuum that affects the nature, timing, and extent of audit procedures, based on the auditor’s judgment. Therefore, the standard should acknowledge the importance of auditor judgment and the auditor’s overall risk assessment when evaluating whether a specialist’s objectivity is impaired. As the Proposal is currently written, it appears to remove the ability of the auditor to

⁷ See page 38 footnote 74 of the Consultation Paper, https://pcaobus.org/Standards/Documents/SCP-2015-01_The_Auditor's_Use_of_the_Work_of_Specialists.pdf.

⁸ See page A1-21 of the Proposal.

apply judgment and additional audit procedures to continue to use the work of the specialist, when certain relationships are identified.

Informing the auditor-engaged specialist of the work to be performed

Similar to auditor-employed specialists, we support the Proposal's requirement to "inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist..."⁹ The language within the Consultation Paper, which is not included in the proposed amendments to AS 1210, suggests that "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs, or other related workpapers."¹⁰ We believe this footnote provides an appropriate amount of flexibility to the auditor and should be explicitly stated within AS 1210.

Rescission of AI 11

The Proposal, if adopted, would rescind AI 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*. We do not believe that rescinding AI 11 is appropriate because it provides tailored guidance to assist auditors in evaluating the sufficiency of audit evidence to support management's assertion that a transfer of financial assets has met the isolation criterion of Accounting Standards Codification Topic 860, *Transfers and Servicing*.

The Proposal states that AI 11 reflects outdated accounting requirements and banking regulations. Although AI 11 requires updating to reflect the release of Accounting Standards Update (ASU) 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, the ASU did not fundamentally change the de-recognition model in Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (including the legal isolation assertion) that has been in effect since 2001. Insured depository institutions that have sold financial assets that they intend to de-recognize must continue to obtain legal opinions to support the legal isolation assertion (certain amendments to the Federal Deposit Insurance Corporation's "safe harbor rule" in 2010 notwithstanding). AI 11 provides tailored guidance to assist auditors in evaluating the sufficiency of legal opinions as audit evidence. As an example, the interpretation requires that the opinions be expressed at a "would level," identifying certain qualifications that may call into question whether the legal analysis adequately demonstrates that the assets transferred meet the isolation assertion, and clarifying under what circumstances a substantive consolidation opinion should be obtained for entities subject to the US Bankruptcy Code. Finally, the "auditor reliance" language that appears in paragraph 18 of AI 11 allows an auditor to rely on counsel's opinion, despite the absence of contractual privity between the two.

V. Applicability

We agree with the comments set forth in the Proposal that the proposed amendments could benefit audits of emerging growth companies and brokers and dealers that are required to be conducted in accordance with PCAOB standards. Accordingly, we support applicability of the Proposal to those entities.

⁹ See page A1-21 of the Proposal.

¹⁰ See page 38, footnote 74, https://pcaobus.org/Standards/Documents/SCP-2015-01_The_Auditor's_Use_of_the_Work_of_Specialists.pdf.

VI. Effective Date

We recognize the Proposal, if approved, could place a significant and possibly disproportionate burden on accounting firms that do not have employed specialists on staff. The Board should also consider this point as it determines the final effective date. The amount of time a firm needs to prepare for the new standard may be different based upon the resources and staffing available and some firms may need more time to prepare for implementation of the proposed changes.

Audit firms will need to develop and implement training and effective quality control processes to support and facilitate the effective implementation. In order to help ensure smaller firms have sufficient time to prepare, we recommend that the standard be effective for audit periods ending two years after the Securities and Exchange Commission approves the final standard.

VII. Conclusion

The CAQ is supportive of the Board's development of Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists, and commends the Board and its Staff for advancements made in this important area. The CAQ appreciates the opportunity to comment on the Proposal and would be pleased to discuss our comments or answer any questions that the Staff or the Board may have regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

SEC

Jay Clayton, Chairman
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
Wesley R. Bricker, Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Marc A. Panucci, Deputy Chief Accountant
Sagar S. Teotia, Deputy Chief Accountant



Key Observations from Recent CAQ Comment Letters to the PCAOB

This document summarizes certain key observations from recent CAQ comment letters submitted to the PCAOB. It should not be viewed as all inclusive, and should be read in conjunction with all CAQ comment letters applicable to the related proposals and concept releases.

I. Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value

Measurements (Proposed Estimates Standard): In response to the PCAOB’s standard-setting project related to auditing accounting estimates, the CAQ has submitted multiple comment letters¹ to the PCAOB. Below is a summary of the comments raised in the most recent [comment letter](#) to the PCAOB on this topic.

a) Objective of the Proposed Estimates Standard

- The Proposed Estimates Standard includes the explicit objective that estimates be free from bias that results in a material misstatement. This could result in confusion regarding the extent of work intended to be performed by the auditor in accordance with the requirements of the PCAOB’s extant standards related to management bias and the requirements in the Proposed Estimates Standard.

b) Identifying and Assessing Risks of Material Misstatement

- It is not clear in the Proposed Estimates Standard that auditors would tailor their audit response to an estimate that represents a significant risk versus an estimate that represents a lower risk of material misstatement.
- We question if it improves risk identification to require the auditor to evaluate whether management’s methods are “appropriate for the nature of the related account or disclosure and the **business, industry,** and environment in which the company operates,” as facts and circumstances of a specific accounting estimate may not always be related to the issuer’s industry. Management’s processes and controls are designed to operate at a greater level of precision than the auditor’s materiality and testing thresholds. Due to this difference, it is possible that the auditor’s conclusion as to which assumptions are significant could differ from management’s. If the auditor is able to demonstrate that an assumption is not significant, the auditor should not be required to identify the assumption as significant solely because management did.

c) Valuation of Investments Based on Investee Financial Condition or Operating Results

- We have concerns with the proposed requirements in Appendix A to Auditing Standard 1105, *Audit Evidence* (AS 1105) in the Proposed Estimates Standard for situations in which the valuation of an investment is based on the investee’s financial condition or

¹ See the following CAQ comment letters submitted to the PCAOB on this topic: [Auditing Accounting Estimates Letter](#) (November 3, 2014), [Auditing Accounting Estimates and Fair Value Measurements - A Framework](#) (December 1, 2015).



operating results. The proposed requirements could significantly expand the current requirements for auditors without benefitting audit quality. For many noncontrolling investments, company management may not have direct access to investee management or may not be entitled to such information pursuant to the terms of the investment arrangement to enable the company auditor to perform the proposed procedures. There are often situations where the financial statements of investees are audited under other auditing standards. The Proposed Estimates Standard should not limit the auditor's ability to use audit reports issued in accordance with standards set by other bodies.

d) **Audit Evidence**

- We also raised concerns in our comment letter on the need for clarification of requirements related to third party pricing information, developing an independent expectation of the estimate, and the evaluation of contradictory audit evidence.

II. **Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists**

(Proposed Amended Specialists Standard): The CAQ has submitted a prior comment letter² to the PCAOB. Below is a summary of the comments the CAQ raised in the most recent [comment letter](#) to the PCAOB on this topic.

a) **Objectivity**

- We support using the term "objectivity" versus the phrase "relationship to the company" for company specialists (employed or engaged). When evaluated appropriately, a specialist's relationship to the company would be considered within the assessment of a specialist's objectivity. Evaluating the degree of objectivity of a company's specialist should be viewed as a continuum that affects the nature, timing, and extent of audit procedures.

b) **Expertise**

- The proposed amendments to paragraphs .B6a and .B8(3) of AS 1105 seem to suggest that the auditor would need to evaluate whether the data was "appropriately" used by the specialist. It is unclear whether this requirement is intended to be similar to paragraph .14 of the Proposed Estimates Standard. 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 and based on auditor judgment, may encounter matters that require such specialized skill. The additional proposed requirements in .B8 that "the auditor should evaluate whether the methods used by the specialists are appropriate and the significant assumptions used by the specialists are reasonable" would require an elevated level of knowledge by the auditor.

² See the following CAQ comment letter submitted to the PCAOB on this topic: [CAQ Specialists Comment Letter](#) (July 31, 2015).



c) Requirement for auditors to apply the same auditing procedures to accounting estimates regardless of whether or not management uses an external specialist

- The Note to paragraph .B8 indicates that the auditor should also comply with the requirements in paragraphs .09 - .18 of the Proposed Estimates Standard, if the company's specialist assisted the company in developing an accounting estimate. We suggest that the nature and extent of procedures should not be the same when a company employed specialist develops an accounting estimate themselves as opposed to when management uses a company-engaged specialist (i.e., an external specialist) that is competent and objective. Furthermore, certain of these procedures may not be practicable given the proprietary nature of certain specialist models or the auditor's lack of sufficient knowledge of the specialist's field to perform all the procedures in these paragraphs. We recommend keeping the principles of extant Auditing Standard 1210, *Using the Work of a Specialist* in regards to this topic.

d) Communication

- We support the requirement to "inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist..." The language within Staff Consultation Paper No. 2015-01: *The Auditor's Use of the Work of Specialists* (Consultation Paper), which does not appear to be included in the potential amended standard, suggests that "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs, or other related workpapers." We believe this provides an appropriate amount of flexibility to the auditor and should be explicitly stated within Auditing Standard 1201, *Supervision of the Audit Engagement* (AS 1201).

e) Smaller Firm Burden

- We recognize the Proposed Amended Specialists Standard, if approved, could place a significant and possibly disproportionate burden on accounting firms that do not have employed specialists on staff. The PCAOB should also consider this point as it determines the final effective date. The amount of time a firm needs to prepare for the new standard may be different based upon the resources and staffing available and some firms may need more time to prepare for implementation of the proposed changes.

III. Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm (Proposed Supervision of Other Auditors Standard): The CAQ has submitted a prior comment letter³ to the PCAOB. Below is a summary of the comments the CAQ raised in the most recent [comment letter](#) to the PCAOB on this topic.

³ See the following CAQ comment letter submitted to the PCAOB on this topic: [Supervision of Audits Involving Other Auditors](#) (July 29, 2016).



a) Lead Auditor Determination

- ...[T]here could be scenarios where no one auditor would meet the criteria [in determining the sufficiency of participation] of proposed Auditing Standard 2101, *Audit Planning* (AS 2101) paragraph .B2, such as when no individual auditor audits the risks of material misstatement associated with a larger portion of the company's financial statements. The determination of a lead auditor should take into account other qualitative considerations, such as legal and licensing requirements of certain jurisdictions.

b) Other Auditors' Compliance with Independence and Ethics

- We have significant concerns related to the implementation of the proposed amendment to AS 2101.B4 to gain an understanding of each other auditor's (1) process for determining compliance with the SEC independence requirements and PCAOB independence and ethics requirements and (2) experience in applying the requirements. Requiring each lead auditor at an engagement team level to gain an understanding of each other auditor's processes (even at the firm level of the other auditor) represents a significant change in existing practice, without a clear understanding of the added benefit. We do not believe such a requirement will necessarily strengthen compliance and could add significant costs. The written representation (premised on consideration of a firm's system of quality control) has an important role to play in considering the independence of the other auditor. Only when there is no such basis for reliance on the system of quality control should the lead auditor consider performing incremental procedures.

c) Qualifications of and Communication with Other Auditors

- The PCAOB is considering a new requirement for the lead auditor to inquire about the other auditors' policies and procedures relating to assignment and training of individuals, and gaining an understanding of the knowledge, skill, and ability of the other auditors who assist the lead auditor with planning or supervision. Inquiring about how other auditors assign individuals to audits and train individuals may not be practical for the lead auditor, as such policies and procedures may be considered confidential and proprietary in nature. Gaining an understanding of the knowledge, skill, and ability of other auditors who assist the lead auditor with planning, supervision, or review enables the lead auditor to appropriately vary the extent of supervision.

d) Lead Auditor Communications

- We believe communicating all identified risks of material misstatement in all cases is too broad of a requirement. We have a concern that the lead auditor may not always be in a position to identify the complete listing of risks at a location or business unit, and the other auditor should be leveraged in this regard. We suggest modifying the proposed amendments to require communication by the lead auditor of significant matters



identified from discussions with engagement team members of risks of material misstatement as required by Auditing Standard 2110, *Identifying and Assessing Risks of Material Misstatement* paragraphs .49 - .51.

e) **Review of Specified Documentation, including Summary Memorandum**

- Proposed amendment AS 1201.B2c requires the lead auditor to “[d]irect the other auditor to provide for review specified documentation with respect to the work requested to be performed....” We believe that in a risk-based approach, the determination of documentation to be reviewed is determined by multiple factors, including the professional competence of the other auditors and the risks of material misstatement addressed by their work. We request that the PCAOB clarify that there may be certain situations where it is not necessary to obtain specified documentation beyond Auditing Standard 1215, *Audit Documentation* paragraph .19 (such as if the lead auditor determines that the extent of supervision provided is sufficient and they were involved in the planning, execution, and conclusions regarding the procedures performed by the other auditor). It would be useful for the PCAOB to acknowledge that specified documentation obtained by the lead auditor may include a summary of the procedures performed.

f) **Multi-tier audits**

- We believe proposed amendment AS 1201.B3 should not require the lead auditor to obtain, review, and retain the summary memorandum of the second other auditor, unless determined necessary by the lead auditor (e.g., due to risk or other audit matters). If the knowledge, skill, and ability of the first other auditor is not appropriately considered in determining the supervisory approach, the lead auditor may spend time that is unwarranted reviewing the work of a competent second other auditor.

Via Email

August 28, 2017

Office of Secretary
PCAOB
1616 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 043/PCAOB Rulemaking Docket Matter No. 044

Dear Madam Secretary:

This letter provides comments on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *Auditing Accounting Estimates, Including Fair Value Measurements* (Estimates Proposal),¹ and the related *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (Specialist Proposal) (Estimates Proposal and Specialist Proposal collectively the Proposals).²

The Council of Institutional Investors (CII or Council) supports the Proposals. The Council is a non-profit, nonpartisan association of public, corporate, and union pension funds, and other employee benefit plans, foundations and endowments with combined assets that exceed \$3 trillion. Our member funds are major, long-term investors committed to protecting the retirement savings of millions of American workers. CII also has associate members, including asset managers with more than \$20 trillion in assets under management.³

¹ PCAOB Release No. 2017-002 (June 1, 2017), <https://pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf>.

² PCAOB Release No. 2017-003 (June 1, 2017), <https://pcaobus.org/Rulemaking/Docket044/2017-003-specialists-proposed-rule.pdf>.

³ For more information about the Council of Institutional Investors ("CII"), please visit CII's website at http://www.cii.org/about_us.

August 28, 2017
Page 2 of 6

CII Policies

As the leading U.S. voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.⁴ That belief is reflected in the following CII membership-approved policy on the “Independence of Accounting and Auditing Standard Setters”:

Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the . . . standards that . . . auditors use in providing assurance that the preparers’ recognition, measurement and disclosures are free of material misstatements or omissions.⁵

This policy establishes the principle that “investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors’ information needs.”⁶ Our membership reaffirmed that principle when it approved substantial revisions to our policy on “auditor independence.”⁷ That policy, as revised, includes the following additional provisions that we believe may be relevant to issues raised by the Proposals:

2.13a Audit Committee Responsibilities Regarding Independent Auditors: The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company’s

⁴ CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

⁵ *Id.*

⁶ *Id.*

⁷ CII, Policies on Corporate Governance § 2.13 Auditor Independence (last updated Sept. 30, 2016), http://www.cii.org/corp_gov_policies.

August 28, 2017
Page 3 of 6

independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality. Even in the absence of egregious reasons, the committee should consider the appropriateness of periodically changing the auditor, bearing in mind factors that include, but are not limited to:

-
- the clarity, utility and insights provided in the auditor’s report
-
- the quality and frequency of communication from the auditor to the audit committee
-

Investors are the “customers” and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.

....

2.13f Shareowner Votes on the Board’s Choice of Outside Auditor: Audit Committee charters should provide for annual shareowner votes on the board’s choice of independent, external auditor.⁸

CII Views on Proposals

Estimates Proposal

We support the Estimates Proposal. We have long believed that fair value accounting with robust disclosures provides investors with more useful information than amounts that would be reported under amortized cost or other existing alternative accounting approaches.⁹ Further, we believe investors assign a high value to the auditor’s testing and evaluation of fair value estimates and other critical accounting estimates reported by issuers.¹⁰ That view is demonstrated by

⁸ *Id.*

⁹ *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors et al., to Mr. Timothy F. Geithner, Secretary, Department of Treasury et al. 2 (Feb. 13, 2009) (“fair value accounting . . . best serves the interests of investors both now and over the long term”), http://www.aicpa.org/Press/DownloadableDocuments/CAQ_CII_CFA_Admin_Fair_Value_Letter.pdf; *see generally* Stephen G. Ryan, “Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch” 1 (July 2008) (describing the key reasons why fair value accounting benefits investors), http://www.cii.org/files/publications/white_papers/07_11_08_fair_value_accounting.pdf.

¹⁰ *See, e.g.*, Jeff Mahoney, “Investor Perspectives & Related Considerations on Auditing Estimates and Fair Value Measurements: Remarks at the Meeting of the Standing Advisory Group of the Public Company Accounting

August 28, 2017
Page 4 of 6

the broad support the PCAOB has received from investors for pursuing improvements to the auditor’s report that would include information directly from the auditor about significant management estimates made in the preparation of the financial statements.¹¹

We are concerned that the “PCAOB continues to identify high rates of audit deficiencies in this area [of accounting estimates].”¹² We commend the Board’s effort’s to address those deficiencies, in part, by “strengthen[ing] auditor responsibilities for accounting estimates, including fair value measurements.”¹³

We believe the Estimates Proposal provides benefits to investors in at least two ways.

First, the Estimates Proposal provides a “single, consistent set of requirements” for auditing accounting estimates.¹⁴ We agree with the Board that creating greater uniformity in the auditing standards in this important area should: (1) “increase . . . the quality of the information presented in the financial statements;”¹⁵ and (2) “enhance the audit committee’s understanding of the auditor’s responsibilities, and, therefore, potentially facilitate communications between the audit committee and the auditor.”¹⁶

Second, the Estimates Proposal provides a better alignment between the Board’s requirements for auditing accounting estimates and the Board’s risk assessment standards.¹⁷ We agree with the Board that by aligning more closely with the risk

Oversight Board” 2 (Oct. 2, 2014), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/10_02_14_JMahoney%20PCAOB%20SAG_%20Investor%20Perspectives.pdf.

¹¹ PCAOB, Exchange Act Release No. 81,187, 82 Fed. Reg. 35,396, 35,397 (July 28, 2017) (“areas that investors have indicated would be of particular interest to them, [include] . . . significant management estimates . . . made in preparing the financial statements”), <https://www.gpo.gov/fdsys/pkg/FR-2017-07-28/pdf/2017-15718.pdf>.

¹² See, e.g., Steven B. Harris, Board Member, “Statement on Proposed Auditing Standard on Auditing Accounting Estimates, Including Fair Value Measurements, and Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists” 2 (June 1, 2017), <https://pcaobus.org/News/Speech/Pages/Harris-statement-auditing-accounting-estimates-specialists-6-1-17.aspx>.

¹³ PCAOB Release No. 2017-002, at 40.

¹⁴ *Id.* at 41.

¹⁵ *Id.* at 42.

¹⁶ *Id.*

¹⁷ *Id.*

August 28, 2017
Page 5 of 6

assessment standards the Estimates Proposal “may lead to increased audit quality for harder-to-measure estimates . . . due to enhanced procedures.”¹⁸ On this point, we generally agree with the 2014 comments of then Chief Investment Officer of CII member Colorado PERA:

While we believe auditing estimates is critical and worthy of its own standard, aligning it with risk assessment standards seem prudent. Investors want auditors to spend their time efficiently, and to be efficient, auditors must first know where the biggest risk to material misstatements are located, and then appropriately plan and execute the audit plan around high risk areas. This approach resonates well with us, and we believe it is the framework that should be used to develop standards for accounting estimates.¹⁹

Specialist Proposal

We also support the related Specialist Proposal. We agree with the Board that as accounting frameworks continue to evolve in response to investor demands for more fair value accounting, “the use of the work of specialists continues to increase in both frequency and significance.”²⁰ The increasing use of specialists heightens the risk that if the specialist’s work is not properly overseen or evaluated by the auditor, the auditor’s work may not be sufficient to detect a material misstatement in fair value (or other) estimates.²¹

We are concerned that the “PCAOB inspections staff continues to observe deficiencies related to auditors’ use of specialists’ work, such as failures to evaluate the assumptions of company specialists in fair value measurements or failures to consider contradictory evidence or issues raised by an auditor's specialist.”²² We therefore endorse the Board’s efforts to address those deficiencies, in part, by pursuing the Specialist Proposal designed to direct

¹⁸ *Id.*

¹⁹ Letter from Jennifer Paquette, Chief Investment Officer, Colorado PERA to Office of the Secretary, Public Company Accounting Oversight Board 1 (Nov. 3. 2014), https://pcaobus.org/Rulemaking/Docket043/013_Colorado_PERA.pdf.

²⁰ PCAOB Release No. 2017-003, at 1.

²¹ *Id.* (“If a specialist's work is not properly overseen or evaluated by the auditor, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.”)

²² *Id.* at 2.

August 28, 2017

Page 6 of 6

“auditors to devote more attention to the work of specialists and enhance[] the coordination between auditor’s and specialists.”²³

In addition to the prospect of improving audit quality generally, we agree with the Board that the “proposed requirements to test and evaluate the work of a company’s specialist may result in some auditors developing a better understanding of a company’s critical accounting estimates related to relevant financial statement accounts and disclosures.”²⁴ The result should be “improved communications between the auditor and the audit committee”²⁵ and, importantly, improved communications between the auditor and investors upon adoption of the Board’s proposed standard to enhance the standard auditor’s report.²⁶

We appreciate the opportunity to provide the Council’s investor-focused perspective on the Proposals. Please let me know if you have any questions about the contents of this letter.

Sincerely,



Jeffrey P. Mahoney
General Counsel

²³ *Id.* at 38.

²⁴ *Id.* at 40.

²⁵ *Id.*

²⁶ 82 Fed. Reg. at 35,397 (proposed standard would require “communication of critical audit matters . . . relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor, focusing attention on issues that would be pertinent to understanding the financial statements, and enhancing investor confidence in the financial statements”).



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August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 044, Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists, PCAOB Release No. 2017-003

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed amendments to auditing standards for the auditor's use of the work of specialists ("proposed amendments"). We support the Board's efforts to improve audit quality by enhancing existing auditing standards and are pleased to provide our observations regarding the proposed amendments below.

AS 1105, Audit Evidence

Risk Assessment - The proposed amendments incorporate risk assessment procedures into AS 1105, Appendix B – *Using the Work of a Company's Specialist as Audit Evidence*. While we agree with adding specificity to the auditor's risk assessment procedures when utilizing the work of company specialists, we believe these risk assessment considerations should be incorporated into AS 2110: *Identifying and Assessing Risks of Material Misstatement*. Paragraph .B1 indicates obtaining an understanding of the company's information system relevant to financial reporting is an objective of Appendix B. This is the exact same objective of paragraphs .28 - .32 of AS 2110.

Further, paragraphs .B2 - .B5 add specificity surrounding the auditor's understanding of the company's specialist and how that understanding will impact the nature, timing and extent of the auditor's procedures. Those procedures include testing and evaluating the work of the company's specialists. In general, these paragraphs require the auditor to:

- Understand the company's information system relevant to financial reporting
- Understand the work and report(s) of the company's specialist(s) and related process and controls
- Understand the professional qualifications of the company's specialists
- Assess the level of knowledge, skill and ability of the specialist
- Assess the relationship to the company of the specialists the entity that employs the specialists

Introducing risk assessments procedures into a standard other than AS 2110 may result in auditors only considering the factors in the proposed amendments of AS 1105 without appropriately considering all factors in the relevant paragraphs of AS 2110 when understanding and assessing a company specialist. We recommend incorporating the risk assessment procedures introduced in the proposed amendments to AS 2110.

Testing and Evaluating the Work of the Company Specialist – We believe paragraph .B8 results in unnecessary procedures with respect to utilizing a company specialist for estimates. Specifically, the note to paragraph .B8 indicates that in addition to evaluating the company specialist under AS 1105, the auditor performs procedures in Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, including Fair Value Measurements*. As a result, the auditor is required to evaluate the company specialist as management, in which case, there would be no need to evaluate the company specialist under AS 1105 but rather evaluate the specialist as management under AS 2110. For example, evaluating a company engaged specialist's objectivity would appear unnecessary as this process does not appear to impact the audit effort performed under paragraphs .09-.18 of Proposed Auditing Standard 2501. We recommend clarifying how the use of a company engaged specialist impacts the auditor's effort when the company specialist is utilized to assist in the preparation of management's estimate.

AS 1210, Using the Work of an Auditor-Engaged Specialist

Objectivity – Paragraph .04 of AS 1210 indicates the auditor "...should assess whether the specialist and the entity that employs the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialists' work related to the audit. This include evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed."

We find the examples provided to assist auditor's in the identification of a specialist's relationship to be helpful, however, these examples are not sufficiently clear to indicate if any relationship between the company and the specialist would impair the objectivity of the specialist and thus require the auditor not to use the specialist based on paragraph .05. For instance, the example of "ownership" is not clear as it does not have any defined threshold level nor does the standard provide for the vehicle of ownership (e.g. a mutual fund). We believe objectivity should be viewed on a spectrum as opposed to a binary conclusion. In situations where the specialist has a relationship with the company; we believe the auditor should be able to evaluate that relationship to determine the impact on the nature, timing and extent of the use of the auditor-engaged specialist.

Effective date

The time and effort necessary to incorporate the proposed amendments into audit methodologies, guidance and audit programs, and to train staff, is anticipated to be significant and is directly impacted by PCAOB exposure draft on estimates. We recommend the proposed amendments be effective two years after the SEC approves the final standard.

Crowe Horwath LLP appreciates the efforts the PCAOB has undertaken to improve the audit quality associated with auditing estimates. We would be pleased to respond to any questions regarding our comments. Should you have any questions please contact James A. Dolinar at (630) 574-1649 or Michael G. Yates at (574) 236-7644.

Cordially,



Crowe Horwath LLP

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August 29, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 044

Deloitte & Touche LLP (“D&T” or “we”) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists* (the “Proposed Amendments” or “the Proposal”), which addresses potential changes to the PCAOB’s auditing standards for using the work of specialists. Our comments herein should be read concurrently with our comments provided in response to the request for comment from the PCAOB on the *Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements* (the “Estimates Proposal”), as certain provisions of the proposed auditing standards include references between the two proposals in order to illustrate how the proposed requirements in the two releases would work together.

Overall Comments

We support the Board’s efforts to enhance the standards of the PCAOB relating to the auditor’s use of the work of a specialist. We acknowledge and appreciate the PCAOB staff’s efforts in this area to date, including their commitment to seek further input through the issuance of the Proposal. We commend the PCAOB Staff and Board Members for devoting a significant portion of the June 1, 2017, *Open Board Meeting to Consider Adopting Standard on the Auditor’s Report, and Proposing Updated Requirements for Auditing Accounting Estimates and an Auditor’s Use of the Work of Specialists* to discussing matters relevant to the Proposal.

In addition, we believe that the PCAOB’s efforts in considering amendments to the standards addressing use of the work of a specialist along with the Estimates Proposal is thoughtful and appropriate. These concurrent proposals allow commenters to better evaluate and analyze the effect of such proposed amendments, both individually and collectively, and for the PCAOB to consider the feedback collectively as well. We continue to believe it will be important that any resulting amendments pertaining to these two proposals become effective at the same time. In addition, we recommend the effective date should provide auditors with a period of at least two years from the time the standard is approved by the SEC, as we believe there could be significant efforts for accounting firms and specialists engaged by auditors to undertake in order to properly prepare to implement these requirements.

We agree with the proposed distinctions among the work of a company’s specialist, an auditor’s employed specialist, and an auditor’s engaged specialist and the related organization of the proposed amendments within the separate auditing standards for *Audit Evidence*, *Supervision of the Audit Engagement*, and *Using the Work of an Auditor-Engaged Specialist*. These distinctions and resulting organization within the auditing standards provide the basis for a better understanding by the auditor of the requirements for each type of specialist based on how that specialist is used in the context of the audit and also provides the ability to compare and contrast the requirements for each type of specialist across the standards.

We are very supportive of the design of the proposed amendments to align the applicable requirements with the PCAOB’s risk assessment standards. The application of a risk-based approach to the testing and evaluation of a company’s specialist’s work and the supervision of an auditor’s specialist will reduce the risk of the auditor failing to sufficiently and appropriately address identified risks of material misstatement and will also avoid unnecessary effort by the auditor and the auditor’s specialist.

We offer certain constructive suggestions to help clarify the final standards’ requirements and auditors’ responsibilities that are applicable when using the work of a company’s specialist or involving an auditor’s

specialist. We are ready to engage constructively with the Board and other stakeholders to provide our perspective and experience in order to facilitate the development of improvements to the PCAOB's auditing standards that will enhance audit quality. We present a summary of the following primary matters for additional consideration, with additional information on each in the attached appendix:

- Assessing the Knowledge, Skill, and Ability of a Company's Specialist and the Specialist's Relationship to the Company.
- Testing and Evaluating the Work of a Company's Specialist.
- Evaluating Whether the Data Was Used Appropriately by a Company's Specialist.
- Auditor-Employed Versus Auditor-Engaged Specialists.

Assessing the Knowledge, Skill, and Ability of a Company's Specialist and the Specialist's Relationship to the Company

We acknowledge that a company's specialist's knowledge, skill, and ability affects the relevance and reliability of the specialist's work, and therefore it is appropriate for auditors to assess these characteristics when evaluating and testing the work of the specialist. However, we believe additional clarity is needed for consistent application by auditors regarding certain of the proposed requirements.

Assessing Relationships with Company-Engaged Specialists

Paragraph B4 of Appendix B of proposed AS 1105 describes the auditor's requirements to assess the company's specialist's relationship to the company and the entity that employs the specialist. Although the intent of the requirement is clear, clarification is needed as to what procedures an auditor would be expected to perform to obtain sufficient appropriate audit evidence to address the requirement, including the nature and extent of audit procedures that may be performed to complete the assessment.

We recognize the proposal acknowledges that proposed AS 1105.B4 "does not prescribe specific steps to perform or information sources to use in assessing the specialist's relationship to the company"¹ and instead lists potential sources of relevant information within Appendix 3 of the release accompanying the proposal. We recommend that the proposed standard incorporate the potential sources of relevant information included in Appendix 3 as guidance and provide further clarity regarding what is considered sufficient appropriate audit evidence supporting the auditor's assessment of any relationship between the company and the company's specialist.

For example, it is unclear as to whether inquiry or responses to questionnaires from the company's engaged specialist would provide sufficient evidence to identify and assess relationships between the company and its specialist in meeting this requirement. Generally, inquiry alone is not sufficient audit evidence.

Further, many entities do not have processes and controls in place to identify and monitor relationships with their customers (e.g., entities that employ specialists engaged by companies may not actively monitor their employees' financial interests, including stock holdings or other investments). Accordingly, with these challenges in mind, we believe that additional clarity is necessary regarding the procedures the auditor would be expected to perform to identify the relationships a company's engaged specialist has with the company.

In addition, it is unclear how the auditor would determine whether a relationship between the company and the company's engaged specialist would result in the company having significant influence over the engaged specialist.

For example, if an auditor becomes aware of a relationship (e.g., a financial interest) between a specialist employed by an organization engaged by the company being audited and the company

¹ Page A3-13 of the Proposal.

being audited that could be material to the individual specialist, would that result in a conclusion that the company has significant influence over the organization employing the specialist? Would the individual specialist have to be directly involved in providing services to the company being audited, or would it make a difference if the specialist with the relationship was not personally providing services to the company being audited? If the specialist with the relationship had a significant role in managing the specialist's organization, would that result in the company having significant influence over the specialist's organization, even if such specialist was not directly involved in providing services to the company being audited?

In situations in which circumstances exist that the auditor concludes the company has the ability to significantly influence the specialist's judgment, it is not sufficiently clear how this would affect the auditor's ability to use the work of the company's engaged specialist as audit evidence and what alternative procedures the auditor may perform in these circumstances.

Consideration of Management's Controls

When indicating factors that are relevant to the assessment of the specialist's knowledge, skill, and ability, the proposed amendments do not mention consideration of management's controls related to a company's specialists. We believe that management's controls related to the selection and supervision of a company's specialist are very relevant to the auditor's understanding and assessment of the knowledge, skill, and ability of the company's specialist. Management's controls over inputs to the company's specialist (including information produced by the company) and output from the company's specialist would also influence the relevance and reliability of the evidence produced by the company's specialist. The auditor could also consider the effect of these controls when evaluating the audit procedures required to evaluate and assess the work of the company's specialist. We recommend providing additional guidance within the proposed amended standards to clarify the role of management's controls and how such controls (or the lack thereof) may affect the auditor's procedures.

Testing and Evaluating the Work of a Company's Specialist

Our observations and recommendations support the goal of a risk-based approach that acknowledges the effect certain factors have on the required persuasiveness of the evidence the auditor needs to obtain when testing and evaluating the work of a company's specialist. As it relates to the methods and significant assumptions used by the company's specialist, the proposal elevates the requirements in the extant standards from "obtain an understanding"² of such methods and assumptions to "evaluating the methods and significant assumptions used by the specialist."³ We agree that this is likely to represent a significant change in practice and have provided the following observations and recommendations specific to these changes.

- *Limitations to the auditor's ability to evaluate work of a company's specialist* — There are certain limitations to the nature and extent of the evaluation an auditor may be able to perform on the work of a company's specialist. Auditors may not have the expertise to fully evaluate the methodologies and assumptions used by a company's specialist. Although in certain situations it would be possible for the auditor to involve a specialist to assist in completing this evaluation, even a specialist may not be able to fully evaluate the methodologies and assumptions in situations in which the company's specialist uses proprietary or otherwise confidential models, methodologies, or frameworks. Furthermore, given continued technological advancements, it is increasingly more common for specialists to use proprietary or confidential models, methodologies, or frameworks.

Therefore, we recommend the proposed amendments include considerations as to how an auditor would test and evaluate the work of a company's specialist when the specialist uses proprietary or otherwise confidential models, methodologies, or frameworks.

For example, specialists who complete volumetric surveys for inventories of various

² PCAOB AS 1210.09.

³ Page A1-12 of the Proposal.

materials may use GPS survey techniques and computer modeling to estimate volumes of inventories that are highly dependent on proprietary and confidential models and methodologies. In this example, the auditor, or an auditor's specialist, may be able to obtain an understanding of the methods and significant assumptions as required under our extant standards, but may not be able to evaluate fully the methods and significant assumptions, given their proprietary nature.

Situations such as the above example would affect the auditor's ability to test and evaluate the work of a company's specialist and the information provided by a company's specialist, and further may preclude the auditor from being able to meet the requirements of the proposed amended standard. Examples of what additional procedures should be performed in such a scenario would better inform the auditor as to how to apply the requirements, and provide for more consistent auditor execution.

- *Additional clarity to illustrate varying responsive procedures* — Examples provided in the release accompanying the proposal illustrating various ways in which factors can affect the necessary audit effort in testing and evaluating the work of a company's specialist are helpful; however, they stop short of illustrating how an auditor's procedures would change depending upon the necessary persuasiveness of audit evidence.

Example 1⁴ in the release accompanying the proposal states that the auditor would need to extensively test and evaluate the work of the company's specialist. However, it is unclear what "extensive" testing would entail in this case, relative to what "less extensive" testing might involve. In contrast, Example 3,⁵ highlights "less extensive procedures," especially when assessing whether the data was appropriately used by the specialist (see further comments in the next section of this letter regarding the requirement for the auditor to evaluate whether the data was used appropriately by the specialist), but does not then contrast that with "extensive" procedures. We recommend expanding Examples 1, 2, and 3 in Appendix 3 to provide additional clarity as to how the auditor's procedures would change in each of these examples, thereby demonstrating the differences in the necessary persuasiveness of audit evidence.

Further, Example 1 states that the auditor would likely need to engage an auditor's specialist to evaluate and test the work of a reserve engineer. As it is unlikely that audit firms will have internally employed reserve engineers, they will likely have to engage a third-party specialist. It may be difficult or impossible to engage a specialist who has the necessary knowledge, skill, ability, and objectivity in such situations. We have similar concerns that other industries may also lack internal and external specialists who have the necessary objectivity for an auditor to engage, in order to assist in testing and evaluating the work of a company's specialist. We recommend using Example 1 as one means to demonstrate how the auditor could manage or overcome these limitations.

Evaluating Whether the Data Was Used Appropriately by a Company's Specialist

In addition to our observations and recommendations above related to testing and evaluating the work of the company's specialists, we have further commentary specific to the requirement for the auditor to evaluate whether the data was appropriately used by the specialist.

Paragraph B8 of Appendix B in the proposed amended standard requires the auditor to "(1) test the accuracy and completeness of company-produced data used by the specialist, (2) evaluate the relevance and reliability of data obtained from external sources, and (3) evaluate whether the data was appropriately used by the specialist." Item (3) in this requirement is new in comparison to the extant standards. However, no additional information was provided regarding the procedures an auditor should perform to meet this requirement. We recommend providing additional clarity on procedures an auditor should perform to make this evaluation, especially in situations in which the auditor may not have the full expertise to make such an evaluation in circumstances in which the specialist is in a highly specialized area.

⁴ Page A3-19 of the Proposal.

⁵ Page A3-20 of the Proposal.

In addition, we are not aware of procedures an auditor could perform to determine whether data was “appropriately” used by the specialist, other than reperformance by the auditor of the specialist’s calculations.

For example, developing an independent estimate and comparing it to management’s recorded estimate may not meet the requirement to evaluate whether the data was appropriately used by management’s specialist. Different methods, assumptions, and/or data could be used by the auditor and the resultant independent estimate may approximate the recorded estimate; however, that would not support that management’s specialist used the data appropriately, but rather only support that the recorded amount was reasonable.

If the intent of this amendment is to require reperformance, we recommend clarifying that the auditor is required to reperform the specialist’s calculations to meet the requirement. If this is not the intent, clarification as to what procedures should be performed in order to meet the requirement is needed. If reperformance by the auditor of the specialist’s work is the intent of meeting this requirement, we believe this would require significant effort in excess of what is currently performed under the extant standards. Reperformance would also be affected by, or may not be possible because of, other circumstances, including for example, the use of proprietary or otherwise confidential models, methods, or frameworks by a company specialist (especially a company-engaged specialist). Therefore, without clarification as to the intent of this requirement, it is likely that the procedures applied by auditors to address these requirements will vary. It is possible that some auditors may perform too much work, while others may not perform enough work, resulting in insufficient audit evidence.

Further, given the nature of the work performed by the specialist, it will often be difficult for the auditor to evaluate whether the data was appropriately used by the specialist, especially depending on the nature and extent of procedures required. This could lead to situations in which auditors are required to engage external specialists to assist in performing such procedures, whereas currently the auditors are able to meet the extant requirements of evaluating the company’s specialist work without the assistance of an auditor’s specialist. In areas in which auditors have historically used the work of an auditor’s specialist in evaluating and testing the work of a company’s specialist, the scope of such work would likely also expand under these requirements. The extended use of an auditor’s specialist in such scenarios would likely add cost and time to the audit. This may also present problems in certain industries that have a lack of external specialists available to assist in performing such procedures (e.g., the energy industry), or when such external specialists would not have the necessary objectivity to assist the auditor.

Auditor-Employed Versus Auditor-Engaged Specialists

We fully support separately defining requirements for an auditor-employed and auditor-engaged specialist. Our observations and recommendations are intended to clarify the definition of an auditor-employed specialist such that audit firms are clearly able to differentiate between auditor-employed and auditor-engaged specialists, considering the manner in which accounting firms and their networks are legally organized, and recognizing there are different approaches in place across the industry for global accounting firms.

As currently drafted, the proposed amendments define an auditor-employed specialist as a specialist employed by the auditor’s firm. Depending on the legal organization and affiliations of an accounting and auditing firm, this may result in inconsistent interpretations regarding whether specialists are auditor-engaged or auditor-employed specialists.

For example, if specialists are not legally employed by the accounting and auditing firm, but rather by an affiliate or a subsidiary of the same parent company of the accounting and auditing firm, it could be interpreted that such specialists are auditor-engaged specialists versus auditor-employed specialists, even in circumstances in which quality control structure and independence requirements are the same for the respective legal entities employing the specialists and the auditors.

Additional clarification specific to these proposed amended standards would help accounting and auditing firms avoid applying the proposed standards differently or other than as intended.

We offer further observations on other areas of the Proposal in the attached appendix.

* * *

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential effects of the Proposal. We are ready to collaborate with the PCAOB on these important matters. If you have any questions or would like to discuss these issues further, please contact Dave Sullivan at 714-436-7788 or Megan Zietsman at 203-761-3142.

Very truly yours,

A handwritten signature in cursive script that reads "Deloitte & Touche LLP". The signature is written in black ink on a white background.

Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeannette M. Franzel, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards

Jay Clayton, SEC Chair
Kara M. Stein, SEC Commissioner
Michael S. Piwowar, SEC Commissioner
Wesley R. Bricker, SEC Chief Accountant
Marc A. Panucci, SEC Deputy Chief Accountant
Sagar S. Teotia, SEC Deputy Chief Accountant
Russell G. Golden, FASB Chairman

APPENDIX

The comments noted in this appendix are intended to provide additional observations and recommendations related to the proposal. These comments are organized by the auditing standards proposed to be amended, along with a general observation at the end of the appendix.

AS 1105, Audit Evidence

- We believe consideration should be given to the nature of the typical relationship between a company and their legal counsel to assess the effect on these proposed amendments. Given the nature of the role of legal counsel engaged or employed by a company, the nature of the relationship between the entities, and the existence of attorney-client privilege and privacy and confidentiality agreements, it is likely that there will be relationships between legal counsel and the company that employs or engages them that would allow the company the ability to significantly affect the specialist's judgment. Additional guidance is necessary for an auditor to understand how they can address these commonplace circumstances in order to apply the auditing standards. In addition, providing greater clarity in the amendments as to how this situation would influence the procedures the auditor performs to assess the knowledge, skill, and ability, and how this influences the relevance and reliability of the specialist's work would be helpful to audit quality. Further, the existence of attorney-client privilege and privacy and confidentiality will influence the auditor's ability to evaluate the work of legal counsel.

For example, if a company obtained a legal opinion from counsel regarding an income tax matter, counsel may not be willing to provide the data or information used and considered in reaching such opinion. Limitations such as these may not be able to be overcome by the auditor.

Therefore, we recommend including additional guidance to inform auditors how to address these circumstances. Lastly, there are also long-standing arrangements and agreements for auditors' interactions with legal counsel, and it is not clear how the proposed amendments are intending to change such arrangements and agreements. The American Bar Association was active in prescribing how legal counsel should respond to an auditor inquiry, so it is likely they may wish to provide further input as this standard approaches finalization.

- Paragraph B10 requires the auditor to perform additional procedures if the auditor determines the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence in accordance with paragraph B9. We recommend providing additional clarity by specifying the procedures auditors would need to perform in responding to the requirement of paragraph B10. In addition, the note to paragraph B10 includes examples of situations in which additional procedures ordinarily are necessary. Item (5) of the note to paragraph B10 states that "the specialist has a conflict of interest relevant to the specialist's work." Clarification as to what this example would relate to would be helpful.

AS 1201, Supervision of the Audit Engagement, Appendix C

- Paragraph C5 of Appendix C refers to requirements to establish and document an understanding related to "the nature of the work that the specialist is to perform" and "the specialist's approach to that work." Additional clarification regarding what is meant by the specialist's "approach" would assist the auditor in understanding how "approach" is different from the "nature of the work" and what the auditor needs to understand and document related to this piece of the requirement.
- Paragraph C7 of Appendix C uses a new term, "measures," when describing that the engagement partner and, as applicable, other engagement team members performing

supervisory activities should implement “measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members.” This terminology is not used in other PCAOB standards, including AS 1201. Examples of what these “measures” to be implemented would be would provide clarity to the auditor as to what is expected of them in meeting this requirement.

- In the note to paragraph C9 of Appendix C, the term “reasonable basis” is used to describe an example of when additional procedures ordinarily are necessary (i.e., when the specialist lacks a reasonable basis for data or significant assumptions). This term is not defined in the proposal, although it is used in AS 1105. However, in that context, it is used in relation to the sufficiency and appropriateness of the audit evidence necessary to support the auditor’s opinion and therefore supported by the context of the additional guidance in AS 1105 about how to make that evaluation and underpinned by the overall concept of the auditor obtaining reasonable assurance. It does not appear that the term, as used in the note to paragraph C9, can have the same meaning, and it’s not, therefore, clear how the auditor would make the determination as to whether a specialist lacks (or has) a reasonable basis for data or significant assumptions.

AS 1210, Using the Work of an Auditor-Engaged Specialist

- Paragraph 04 of the proposed amended standard includes a requirement to “assess whether the specialist and the entity that employs the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist’s work related to the audit.” It is unclear what extent of procedures are necessary for an auditor to perform to evaluate objectivity. In addition, it will be difficult for an auditor to predict all issues encompassed by the specialist’s work in making this objectivity evaluation as required in paragraph 04.

The requirement also includes evaluating whether the auditor-engaged specialist or the entity that employs the auditor-engaged specialist has a relationship to the company or any other conflicts of interest relevant to the work to be performed. Similar to our concerns regarding this requirement for a company-engaged specialist included in our letter above, additional clarity is needed on the extent of procedures to evaluate this relationship requirement. As currently written, we believe this requirement will result in different interpretations that will lead to inconsistencies in practice. Examples of how different situations involving different relationships may influence the auditor’s ability to evaluate objectivity would be helpful in assisting the auditor in meeting these requirements.

- In situations in which an auditor-engaged specialist is found to lack the “necessary objectivity to exercise impartial judgment,”⁶ the proposed amended standard appears to preclude auditors from using the work of the specialist. Clarification or examples to assist with understanding the “threshold” of when a circumstance may cross into having a lack of “necessary objectivity to exercise impartial judgment” are needed, as leaving that “threshold” open to interpretation may lead to inconsistencies in applying the requirements.
- Since auditor-employed and auditor-engaged specialists are supervised and reviewed by the auditors in a similar manner in the proposed amended standards, we recommend including a reference to address how disputes or disagreements between the auditors and specialists should be resolved.

Additional Comment on the Proposal

- Elimination of the distinction between being “in the field of accounting and auditing” or “outside the field of accounting and auditing” as it pertains to the auditor’s specialist and clarification on how the difference pertains to the company’s specialist would provide clarity

⁶ Page A1-21 of the Proposal.

to the standards and also align with the nature of work performed by these specialists, particularly as it is becoming harder to draw a distinction between when a specialist may be inside or outside the field of accounting and auditing. For example, as accounting standards move towards fair value accounting, there could be arguments supporting that a specialist in the area of fair value may be no different than a specialist in the area of income taxes.

August 30, 2017

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Reference: PCAOB Rulemaking Docket Matter No. 044 (PCAOB Release No. 2017-003)

Dear Board and Staff:

We are pleased to respond to the *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (the "Specialists Proposal"). As the leading provider of qualified, experienced and credentialed third-party valuation support to public registrants and investment company managers, we have unique insight and experience with respect to the current rigor preparers of financial statements utilize in estimating fair value, and the scrutiny auditors apply in auditing fair value measurements.

Our role in the financial statement preparation process is distinctive. We support management in enhancing its internal control process with respect to estimating fair value, and our fair value analyses serve as an input for consideration by management in preparing its financial statements. We believe that our consultative advisory process results in more relevant and reliable fair value estimates. As such, our role is that of company-engaged third party specialists, as described in the Specialists Proposal.

Our comments are founded on years of experience assisting management with its valuation estimates. In 2016 alone we performed more than 12,000 engagements for 5,000 clients, including nearly half of the S&P 500, over 70% of top tier private equity firms and 64% of Fortune 100 companies. Our professionals are deeply involved in industry efforts to enhance valuation consistency and transparency, including participation on various task forces and working groups of the AICPA and The Appraisal Foundation; on boards, such as the International Private Equity and Venture Capital Valuation Board, and the International Valuation Standards Council; and in the Fair Value Quality Initiative.

We have previously responded to PCAOB's Staff Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements* (2014) and the PCAOB Staff

Consultation Paper on *The Auditor's Use of the Work of Specialists* (2015). We have also participated in the SAG meetings on this topic. Presently, we are also separately responding to PCAOB's Proposal on *Auditing Accounting Estimates, Including Fair Value Measurements* (PCAOB Rulemaking Docket Matter No. 043/ PCAOB Release No. 2017-002) (the "Estimates Proposal").

Our goal in responding to the Specialists Proposal is to provide our expertise as experienced third-party valuation specialists as the PCAOB considers changes to audit standards which, in turn, will guide the accountability of auditors in exercising their role in capital markets - ensuring that financial information meets the needs of investors and is provided on a reliable, high-quality, consistent, transparent and cost-effective basis.

Key Observations

We understand that the Specialists Proposal addresses the work of various types of specialists. Given the prominence of fair value in financial reporting and our specific expertise in assessing fair value, our comments and observations are directed specifically to auditing the work of valuation specialists assisting management with its fair value assertions, and are written from the perspective of **experienced, credentialed, company-engaged third-party specialists**.

PCAOB's Auditor Guidance Must Reflect Important Recent Developments Affecting Valuations for Financial Reporting

We applaud the Board's focus on reorganizing, streamlining and improving the auditing standards for use of the work of specialists. The Specialists Proposal, however, does not consider recent key developments affecting valuations for financial reporting purposes, which we believe will have a direct impact on advancing the quality of documentation and support provided by company-engaged specialists. The Specialists Proposal should be enhanced by incorporating reference to and giving effect to the impact to these developments. These events include the establishment of the "Fair Value Quality Initiative", tasked with the creation of a valuation professional infrastructure, the subsequent launch of the CEIV (Certified in Entity and Intangible Valuations) credential, and the pending launch of the CVFI (Certified in Valuations of Financial Instruments) credential.

The Fair Value Quality Initiative was undertaken in response to statements made by regulators (SEC) calling for increased quality and accountability of valuation specialists performing valuations for financial reporting purposes. The resulting CEIV credential (launched in January 2017) is designed for both management (company-employed) and third-party (company-engaged) valuation specialists who perform fair value measurements for financial statement reporting purposes. To obtain and maintain the credential, the valuation professional: (1) must meet rigorous qualification, as well as ongoing education and experience requirements; (2) must adhere to the requirements of a Mandatory Performance

Framework (MPF)¹, which governs the scope of work and level of documentation; and (3) agrees to be subjected to a periodic independent Quality Control review.

Adherence to the MPF is mandatory for CEIV credential holders, and is considered best practice for non-CEIV valuation specialists; the same holds for CVFI credential holders who would have to comply with an equivalent to the MPF Disclosure Framework (DF). We believe that both the CEIV and CVFI credentials and related MPF and DF will further enhance the robustness and quality of company-employed and company-engaged valuation specialists' work, and will have a direct impact on the quality of documentation and support for fair value estimates. The MPF lays out detailed requirements and procedures addressing the depth of analysis and documentation necessary to prepare a professional work product that will be used by management for financial reporting purposes. This includes a critical assessment by the valuation specialist of data and projections provided by management, significant assumptions used, and other inputs to the valuation analysis, and a thorough documentation thereof. This will further enhance the relevance and reliability of management's fair value assertions and thereby will make the audit more efficient, and more cost-effective, to the benefit of all parties involved.

However, notwithstanding the new valuation infrastructure in place, the new MPF/DF requirements, and the expectation that a CEIV's/CVFI's work is subject to an independent Quality Control review, we did not clearly discern that the Specialists Proposal would supportively guide auditors to adjust their procedures, and re-define the scope of various audit efforts - including testing, reperformance and analytical procedures, or development of independent estimates – in a way that takes into account MPF/DF-compliant specialist work and documentation. For example, in the context of company specialists, there is only one passing mention of performance standards in the Specialists Proposal, and this does not even occur in the text of the actual amendments for company specialists (Appendix B).

We believe that the Board should consider the results of the Fair Value Quality Initiative which was undertaken at the behest of the SEC.

Risk of Unnecessarily Expanding Audit Procedures

While the Specialists Proposal embraces a "risk-based" approach to auditing, we found that the guidance provided could be subject to broad interpretation which may result in even greater incremental, and at times duplicative, auditor effort when auditing the work of company specialists. Although the document acknowledges that some of the proposed requirements may already have been incorporated in audit firms' audit methodologies or applied in practice by individual teams, in its current iteration, the Specialists Proposal's net

¹ The *Mandatory Performance Framework* document, and its companion document, the *Application of the Mandatory Performance Framework*, collectively referred to as "MPF" for the purpose of this letter, can be located here: <https://ceiv-credential.org/mandatory-performance-framework-and-application/>

August 30, 2017

4

result would likely be an increase in audit time and effort incurred in evaluating the work of company specialists, notwithstanding the recent infrastructure developments in the valuation profession, and other existing safeguards of valuation quality.

Auditors can and should test the company's process - which may utilize engaged specialists, as applicable - to develop fair value estimates. However, when such testing by the auditor demonstrates that management's fair value assertions are reasonable and credentialed company specialists were part of the process, providing consultative support, the auditor should not feel compelled to unnecessarily extend testing. The Specialists Proposal (in conjunction with the companion Estimates Proposal) may inadvertently encourage auditors to unnecessarily expand the audit approaches utilized. Instead, by referencing the MPF/DF process and applicable certifications, the PCAOB standards could provide better guidance and confidence to auditors in making their risk-based judgments, and thereby establishing the extent of testing required.

The increase in costs in the system may be pervasive and far-reaching, as there may be a spillover effect on private company audits as well. It would be difficult to conceive that an auditor would behave differently and exercise a different level of skepticism and professional care in a public vs. a private company audit, even though separate audit methodologies may be maintained.

Risk of a Decrease in the Overall Quality of Financial Reporting

The audit guidance in the Specialists Proposal should communicate a clearer recognition of the beneficial, value-adding, time- and cost-saving impact on the audit process of a qualified and credentialed company specialist, who complies with performance standards, and is subject to independent Quality Control and a code of professional conduct and ethics.

We believe that the Board's intent is to improve audit quality in a cost-effective manner, so as to benefit investors and promote investor protection. However, if the auditor is generally encouraged, expected, or feels obliged to perform more procedures and incur more effort, regardless of the involvement of a qualified company specialist, this could shift the balance between the work of the company specialist and the auditor specialist (as acknowledged in the Specialists Proposal) with negative effects, including degradation of the output of the internal control environment, and potential impairment of auditor independence.

We recognize that management earnestly exercises its responsibility to prepare GAAP-compliant financial statements providing users with relevant and reliable financial information. However, if faced with the prospect of increasing audit scope and costs, situations may arise where management may feel compelled to invest less time, cost and effort in supporting certain assertions in the financial statements by not engaging a specialist when one would otherwise be called for - especially given the expectation that the auditor's specialist would perform extensive testing and calculations as part of the audit.

This outcome could decrease the quality of financial reporting and may also create situations in which auditor independence could be deemed impaired because the auditor's specialist is de facto providing management with estimates, which the auditor must review and audit.

Overall, these factors pose a risk of creating an environment that not only does not meet the PCAOB's objectives in the rewriting of this standard, but also fails to foster the best outcome for investors.

Credentialed Company Specialist MPF/DF Compliance Should Enable Auditors to Appropriately Adjust their Scope of Work

Auditors' risk assessment should consider management's and its specialists' compliance with the MPF/DF, and auditors should be able to tailor their procedures accordingly. While the amendments in the Specialists Proposal address key considerations such as the specialist's knowledge, skill and ability, there is no direct reference to performance standards that govern the specialist's work, meaning the *actual application* of the specialist's knowledge, skill and ability to a specific valuation, rather than the skill and ability merely as a professional attribute.

MPF/DF compliance directly impacts the specialists' *scope of work, depth of analysis and documentation* as it relates to fair value measurements, and a CEIV/CVFI credential further signals that the specialist's work may be subject to an independent Quality Control review by the organization issuing the specialist's credential. These are key safeguards of valuation quality that should be made explicit in the Specialists Proposal - and should be considered as significant factors in the auditors' risk assessment and resultant scope of work.

Company Specialists - and Particularly Company-Engaged Specialists - are an Enhancement to Management's Internal Control Process

Management is responsible for the assertions contained in the financial statements and cannot relinquish this role to a third party. However, management can enhance its process by obtaining consultative advice from experienced valuation specialists.

Typically, management has sought assistance from third party valuation specialists in complying with financial reporting requirements related to business combinations, impairment testing, and share-based compensation, among others. Additionally, it has become best practice of the largest private equity and hedge fund investment managers to validate fair value estimates using a qualified, experienced third party valuation specialist. Investors have come to rely on enhanced internal control systems which appropriately include specialized valuation expertise. In these situations, the valuation specialist is engaged to assist management, by providing consultative advice, in fulfilling management's responsibility of supporting the assertions included in the financial statements.

As such, management should not be put at a disadvantage for using qualified and credentialed company-engaged or company-employed specialists. The prospect of a broadly increased audit mandate (issues previously discussed) despite the use of qualified company specialists seems to be at odds with such an internal control enhancement that management has traditionally utilized.

Presumption of Bias

We think that the presumption of bias is over-emphasized in the Specialists and Estimates Proposals, collectively. When a professional (in this case, an auditor) has a questioning mind and applies a healthy degree of professional skepticism in performing his/her job, it does not imply that the subject or party to the inquiry (management) is inherently biased.

Professional skepticism (which includes evidential skepticism and self-skepticism) is an attitude, rather than a verdict on the character or actions of those to which the inquiry is addressed. Overemphasizing the potential for any bias, against the backdrop of an already robust PCAOB inspection process, and existing robust review procedures of the work of company specialists, could lead to behavior that is reactionary and results in unnecessarily expanding audit procedures with arguably little incremental benefit. Management has a duty of care; engaged specialists abide by duty of care and ethics standards, as do auditors. The current tone may inadvertently promote a negative perception that management and its employed or engaged specialists will always be biased against exercising proper care. Such a premise is without general merit.

The benefit of professional skepticism and the instruction to rely on persuasive evidence can be highlighted without casting management, specialists, or auditors in a negative light. Professional skepticism is also consistent with the approach taken by the MPF/DF and reflected in the work performed by the CEIV- (or CVFI-) credentialed, company-employed or company-engaged specialist.

Conclusion

We appreciate the opportunity to comment on the Specialists Proposal. We fully support the Board's efforts to set standards that result in high quality audits.

We believe that without appropriate amendments, in the current regulatory and financial reporting environment, the proposed guidance in the Specialists Proposal (and the companion Estimates Proposal) will likely lead to auditors significantly and unnecessarily expanding procedures, with arguably little incremental benefit. Thus, we urge the PCAOB to reconsider certain aspects of the guidance, and the overall tone and direction of the Specialists and Estimates Proposals, collectively.

August 30, 2017

7

Subject to our foregoing comments, in *Appendix 1 below*, we have provided comments, by paragraph, on the proposed amendments in Appendix B to AS 1105 of the Specialists Proposal. In *Appendix 2 below*, we have also provided responses to certain specific questions posed in the Specialists Proposal.

We would be pleased to further discuss our comments with the PCAOB staff. Please direct any questions to any of us via the contact information set forth below.

Sincerely,



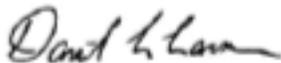
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Appendix 1

Specific Comments on Proposed Appendix B to AS 1105, Audit Evidence

B3.

We think that the proposed wording should be more robust in describing the factors for assessing the specialist's knowledge, skill and ability. Considerations such as qualification requirements, professional accreditation, performance standards, continuing professional education requirements and standards need to be specifically identified in Appendix B.

Above all, specialist performance standards - and particularly compliance with mandatory performance standards as part of a specialist certification designed specifically for financial reporting purposes - should be given prominence.

B4.

While we agree that the auditor should assess the relationship between the company and the specialist, there should be no presumption for bias, which is what one might take away from reading this paragraph (as well as other parts of the Specialists Proposal). The current guidance overlooks the fact that a credentialed company specialist subject to performance and ethical standards, and a work file independent Quality Control review has a significant professional and ethical incentive to remain objective and unbiased, notwithstanding a relationship of any kind with the company. This is particularly true of third-party company specialists that are CEIV/CVFI credentialed.

Furthermore, the MPF (and DF) requires the valuation specialist to exercise professional skepticism – both evidential skepticism (i.e., exercise due professional care by regularly questioning and critiquing all information and data with the appropriate level of skepticism), and self-skepticism (i.e., monitoring his/her own client-based presuppositions that could detract from evidencing skepticism as a result of comfort level or familiarity with the client, industry, or both.) (MPF, par. 2.17).

Also, consider the following MPF guidance:

“When evaluating management-generated and management-provided information, the valuation professional must consider the experience of management and the sufficiency of the documentation and analyses provided by management throughout the valuation engagement. The valuation professional should not presume management is biased; however, the valuation professional should not accept and rely on less-than-persuasive evidence because the valuation professional believes management is unbiased. This requirement extends to third-party specialists retained by management, their competence, and the sufficiency of their work product.”

And,

“Each valuation professional must implement a degree of professional skepticism with the expectation that the conclusions reached in the report will be subjected to review (for example, by the client, external auditors, regulators).”

The above is an illustration of the performance and ethical standards that valuation specialists with the CEIV (and CVFI) designation are subject to, and we believe that these standards are meaningful and consequential in practice.

B5.

We think that the fact the specialist complies with performance standards would impact (increase) the quality of the evidence, and should be considered in the balance of evidence evaluated. Also, please see our comments to B3.

B6. and B7.

It should be made clear that the auditor’s risk-assessment, scope of testing, and necessary evidence sought is a function of whether such performance standards were adhered to by the company specialist, especially when it comes to audit procedures such as recalculation, reperformance, and analytical procedures, as well as the development of an independent estimate.

For example, note that the MPF also calls for testing the data by the valuation specialist (*Application of the Mandatory Performance Framework*, par. A1.4):

“The valuation professional is responsible for evaluating whether the prospective financial information (PFI) provided by management is representative of expected value and properly supported... Valuation professionals who obtain management’s PFI for use in their valuation procedures must review the PFI with the appropriate level of professional skepticism... Part of the valuation professional’s responsibility is to evaluate the PFI provided by management for reasonableness in general, as well as in specific areas.”

The MPF also states that factors and common procedures to consider when performing this assessment may include, but are not limited to:

- Comparison of PFI for an underlying asset of the subject entity to expected values of the entity cash flows.
- Frequency of preparation.
- Comparison of prior forecasts with actual results.
- Mathematical and logic check.
- Comparison of entity PFI to historical trends.
- Comparison to industry expectations.
- Check for internal consistency.

Given the discussion in the preceding few paragraphs, what we think is missing from B7 is the explicit recognition and emphasis on any performance standards that the company specialist is subject to. Currently, B7c. only implicitly addresses the technical skill of the specialist, but does not directly address the performance standards that govern the specialist's work, meaning the *actual application* of the specialist's knowledge, skill and ability to a specific valuation, rather than the skill and ability merely as a professional attribute.

MPF/DF compliance directly impacts the specialists' *scope of work, depth of analysis and documentation*, and a CEIV/CVFI credential further signals that the specialist's work may be subject to an independent Quality Control review by the organization issuing the specialist's credential. These are key safeguards of valuation quality that should be made explicit in the PCAOB proposal - and should be considered as significant factors in the auditors' risk assessment.

What we think is missing from B7d., or perhaps a separate point is warranted, is whether the company specialist is subject to a professional code of conduct and ethics requirements and sanctions for any violations by his/her accrediting organization, as well as the company specialist's employer. Without giving recognition to these factors, only one side of the issue would be examined (e.g., a threat to a specialist's objectivity), without giving due consideration to any safeguards in place.

B8.

Here too, there may be a potential for an unnecessarily increased audit scope when in fact a qualified, credentialed company specialist is involved, who complies with the MPF/DF.

Although the document acknowledges that some of the proposed requirements may already have been incorporated in audit firms' audit methodologies or applied in practice by individual teams, we think that given the current regulatory environment, this might encourage a more reactionary behavior than anticipated. Even if the auditor is already performing many of these procedures, behaviorally, the response might be to further reconsider or augment the existing audit procedures rather than accept the status quo as adequate, and "do nothing" in response to new PCAOB auditing standards.

Also, see our comments to B6 and B7.

B9 and B10.

Considering the guidance in these paragraphs, and particularly items B10 (1) i. and ii, we would like to highlight the concept of *contrary evidence* in a valuation analysis. Per the MPF (and DF), source documents that are relevant to the analysis and indicate contrary evidence to the conclusion of value, along with the valuation professional's explanation of how this information was considered, must be identified and discussed in the company specialist's report.

The requirement to disclose and discuss contrary evidence *in the report* is a new development in practice, although it is difficult to predict how often this will occur. Prior to the MPF/DF, the valuation specialist may have undertaken the same thought process of addressing, reconciling, and rationalizing contrary evidence, but this may not have been previously documented in the report.

Based on the guidance in B9 and B10, contrary evidence might be misconstrued if considered at face value, without giving due consideration to the company specialist's explanation. We recommend that the principles laid out in Appendix B be further clarified to first focus the auditor's attention on the reason for such exceptions and/or how the specialist has addressed the issue, if applicable, prior to the auditor performing additional procedures or assuming that the specialist report cannot meet the auditor's objectives.

Appendix 2

Responses to Certain Specific Questions

Questions:

2. **Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?**
3. **Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?**

Response

In general, we agree with distinguishing between auditor and company specialists; however, we believe that a more explicit distinction could be made between company-employed and company-engaged specialists in the risk assessment process, as there is a meaningful difference between the two. In addition to the engaged specialist being a third party, which would presumably affect the reliability of management's assertions supported by such specialist's work from an audit perspective – a company-engaged specialist is specialized and occupied full-time in valuation.

Question:

6. **The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?**

Response

Investors will benefit if the audit standards appropriately recognize the safeguards of valuation quality (e.g., credentials specifically for financial reporting, valuation performance standards), to give auditors confidence in their risk assessment and enable them to adjust their audit scope, where appropriate.

As discussed earlier, we believe that a qualified company specialist, and especially a credentialed third-party specialist, is an enhancement to management's internal control process in supporting management's assertions in the financial statements.

Accordingly, we believe that the audit guidance in the Specialists Proposal should communicate a clearer recognition of the beneficial, value-adding, time- and cost-saving impact on the audit process of a qualified management specialist, who complies with performance standards, and is subject to independent Quality Control and a code of professional conduct and ethics.

Question:

7. **The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?**

Response

As the Specialists Proposal has acknowledged, because of the proposed amendments, there is a likelihood for an increase in audit costs and fees, and the additional need for management and company specialists to devote more time and resources to respond to auditor's requests and inquiries.

However, the use of qualified third-party company specialists can in fact *reduce costs* in the system by enabling auditors to appropriately define their scope of work. Auditors can and should test the company's process (which may utilize engaged specialists, as applicable) to develop fair value estimates. However, when such testing by the auditor demonstrates that management's fair value assertions are reasonable, the auditor should not feel compelled to extend testing.

The Specialists Proposal (in conjunction with the Estimates Proposal) may inadvertently encourage auditors to unnecessarily expand the audit approaches utilized. Instead, by referencing the MPF/DF process and applicable certifications, the PCAOB standards could provide better guidance to auditors in making their risk-based judgments, and thereby the extent of testing required.

Question:

8. **The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?**

Response

We think that as currently laid out and worded, the Specialists Proposal (and the related Estimates Proposal) can have several unintended consequences:

- *Risk of unnecessarily expanding audit procedures and increasing costs in the system.* Against the backdrop of the already robust PCAOB inspection process, a possible consequence is for auditors to perform additional audit procedures, where the cost of these procedures out-weigh their benefit.
- *Risk of a decline in the quality of financial reporting.* If the auditor is generally encouraged, expected or feels obliged to perform more procedures and incur more effort, regardless of the involvement of a qualified company specialist, this could shift the balance between the work of the company specialist and the auditor specialist (as acknowledged in the Specialists Proposal), with negative effects. If management invests less time, cost and effort in supporting certain

assertions in the financial statements with the expectation that they will be tested and recalculated by the auditor's specialist as part of the audit, this could degrade the output of the internal control process and reduce the quality of financial reporting.

- *Risk of impairing auditor independence.* A threat to auditor independence could arise in situations in which the auditor's specialist performs independent calculations as part of the audit, and management ends up using these estimates, notwithstanding the use of a company specialist. In this case, auditor independence could be deemed impaired because the auditor's specialist is de facto providing management with estimates, which the auditor must review and audit. This poses a risk of creating an environment that not only does not meet the Board's objectives in the rewriting of this standard, but also fails to foster the best outcome for investors. Please also see our comments in the Key Observation section of this letter.
- *Risk of private companies being indirectly affected by a change in auditor behavior, and increased costs.* Even though the PCAOB standards pertain to the audits of public companies, to the extent the Specialists Proposal and Estimates Proposal drive a change in auditor behavior, this may also affect private company audits. It would be difficult to rationalize that an auditor would behave differently and exercise a different level of skepticism and professional care in a public vs. a private company audit, even though separate audit methodologies may be maintained.

We think that it is counter-intuitive to arrive at such results. If company-employed and company-engaged specialists can enhance management's ability to support an assertion, one should not face such unintended consequences.

Separately, in regards to third-party specialists, we do not agree that "companies control the work of a company's specialist over information to be used in the financial statements". Any "control" over the work of a specialist is incongruent with the concept of third-party specialists, especially when they are required to adhere to a professional code of conduct and ethical standards.

Questions:

- 10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?**
- 11. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?**

Response

With regards to company specialists, we do not believe that the alternatives the Board had considered, but is not proposing, are preferable to the main provisions of the current Specialists Proposal. The main reason for this is that a company specialist has a specific and valuable role in the financial reporting process, possessing specialized skill and knowledge, and providing support for management's assertions in the financial statements through consultative advice and enhancements to a company's internal control process.

However, we think that the Board could make a more explicit distinction between company-employed and company-engaged specialists, for reasons discussed earlier in this letter, in terms of the auditor's risk assessment. We suggest that the Board consider how it may convey in the new standard that the involvement of a company specialist, and particularly a qualified, credentialed third-party specialist is an enhancement to the quality of financial reporting that should be considered in the audit process.

Question:

- 19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?**

Response

In general, we think that the proposed requirements are scalable (if our observations are considered) and are described as principles. However, we recommend that the principles be augmented further to more fully consider the involvement of qualified, credentialed company specialists complying with performance standards for valuations for financial reporting purposes.

Also, please see our response to Question 23.

Question:

- 20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.**

Response

We think that overall, auditors are likely to incur greater time and effort auditing the work of company specialists. While we support improving audit quality, we think that as currently proposed, the guidance may have certain unintended consequences as discussed in the answer to Question 8, and in the Key Observations section earlier in this letter.

Question:

- 21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?**

Response

We think that the proposed requirements are clear, subject to our other comments and suggestions elsewhere in this letter.

Question:

- 22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?**

Response

Please see our comments (located in Appendix 1) on par. B3, B4 and B5 of proposed Appendix B, in addition to our comments made earlier under *Key Observations*.

Question:

- 23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?**

Response

We believe that to be useful, the examples provided need to address all factors that determine the necessary audit effort for testing and evaluating the work of a company specialist, and explain how each factor was considered in arriving at an audit scope.

Specifically, footnote 17 to Example 1 (page A3-19) could be misinterpreted as encouraging the development of an independent expectation by auditors as a readily available fallback, after assessing the aforementioned factors, which may lead to unnecessarily extending audit procedures.

As to the examples in the text on restrictions, limitations and disclaimers in the specialist's report (page A3-23), we think that in practice the situations encountered

would be much more nuanced than the examples provided. Furthermore, the auditor needs to obtain an understanding of the reason for any limitations and disclaimers.

Finally, as discussed earlier in our comments to B9. And B10, the concept of *contrary evidence* to the conclusion of value in the specialists' report may present a similar issue. Contrary evidence might be misconstrued if considered at face value, without giving due consideration to the company specialist's explanation of how this evidence was addressed and reconciled.

Question:

- 24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?**

Response

Please see our comments (located in Appendix 1) on par. B9 and B10 of proposed Appendix B, in addition to our comments made earlier in the *Key Observations* section of this letter.



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August 30, 2017

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Public Company Accounting Oversight Board
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Ref: PCAOB Docket 043 (Auditing Accounting Estimates, including FVM), and
PCAOB Docket 044 (Auditor's Use of the Work of Specialists)

For Docket 043, I request deletion of the word “remediation” from AS 2401.54; for Docket 044 (Release 2017-003) in Figure 2, I also request deletion of the word “remediation”. My justification is to include other subtypes of environmental liabilities (asset retirement, commitments, guarantees) that do not contain remediation spending; while AICPA SOP 96-1 (1996) was titled “environmental remediation liabilities”, the definition of asset retirement obligations in 2001 and recent emergence of financial assurance guarantees show that material environmental liabilities have not been intrinsically limited to remediation.

For both Docket 043 and 044, I propose a standardized cover page (next page) for estimate parameters; this step ensures the thinking process is highly visible and auditable.

Otherwise, these documents have my full support in all respects.

Cordially,

John Rosengard
President

Ref: PCAOB Docket 043 (Auditing Accounting Estimates, including FVM), and
PCAOB Docket 044 (Auditor's Use of the Work of Specialists)

Standardized cover page for estimate parameters

ASTM and AACEI citations are relevant to environmental liabilities.

Estimate Parameter	Value(s) Used (examples)	Source or Justification (examples)
1. Inflation rate applied to future costs	x.xx%/year	US Federal Reserve System: Monetary Policy Report June 2015
2. Nominal discount rate applied to pacing of spending	x.xx%/year	White House OMB Circular No. A-94, Appendix C, 15-year rate; November 2016
3. Duration of environmental liability spending	n years	<i>"Comparable sites complete all phases of work in 10-15 years"</i>
4. Purpose of the estimate (feasibility, provision, fair value measurement, captive insurer funding, budgeting, acquisition/divestiture, cashout)	See ASTM E2137-16 ¶1.1	<i>"Validation of the current provision is the only active purpose"</i>
5. Level of effort applied to estimate, as rough order of magnitude (10, 100, 1000 hours)	<i>1 hour</i>	<i>"Meant to be peer review of units and prices in previous year's estimates for four locations"</i>
6. Turnaround time of estimate	<i>1 day</i>	<i>"unplanned cost engineering task"</i>
7. Comparable liabilities evaluated	<i>Site a, site b, site c</i>	<i>"These liabilities have waste streams which are common to this industry; an active marketplace exists for remediation"</i>
8. Cost Estimate Class of estimate	Class 1 to 5, per AACEI 56R-08 (2012), Table 1, <i>Cost Estimate Classification System</i>	<i>"Class 5, based on analogues and estimator's parametric model; owner lacks current scientific data and regulatory framework to create Class 3 or 4 estimate"</i>
9. Fair Value Measurement Class of estimate	Class 1 to 3	<i>"Class 2; 95% of estimate is based on common carrier trucking rates (which track a diesel fuel price index) and published landfill rates"</i>
10. Exclusions from estimate	See ASTM E2137 (2016), Table 1, <i>Examples of Environmental Costs and Liabilities</i>	<i>"NRDA claims deemed immaterial from outset, no evidence to the contrary"</i>



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30 August 2017

Re: Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists, PCAOB Rulemaking Docket Matter No. 044

Dear Ms. Brown:

Ernst & Young LLP (EY) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its proposed amendments relating to the auditor's use of the work of specialists (the Proposal). We support the Board's efforts to strengthen the requirements that apply when auditors use the work of specialists in an audit, and we believe that many of the proposed changes would improve the quality of auditing in this area.

Overall observations

We recognize and appreciate the Board's efforts to streamline the audit standards for the use of the work of specialists in an audit. We agree that providing separate guidance for each of the three categories of specialists (company specialists, auditor-employed specialists and auditor-engaged specialists) is an improvement over existing standards, and we support the structure of the Proposal. However, we have concerns about the proposed guidance on the extent to which an auditor may need to test and evaluate the work of a company's specialist.

We believe that management's use of a specialist generally results in a better application of the relevant financial reporting framework and a decrease in risk of material misstatement in the financial statements. Accordingly, the new standard and the nature and extent of the audit procedures required should acknowledge the potential decrease to audit risk.

We also believe that while the auditor's education and experience enable him or her to be knowledgeable about business matters in general, the auditor should not be expected to have the expertise of a person trained or qualified to engage in the practice of another profession or occupation. Thus, we have concerns about certain elements of the Proposal which could be interpreted as requiring auditors to perform procedures related to aspects of a company's specialists' work that may not be possible or practical. In our view, as more fully described below, without further clarification, these aspects of the proposal could significantly increase the cost of the audit without a commensurate improvement to audit quality.

In addition, we have concerns regarding the proposal to rescind Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210 (AI 11)*, which we believe provides important prescriptive guidance and examples to help the auditor assess the level of assurance obtained from legal opinions.

Testing and evaluating the work of a company's specialist

We are concerned that certain aspects of the Proposal could be interpreted to require auditors to inspect company specialists' models and re-perform their work. For example, paragraph .B8 of the proposal for AS 1105, *Audit Evidence, Appendix B – Using the Work of a Company's Specialist as Audit Evidence* (Proposed Appendix B to AS 1105), states that the auditor "should ... (3) evaluate whether the data was appropriately used by the specialist." It is not clear what "appropriately used" means in this context.

We are also concerned about the note to paragraph .B8. That note indicates that if the specialist is involved with an estimate, the auditor should also comply with Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (Proposed AS 2501). The note to paragraph .10 of that proposal would require the auditor to evaluate whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework. Similar to our concerns about what "appropriately used" means, it is not clear to us what "appropriately applied" means in this context.

If the Board's intent is to require auditors to inspect company specialists' models and re-perform their work, we would have several concerns. First, the auditor may not have sufficient expertise in the specialist's field to perform these procedures. For example, in the oil and gas industry, companies use reports prepared by geologists to value their oil reserves. We agree with the Board that auditors should be required to test the company-produced data used by the specialist and evaluate the (1) relevance and reliability of data obtained from external sources, (2) reasonableness of the significant assumptions and (3) appropriateness of the methods used by the geologist.

However, we do not believe that auditors should also be required to inspect the geologist's models and re-perform the geologist's work if the auditor has determined that the geologist has a high level of knowledge, skill and ability and has a sufficient level of objectivity. Requiring inspection and re-performance of a specialist's work would likely require the auditor to hire another geologist to perform this procedure. Given the highly specialized nature of the work, hiring an additional specialist may not be practical or possible in all cases.

Another issue is that auditors do not always have access to the proprietary models the company specialist uses. If this is the case, a specialist engaged by or employed by an auditor would not be able to test the company's process used to develop the accounting estimate pursuant to paragraphs .09–.18 of Proposed AS 2501. As a result, the auditor's specialist would need to develop an independent expectation of the estimate pursuant to paragraphs .21–.26 of Proposed AS 2501, and that would be impracticable for many estimates such as oil reserve valuations and pension liabilities.

For example, companies often engage third-party actuaries who use proprietary software to estimate pension liabilities. While auditors often employ or engage their own actuaries to evaluate these estimates, it would be impracticable for the auditor's actuaries to be required to develop an independent expectation of these estimates given the time and effort required for initial setup and ongoing maintenance of such an independent model.

We believe that the proposed requirement for auditors to apply the same auditing procedures to accounting estimates regardless of whether management uses an external specialist could have unintended consequences. For example, if the auditor cannot rely on a specialist's work, a company might decide not to engage a specialist to develop an independent estimate, even though using a specialist would likely result in a better application of the relevant financial reporting framework and would likely decrease the risk of misstatement in the financial statements. We believe the Board should acknowledge the decreased risk of misstatement when a company engages a sufficiently competent and objective specialist and should require less testing of the company specialist's work in these cases.

The proposed standard seems to contemplate allowing auditors to scale testing of the company specialist's work based on the auditor's risk assessment. Proposed paragraph .B7 of Appendix B to AS 1105 indicates that the persuasiveness of the evidence the auditor would be required to obtain through testing and evaluating the specialist's work can vary based on a number of factors.

We agree with this, but it is not clear to us how auditors in practice would adjust the extent of their evaluation of whether the data was appropriately used by the specialist (per paragraph .B8 of Proposed Appendix B to AS 1105) or the extent of their evaluation of whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework (per paragraph .10 of Proposed AS 2501). We recommend that the Board clarify these proposed requirements, including indicating whether there is a base level of evaluation the auditor should perform that could then be adjusted based on the auditor's risk assessment.

Rescinding AI 11, Using the Work of a Specialist: Auditing Interpretation of AS 1210

The proposal, if adopted in its current form, would rescind AI 11. Auditors have long relied on AI 11 when evaluating the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in Accounting Standards Codification 860, *Transfers and Servicing* (ASC 860).

Among other things, AI 11 provides guidance for assessing the qualifications of attorneys involved and the sufficiency of the legal analysis used as audit evidence, including examples of legal opinions that have been widely used and accepted in practice by both auditors and non-auditors.

AI 11 also provides examples of language that attorneys use as a guide when drafting legal opinions that also include permission for the auditor to use the legal opinion. Rescinding AI 11 could lead to more diversity in practice by companies and legal counsel related to the form and content of the legal opinions. This could result in inconsistencies in the level of evidence obtained by auditors when evaluating whether the isolation criterion in ASC 860 has been met.

The effort to create AI 11 was significant. We are concerned that rescinding AI 11 would be a step backwards and introduce unnecessary threats to audit quality. Its removal would potentially re-open the debate about whether "could" (versus "would") language would provide sufficient evidence to evaluate ASC 860's legal requirement, leading to more diversity in practice by companies and legal counsel related to the form and content of the legal opinions. We recommend that the Board not rescind AI 11.

Rescinding AI 28, Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

The proposal, if adopted in its current form, would rescind AI 28. Auditors rely on AI 28 to determine the nature, timing and extent of audit procedures over the company's application of ASC 740, *Income Taxes*, including its income tax positions and tax disclosures. We note that companies often have concerns about the sensitivity of information included in tax opinions, tax accrual or tax contingency workpapers.

AI 28 provides prescriptive guidance regarding the audit requirements over certain tax working papers. Rescinding AI 28 could lead to more diversity in practice, by both companies and their advisers, with respect to providing the documentation auditors need. While the proposed standard incorporates the basic principles of AI 28, rescinding AI 28 could make it more difficult for auditors to accumulate sufficient appropriate audit evidence to form the basis of their conclusions over a company's income tax accounting and disclosures. We do not believe that the Board should rescind AI 28.

Company specialists – Understanding of internal controls

It is unclear from the proposal whether the auditor would be required to evaluate the design of internal controls and determine whether they have been implemented, even if the auditor is not performing an audit of internal control or planning to rely on controls for the related assertions.

Paragraph .B2 of Proposed Appendix B to AS 1105 states that the auditor "should ... obtain an understanding of the work and report(s) of the company's specialist(s) and related company process and controls ..." Paragraph .20 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*, states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

The note to paragraph .34 of AS 2110 is less ambiguous. It says: "A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit."

We believe the Board should clarify and better link the requirements of AS 2110 to avoid the misapplication of the requirements of Paragraph .B2 of Proposed Appendix B to AS 1105. Specifically, the Board should indicate whether the auditor may continue to follow Paragraph .34 of AS 2110 in determining the extent to which the auditor understands control activities depending on whether the auditor plans to rely on upon controls. We suggest the following edits to Paragraph .B2:

.B2 The auditor should, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting,² obtain an understanding of the work and report(s) of the company's specialist(s) ~~and related company processes and controls~~, which includes:

- a. The nature and purpose of the specialist's work;
- b. Whether the specialist's work is based on data produced by the company, data obtained from external sources, or both; and

- c. The company's processes and controls³ for ~~selecting and~~ using the work of specialists.

² See paragraphs .28-.32 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

³ See paragraph .34 of AS 2110

Company specialists – Understanding the selection process

Paragraph .B2(c) of Proposed Appendix B to AS 1105 indicates that the auditor should understand the company's process for selecting and using the work of specialists, including when the specialist is employed by the company. It isn't clear to us what is meant by "selecting" in this context. The statement appears to refer to the process of how the company chooses one specialist over another. If that is the case, we do not believe auditors should be required to understand this process, as an evaluation of the selection process would not, in our opinion, provide a significant amount of incremental insight regarding the specialist's competence and objectivity to warrant the additional audit effort in this area. We recommend that the proposal focus on evaluating the specialist selected by management, including management's evaluation of the specialist's qualifications and expertise.

Auditor-employed specialists – Documentation of understanding with specialist

Paragraph .C5 of proposed AS 1201, *Supervision of the Audit Engagement – Proposed Appendix C – Supervision of Auditor-Employed Specialists* (Proposed Appendix C to AS 1201) requires the auditor to establish and document an understanding with the specialist regarding various matters. Appendix 3 of the Proposal indicates that the Board intends for this understanding to be documented in planning memoranda, separate memoranda, audit programs or other related work papers. However, this language isn't included in the proposed standard. We believe the auditor should have the flexibility to determine where to document its understanding with an auditor-employed specialist and this language should be incorporated into the proposed standard.

We note that Paragraph .06 of proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist* (Proposed AS 1210), includes the same requirement as .C5 of Proposed Appendix C to AS 1201. We believe this requirement is appropriate because the documentation should generally be more formal when an auditor engages an external specialist.

Auditor-employed and auditor-engaged specialists – Approach to work

We suggest clarifying what is meant by specialists' "approach to that work." Proposed paragraphs .C5(b) of Appendix C to AS 1201 and .06(b) of AS 1210 indicate that the engagement partner and other engagement team members who perform supervisory activities should establish and document an understanding with both auditor-employed and auditor-engaged specialists regarding the nature of the work that the specialist will perform and the specialist's approach to that work. However, it is not clear to us what the specialist's "approach to that work" means. We believe the Board should clarify its intent.

Auditor-engaged specialists and company specialists – Objectivity

Paragraph .05 of proposed AS 1210 indicates that the auditor should not use a specialist who lacks the necessary objectivity. Proposed Paragraph .04 indicates that assessing whether the specialist (and the entity that employs the specialist) has the necessary objectivity includes evaluating whether the specialist (or the entity that employs the specialist) has a relationship with the company. Together, these two paragraphs

appear to imply that if any relationship is identified (e.g., employment, financial ownership, another business relationship, contractual rights, family relationships), the auditor should not use the specialist.

Such an interpretation would be inconsistent with Paragraph .11 of extant AS 1210, which generally enables the auditor to consider the nature of the relationship in evaluating the specialist's objectivity. We believe that a specialist's objectivity should be viewed as a continuum that affects the nature, timing and extent of procedures auditors need to perform. We believe the auditor, who is required to be independent under the most restrictive standards, should be allowed to exercise judgment and determine whether additional procedures are necessary to provide sufficient appropriate audit evidence. We recommend that the Board clarify paragraph .05 to better reflect the degree of judgment intended in the evaluation of the specialist's objectivity.

Proposed paragraph .B4 of Appendix B to AS 1105, *Audit Evidence*, would require auditors to assess the relationship to the company of the specialist and the entity that employs the specialist (if the specialist isn't employed by the company). On the other hand, the proposed standard on auditor-engaged specialists (paragraph .04 of proposed AS 1210), would require auditors to assess whether the specialist and the entity that employs the specialist have the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit.

While both standards appear to require the consideration of the same factors, it is not clear to us why the proposal on auditor-engaged specialists uses the term "objectivity" while the proposal on company specialists does not. We also note that extant ISA 500 includes requirements for the auditor to evaluate the objectivity of a specialist and specifies in paragraph .A43 that it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate.

Given the different ways in which the proposal addresses the auditor's consideration of objectivity related to auditor-engaged and company specialists, we believe the Board should clarify the differentiating factors in the nature, timing and extent of testing when evaluating the work of an auditor-engaged versus company-engaged or company-employed specialist.

In addition, proposed paragraph .B5 of Appendix B to AS 1105 indicates that the necessary evidence to assess the level of knowledge, skill and ability of the company's specialist and his or her relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion and (2) the risk of material misstatement. Given that the persuasiveness of the evidence the auditor should obtain for those assessments increases as the significance of the work and risk of material misstatement increases, we believe the Board should clarify whether there is a base level of audit evidence that the auditor should obtain in this assessment and how it should vary based on audit risk or the estimation uncertainty associated with the specialist's work.

Other comments relating to testing and evaluating the work of a company specialist

The proposal would add points (4) and (5) about whether the auditor has doubt about the specialist's knowledge, skill and ability and whether the specialist has a conflict of interest relevant to his or her work to the note to Paragraph .B10 of Proposed Appendix B to AS 1105. These points appear to be misplaced. We believe the Board should move points (4) and (5) to an earlier paragraph in Appendix B under the heading "Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company."



Applicability

We agree that the proposed amendments could benefit audits of emerging growth companies and brokers and dealers that are required to be conducted in accordance with PCAOB standards. Accordingly, we support making any final standard apply to audits of those entities.

Outreach to preparers

We believe that implementation of the Proposal, particularly in the area of testing and evaluating the work of a specialist and the rescission of AI 1.1, could also have implications for preparers. We encourage the Board to seek feedback from preparers on how they believe potential changes in the auditing standards could affect their processes (if at all) and consider that input before finalizing the Proposal.

Effective date

We believe that a final standard should be effective at the same time as any new standard and related amendments on auditing accounting estimates, including fair value measurements. As described in this letter, if our understanding of the Proposal is correct and changes to it are not made, we believe that its implementation could be a significant undertaking. As a result, we recommend that the standard be effective for audit periods ending two years after the Securities and Exchange Commission approves the final standard.

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

Very truly yours,

Copy to:

PCAOB

James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Securities and Exchange Commission

Jay Clayton, Chairman
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner
Wesley R. Bricker, Chief Accountant
Marc A. Panucci, Deputy Chief Accountant

**Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency**

September 20, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 044 – *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*

Dear Office of the Secretary:

The staffs of the federal banking agencies (the agencies) appreciate the opportunity to comment on the Public Company Accounting Oversight Board’s (PCAOB) *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists* (the Proposed Amendments). The agencies support the PCAOB’s efforts to strengthen the existing auditing standards on the auditor’s use of the work of specialists. We believe the Proposed Amendments, along with the PCAOB’s *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements, and Proposed Amendments to PCAOB Auditing Standards*, will improve the quality and the consistency of audits, reinforce the need for professional skepticism, and enhance market discipline.

The one aspect of the Proposed Amendments with which the agencies do not agree is the PCAOB’s proposal to rescind *Auditing Interpretation 11: Using the Work of a Specialist: Auditing Interpretations of AS 1210* (AI 11). We strongly recommend the PCAOB update and retain, rather than rescind, AI 11 because the concepts set forth in AI 11 continue to be relevant, and their proper application is critical when evaluating legal isolation related to transfers of financial assets.

The agencies note the importance of legal opinions as audit evidence for determining legal isolation in connection with transfers of financial assets. Financial Accounting Standards Board Accounting Standards Codification (ASC) paragraph 860-10-40-5 requires that a transferor of financial assets surrender control over the financial assets in order to account for the transfer as a sale, and sets forth three conditions that must be met

to provide evidence of surrender of control. One of these conditions is a legal isolation test. In this regard, ASC paragraph 860-10-40-5a requires that “[t]he transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.” This requirement covers entities subject to bankruptcy, conservatorship, or other receivership procedures in the United States and other jurisdictions, including FDIC receivership and conservatorship.

AI 11 includes sample language that should be included in legal opinions to provide audit evidence to support management’s assertion that a transfer of financial assets has met the legal isolation requirement of ASC paragraph 860-10-40-5a, as well as examples of language that would not be acceptable. Although the Proposed Amendments include high-level general statements about inadequate language (e.g., restrictions, disclaimers, or limitations that affect the auditor’s use of a specialist’s report), the valuable sample paragraphs of acceptable and unacceptable language in legal opinions that are included in AI 11 would be lost if the interpretation is rescinded. Therefore, we strongly recommend that the PCAOB not rescind AI 11, but rather update and retain it. The agencies would be pleased to assist in updating AI 11. Also, since the guidance in the updated AI 11 would be applicable to the auditor’s use of the work of a company-employed or -engaged specialist and an auditor-employed or -engaged specialist, we recommend that updated AI 11 be explicitly identified as auditing interpretations of proposed Appendix B to Auditing Standard (AS) 1105, *Audit Evidence*; proposed Appendix C to AS 1201, *Supervision of the Audit Engagement*; and proposed replaced and retitled AS 1210, *Using the Work of an Auditor-Engaged Specialist*.

As for the other aspects of the Proposed Amendments, we believe they clearly articulate the objectives and responsibilities of the auditor with regard to the use of specialists, thereby complementing the agencies’ supervision of public financial institutions. In particular, we support (1) adding a new Appendix B to AS 1105 that would supplement the requirements of AS 1105 when the auditor uses the work of a company-employed or -engaged specialist as audit evidence; (2) adding a new Appendix C to AS 1201 that would supplement the requirements of AS 1201 when using the work of an auditor-employed specialist to assist the auditor in obtaining or evaluating audit evidence; and (3) replacing existing AS 1210 with proposed AS 1210, which would establish requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence.

The agencies believe the PCAOB’s outreach efforts and public discussions on the Proposed Amendments have been beneficial. We encourage the PCAOB to continue to coordinate with other standard setters, particularly the American Institute of Certified Public Accountants’ Auditing Standards Board and the International Auditing and Assurance Standards Board, to promote international consistency in the standards governing the auditor’s use of the work of specialists.

We would be pleased to discuss in more detail our views on the Proposed Standards.

Sincerely,

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Joanne Wakim
Assistant Director and
Chief Accountant – Supervision
Board of Governors of
the Federal Reserve System

Louis A. (Rusty) Thompson, Jr.
Deputy Comptroller and Chief Accountant
Office of the Comptroller of the Currency



August 30, 2017

Office of the Secretary
Public Company Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 44

Submitted via comments@pcaobus.org

Dear Board Members,

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) appreciates the opportunity to comment on the PCAOB’s “Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists”.

FEI is a leading international organization representing approximately 10,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior-level financial executives. CCR is a technical committee of FEI, and reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. CCR member companies represent approximately \$7.5 trillion in market capitalization and actively monitor the standard setting activities of the PCAOB.

This letter represents the views of CCR and not necessarily the views of FEI or its members individually.

Executive Summary

CCR is supportive of the efforts being made by the PCAOB to improve the guidance on the auditing standards for the auditor’s use of the work of specialists. However, we ask the Board to clarify language in the proposal that we believe is vague and may introduce inconsistencies in practice.

Insufficiently Precise Language

The proposed Appendix B, *Using the Work of a Company’s Specialist as Audit Evidence*, is designed to supplement the requirements in AS 1105, *Audit Evidence*, for circumstances in which the auditor uses the work of the company’s specialist as audit evidence in a few key areas. One area would require the

auditor to test data used by the company's specialist, and evaluate whether the data was "appropriately used" by the specialist. This evaluation leaves the auditor to interpret what would be considered *appropriate*. Preliminary discussions lead some to believe this means the auditor should recalculate or reperform the work of the specialist.

We believe the PCAOB should amend the guidance to clarify the intended requirements of the auditor in this area. In many cases, companies engage external specialists who use proprietary models not available to the auditor. Therefore, it will not be possible for the auditor to recalculate or reperform the work done by the specialist, and the preparer will be burdened with the responsibility of providing the necessary documentation to support the auditor's determination of "appropriately used."

Specialist vs. Regular Employee Differentiation

Paragraph B8 of the proposal requires the auditor to evaluate whether the methods used by the company's specialist¹ are appropriate and the significant assumptions are reasonable. The note to this paragraph directs auditors to the requirements in paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, when testing and evaluating data, methods, and significant assumptions made when the company's specialist assists the company in developing an accounting estimate. The requirements in paragraphs .09-.18 outline the testing of a company's process used to develop the accounting estimate, and how the auditor should evaluate the company's methods, test the data used, and identify and evaluate the reasonableness of significant assumptions. It should be noted, however, that these additional requirements apply to any estimate made by the company when such estimates are made without the assistance of a company specialist.

Effectively, the proposal directs auditors to apply the same procedures used to evaluate an estimate made internally by regular employee² of the company without the use of a specialist, as they apply to an estimate made by a company specialist (engaged or employed). However, CCR recommends permitting the auditor to place more reliance on the work performed by a company's specialist than an estimate generated without the assistance of a specialist (engaged or employed), given the nature of their education, training, and experience in the given field. Using the work of a company specialist (engaged or employed) should not be viewed as similar to a regular employee. Companies look to leverage the work of specialists (engaged or employed) with appropriate credentials and that should be acknowledged by the auditor when evaluating the estimate made. The proposal, as written, does not clearly acknowledge this important differentiation.

Professional Skepticism

It is important that auditors maintain professional skepticism as a key tenant of auditor behavior. Some stakeholders have noted that the language in the proposal may suggest a higher degree of skepticism

¹ "Company specialist" as outlined within the proposal may refer to either a specialist employed by the company or a specialist engaged by the company. In either case, the term specialist does not refer to a regular employee of the entity.

² While not defined, our reference to "regular employee" is intended to imply the use of the work of an employee that is not a specialist, as that term is defined within the standard.

than is currently required³, with some suggesting that the auditor is being instructed to be cynical in their approach to management assertions. These concerns are in reaction to the extensive use of the word “bias” throughout the proposal. We recommend clarification that the standards around professional skepticism and due professional care as outlined in existing PCAOB standards continue to apply and that this proposal is not intended to amend, revise, or expand those standards.

Legal Specialist

The proposal also proposes to rescind AI 11: *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, however, this guidance is particularly important when a sale is to be recognized for transfer arrangements, especially in those cases where the transferor has continuing involvement with the transferred financial assets. Often, legal opinions are required to support significant assertions about the transaction (i.e., attorney opinion is often required to support a conclusion that transferred financial assets are isolated from the transferor, any of its consolidated affiliates included in the financial statements being presented, and its creditors). The standards for use of a legal opinion as evidence to support the legal isolation criterion are contained in Auditing Interpretation 9336: *Using the Work of a Specialist: Auditing Interpretation of Section 336* (AU 9336). By rescinding this interpretation, companies may struggle to anchor their accounting conclusions to guidance. We recommend the PCAOB retain this portion of the existing guidance to avoid confusion and unnecessary work.

Conclusion

Based on the foregoing, we recommend the Board amend the proposal to clarify the intention of the Board in the areas related to what is considered appropriate, clarify guidance to affirm that the auditor may rely more heavily on the work of company specialists, and clarify within the proposal the intention of the PCAOB as it related to the degree of professional skepticism required of the auditor. Furthermore, we ask the Board to consider retaining the principles found in AI 11.

Should you have any questions, we welcome the opportunity to discuss our comments further.

Sincerely,

Mick Homan

Mick Homan
Chairman
Committee on Corporate Reporting
Financial Executives International

³ Refer to AS 1015: Due Professional Care in the Performance of Work



August 30, 2017

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Via Email to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 044, Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board’s *Proposed Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists*, and we respectfully submit our comments and recommendations thereon. We commend the Board’s overall efforts with regard to enhancing the auditing standards pertaining to the auditor’s use of the work of specialists. While we are supportive of the approach, we have concerns with certain aspects of the proposal.

AS 1105, Audit Evidence

Obtaining an understanding and assessing knowledge, skill, and ability

While we previously suggested revisiting the definition of “specialist,”¹ we understand the Board’s decision to retain the extant definition and the reasons therefor. We would, however, recommend that the Board continue to gather information regarding the use of various subject matter specialists on engagements, particularly in areas of heightened complexity (for example, information technology security specialists, data analysts, etc.), during its further deliberations and outreach, including considerations of results of firm inspections, on the proposed standard.

We believe the definitions of the other terms used in the proposal, specifically “company’s specialist,” “auditor-employed specialist,” and “auditor-engaged specialist,” are clear and appropriately align with the respective roles in an audit.

Although linking the proposed changes directly to the risk assessment standards is helpful, we believe that obtaining an understanding of the company’s specialists, as discussed in proposed paragraph .B2, in conjunction with obtaining an understanding of the company’s information

¹ Refer to our letter dated July 31, 2015 submitted to the PCAOB in response to the Staff Consultation Paper, *The Auditor’s Use of the Work of Specialists* (May 28, 2015)

system is not appropriate. We are concerned that linking the obtaining an understanding of the specialist to an understanding of the information system gained at the “entity-level” indicates that such understanding is obtained without regard to risk at the assertion level related to the specialist’s work. This could have unintended consequences as the level of work effort expended may not provide corresponding improvement to risk identification or the auditor’s related response.

Particularly, we are concerned this could unnecessarily broaden the scope of both the audit of internal controls over financial reporting (ICFR) and the financial statements, since all specialists, regardless of risk and affected financial statement area, would be within scope. A more appropriate approach would be for the auditor to consider the fact that the company uses a specialist to inform the risk assessment. Ultimately, obtaining an understanding of the specialist and how his/her work is used by the company should be risk-based and correspond to the related financial statement account, class of transactions or disclosure(s).

Further, we believe the proposed requirement in paragraph .B2 may also introduce operational challenges, especially from an ICFR perspective, since it further broadens the scope of ICFR. Expecting management to have documented the processes and controls around the selection of specialists could bring into question whether the company’s selection of any vendor should be subjected to testing by the auditor, which we do not think is the Board’s intention. We see potential value in gaining this understanding, but only within the context of being one factor to consider when evaluating the specialist’s objectivity, not in the operation of the entity’s ICFR. Therefore, we ask the Board to consider whether more appropriate placement of this concept would be within the requirements when evaluating objectivity.

We found the additional discussion related to assessing a specialist’s knowledge, skill, and ability on page A3-11 of the proposal to be helpful guidance and ask the Board to consider whether these bullet points could be retained in the final standard through an appendix or note to the paragraph. We believe these are valuable examples that could assist the auditor in identifying applicable and appropriate sources of information to fulfill the related requirement in paragraph .B3.

However, the additional discussion around assessing the specialist’s relationship to the company on pages A3-13 and 14 does not provide greater clarity as to what would be considered sufficient appropriate audit evidence for purposes of proposed paragraph .B4. These bullets are limited to inquiry or otherwise are not likely operational given the absence of regulatory or legislative requirements. Many professions do not have requirements regarding relationships with clients. Additionally, the entities employing specialists generally do not have robust tracking and reporting mechanisms for monitoring independence on the part of the specialist. We are concerned that the results of such inquiries described on pages A3-13 and 14 would not be considered sufficient in practice and therefore request the Board to consider providing more practical suggestions that would be responsive to the proposed requirement, or absent any such suggestions, consider removing the requirement.

We further believe that proposed paragraph .B4 unnecessarily overemphasizes the specialist's relationship to the company by eliminating the notion of objectivity, which is retained elsewhere in the proposal. While we acknowledge the Board's consideration of the differences in how the specialists' work is used in an audit, objectivity remains relevant and important. We strongly urge the Board to replace this paragraph with the wording found in proposed AS 1210.04. In that paragraph, objectivity is the primary focus, with consideration being given to the specialist's relationship to the company. We believe this is likely to be more easily understood and provides better positioning of the two concepts.

Testing and evaluating the specialist's work

Paragraph .06 of existing AS 1201, *Using the Work of a Specialist*, states that "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." It is our view that this notion is essential and should be explicitly carried forward to the new standard.

Proposed paragraphs .B6a and .B8 require the auditor to evaluate whether the data used by the specialist in developing or supporting an accounting estimate was appropriately used by that specialist. However, it is unclear how the auditor would conduct such an evaluation, especially considering that auditors are not expected to have expertise in specialists' areas or proficiency. This requirement also introduces a level of prescription that we do not believe is appropriate for principles-based standards. We do not see a benefit to audit quality by requiring this evaluation and question whether this proposed requirement would introduce unnecessary cost into the audit process, since auditors may have to consistently retain their own specialists for purposes of meeting this requirement.

AS 1201, *Supervision of the Audit Engagement*

Qualifications and independence

We agree with aligning existing PCAOB requirements regarding auditors' qualifications and independence to apply to auditor-employed specialists. Nevertheless, we suggest the final standard include greater clarity on how a firm's system of quality control can aid the auditor in meeting these requirements. Audit firms have, among other things, robust independence and quality monitoring mechanisms that we believe can be relied on by an audit team for purposes of assigning specialists to an audit.

Informing the specialist of work to be performed

We are supportive of strengthening the requirements around the use of, and collaboration with, auditor's specialists. However, we are concerned that proposed paragraph .C5 could be interpreted to require formal documentation akin to an engagement letter between the auditor and the auditor-employed specialists. Therefore, the final standard could clarify that such documentation could be in the form of a planning memorandum, audit work program, or other workpapers. This would provide auditors with appropriate flexibility and balance between enhancing audit quality and minimizing potential administrative burden.

Amendments to AS 1210, Using the Work of a Specialist

We have concerns regarding the documentation requirement in proposed paragraph .06, specifically as it relates to the requirements regarding the specialist's report. We would note that depending on the nature of the engagement, the report might not address each of the items listed in the requirement. We recommend the final standard provide more flexibility with regard to how an understanding between the auditor and the specialist is established and documented, and how the results are communicated.

Rescission of AI 11

The proposal, if adopted, would rescind Auditing Interpretation (AI) 11, *Using the Work of Specialist: Auditing Interpretation of AS 1210*. We do not believe that rescinding AI 11 is appropriate because the interpretation provides valuable guidance to auditors in obtaining audit evidence to support management's assertion that a transfer of financial assets has met the isolation criterion of ASC 860-10-40, *Transfers and Servicing*. We do not believe that the requirements to evaluate the work of management's specialist would be adequate for purposes of generating sufficient appropriate audit evidence on these very narrow and technical transactions. In our view, rescinding such guidance would diminish audit quality.

Applicability and effective date

We believe all audits, including those of emerging growth companies and broker-dealers, would benefit from the enhancements and clarification that would come with the final standard. While we do not expect a significant impact on our audit practice as a result of adoption, we generally expect that firms, including ours, would need sufficient time to update policies, methodologies, and related training in order to carry through the objectives of the overall project. Given the timing of when these updates are usually made during an audit cycle, we recommend the Board provide an effective date of two years after SEC approval.

If you have any questions about our response, or wish to further discuss our comments, please contact Trent Gazzaway, National Managing Partner of Professional Standards, at (704) 632-6834 or Trent.Gazzaway@us.gt.com.

Sincerely,





August 30, 2017

Office of the Secretary
 PCAOB
 1666 K Street NW
 Washington, D.C. 20006-2803
 Via email: comments@pcaobus.org

Re: PCAOB Release no. 2017-003
 (June 1, 2017), Proposed
 Amendments to Auditing Standards
 for Auditor's Use of the Work of
 Specialists

To the Board:

Harvest Investments, Ltd. thanks the Board for the opportunity to comment on its Release 2017-003, "Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists." Before offering our thoughts on the substance of the release, we would like to express our appreciation for all the work the Board has done in preparing this document, which reflects a substantial engagement with contemporary academic research as well as a commendable integration of previous stakeholder commentary. We think the Board has drawn attention to a number of important issues and challenges, and that it has provided practical and effective guidance for the auditor's use of specialists. We hope our comments prove useful to the Board's deliberations.

Question 1: Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

Harvest agrees that the Board sufficiently describes the nature of concerns arising from the use of the work of specialists. The PCAOB proposal on the use of pricing-service information in the companion release on fair value estimates (Release no. 2017-002) does a good job of addressing the requirements for the use of that information.

In current practice, specialists are used by companies and audit firms principally in "special situations," such as valuing complex derivative investments like employee warrants. These valuations are generally more academic than directly marketplace-oriented. All financial instruments can and should have a tested ASC 820 fair exit value, however, meaning they should have a real price that is derived the way a market player would calculate the price using the same inputs a market participant

would. As the Board is aware and as we state in our value paper¹, the bulk of the capital markets today are valued by pricing services, as was also the case before the crisis; they are not valued by specialists. Among issuers of financial instruments, it is widely accepted that the use of nontransparent prices requires strong internal controls with observable and/or documented inputs in order to avoid (unnecessary) risks to investors. The same standards should apply to audit use.

Question 2: Do these proposed amendments to existing standards appropriately address the reasons to improve the standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist and an auditor-engaged specialist clear?

Yes, we find the changes to be clear. We have worked closely with our clients to design deliverables that they can easily use and critically evaluate, in accordance with both existing and proposed specialist rules. While we cannot speak for others, we did not find the practical implementation of such guidance to be burdensome, and we agree that it contributes to investor protection.

Question 3: Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

On page 26, the Board presents data showing that smaller firms do not use a specialist at all 75% of the time. While we view this information with alarm, it nonetheless confirms what we hear from smaller auditing firms.

In practice, both smaller firms and management generally use a pricing service in lieu of a specialist. During the audit process, either a field auditor or their pricing desk will test prices by comparing them with another source. Larger firms often staff the desks with an employed specialist, whereas smaller firms do not. Too often, small auditing firms use the same ultimate source as the issuer - either knowingly or unknowing - and therefore perform no testing at all. Whoever uses a pricing service is acting as a specialist and should be subject to specialist rules.

Question 5: The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

The Board has done a tremendous job in keeping abreast of current academic research. We note in passing that at least three of the recent articles cited in the Board's two Releases indicate that

¹ Harvest Investments, Ltd. Comment on PCAOB Release No. 2017-002 (30 August 2017), <https://pcaobus.org/Rulemaking/Pages/docket-043-comments-auditing-accounting-estimates-fair-value-measurements.aspx>

researchers may be starting to move away from treating price as if it were a natural, unproblematic datum.² Each of these articles touches on relations between pricing services and specialists, albeit in different contexts and for different ends. We think researcher inquiry into the manufacture and use of pricing data is very useful, and look forward to seeing more work that deals with these important topics.

Question 7: The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

Harvest agrees with the Board when it states that:

“From a capital market perspective, an increase in investors’ perception of the credibility of information (...) can increase the efficiency of capital allocation decisions.”³

Given that the U.S. fixed-income market is currently valued at \$40 trillion, consistent use of ASC 820-compliant methodologies is a small cost to bear.

Question 14: How much time following SEC approval would audit firms need to implement the proposed requirements?

Harvest has already instituted these new requirements, and the process was neither cumbersome nor expensive.

Question 36: Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?

The requirements seem clear and appropriate. In practice, we find that the Board’s focus on the work of specialists has improved communications, to the ultimate benefit of investors.

² Emily Griffith, “Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values” (March 1, 2015). Available at SSRN: <https://ssrn.com/abstract=2460970>, Glover, Taylor and Wu, “Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy” in *Auditing: A Journal of Practice and Theory* 36(1) 2/2017 pp. 63-84; Cannon and Bedard, “Auditing Challenging Fair Value Measurements: Evidence from the Field” in *Journal of Accounting* 92(4) 7/2017, pp. 81–114.

³ PCAOB 2017-03, pp. 38-9.

Question 37: To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?

These standards indeed represent changes, and we welcome the Board's emphasis on establishing and documenting understanding with auditor-engaged specialists. We find the highlighting of independence and skepticism to be important, just as we valued the PCAOB's emphasis on transparency after the financial crisis. We do not find the proposed changes burdensome and agree that they will improve the financial reporting industry.

* * *

We thank the Board for its time in reviewing our comments. If the Board would find it useful to discuss any of them in more detail, or if it has any additional questions for us related to this Release, please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.



August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket No. 044

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society (“Committee”) is pleased to comment on the PCAOB’s Proposed Amendments relating to the *Auditing Standards for Auditor’s Use of the Work of Specialists* (Docket Matter No. 44), dated June 1, 2017. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

GENERAL COMMENTS:

As a Committee, we agree with efforts made by the PCAOB and believe the proposed amendments to AS 1105, AS 1201 as well as rescinding and replacing AS 1210, AI 11, AI 28 are needed to help drive audit quality. Our response is limited to the following questions.

PCAOB QUESTIONS:

Question 1: Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

Response: We agree with much of the characterization of the existing audit practice as listed in the release notes. However, the description starting on page twelve that differentiates between “smaller firm practices” and “larger firm practices” unnecessarily and unfairly implies that small firms do not perform procedures as thoroughly as large firms. The PCAOB acknowledges that the small firms do follow PCAOB standards so the delineation unfairly depicts the smaller firms as performing lower quality engagements. Small and large firms audit different types of entities with risk profiles that vary greatly, these differences are not acknowledged in the PCAOB’s notes. A similar concept is depicted on page 42 in footnote 72. Our preference is to delete the discussion on page twelve and thirteen.

Question 2: Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?

Response: The proposed amendments as discussed in the notes do appear to appropriately address the reasons to improve the standards and for dividing the standard based upon who is engaging/employing the specialist. The table on page seven is particularly helpful when understanding the changes.



Question 7: The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

Response: We urge the Board to remain mindful of firms of all sizes when drafting standards and publishing release materials. The Costs section, beginning on page 41, notes differences in auditing methodologies by smaller firms, which are currently allowable and follow the current set of auditing standards. Continually pointing out items that “smaller” firms are not performing even though not required by professional standards could tarnish the reputation of smaller firms unnecessarily. We kindly ask the Board not to include implicit expectations of performance in the release notes, instead we request the Board to include all requirements in the proposed standard itself.

Question 9: The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

Response: Smaller firms may not respond to audit opportunities that require an auditor engaged specialist or when they don't have the expertise to when a company specialist is used. However, in certain industries (i.e. construction or mining) a smaller firm could have the necessary expertise internally to service these industries. Audit fees could increase for the smaller firm, if needed to engage a specialist. However, we don't believe the availability of qualified auditors would be affected by the proposal.

Question 12: The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

Response: No, we believe the proposal should apply to EGCs. Typically, a specialist is used in connection with a significant account, estimate, or fair value measurement, regardless if the company being audited is an EGC. Higher quality audits and better investor information would result if the proposal applied to EGCs.

Question 13: Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

Response: No, we believe the proposal should apply to brokers and dealers, particularly to carrying brokers and dealers that hold securities or funds for customers. Audit quality will increase from this proposal, as well as better information will be provided to customers.

Question 18: Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?

Response: We do not believe the proposed approach poses any particular challenges to auditors, but will increase audit quality.



Question 19: Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?

Response: We believe the proposed requirements, as described, are scalable.

Question 20: How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.

Response: See response in question 18, above.

Question 21: Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?

Response: Yes, we believe the proposed requirements related to obtaining an understanding of the work and reports of a company's specialist are important to a high quality audit.

Question 22: Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?

Response: We believe the proposed requirement for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability is critical to the audit.

Question 23: The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?

Response: We believe the factors described in the proposed requirements are appropriate, clear, and helpful.

Question 24: Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

Response: We believe the proposed requirements to evaluate the relevance and reliability of the company specialist's work are clear and appropriate and complement the requirements to evaluate the relevance and reliability of other audit evidence.

Question 25: Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?



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Response: The proposal contains a challenge to effective implementation and improved coordination with the specialist and others involved in the audit. This is an area of critical nature and where the profession can improve as noted by the Board. The language used at .C5c “the degree of responsibility” when referring to potential areas of performance for the auditor-employed specialist seems to unnecessarily shift the burden onto the specialist alone, in isolation from others like the engagement partner. The language can be construed to leave the specialist with an inappropriate amount of ownership for their area instead of ultimately with the partner where it lies. We encourage the Board to refer to the items in (1) – (3) as potential roles or areas for testing that the specialist could perform, rather than responsibilities. We do not want the teams to use this language as a means of abdicating “responsibility” to specialists and not understanding those items as noted throughout the proposal.

Question 26: Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?

Response: We think the extent of supervision can also be influenced by the existing quality control framework established by the firm. This framework is established to address the quality control requirements and provides a basis for the auditor to understand the specialist and determine an appropriate course of action. The quality control structure can often dictate the level of reviews necessary with other firm specialists or additional reviewers. The standard should acknowledge these important and well-established means of review rather than have them exist in isolation.

Question 27: Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?

Response: The extent of supervision does seem scalable to the size and complexity of the audit engagement. We agree with the proposal that the extent should be based upon the significance of the work and the risk of material misstatement. But, we think the proposal should contemplate the firm’s existing quality control system in a more explicit manner. The notion of “the knowledge, skill, and ability” is redundant to include in both Appendices at .C2(3) and in .C3. The auditor-employed specialist is part of the firm and subject to the firm’s existing system of quality control that ensures objectivity, independence, competence, etc. It seems unnecessary for the team to perform extra supervision of the specialist they are employing when these requirements are part of the firm’s system of quality control.

Question 28: Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?

Response: The description in .C5 seems to imply that the auditor is “informing” the specialist of their role, responsibilities, and involvement. This language feels “one-way” rather than “two-way” in nature because it can be interpreted to mean that the team just tells the specialist what to do. Instead, we think the specialist, who understands the subject matter better than the team, should be involved and assist in determining their role using their deep subject knowledge and based upon the risk of material misstatement.



ILLINOIS CPA SOCIETY

Question 30: Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

Response: When using an auditor-employed specialist, we suggest adjusting the wording in AS 1201 Appendix C5 to remove the notion of a “report, or equivalent documentation” because the language connotes a formal, signed report as part of a formal assurance engagement. These specialists are part of the team and firm. We think the standards should allow for their documentation to be in the same fashion as any other engagement team member. The information noted in the “report” in the proposal can be sufficiently documented within the existing work program, or equivalent, already included as part of the firm’s methodology. The expectation for a formal report seems to discourage effective two-way communication rather than encourage greater collaboration.

Question 32: Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

Response: In Appendix 3, it is mentioned that smaller firms may have difficulty in documenting the understanding of the engagement with the Auditor-Employed/ Auditor-Engaged specialist. We don’t believe this would have too much of an impact for a smaller firm to start recording this in a planning memo or form. We believe that smaller firms will have done some of this already.

Question 33: Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

Response: We believe the revised standard and Appendices explain in detail the requirements and suggested method of handling those requirements for Auditor-Engaged and Auditor-Employed specialists.

Question 34: Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?

Response: Yes, this is clear.

Question 35: Does the proposed requirement to assess the objectivity of the auditor engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?

Response: The proposal contains a challenge to effectively obtain and/or have access to certain detailed and/or proprietary working papers that may have been used in developing the specialist’s conclusions. The challenge is the result of disparity among service providers in contractual practices across various industries and/or the legal/regulatory knowledge regarding the arrangements and our obligations in accordance with the proposed requirements.



Question 36: Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?

Response: Yes, with consideration of the challenge noted in response to Question #35.

Question 38: Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

Response: Yes, with consideration of the challenge noted in response to Question #35.

Question 42: Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?

Response: Yes, they are clear.

Question 43: In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210?

Response: None noted.

The Committee greatly appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

James R. Javorcic, CPA
Chair, Audit and Assurance Services Committee

Scott Cosentine, CPA
Vice Chair, Audit and Assurance Services Committee



ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2017 – 2018

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:**National:**

Timothy Bellazzini, CPA	Sikich LLP
Todd Briggs, CPA	RSM US LLP
Scott Cosentine, CPA	Ashland Partners & Company LLP
Heidi DeVette, CPA	Johnson Lambert LLP
James J. Gerace, CPA	BDO USA, LLP
Michael R. Hartley, CPA	Crowe Horwath LLP
James R. Javorcic, CPA	Mayer Hoffman McCann P.C.
John Offenbacher, CPA	Ernst & Young LLP
Michael Rennick	Grant Thornton LLP
Elizabeth J. Sloan, CPA	Grant Thornton LLP
Richard D. Spiegel, CPA	Wipfli LLP
Kevin V. Wydra, CPA	Crowe Horwath LLP

Regional:

Jennifer E. Deloy, CPA	Marcum LLP
Michael Ploskonka, CPA	Selden Fox, Ltd.
Genevra D. Knight, CPA	Porte Brown LLC
Andrea L. Krueger, CPA	CDH, P.C.

Local:

Arthur Gunn, CPA	Arthur S. Gunn, Ltd.
Lorena C. Johnson, CPA	CJBS LLC
Mary Laidman, CPA	DiGiovine, Hnilo, Jordan & Johnson, Ltd.
Carmen F. Mugnolo, CPA	Trimarco Radencich, LLC
Jodi Seelye, CPA	Mueller & Company LLP
Joseph Skibinski, CPA	



ILLINOIS CPA SOCIETY

Industry/Consulting:

Sean Kruskol, CPA

Cornerstone Research

Educators:

David H. Sinason, CPA

Northern Illinois University

Staff Representative:

Heather Lindquist, CPA

Illinois CPA Society



August 30, 2017

Office of the Secretary
PCAOB
1666 K Street, NW
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submitted via email to comments@pcaobus.org

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**PCAOB Release No. 2017-003, June 1, 2017, PCAOB Rulemaking
Docket Matter No. 044: Proposed Amendments To Auditing Standards For
Auditor's Use Of The Work Of Specialists**

Dear Sirs,

The IDW appreciates the opportunity to comment on the above mentioned Release, hereinafter referred to as "the Release". We also commented on the Staff Consultation Paper: The Auditor's Use of the Work of Specialists in a letter dated July 31, 2015. In commenting below on specific aspects of the current proposal we refer to that letter as "our previous letter".

In this letter, we express general support for the PCAOB's initiative, and then comment on those aspects of the Release with which we have concerns or upon which we hold firm views. We have chosen not to respond to individual questions posed throughout the Release.

General Support

As stated in our previous letter, we agree that the revision of the PCAOB's interim auditing standards is needed in this area. For the reasons explained in our previous letter, we also support the proposals to consider separately a company's specialist, not to integrate an auditor's engaged specialist into the engagement team and are pleased to note the Board's proposed stance in this context.

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB;
Dr. Daniela Kelm, RA LL.M.



page 2/4 to the comment letter to the PCAOB dated August 30, 2017

Potentially Impractical or Excessive Requirements

In general we are concerned that PCAOB standards are more rules based than ISAs and have commented on this in the past in a number of comment letters we have submitted to the Board. In the following, we discuss examples in this context.

- Specialist's Reputation and Standing: We understand the intention behind the proposed requirement to assess both a company's and auditor-engaged specialist skills by obtaining an appropriate understanding of certain matters. We also appreciate that the proposed wording of paragraphs AS 1105.B3c. and AS 1210.03c.: "The reputation and standing of the specialist in the particular field" is more practicable than the wording originally discussed in the staff consultation paper, which had also included a reference to the views of peers in this context. Nevertheless, we are concerned that this, as a requirement in every case, could still be excessive, especially when the auditor is satisfied as to professional certification, license or accreditation as well as experience of an auditor-engaged specialist in the particular field. Obtaining reliable information for such an understanding may also be impracticable (i.e., questions arise such as from whom?, can e.g., internet rating be relied upon? etc.). In our view a risk based approach would be appropriate such that this proposed requirement should not be applicable in every case when a specialist is engaged by the auditor.
- Acceptance of Work by A Company's Specialist: We agree that it is not appropriate for auditors to "blindly" accept work by company specialists, purely on the basis that the work was performed by a specialist. In our previous letter we did, however, question whether there might be unintended consequences if an auditor were – contrary to the extant standard – always precluded from using a specialist's work as audit evidence without further consideration. Whilst we support the requirement to evaluate the relevance and reliability of the specialist's work and its relationship to the relevant assertion (AS 1105.B6c.) and understand that this ties in with the risk based approach in AS 1105.B7, we fail to see the compatibility to the proposed requirement in AS 1105.B6a. for "testing and evaluating the data used by the specialist and evaluating whether the data was appropriately used by the specialist"; which shall apply even in cases where the auditor, applying professional skepticism is satisfied with the specialist's skills, competence, independence, little risk is involved and the auditor has gained no contradictory information etc. In contrast, ISA 500.8(c) and A 48 allow a



page 3/4 to the comment letter to the PCAOB dated August 30, 2017

degree of flexibility. We continue to believe that there may be cases in which requiring detailed testing may be excessive as proposed.

- Professional Skepticism: Given the increased focus on the significance of professional skepticism – especially in regard to audit procedures relating to accounting estimates – we believe the role of specialists in regard to the auditor’s duty to exercise professional skepticism needs to be given increased prominence. According to AS 1015.07-.09 due professional care requires the auditor to exercise professional skepticism. Thus the exercise of professional skepticism cannot be passed over to either an auditor-employed or an auditor-engaged specialist. Consequently measures to ensure proper coordination of the specialist’s work (AS 1201.C7 and AS 1210.08) will be important in this regard. We note the proposal to require the auditor to inform an auditor employed specialist of the auditor’s need to apply professional skepticism, and believe that an auditor-engaged specialist should equally be made aware of the auditor’s need to exercise such skepticism, so that the specialist is informed that relevant information should be passed on to the auditor, if and when applicable.
- Differentiation of Expertise: In practice it can be less than straightforward to differentiate between expertise in auditing and accounting and other areas, especially for those who are not members of the accounting or auditing profession. It might be helpful to expand on the proposed text in AS 1105.B1.1, AS 1201.C1.1 and AS 1210.01.1 to explain that e.g., an individual who specializes in complex taxation law would be providing legal expertise and so would constitute a legal specialist, or that at expertise in IT beyond the basic accounting system would be an IT specialist. In this context we refer to ISA 620.A2.

Desirability of Alignment with the International Standards on Auditing (ISA)

We refer to our previous letter in which we also referred to the desirability of aligning PCAOB standards with their corresponding ISA to the maximum extent possible, as well as our belief that it is not appropriate for the PCAOB to go further than the IAASB in requiring the auditor perform additional procedures that are based on guidance as opposed to requirements within the ISAs.

We would like to reiterate our calls for maximum possible alignment and urge the two respective Boards to coordinate in this regard.



page 4/4 to the comment letter to the PCAOB dated August 30, 2017

If you have any questions relating to our comments in this letter, we should be pleased to discuss matters further with you.

Yours truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Head of International Affairs



The Association of
Accountants and
Financial Professionals
in Business

August 9, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 43/Release No. 2017-002, Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and PCAOB Rulemaking Docket Matter No. 44/Release No. 2017-003, Proposed Amendments to Auditing Standards for Auditor’s Use of *Specialists*

Dear Board and Staff Members:

This letter provides the comments of the Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) on the Public Company Accounting Oversight Board’s (PCAOB or Board) Proposed Auditing Standard, *Auditing Accounting Estimates, Including Fair Value Measurements* (Estimates Proposal) and the *Proposed Amendments to Auditing Standards for Auditor’s Use of Specialists* (Specialists Proposal). We have chosen to provide one combined letter for the two Proposals as we believe the development of accounting estimates for financial reporting and the possible use of specialists in that process are interdependent in a great number of situations, particularly for more complex estimates. The Proposals recognize this interdependence through numerous cross references between the two documents.

The IMA is a global association representing over 90,000 accountants and finance team professionals. Our members work inside 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 FRC is the financial reporting technical committee of the IMA. 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 (About IMA, Advocacy Activity, Areas of Advocacy, Financial Reporting Committee).

We previously commented on the August 19, 2014 PCAOB Staff Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements* (FRC letter dated February 25, 2015) and the May 15, 2015 PCAOB Staff Consultation Paper on *The Auditor’s Use of the Work of Specialists* (FRC letter dated July 15, 2015). We are pleased that the Proposals address some of the matters raised by us and many others. However, the Proposals present no clear evidence which indicates that the audit deficiencies found by the PCAOB related to accounting estimates and the use of specialists result from deficiencies in the existing auditing standards. Accordingly, we are not convinced that new or revised standards are required. We are concerned that the Proposals may result in incremental work not necessitated by circumstances but by fear of inspections. We do support changes to revise the organization of the existing auditing standards to make them more logical and easier to apply.

Below we share our concerns and observations regarding the Proposals.



Management's Responsibility vs Tone of Proposals

As noted in the Estimates Proposal, financial reporting requirements have called for more and more accounting estimates over the years, often having a significant impact on results of operations and financial position. And many of these recent requirements involve complex processes and methods.

Numerous examples of accounting estimates are included in the Proposals. For example, the Estimates Proposal lists certain valuations of financial and non-financial assets, impairments of long-lived assets, allowances for credit losses, contingent liabilities, revenues from contracts from customers, valuation of certain liabilities, fair value of financial instruments, valuations of assets and liabilities in a business combination, inventory valuation allowances, and equity-related transactions. And Figure 2 in the Specialists Proposal includes several of these as well as some others in a list of fourteen examples of activities that involve the work of specialists.

While not stated explicitly in the Proposals, accounting estimates could be arrayed on a continuum ranging from "simple" to "complex." For example, it is common for companies to accrue estimated payables such as a month's utility expense – based on monthly averages or perhaps some even more accurate internal record keeping. Companies thus record expenses in periods in which they are incurred even though invoices that include more precise measures are not received until after the closing process is complete. These would be examples of "simple" accounting estimates which can be prepared by most company accounting staff without the need of specialists.

The "complex" estimates include such matters as asset retirement obligations to decommission a nuclear power plant many years in the future and the determination of oil & gas reserves used in the amortization of exploration and development costs and used for impairment evaluations of oil & gas properties. While such estimates lend important credibility to financial reporting, these "complex" estimates obviously involve a great deal of judgment and their ultimate accuracy is not knowable until many years into the future. And most importantly, the skills involved in making knowledgeable estimates go well beyond accounting and require individuals with special skills.

The inclusion of only certain accounting estimates in Figure 2 of the Specialists Proposal implies that the PCAOB believes there is a bright dividing point on the above continuum of "simple" to "complex" accounting estimates. For certain estimates, it is an important management judgment as to whether expertise beyond that in the company accounting/finance function is needed. For example, consider allowances for credit losses. For companies with a relatively stable customer base and many years of experience therewith, accounting personnel may feel quite comfortable estimating credit losses. However, for a large bank, such process is likely to involve company personnel specialized in at least credit and legal matters. Similarly, inventory valuation allowances might well be reliably estimated by company accounting personnel in certain cases but require manufacturing, sales, and legal specialists to assist in other cases.

Our point is not just to take issue with the listing in Figure 2 of the Specialists Proposal. Rather, it is to note that in all cases along the continuum described above financial management must judge whether it has sufficient expertise within its own function to make reliable accounting estimates. If not, financial management will have to determine whether to "make or buy" such expertise. In other words, management will determine if such expertise exists within the company and can be used, and if not whether it is cost



beneficial to hire such expertise, or use outside specialists. Management takes this responsibility quite seriously.

The Securities and Exchange Commission (SEC) requires companies to include disclosure about critical accounting policies and estimates in Management's Discussion and Analysis. The estimates that have the greatest impact on the financial statements, and/or involve the greatest amount of management judgment are so disclosed by companies. The SEC expects companies to provide sensitivity analysis information to provide investors and other users with an understanding of the subjectivity involved. Financial management takes seriously its responsibility to provide accounting estimates and related disclosures according to generally accepted accounting standards and SEC requirements.

We are concerned that the tone of the Proposals asserts a strong predisposition by management to present its financial statements in a biased manner. In fact, the word "bias" or a form thereof is used 124 times in the Estimates Proposal and five times in the Specialists Proposal. Further, "moral hazard" is a prominent justification given for the positions taken in the Specialists Proposal and is also mentioned in the Estimates Proposal. Together, these words and notions suggest a strong prejudice that management will not act in the best interests of investors and other users of their financial statements. We can certainly understand emphasizing the need for auditor skepticism, but our reading of these proposals leads us to believe that the PCAOB believes auditors must become cynical about management's motives. Is it the PCAOB's intention to establish a new threshold beyond healthy skepticism? Further, we fear that the cynical tone when reflected in the inspection process will result in incremental audit work not necessitated by facts and circumstances but driven by fear of second guessing in the inspection process.

While asserting that auditors need to be more skeptical in auditing accounting estimates, the Estimates Proposal presumes this will be accomplished largely by wording changes to existing standards. As noted on page 41, "The use of terms such as 'evaluate' and 'compare' instead of 'corroborate' and greater emphasis on auditors identifying the significant assumptions in accounting estimates could promote a more deliberative approach to auditing estimates, rather than a mechanical process of looking for evidence to support management's assertions." In our opinion, such subtle shadings of meaning are unlikely to have any impact in behavior. A more likely outcome of such wording changes would be for them to be used by PCAOB inspectors to challenge auditors to perform much more work. At a minimum, such wording changes add to our concern that firms will "audit up" in fear of more critical inspections.

We believe that standards setters should be objective and that standards reflect objectivity. Rather than the unnecessary negative emphasis, we urge the PCAOB to provide a more balanced discussion in any final standards. While it may be perfectly appropriate to warn auditors of the possibility of management bias in certain situations, a more objective discussion should also mention the many factors that require or at least motivate management to act responsibly. For example, consider the following guardrails.

- CEO and CFO attestations as supported by disclosure committees.
- Required company reporting on internal control over financial reporting supplemented by external auditor attestation for larger companies.
- Internal auditing.
- Audit committee oversight of significant accounting policies and estimates as well as the overall financial reporting process.
- Codes of ethics for accounting/finance and other company personnel.



- SEC reviews of periodic filings.
- Possibility of civil litigation for any accounting misstatements.

In addition, we note the guardrails in the recently issued *Mandatory Performance Framework for the Certified in Entity and Intangible Valuations Credential* that require professional skepticism as well as a consideration of management bias when valuation professionals perform valuation services for financial reporting. We expect similar requirements for valuation professionals to be included in guidance for the valuation of financial instruments.

More Auditing ≠ Better Estimates

Uncertainty is inherent in estimates. By definition, estimates lack precision/accuracy. The Proposals indicate that more auditing of accounting estimates and more attention to the use of specialists in the audit process will automatically result in more reliable or accurate accounting estimates. For example, page 40 of the Estimates Proposal includes, "These improvements should enhance audit quality and, in conjunction with the clarification of the procedures the auditor should perform, give investors and audit committees greater confidence in the accuracy of financial statements (footnote omitted)." And page 41 in that Proposal notes, "In turn, assuming that firms comply with the new requirements, this should increase and make more uniform the quality of the information presented in the financial statements." Page 40 in the Specialists Proposal states "In turn as auditors are better able to identify and detect potential risks of material misstatements, this may also spur companies and their specialists over time to improve the quality of financial reporting and their work".

Contrary to these statements, more audit work will not necessarily produce high quality accounting estimates. Management has the responsibility for high quality accounting estimates. If a company has done a truly slip shod job, such as in a couple of the egregious enforcement cases cited, reasonable auditing could catch the situation. But more auditing will not help determine whether, for example, there will be slightly better technology available 25 years from now to help decommission a power plant or whether future oil & gas prices will be sufficient to cover estimated drilling and completion costs to warrant extraction of estimated oil & gas reserves. While auditing may identify certain material omissions or errors, all the auditing in the world will not automatically help make an estimate of something that will or may occur many years in the future more accurate.

As noted in the FRC letter dated July 15, 2015 on page 3, auditors can add confirmation value to the financial reporting process but they should not be expected to overcome basic deficiencies in the information to be assessed. The Specialists Proposal seems to confuse auditing and accounting as indicated by the statement on page 32 "Because investors' perceptions of the credibility of financial statements are influenced by their perception of audit quality, the auditor's appropriate use of the work of specialists may increase the credibility of the accounting estimates in the financial statements."

Incremental Audit Work

It is very difficult to determine whether or how audit procedures would actually change from the wording in the Specialist Proposal. For example, on page 41 of that Proposal in describing the potential costs of the new standard, the Proposal says, "The most significant impact of the proposal on costs for auditors is expected to result from the proposed requirements to test and evaluate the work of a company's specialist. Compared with the existing requirements, the auditor will be required in all cases to evaluate the significant assumptions used



by the specialist, as currently required by other auditing standards only in certain circumstances, as well as the methods used by the specialist (footnotes omitted)." But page 42 of that Proposal notes that, "The proposal's impact would also likely vary, however, depending on whether any of the proposed requirements have already been incorporated in audit firms' audit methodologies or applied in practice by individual engagement teams." In several places in the Specialists Proposal it mentions that some, if not all, of the major firms have already implemented most of the procedures suggested in the Specialists Proposal.

Specifically, auditors in testing and evaluating the work of a company's specialist will now have to (i) test and evaluate data used by the specialist and evaluate whether the data was appropriately used by the specialist, (ii) evaluate the appropriateness of methods and reasonableness of significant assumptions used by the specialists, and (iii) evaluate the relevance and reliability of the specialist's work and its relationship to the relevant assertion. It is uncertain whether these specific procedures in the Specialists Proposal would cause firms to "fine tune" or otherwise to increase current procedures and how the PCAOB inspection process might affect how firms apply such new guidance. In addition, we are uncertain how these specific procedures will improve audit quality.

We understand that the larger audit firms indicate that they generally follow procedures similar to the Proposals but note that any new standards will cause the firms to carefully evaluate their procedures. Preparer FRC members believe that their auditors will do more work as a result of both Proposals based on concern that PCAOB inspectors may expect more work around estimates and the use of specialists. We are reminded of the original internal control auditing work that apparently went well beyond what was "intended." We urge the PCAOB to get specific feedback from audit firms of all sizes to determine the potential costs to shareholders of the Proposals.

Readability of Proposals

We find the Proposals difficult to digest. Consider the following.

	<u>Estimates Proposal</u>	<u>Specialists Proposal</u>
Pages of text	57 ^a	61 ^b
Pages of appendixes	92	78
Number of footnotes ^c	173	141
Questions for commenters	43	43

^a includes 29 pages of economic analysis

^b includes 31 pages of economic analysis

^c largely referring to academic studies and auditing standards

After wading through the dense documents, we do not find the economic considerations convincing and object to the tone as discussed above. The academic studies seem to be fairly selective in quoting those who agree with the direction the PCAOB proposes and include no studies that would be in conflict.

To obtain broad feedback, we suggest the PCAOB take a more reader friendly approach to its proposals. The PCOAB could have simply said something like the following.



The Association of
Accountants and
Financial Professionals
in Business

- Audit deficiencies are still being found with respect to auditing estimates and the use of specialists, primarily with smaller firms and foreign firms.
- Amendments in the Estimates Proposal will improve the existing standards by placing audit guidance in a single standard and updating the standards for certain developments.
- Amendments in the Specialists Proposal segregating and clarifying requirements for evaluation of company's employed or engaged specialists from supervision requirements for auditor employed or engaged specialists will clarify existing standards.
- Proposals largely reflect current practices at larger firms and practices followed to remediate audit deficiencies.
- Let us know what you think.

We believe that a clear, more direct style will elicit more feedback.

In Conclusion

We disagree with the assertion on page 2 of the Estimates Proposal that further integration with risk assessment standards could prompt greater audit attention to estimates with a greater risk of material misstatement. We believe that management and auditors pay a great deal of attention to significant estimates and we are concerned that the Estimates Proposal will result in incremental audit work across the board. Our concern would be mitigated in a final standard without a negative tone and the implication that more audit work equals better numbers and that clearly indicates that the objective is to improve the existing standards by placing audit guidance for estimates in a single standard and updating standards for certain developments.

We agree with the reorganization aspects of the Specialists Proposal but are concerned about any expansion of auditing procedures given the extensive discussions of moral hazard and management bias. The amendments are fairly reasonable as they are mainly revising the auditing literature so that specialists employed by or engaged by companies and specialists employed by or engaged by accounting firms are treated appropriately. We agree that the current auditing standards can be clarified.

The SEC and PCAOB enforcement cases cited seem to demonstrate that a few auditors will not follow auditing standards no matter how detailed they are or how clearly they are written. We are concerned that the net result of the two Proposals would be to require more work by all auditors at more cost to companies as a way of trying to address the failures of a few.

We appreciate the opportunity to express our views on the Proposals. Please let me know if you would like us to further explain these views or provide added information.

Sincerely,

A handwritten signature in blue ink that reads 'N. Schroeder'.

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August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 044
Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

Dear Madam Secretary:

KPMG LLP is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2017-003, *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (the PCAOB Release or the Proposed Amendments). We welcome the opportunity to work with the Board, PCAOB staff (the Staff), and other stakeholders to improve audit quality through enhanced auditing standards.

Overview

The Board has requested public comment on the PCAOB Release for amending its standards for the auditor's use of the work of specialists. The objective of the Proposed Amendments is to strengthen the requirements for evaluating the work of specialists engaged or employed by a company and to apply a risk-based approach to supervising and evaluating the work of auditor-employed and auditor-engaged specialists.

As noted in the PCAOB Release, the "use of the work of specialists, both by companies and auditors, continues to increase in both frequency and significance."¹ This is in large part due to the increased requirements of financial reporting frameworks to use accounting estimates, including those that are based on fair value measurements. We agree with the Board that audit quality could be improved through enhancement of the PCAOB standards and fully support the Board's efforts to establish a uniform, risk-based approach when auditors use the work of a company's specialist as audit evidence and to

¹ See page 15 of the PCAOB Release

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 2

require auditors to apply a risk-based supervisory approach to the use of specialists employed or engaged by the auditor.

The remainder of this letter provides our specific comments on the Proposed Amendments and other matters.

Applicability of Proposed Amendments

We believe that the Proposed Amendments should be applicable to audits of emerging growth companies (EGCs). In our experience, the use of the work of a specialist is common in audits of EGCs. Because users of financial statements of EGCs generally have less visibility into the company, as noted by the Board, and because specialists are often used by auditors when evaluating significant estimates and judgments, there is an increased importance on quality and consistency in the application of auditing standards related to the use of specialists.

Likewise, we also believe that the Proposed Amendments should be applied to audits of brokers and dealers. It is not uncommon for auditors of brokers and dealers to use specialists to address regulatory or valuation matters. We agree with the Board's assertion that having different standards for some entities (i.e., EGCs and brokers and dealers) has the potential to create confusion and may require audit firms to maintain different methodologies for using the work of a specialist.

Definition of a Specialist

For purposes of the Proposed Amendments, a specialist is defined as “a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.”² The Proposed Amendments require assessments of the specialist and the entity that employs the specialist as two separate evaluations. For example, the proposed amendment to AS 1105, *Audit Evidence* (AS 1105), states in paragraph .B3 that “[t]he auditor should obtain an understanding of the professional qualifications of the company's specialist in the particular field, and the entity that employs the specialist (if other than the company).”

We acknowledge that the definition of a specialist is consistent with the current definition in extant AS 1210, *Using the Work of a Specialist*. However, we believe that the definition of a specialist should refer only to an individual and not to a firm. This would be consistent with the different requirements and treatment for assessing a specialist versus the entity that employs the specialist.

² See pages A1-10 and A1-20 of the Proposed Amendments

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 3

Use of a Company's Specialist

Assessing the Knowledge, Skill, and Ability of the Specialist and the Specialist's Relationship to the Company

We believe that additional guidance could be included to indicate what the auditor should consider when obtaining an understanding of the professional qualifications of the entity that employs the company-engaged specialist. Paragraph .B3 of the proposed amendment to AS 1105 lists factors to be considered by the auditor when assessing a specialist's knowledge, skill and ability (and such items would help demonstrate compliance with the requirement to obtain an understanding of the professional qualifications of the company's specialist). It is not clear whether these are the same factors that should be considered when obtaining an understanding of the entity that employs the specialist.

In our view, the reputation and expertise of an entity that employs the specialist is an important factor to consider when assessing the specialist's knowledge, skill and ability. We agree with the Board that a strong reputation and standing of the specialist's employer in the specialized field can indicate that the employer maintains qualified staff and that a poor reputation and limited expertise of the employer should result in the auditor increasing its scrutiny when evaluating the qualifications of the individual specialist. We believe reflecting this guidance in the proposed amendment to AS 1105 would assist the auditor when considering the results of the evaluation of the entity that employs the company-engaged specialist for purposes of determining the nature and extent of procedures to be applied when assessing the individual specialist who performs the work that is used by the auditor.

In addition, the proposed amendment to AS 1105 would benefit from guidance on the expected sources of evidence when evaluating a specialist's knowledge, skill, ability, and relationship to the company in accordance with paragraphs .B3 and .B4. Page A3-11 of the PCAOB Release includes potential sources of information that could be incorporated into the relevant amendment. As an example, AS 1105 could address whether the use of a questionnaire provides sufficient evidence by itself with respect to evaluating whether the specialist has a familial relationship with the company. We believe differences in practice could be reduced by including the additional guidance in the proposed amendment to AS 1105.

Evaluating the Work of the Company's Specialist

Paragraph .B8(3) of the proposed amendment to AS 1105 requires the auditor to evaluate whether data was "appropriately used" by the specialist. We believe that additional

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 4

clarification is needed as the existing wording may lead auditors to believe they are required to employ or engage a specialist in order to fulfill this requirement. For example, a company's pension specialist uses census data in their models for calculating a company's pension obligation; however, the auditor may not have the expertise to assert that the data was "appropriately used." We suggest that clarifying language be used in the proposed amendment to AS 1105 to state specifically what aspects of the specialist's use of data should be evaluated.

Supervising or Using the Work of an Auditor's Specialist

Assessing the Knowledge, Skill, Ability, and Objectivity of an Auditor-Engaged Specialist

The requirement in paragraph .04 of the proposed amendment to AS 1210, *Using the Work of an Auditor-Engaged Specialist* (AS 1210), to evaluate "whether the specialist or the entity that employs the specialist has ... any other conflicts of interest relevant to the work to be performed" would require the auditor to search for all possible conflicts (due to the use of the word "any"), including those that are not significant or would not impact the judgment of the specialist. In our view, the proposed amendment to AS 1210 should require the auditor to evaluate whether significant conflicts of interest exist based on the procedures performed. If significant conflicts of interest are identified, the auditor should determine whether they could reasonably be expected to influence the judgment of the specialist as it relates to the work to be performed.

In addition, the PCAOB should consider providing guidance within the proposed amendment to AS 1210 about what procedures might be appropriate when assessing whether the specialist and the entity that employs the specialist have the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Page A3-40 of the PCAOB Release describes sources of information that might be relevant, and we believe it would be helpful to have that guidance included in the proposed amendment to AS 1210.

As previously discussed, we believe a strong reputation and standing of a specialist's employer can indicate that the employer maintains qualified staff and that a poor reputation and limited expertise of the employer should result in the auditor increasing its scrutiny when evaluating the qualifications of the individual specialist. We believe this is equally applicable to specialists engaged by the auditor and that the proposed amendment to AS 1210 would benefit from guidance about the auditor's consideration of the results of the evaluation of the entity that employs the auditor's engaged specialist when determining the nature and extent of procedures to be applied when assessing the individual specialist.

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 5

Evaluating the Work of an Auditor-Employed or Auditor-Engaged Specialist

The proposed amendments to AS 1201, *Supervision of the Audit Engagement* (AS 1201), and AS 1210 both make reference to “auditor’s instructions” (see Notes to paragraph .C9 of AS 1201 and paragraph .11 of AS 1210). It would be helpful to clarify whether “auditor’s instructions” is different than establishing an understanding with the specialist of the procedures to be performed (see paragraph .C5 of AS 1201 and paragraph .06 of AS 1210). If these terms are referring to the same concept, then confusion may be avoided if the proposed amendments to AS 1201 and AS 1210 use more consistent terminology. If these are meant to be separate elements, auditors may benefit from an explanation of what the term “auditor’s instructions” encompasses and how that may differ from establishing an understanding of the procedures to be performed, including a statement about the objective and purpose of each requirement.

The examples of situations in which additional procedures are ordinarily necessary to evaluate the work of an auditor-employed specialist (see Note to paragraph .C9 of AS 1201) are the same as the examples for an auditor-engaged specialist (see Note to paragraph .11 of AS 1210). Based on our experience, the report of an auditor-employed specialist would not contain restrictions, disclaimers, or limitations that affect the auditor’s use of the report, and therefore that language could be removed from the Note to paragraph .C9 of AS 1201.

Supervisory Activities

The proposed amendment to AS 1210 uses the phrase “the engagement partner and, as applicable, other engagement team members performing supervisory activities” in various paragraphs. In order to make the linkage more clear, we recommend that a footnote reference to paragraph .04 of AS 1201 be made the first time this phrase is used at paragraph .03 of AS 1210 to clarify that the involvement of “other engagement team members performing supervisory activities” would be subject to the requirements of AS 1201. Adding such reference will assist auditors in their understanding of the responsibilities of the engagement partner and other engagement team members that perform supervisory activities with respect to using the work of an auditor-engaged specialist.

Rescission of Auditing Interpretation 11

Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210* (AI 11), although not reflective of current accounting requirements and banking regulations, has specific guidance that we recommend be retained and updated.

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 6

Alternatively, if AI 11 were to be rescinded, we believe that the proposed amendment to AS 1210 should provide specific guidance on the following matters:

- Considerations of when to obtain periodic updates to legal isolation opinions with the passage of time;
- Considerations of whether a new legal opinion should be obtained for each transaction or whether a prior opinion is sufficient audit evidence;
- The level of affirmation within a legal letter to support the legal isolation criteria (i.e., “would level”);
- Identification of key assumptions embedded in legal opinions regarding legal isolation;
- Examples of adequate and inadequate wording for a legal opinion to support the accounting assertion; and
- An explicit statement that a legal opinion that restricts the use of the opinion to the client, or to third parties other than the auditor, are not acceptable audit evidence.

Rescission of Auditing Interpretation 28

We believe that it would be beneficial if certain portions of Auditing Interpretation 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations* (AI 28), were retained. The third and fourth question and interpretation of AI 28 provide detailed guidance on who is considered a tax specialist. Because the Proposed Amendments do not include the use of tax specialists within their scope, retention of these portions of AI 28 would help to provide important clarity about the scope of the Proposed Amendments.

Effective Date

We believe that the simultaneous adoption of the Proposed Amendments and the Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* and Proposed Amendments to PCAOB Auditing Standards (the Estimates Proposal) would result in significant efficiencies and prevent inconsistencies in their application. The use of a specialist in an audit frequently occurs in connection with auditing an accounting estimate, and the Proposed Amendments and the Estimates Proposal include references to each other.

If final amendments are approved by the SEC on or before June 30, 2018, we would support the amendments becoming effective for audits of periods ending on or after December 15, 2019. We believe this would allow sufficient time for audit firms to make the necessary adjustments to their system of quality controls and update their methodologies, guidance, tools, and templates and to develop and provide training.

Office of the Secretary
 Public Company Accounting Oversight Board
 August 30, 2017
 Page 7

Editorial Comments

We provide the following editorial comments to the Staff for its consideration (deletions, where applicable, are struck through in bold and additions are underlined).

Paragraph .B8 of AS 1105 – “... external sources and used by the specialists, and ...”

Proposed amendment to AS 1201 – A specialist employed by the auditor is defined in paragraph .C1 of AS 1201 as an auditor-employed specialist, yet that defined term is not subsequently used in paragraphs .C5 and .C7-.C9 (instead the general term of “specialist” is used). We recommend that the defined term of “auditor-employed specialist” be used, where applicable, in those paragraphs.

Paragraph .C8 of AS 1201 – “...provides sufficient appropriate audit evidence. Specifically, the engagement partner and, as applicable, other engagement team members performing supervisory activities should evaluate whether: ...”

Proposed amendment to AS 1210 – A specialist engaged by the auditor’s firm is defined in paragraph .01 of AS 1210 as an auditor-engaged specialist, yet that defined term is not subsequently used in paragraphs .03-.11 (instead the general term of “specialist” is used). In addition, paragraph .08 of AS 1210 introduces a new term (“auditor’s specialist”). We recommend that the defined term of “auditor-engaged specialist” be used, where applicable, in those paragraphs.

We appreciate the Board’s and Staff’s careful consideration of our comments, and welcome the opportunity to discuss our comments further with the Board and Staff. If you have any questions regarding our comments included in this letter, please do not hesitate to contact Rob Chevalier (212-909-5067 or rchevalier@kpmg.com).

Very truly yours,

KPMG LLP

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 8

cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

SEC

Jay Clayton, Chair
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
Wesley Bricker, Chief Accountant
Julie A. Erhardt, Deputy Chief Accountant
Marc A. Panucci, Deputy Chief Accountant
Sagar S. Teotia, Deputy Chief Accountant



August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2017-003 Rulemaking Docket Matter No. 044 - *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

Dear Members of the Board and Staff:

Mazars USA LLP ("Mazars") welcomes the opportunity to comment on PCAOB Release No. 2017-003 Rulemaking Docket Matter No. 044 - *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* ("Docket 044"). Mazars appreciates the PCAOB's efforts since the issuance of Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* ("SCP"). Mazars continues to support the PCAOB's goal of aligning the standards addressing the requirements for evaluating the work of a specialist employed or engaged by either the company or the auditor with the PCAOB's risk assessment standards and believes the proposed amendments, replacements, and rescindments take steps toward reaching those goals. This letter presents our views regarding the changes outlined in Docket 044 for the Board's consideration.

Mazars is a firm with over 100 partners and 700 professionals across the United States ("U.S."), an independent member firm of the Mazars Group, an organization with over 18,000 professionals in more than 79 countries around the world, and a member of Praxity, a global alliance of independent firms. As a U.S. registered public accounting firm and a member of an international network, Mazars holds a unique perspective that may differ from those of our international counterparts due to variations in the client population and in the regulatory and litigation environments.

Our views on Docket 044 are driven primarily by our position in the U.S. marketplace as a medium-sized public accounting firm servicing mostly small to mid-size business issuers (accelerated and non-accelerated filers) in a variety of industries, Form 11-K filers, registered investment companies, and broker-dealers. As such, our primary focus is to address our concerns and challenges related to audits of companies with similar characteristics to our current client base as well as to similar accounting firms.

We recognize the PCAOB's extensive efforts related to addressing the use of specialists standards including the considerations of the feedback received from the SCP, the numerous discussions and considerations of the members of the Standing Advisory Group of the PCAOB, and the data gathering and analyses from recent inspections and available economic information. As noted in our response to the SCP, we did not believe rescinding extant AU 336 (AS 1210) would improve audit quality and recommended certain enhancements to improve auditor performance.

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MAZARS USA LLP IS AN INDEPENDENT MEMBER FIRM OF MAZARS GROUP.





We present our thoughts on Docket 044 in the following categories:

- I.** Overview
- II.** Amendments to PCAOB AS 1105, *Audit Evidence* (AS 1105)
- III.** Amendments to PCAOB AS 1201, *Supervision of the Audit Engagement* (AS 1201)
- IV.** Amendments to PCAOB AS 1210, *Using the Work of a Specialist* (AS 1210)
- V.** Applicability
- VI.** Effective Date
- VII.** Conclusion

I. Overview

The Staff clearly outlines the scope and objectives of the proposed changes to the standards. We concur with continuing to define a specialist, as stated in AS 1210 as “ a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing,” with information technology and income taxes deemed specialized areas of accounting and auditing. As noted in the proposal, using a specialist, as defined above, is definitively becoming increasingly prevalent and important during an audit engagement due to increasing complexity of transactions and the necessity to meet the standards of various reporting frameworks. Whether the specialist is employed/engaged by the company or auditor-employed/engaged, or whether the public accounting firm is large or small, the goal remains the same. The auditor must gain the comfort that the work of the specialist can be relied upon to provide evidential matter that supports that the financial statements are not materially misstated.

The Staff’s discussion of smaller firm practices fairly describes our practices, but often, like larger firms, our engagement teams add the use of an auditor-employed/engaged specialist when relying upon the work of a company specialist in order to assess the appropriateness and reasonableness of the company specialist’s methodology, if deemed necessary based on the facts and circumstances evaluated during the assessment of a particular engagement’s risk of material misstatement in the financial statements. The risk-based approach discussed in the proposal aligns the use of specialist standards with the risk-based approach adopted in other PCAOB auditing standards. Use of a specialist’s work, whether company-employed/engaged or auditor-employed/engaged, is a decision based on significance and risk of material misstatement and the need for a specific expertise in order to comply with professional standards.

Our understanding, based on published PCAOB inspection results and speaking with other professionals, is that inconsistencies do exist throughout the profession. These variations in handling the increasingly complex transactions and frameworks necessitate change to existing standards to ensure that a risk-based approach focuses the engagement teams to obtain the sufficient appropriate audit evidence and address the risks of material misstatement in the financial statements. We support appropriate augmentations through clarifications and modifications to the existing standards that could lead to increased investor protection, greater consistency in how members of the profession meet standards, realistic investor, audit committee, and company expectations, and increased efficiency in the audit process without diminishing the auditors’ ability to rely on the work of a specialist. Relying on the specialized skills and knowledge of a specialist, improves the quality of the audit



engagement, since the auditors do not possess the same level of subject-matter expertise as the specialists, hence why the specialist is involved with the company and/or the work performed to support the auditor’s opinion.

II. Amendments to PCAOB AS 1105, *Audit Evidence* (AS 1105)

The goal of AS 1105 as noted in paragraph .01 is to address “what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.” Sufficiency focuses on the quantity and quality of audit evidence based on the auditors’ assessed risk of material misstatement. Appropriateness focuses on the relevance to the assertion which would be identified in the risk assessment and reliability of the nature, source, and circumstances surrounding the obtained evidence. During the planning phase of an audit, the engagement team identifies the significant audit areas and gains an understanding of the controls and processes in place in order to properly plan the nature, timing, and extent of testing, which includes identifying the type of support that would provide the most sufficient and appropriate audit evidence.

Obtaining sufficient appropriate evidence enables the auditor to meet the standards in AS 1105.10 which states, “The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud.” The concepts of reasonable assurance and absolute assurance are of particular importance when considering the audit evidence obtained from the company’s specialists. The types of areas addressed by the engagement team when dealing with the work of the company’s specialist tend to require a great deal of judgment and subjectivity whereby the auditor could only obtain reasonable assurance. Developing and performing audit procedures to test and examine the work of a company’s specialist should provide sufficient and appropriate audit evidence to obtain reasonable assurance regarding an audit area.

Assessing the Knowledge, Skill, and Ability of the Company’s Specialist and the Specialist’s Relationship to the Company

When considering using a company’s specialist, whether employed or engaged, the auditors must continue to obtain an understanding of the professional qualifications of the specialist as previously required. As noted in Docket 044, Appendix 3, Page A3-11, proposed AS 1150.B3 does not provide specific steps to perform in order to understand the professional qualifications of the specialist. Including more guidance on the potential acceptable sources of relevant information, with the caveat that the auditor should use judgment to determine if additional or alternative sources of information are necessary given the facts, circumstances, and identified risks associated with the engagement, would be beneficial to avoid inconsistencies in the procedures performed by auditors.

Considering the relationship to the company is also important in understanding the nature and work of the specialist in order to assess the reliability of the audit evidence to be obtained from the company’s specialist. Paragraph .B4 calls for identifying “ whether circumstances exist that give the company the ability to significantly



affect the specialist’s judgments about the work performed, conclusions, or findings.” However, Docket 044 does not provide sufficient guidance in paragraph .B5 regarding what the implications are and how the auditor should respond if the company has the ability to exert influence. In fact, the wording used in the proposed standard implies that if the company can exert significant influence over the specialist, which it potentially would if the company employs the specialist or engages the specialist, then the audit evidence provided by the company’s specialist would not be reliable. This implication is contradictory to the ideas that the auditors should be able to use the company’s specialist’s work as audit evidence, and that the auditors should not be required to use an auditor employed or engaged specialist. The company could end up in the position that they will need to pay for their own specialist and the auditor’s specialist, which seems unnecessary. We recommend that the Staff revisit this part of Docket 044, including considering use of the term “objectivity” versus “relationship to the company” (similar as proposed for auditor-engaged specialists) and providing guidance as to how the nature, timing, and extent of audit procedures may be impacted by the auditor’s assessment of the specialist’s objectivity.

Testing and Evaluating the Work of a Company’s Specialist

Testing and evaluating the work of the company’s specialist falls under paragraph .10 of AS 1105 that addresses using information produced by the company. Under this standard, the auditor must test the accuracy and completeness of the information and evaluate the sufficiency of the information to serve as audit evidence. Building on this standard, paragraphs .B6a and .B8 of Docket 044 call for the auditor to evaluate if the data was appropriately used by the specialist, and methodologies appropriately applied by the specialist. These requirements imply that the auditor would have the same special knowledge or skill in an area outside of accounting and auditing that the company’s specialist would possess and contradicts the intentions that the auditor should be able to use the work of a company’s specialist as audit evidence and that the auditor should not be required to have its own specialist. We object to performance requirements that would imply or require the use of auditor employed/engaged specialists to comply with the standards.

Furthermore, paragraph .B7d indicates that the auditor should include the ability of the company to significantly affect the specialist’s judgments in its evaluation of what is necessary evidence for testing and evaluation. Since a wide range of factors impact the ability of the company to exert varying levels of influence over the specialist’s judgment, specialist objectivity varies as well. The Note included after paragraph .B7d addresses some of the factors and how they may influence the testing and evaluation of evidence, but additional clarification would ensure greater consistency in the execution and compliance of audit procedures.

III. Amendments to PCAOB AS 1201, *Supervision of the Audit Engagement* (AS 1201)

Qualifications and Independence of Auditor-Employed Specialists

The auditor-employed specialists are subject to the same standards as all employees of a PCAOB registered public accounting firm. As such, we believe that the standards outlined in QC Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (“QC 20”), contain the necessary guidance related to auditor-employed specialists and the additional guidance proposed is duplicative.



Informing the Auditor-Employed Specialist of Work to be Performed

We concur with the standards outlined in paragraphs .C5 through .C7 addressing the relevant communication and expectations of the auditor-employed specialist’s role in an audit engagement and with members of an engagement team. The auditor-employed specialist should be included as a member of the engagement team, from the planning meeting through documentation and conclusion. As such, the work performed by the auditor-employed specialist should be conducted with the same due professional care, in accordance with AS 1015, as all work performed in order meet the “objective to obtain sufficient appropriate evidential matter to provide a reasonable basis for forming an opinion,” as stated in AS 1015.11. Increasing the involvement and communication between the engagement team and the auditor-employed specialist throughout the engagement could benefit the entire team in some instances, since the auditor-employed specialist offers specialized knowledge and skill and potentially a different perspective, and the auditor-employed specialist would be exposed to areas of the financial statements beyond the area assigned. For example, including the auditor-employed specialist in the planning meeting could enlighten all engagement team members, provide a greater understanding of the client and the financial statements, and identify additional risks of material misstatement thus improving the quality of the audit. Through increased communication and involvement, the auditor will be able to improve audit quality while being able to rely on the specialized skills and knowledge of the specialist with the auditor’s judgment prevailing.

Evaluating the Work of the Auditor-Employed Specialist

As part of conducting an audit with due professional care, AS 1015.06 states, “The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.” The guidance in AS 1201.03-.04 elaborates on the responsibility of the engagement partner, and those who assist the engagement partner in supervising the audit, to include specialists. The proposed language in paragraphs .C8 and .C9 of Docket 044 offers more specific guidance on how to accomplish this supervision, with audit judgment prevailing. We believe this additional guidance will improve audit quality and consistency in the profession.

IV. Amendments to PCAOB AS 1210, *Using the Work of a Specialist* (AS 1210)

Assessing the Knowledge, Skill, Ability, and Objectivity of the Auditor-Engaged Specialist

In contrast to the auditor-employed specialist, the auditor-engaged specialist is not included under QC 20. As such, we concur with the proposed changes that the auditors need to assess the auditor-engaged specialist’s knowledge, skill, and ability as well as objectivity. In assessing objectivity of the specialist, giving consideration to the nature and significance of the specialist’s work and the auditor’s opportunity to perform other procedures, the auditor will be able to determine the extent of the work to be performed by the specialist and the audit engagement team in order for the engagement team to be able to rely on the specialist’s work.



Informing the Auditor-Engaged Specialist of the Work to be Performed

The auditor-engaged specialist must be included in different phases of the engagement in a similar manner to the auditor-employed specialist, except for those standards that would apply to a person employed by the firm as noted above. The goal of the auditor-engaged specialist is no different than that of the auditor-employed specialist, as stated in AS 1015.11, "...to obtain sufficient appropriate evidential matter to provide...a reasonable basis for forming an opinion." Paragraphs .06 through .08c outline appropriate communications between the engagement team and documentation from the auditor-engaged specialist.

Evaluating the Work of the Auditor-Engaged Specialist

Utilizing the services of an auditor-engaged specialist supplements the accounting and auditing knowledge and skill of the auditors with knowledge and skills that the auditor does not possess. With that said, the engagement partner and those with supervisory responsibilities must be able to assess the work performed, the relation of the work performed to other areas of the engagements, the relation to the risks of material misstatement identified, and the conclusions reached by the auditor-engaged specialist in the same manner as the auditor-employed specialist. Communicating and reviewing the work of the auditor-engaged specialist and ensuring the consistency with the findings of other audit areas is imperative to be able to utilize the audit-engaged specialist's work as sufficient appropriate audit evidence.

V. Applicability

This guidance would benefit on audits of emerging growth companies and broker-dealers. Having one standard will eliminate confusion and ensure consistency with small firms incurring less costs for training and implementation throughout the firm. With that said, costs related to specialists must be kept down for smaller entities like emerging growth companies and introducing broker-dealers. For example, introducing brokers primarily value stock options with in house personnel using common valuation techniques including Black Scholes, which is commonly practiced and requires little expertise. The auditors' assessment, procedures, and conclusion on the methodology, valuations, observance of inputs, and review of assumptions have not previously required specialists. Auditors generally have experience in this area and are able to gain reasonable assurance regarding the items noted above as prepared by the company's specialist. If the auditor would be required to perform more procedures, unnecessary costs to the company may be incurred.

VI. Effective Date

Implementing a new standard such as the proposed standards in Docket 044 requires training, analysis of the implications on all audit engagements utilizing specialists, and making adjustments to quality control procedures. We recommend an effective date of years ending at least two years after the SEC approves the final standards. The two year window should give smaller firms the ability to analyze, prepare, and implement the new standards.



VII. Conclusion

We applaud the Board and the Staff in its efforts in continuously improving its auditing standards relating to the auditor's use of the work of specialists that will lead to enhancements in audit quality and consistency in application of the standards. We remain committed to participating in future discussions with the Board and the Staff about how to best implement appropriate recommendations generated by the proposed auditing standard and related amendments to certain other auditing standards that would further enhance audit quality with respect to issuers and improve transparency. Lastly, we fully support the mission of educating investors and other users of financial statements about the process using the work of specialists in the audits of issuers and broker-dealers.

We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Wendy B. Stevens, Practice Leader, Quality & Risk Management, at (212) 375-6699 (wendy.stevens@mazarsusa.com) or Bonnie Mann Falk, Quality & Risk Management, at (516) 620-8554 (bonnie.mannfalk@mazarsusa.com).

Very truly yours,

Mazars USALLP
Mazars USA LLP

August 30, 2017

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

**Re: PCAOB Rulemaking Docket Matter No. 043/Release No. 2017-02,
Proposed Auditing Standard – *Auditing Accounting Estimates, Including
Fair Value Measurements and Proposed Amendments to PCAOB Auditing
Standards***

And

**PCAOB Rulemaking Docket Matter No. 044/ Release No. 2017-03, *Proposed
Amendments to Auditing Standards for Auditor’s Use of the Work of
Specialists***

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitations for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to Proposed Auditing Standard, *Auditing Accounting Estimates, Including Fair Value Measurements* (Estimates Proposal) and the *Proposed Amendments to Auditing Standards for Auditor’s Use of Specialists* (Specialists Proposal) (collectively, the Proposals).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.



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Ms. Phoebe W. Brown
August 30, 2017
Page 2

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 228 companies representing an equity market capitalization of \$1.121 trillion at July 31, 2017. Of these companies, 188 were Equity REITs representing 94% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to \$1.054 trillion)¹. The remainder, as of July 31, 2017, is represented by 40 stock exchange-listed Mortgage REITs with a combined equity market capitalization of \$67 billion.

NAREIT previously responded to the PCAOB's August 19, 2014 PCAOB Staff Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements* (NAREIT letter dated October 31, 2014²) and the May 15, 2015 PCAOB Staff Consultation Paper on *The Auditor's Use of the Work of Specialists* (NAREIT letter dated August 3, 2015³). We appreciate the PCAOB's effort to address a recommendation we previously made in not viewing a third-party expert hired by management as an extension of management. We agree with the Specialists Proposal's guidance to provide a risk-based approach in the application of audit procedures surrounding external experts hired by management. Additionally, we generally agree with the format that the Board developed to apply different audit procedures depending on whether the specialist is hired by management, employed by management, hired by the auditor, or is employed by the auditor. While we appreciate these aspects of the new iterations of the Proposals, we continue to question why a fundamental change in audit guidance is necessary.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

Why is a change to the existing audit framework for auditing accounting estimates and the auditor's use of specialists warranted?

NAREIT is not persuaded that a change to the audit framework for the audit of accounting estimates or the auditor's use of specialists is necessary. In NAREIT's view, any expansion of audit requirements for accounting estimates and corresponding audit work for the work of specialists are unnecessary changes given the amount of work performed by auditors today. Additionally, adding additional audit work does not automatically lead to more accurate accounting estimates.

¹ <https://www.reit.com/sites/default/files/returns/FNUSIC2017.pdf>

² <https://www.reit.com/sites/default/files/NAREIT%20Comment%20Letter%20on%20PCAOB%20Staff%20Consultation%20Paper%20Auditing%20Estimates%20and%20FV%20Measurements%20FINAL.pdf>

³ <https://www.reit.com/sites/default/files/media/PDFs/NAREITCommentLetter20150803.pdf>



Ms. Phoebe W. Brown
August 30, 2017
Page 3

NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding accounting estimates prepared by specialists pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions at times *exceed* the fees paid to the third-party valuation companies that develop the estimates. In NAREIT's view, the proposed amendments to audit guidance in the Estimates Proposal and the Specialists Proposal do not pass a cost benefit test.

Why do the Proposals repeatedly use the words "inherent management bias" and "moral hazard?"

The Proposals include a negative connotation toward management's responsibility in preparing financial statements. The repeated use of the words "management bias" and "moral hazard" seem to go above and beyond the auditor's responsibility to conduct the audit with professional skepticism. These words imply that management has a predisposition to inflate financial results instead of being stewards of public capital and reporting financial results faithfully in accordance with U.S. GAAP. Given the negative tone, auditors may feel compelled to do more audit work than they do today. In our view, the Proposals would expand the work that auditors perform, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards on auditing accounting estimates or the auditor's use of the work of specialists fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and corresponding audit fees) would provide any measurable benefit to improve audit quality.

What are the underlying problems that the Estimates Proposal and Specialists Proposal are trying to solve?

NAREIT does not believe that either the Estimates Proposal or the Specialists Proposal articulate a pervasive problem that would be solved by a change in auditing standards. The Proposals seem to justify a significant increase in audit work (and cost) based on academic research papers and limited circumstances where *existing audit guidance was not followed by the auditor*. The Specialists Proposal acknowledges that "inspection staff have observed a decline in the number of instances by larger firms in which auditors did not perform sufficient procedures related to the work of an auditor's specialist."⁴ Failure to conduct an audit in accordance with current audit guidance does not, in and of itself, warrant revised auditing standards. Rather, this seems to be an "easy fix" for the PCAOB to address in its inspections of audits conducted by public accounting firms.

⁴ <https://pcaobus.org/Rulemaking/Docket044/2017-003-specialists-proposed-rule.pdf> at page 14.



Ms. Phoebe W. Brown
August 30, 2017
Page 4

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to enhance audit quality. However, NAREIT does not believe that the PCAOB has presented solid evidence to warrant further amendments to auditing standards. While the PCAOB cites academic research papers and limited examples of where the auditor failed to follow existing auditing standards, NAREIT fails to recognize these issues as the basis for a change in auditing standards. In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach that addresses the root cause of problems that are identified.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards
NAREIT



Christopher T. Drula
Vice President, Financial Standards
NAREIT

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National Association of State Boards of Accountancy

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August 30, 2017

The Office of the Secretary
The Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 044 - Proposed Amendments to Auditing Standards for Auditor's Use of Specialists

Dear Members and Staff of the Public Company Accounting Oversight Board:

We appreciate the opportunity to offer our comments on the PCAOB Rulemaking Docket Matter No. 044 - Proposed Amendments to Auditing Standards for Auditor's Use of Specialists (the Proposal).

The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness and advance the common interests of the Boards of Accountancy that regulate all certified public accountants and their firms in the United States and its territories.

We understand that the Proposal is aiming to strengthen the requirements for (1) evaluating the work of a specialist employed or engaged by the company and (2) applying a risk-based approach to supervising and evaluating the work of a specialist employed or engaged by the auditor. We would like to commend the PCAOB on recognizing the need for amending the auditing standards for the auditor's use of specialists. The increasing complexity of the market environment and accounting transactions create a growing need for the use of various specialists in audits. Consequently, we would like to express our overall support for the PCAOB's developing the Proposal.

We offer the following comments on the Proposal. Notwithstanding the above, we wish to emphasize the following matters:

OVERALL COMMENTS

- The distinction between auditor engaged and auditor employed specialist is not clear. The definition of an auditor employed specialist does not appear to consider situations where the specialist may be a part of a network firm wherein the specialist is subject to the same quality control and independence requirements within their network firm.
- The proposed amendments do not include consideration of management's controls related to company specialists. We believe management controls over selection and supervision of a company specialist as well as controls over inputs provided to the specialist would be

The Office of the Secretary
The Public Company Accounting Oversight Board
August 30, 2017
Page 2 of 2

important for the auditor to consider. Further application guidance should be provided regarding consideration of these types of controls.

- It would be helpful to provide application guidance on procedures to be performed by auditors to evaluate specialists used (e.g. review of qualifications, methods, etc.). We do not believe inquiry alone is likely sufficient to evaluate the specialist. We would expect that the level of procedures to be performed would increase as the risk of material misstatement of the related account balance increases. Application guidance should include examples of other procedures the auditor may consider as well as type of evidence that should be obtained to support their evaluation.
- Paragraph .04 of the Proposal states that engagement partner and other engagement team members performing supervisory activities should assess whether the specialist and the entity that employs the specialist have the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. We recommend providing application guidance on how the auditor should evaluate the objectivity in these types of situations.
- Paragraph .11 of the Proposal imposes additional requirements on auditors in situations where the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence. The wording does not reconcile to the example provided. Specifically, the example wording implies that the reason for the contradiction relates to errors in the specialist's work. We recommend it also address the possibility the contradiction is attributable to a financial statement misstatement by the Company.

Again, we appreciate the opportunity to comment on the Proposal.

Sincerely,



Telford A. Lodden, CPA
NASBA Chair



Ken L. Bishop
NASBA President and CEO



August 22, 2017

VIA Email

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PCAOB
1666 K Street, N.W.
Washington DC 20006-2803
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RE: Docket Matter No. 43/Release No. 2017-002, *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements* and Docket Matter No. 44/Release No. 2017-003, *Proposed Amendments to Auditing Standards for Auditor’s Use of Specialists*

INTRODUCTION

The National Venture Capital Association (“NVCA”) represents the vast majority of American venture capital under management.¹ Venture capital funds invest across the spectrum of company stages of development, typically from early stage startup through IPO or acquisition.

NVCA’s comments are informed by its CFO Task Force. This group is made up of the Chief Financial Officers and Operating Partners of more than 100 of our member firms. Most of our CFO Task Force Members are CPAs and many have audit experience

¹ Venture capitalists are committed to funding America’s most innovative entrepreneurs, working with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. As the voice of the U.S. venture capital community, the National Venture Capital Association empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community’s preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its nearly 400 members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

Comment of the National Venture Capital Association
Accounting Estimates Including Fair Value Measurements
Auditor's Use of Specialists
August 22, 2017

with leading national firms. They are responsible for the financial statements of hundreds of venture capital funds. Our task force members also offer a perspective on the audit process related to hundreds of companies across numerous industries.

The typical venture capital fund ("VCF") is a limited partnership in which the bulk of the capital commitments come from pension funds, foundations, endowments, insurance companies and other institutional investors. VCFs must provide these limited partner investors ("LPs") with audited financial statements prepared in accordance with ASC Topic 946 on Investment Companies. As such, VCFs report assets at fair value in accordance with ASC Topic 820. The most important elements of VCF financial statements are the values of their portfolio company assets. Because many of these portfolio companies do not yet have proven business models or technologies they are valued based upon "level 3" inputs. Therefore, fair values exhibit a great deal of estimation uncertainty. Realized returns from exits can range from liquidation value to many multiples of the fund's investment.

We are filing a comment letter on these two PCAOB Proposals for several reasons. First, NVCA's members -- although they are primarily private entities -- are intensely interested in these PCAOB rules. Audit firms use the same procedures for auditing private funds as they use for publicly traded ones. These procedures are driven by PCAOB standards and examination practices. We noted this in our lengthy letter in response to the 2014 Staff Consultation Paper, *Auditing Estimates Including Fair Values*. That letter² sets out the difficult and persistent problems that arise from auditors' use of standardized audit procedures to test the values of venture capital assets. Excessive audit procedures around uncertain estimates of value waste scarce resources and can convey an erroneous and inappropriate sense of precision. Furthermore, the use of valuation techniques that are not useful to marketplace participants is inconsistent with the requirements to Topic 820. I will not belabor these points or repeat the comments in our earlier letter on fair value audits. However, the comments in that letter remain valid. I commend them for your further consideration.

We are combining our comments on these two proposals because, as noted in the Staff Consultation Paper, *Auditors' Use of the Work of Specialists*, there is significant overlap between issues arising from audits of estimates and auditors' use of specialists. This is especially true for VCFs. The reasons for this are set out in NVCA's letter in

² https://pcaobus.org/Rulemaking/Docket043/042_NVCA.pdf

Comment of the National Venture Capital Association
Accounting Estimates Including Fair Value Measurements
Auditor's Use of Specialists
August 22, 2017

response to the SCP on Use of Specialists. Unnecessary, ineffective and inappropriate use of valuation specialists is a major contributor to the excessive cost and effort that VCFs continue to experience in obtaining GAAP audits. Rather than reiterate those points here, I will reaffirm those views, incorporate that letter³ by reference and commend our comments there for your further consideration.

This letter is abbreviated compared to our earlier letters. One reason for this is that we know that both the PCAOB Chairman and senior staff are aware of our concerns and have provided our members meaningful opportunities to explain them. We very much appreciate the way the PCAOB has engaged with NVCA to date and we hope to continue to engage with the Board and the staff as any changes to these audit standards are implemented.

Finally, this letter is brief because we are not auditors and will not be responsible for interpreting or implementing any new standards. We will, of course feel the impact of any new standard. Therefore, rather than attempt to parse the proposed language we will offer some observations on the negative impact we expect from these amendments as well as some recommendations on mitigation.

COMMENTS AND RECOMMENDATIONS

Auditors' implementation of any new standards will be driven by PCAOB oversight. Auditors' "default" position will be to do more checks and require more documentation of valuations and to use more experts. From our perspective, existing rules, inspection priorities and peer reviews are already driving enhancements to audit procedures. Our members already see an ongoing trend toward more documentation and more unnecessary testing.

The difficulty of auditing inherently judgmental assumptions and other inputs has already caused an undue emphasis on testing of things that can be audited, but are not material. Specifically, for estimates in which the most meaningful inputs are entirely subjective, auditors place undue emphasis on testing inputs that are the easiest to audit, even when such assumptions *per se* may have only a limited impact upon an estimate. For example, in auditing a discounted cash flow, auditors can spend considerable time evaluating whether the correct discount rate was used when it is the

³ https://pcaobus.org/Rulemaking/Docket044/045_NVCA.pdf

Comment of the National Venture Capital Association
Accounting Estimates Including Fair Value Measurements
Auditor's Use of Specialists
August 22, 2017

estimate of future cash flows that is the most meaningful input and creates the most volatility.

Every indication we have seen is that the proposed changes will accelerate and exacerbate the trend for auditors to do more and more work on matters that do not present a risk of a material misstatement. Therefore, the proposed standard on *Estimates* would be greatly enhanced by a clear recognition that the reasonable range of estimated values for some assets exceeds their materiality. Furthermore, we believe that any new standard should recognize that when the most relevant aspects of a valuation are inherently judgmental no amount of additional audit work will produce a value the uncertainty of which is less than the materiality standard. Nor can the use of experts to review inherently judgmental valuation inputs improve an audit when estimation uncertainly is greater than materiality.

We appreciate that the proposed new standards are written with an eye toward balancing risks and costs. The proposed text can be read to allow auditors a degree of flexibility in the conduct of fair value audits or the use of specialists. However, the consequences for an auditor subject to PCAOB oversight of doing too little work remain exponentially more troubling to the auditor than those for doing too much work. Given this reality, there is a glaring absence in the proposed language of any caution to avoid excessive work or any comfort regarding the exercise of professional judgment or discretion. Therefore, we are concerned by the absence in the proposed standards of encouragement to use judgment and to assess the cost-effectiveness of audit procedures or the use of specialists.

Further adding to this risk of wasteful audit work are long lists in the proposed standards of matters that the auditor should evaluate or consider. For example, proposed AS 2501.15 sets out a minimum of five “[f]actors that are relevant to identifying significant assumptions...”⁴ Similarly 2501.16 requires the auditor to evaluate seven specific issues regarding the “reasonableness of significant assumptions [in a fair value estimate], both individually and in combination.”⁵ Seven more “factors” are identified in 2501.17 that an auditor should “take into account ... in evaluating the reasonableness of [significant assumptions based on the company’s intent and ability to

⁴*Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements*, P. A1-6. Available at <https://pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf>

⁵ *Id.*, P. A1-7.

Comment of the National Venture Capital Association
Accounting Estimates Including Fair Value Measurements
Auditor's Use of Specialists
August 22, 2017

carry out a particular course of action].”⁶ Nothing in these various lists directs consideration of a cost-benefit balance or whether further testing and analysis will meaningfully improve the auditor’s ability to assess the reasonableness of the estimate overall.

We believe it is likely that auditors will assume that each of these factors or considerations will need to be addressed in a granular way absent explicit language to the contrary. Therefore, if the Board intends for auditors to exercise professional judgment and apply these standards in a risk-based manner, we think it imperative that the standards explicitly state that not all listed factors and considerations should be part of a typical audit. More generally, the PCAOB should signal that wasteful, self-protective auditing practices are inconsistent with overall PCAOB standards. Otherwise, “factors to be considered” will become part of mandatory check lists to be documented, leading to excessive and meaningless audit procedures.

The Board intends that these standards be implemented in a risk-based, cost-effective manner. Release No. 2017-003 justifies application of the Use of Experts amendments to Emerging Growth Companies (EGCs), in part on the assumption that the new requirements will be implemented in a risk-based and “scalable” manner.⁷ While we hope this is true, we are certain that the Release is correct where it says that “even a small increase in audit fees could negatively affect [small companies’] profitability and competitiveness.”⁸ Experience drives us to skepticism about the likelihood of risk-based or scalable implementation. Therefore, we strongly recommend that the Board commit to a systematic and objective post-implementation review of the impact of any new standards on the costs and benefits of audits for smaller companies, including EGCs should the SEC accept the PCAOB’s recommendation to apply these new standards to EGCs.

Summary of Recommendations

- The new standards need to explicitly recognize that there are situations in which estimation uncertainty exceeds materiality. In such situations, there may be limited value to applying additional testing and audit procedures, when the

⁶ *Id.*, P. A1-8.

⁷ *Proposed Amendments to Auditing Standards for Auditor’s Use of Specialists*, P. 58. Available at <https://pcaobus.org/Rulemaking/Docket044/2017-003-specialists-proposed-rule.pdf>.

⁸ *Id.*

Comment of the National Venture Capital Association
Accounting Estimates Including Fair Value Measurements
Auditor's Use of Specialists
August 22, 2017

additional procedures won't reduce estimation uncertainty to any meaningful degree.

- To promote professional judgment and risk-based application, the standards should explicitly state that not all listed factors and considerations should be part of a typical audit.
- The Board should send a general signal that wasteful, self-protective auditing practices are inconsistent with overall PCAOB standards.
- The Board should schedule a systematic and objective post-implementation review of the impact of any new standards on the costs and benefits of audits for smaller companies, including ECGs, should the SEC decide to apply these new standards to ECGs.

Conclusion

NVCA appreciates the opportunity to participate in the PCAOB's rulemaking process and the Board's consideration of our views. We stand ready to work with the Board and the staff on this and other important matters. Please feel free to contact me at (202) 864-5925 or bfranklin@nvca.org or Justin Field, Vice President of Government Affairs at (202) 864-5929 or jfield@nvca.org.

Sincerely yours,



Bobby Franklin
President & CEO



September 4, 2017

Dear Public Company Accounting Oversight Board,

I would like to submit my comments on the proposed amendments to auditing standards outlined in PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates and their potential impacts. My perspective is one of an internal (employed and engaged) environmental specialist supporting public accounting firms. Since environmental liability and asset retirement obligation (ARO) estimates contain issues that will, in most cases, be subject to both proposals, my comments are not divided between the documents but presented for consideration together.

While my experiences have allowed me to observe certain complexities with both management estimates and specialists, I would not presume to have sufficient accounting and auditing knowledge to propose revisions or additions to the proposals. Instead, I hope the Board can use these experiences and examples of difficulties in performing the proposed requirements to inform their discussions and revisions, as appropriate. Some of these observations may represent challenges in meeting the current requirements and others of meeting the proposed requirements. If the Board desires further clarification of any of these comments to support its work, I would be pleased to discuss them further.

I am an environmental remediation specialist and have served as an audit specialist (employed and engaged) supporting financial audits of environmental liabilities and asset retirement obligations for approximately eight years. In most cases, I believe my work and those of my teammates, largely with bigger firms, has, as the specialist proposal described, "*exceed[ed] the existing requirements of AS 1210.*" In most cases, audits in which I was scoped to provide support did include "substantive procedures, including tests of details and substantive analytic procedures" of management estimates (typically using specialists) that were not measured at fair value but which were considered to contain a high degree of uncertainty and management judgment.

Such procedures included "*testing and evaluating the data used by the specialist, evaluating the methods and significant assumptions used by the specialist, and evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.*" For the most part, we considered the assumptions and conclusions of managements' engaged specialists to be as management's own for reasons I will discuss herein.

While I have been privileged to learn a great deal regarding accounting and auditing from my colleagues and my firms, my experience in audit support, naturally, was focused only on environmental liabilities and AROs. As such, the observations made here are not intended to describe circumstances involving other management estimates or specialists or imply there may be similarities, though it is possible that they may exist. I hope that these responses will be helpful to your team in spite of these limitations. My most general comments on the expected results of, and concerns with, the proposed requirements are included in the section "Overall Comments." Specific observations of difficulties auditing specialist estimates that I hope will also be of use to the Board are included in the "Specific Comments" section.

Regards,

J. M. Young,
Principal, Environmental Specialist



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

OVERALL COMMENTS

At the highest level, the proposed changes specify that management estimates, specifically including contingencies like environmental liabilities and AROs (which are commonly supported by the work of internal or external specialists), be subject to greater efforts, subject to their identification by the audit team as being of significant risk.

I first joined a "big 4" firm in the fall of 2009 when that firm (U.S.) had launched an initiative to assemble a group of environmental and other technical specialists specifically to provide environmental specialist support to the audit function. The newly formed group was invested with a former audit partner to guide the work of the group and to dialogue with the current firm audit partners that would form the body of internal customers. This would later be augmented by support from National Audit Practice leaders. I believe the success of that group, in terms of improving audit quality, was very much based upon the fact that both perspectives were represented: deep knowledge of auditing expectations and norms along with deep but "fresh" technical engineering perspectives with no auditing or accounting knowledge whatsoever. In hindsight, we would realize that the extensive communication gaps that existed between our professions in the microcosm of our team also existed in companies and external auditors at large. I believe both sides were surprised by the depth of knowledge the other did not possess.

For this reason, at first, the engagements were challenging, time-consuming, and, occasionally, contentious as specialists and audit team colleagues came to understand the complexities in each other's area of expertise and develop a common language between fields of expertise. Additionally company environmental specialists, both employed and engaged, unused to the additional scrutiny and challenge to their conclusions, were often times confused and frustrated by the new requests, questions, and additional company effort required. Over time, as understanding of the complexities, uncertainties, and level of subjectivity in these estimates grew within the firm, the audit procedures designed to address these risks focused increasingly in assessing management assumptions, data, and methodologies and quality of documentation. In the first couple of years, hundreds of specialist hours (and in at least one engagement, over a thousand) were added to some audits to the consternation of audit teams under market pressure to provide more and more cost efficient audits. Later, it was possible to streamline efforts somewhat due to the updated and refined risk methodologies promoted in 2010/2011 and, the maturation of the auditor-specialist communication. Even in these latter cases, assessments of site estimates (typically large estimates for large clients) were difficult to complete with appropriate levels of scrutiny, documentation, and senior review for less than 80 hours per estimate. On the other hand, procedures performed by auditor's specialists for other firms have involved less than 20 hours. It seems reasonable that the proposed guidance offered by the Board will allow the development of some consistency, both in scope and effort, across engagements and firms. However, I would offer to the Board based on my experiences, and for informational purposes, that the impact per estimate assessed on engagement budget may be in the range of 50+ specialist hours.

Based on the audits performed, I concur that the proposed changes in audit approach to estimates and using the work of specialists will increase audit quality and financial reporting of environmental liabilities and AROs. Out of over 200+ environmental liability estimates and AROs audits in which I participated, using the methods like those proposed, I have observed only one estimate without identifiable errors, based on the work performed. The majority of errors in the remaining estimates, while they were important from a sampling/extrapolation and internal controls standpoint, were not, alone, material to the financial statements.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

(In my experience, auditor specialists are rarely, if ever, informed of the potential for impact in combination with errors identified from other procedures) However, large errors were not as rare as might have been expected. At one site, a \$100M estimate was found to be over 100% understated in the first year of specialist support for the audit. At another, a \$1.5M estimate was found, in conjunction with environmental due diligence providers, to be more accurately estimated at \$150+M (two orders of magnitude understated). While our team did not maintain statistics about the frequency and size of errors, I would anecdotally estimate that approximately 10% to 15% of management environmental liability and ARO estimates contained significant errors or omissions requiring the company to revise the estimate before the close of the reporting period. Based on these observations, I agree that material errors in environmental liabilities may have gone, and may continue to go, undetected under the current requirements.

Further, it has been my observation that multiple public accounting firms are using environmental specialists to assist financial audits of environmental liability and ARO estimates; however, there is a noticeable disparity in the nature, scope, and objectives in these procedures between firms, and not uncommonly, between engagements performed for the same firm. I believe the PCAOB proposals for estimates and use of specialists will drive greater intra-firm and inter-firm consistency in the scope, objectives, completeness, quality, and documentation of specialist work and not only result in meaningful comparability in financial statements for investors but also 'level the playing field' for companies that may already have subject themselves to greater audit procedures relative to their competitors.

One concern I do have regarding the proposals is the references to assessing the company's engaged specialist's estimates as if it was the company's estimate. As I discuss below regarding what I believe to be a systemic bias and challenges to objectivity in estimates provided by environmental consulting/engineering providers, in general, I agree that company-engaged specialist estimates and data should be subject to greater auditing procedures. In practice, I have discovered large errors in engaged specialist estimates resulting from many factors.

What is not clear from the current or proposed standards, however, is if, or where, such consideration ends. For example, if I acknowledge that the engineering consultant's report may contain bias or a lack of objectivity for which I should design procedures; may I still appropriately rely upon the data provided by the specialist's subcontractors like laboratories, surveyors, soil engineers, remediation equipment providers, etc.? (For reference, a description of these roles in the "typical" environmental response is included in the Appendix). Does this data qualify as "*data from an external source*" used by the company? In terms of environmental liabilities, in particular, this data is typically extensive. In practice, such data is not confirmable or verifiable by the auditor or the auditor's specialist (as an example, we generally cannot collect soil samples and submit them for independent analysis). If possible, it would be helpful to have more explicit guidance or interpretation on the degree of separation at which it is appropriate to accept data without further assessment so that auditor and specialist effort is not wasted in the performance of unnecessary procedures.

SPECIFIC COMMENTS

Systemic Estimate Bias

In my experience, first as an environmental remediation consulting, providing environmental remediation estimates for corporate clients, and then as an audit environmental specialist, bias in the development of environmental liability estimates and ARO estimates is systemic and heavily skewed to underestimation. Due



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

to motivations having nothing to do with the relevant accounting guidelines(see further discussion in the background information presented in the attached Appendix), about which the large majority of environmental remediation professionals have little knowledge, the default approach for environmental response professionals is to provide and advocate for, the lowest possible estimate. As such, upon discussion with the company's specialists (employed or engaged), it often becomes apparent that the estimate presented for financial reporting purposes, is either or both, not the best point in the range or demonstrates significant omissions.

In my observations, management typically has not addressed this bias in its review of the estimates prior to performance of audit procedures like those proposed by the Board. This appears to be due to a combination of management not being keenly motivated to search for "bad news" with respect to estimates and not having identified that a bias exists in the environmental/legal function in the first place due to the knowledge and culture gaps between the environmental/legal and accounting functions.

Interestingly, in many of the audit engagements which I have supported for multiple years in a row, management continues to insufficiently or ineffectively address this bias, despite its illumination by the repeated identification of understatement errors of various magnitudes. However, perhaps improvements in this area will be realized as the PCAOB proposals drive public accounting firms to provide more consistent attention to this area.

Moral Hazard

The Board raised the issue of moral hazard on the part of the public accounting firm with the example that auditors may have incentives to behave sub-optimally, from investors' point of view by, not "sufficiently challenging management's estimates or underlying assumptions in order not to disturb the client relationship"...or "seeking to maximize profits and/or minimize costs." The Board also acknowledges that "it is conceivable that, in some situations, moral hazard may take the form of the auditor either influencing the findings or conclusions that the specialists reach or modifying the specialist work after the fact to support the conclusions sought by the auditor."

I would alert the Board, if it has not already been considered in the statement above, that moral hazard may also exist on the part of the specialist due to an awareness of "client relationships" and the motivation to "maximize profit/minimize cost." Since it would likely be financially and logistically prohibitive for each audit team to have its own embedded specialist for each area of specialty, the specialists whether engaged or employed, are expected to be organized separately from the audit teams and, more importantly, have as their "clients", not the audited entity but the audit teams themselves.

Depending on the organizational structure, the specialist team may not be subject to the same consequences as the audit team, should the audit work be concluded to be insufficient and therefore the risk of moral hazard (to maintain client relationships or reduce costs) may be greater at the specialist level than at the auditor level; particularly in the case of the engaged specialist.

Many times I have experienced an audit partner "pushing back" on either scoped effort due to budgetary constraints or specialist conclusions due to concern about his client relationship, the financial reporting deadlines, etc. In most of these cases, the partner-level leadership of the environmental specialist team shared in the potential consequences of poor audit quality and, thus, was appropriately resolute in her position. However, specialists, either engaged or employed, without such visible and engaged senior sponsorship may be influenced to inappropriately adjust their position. Further, a specialist having learned in one engagement



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

what scope or conclusions are not desired by an audit team ("client"), may not propose scopes or put forth conclusions anticipated to be rejected by another audit team ("client") before auditor pressure is even applied.

It appears conceivable that this risk, while present with both employed or engaged auditor specialists, would be greater with an auditor engaged environmental specialist due to the fact that the engaged specialist is unlikely to face the same professional or financial consequences of a poor financial audit (see the related comments on Specialist Qualifications below) and that if multiple specialist companies are engaged, consistency and performance quality trends across the work of any one engaged specialist will be difficult for the audit firm to monitor.

The Board states that moral hazard and poor work quality on the part of the specialist may be, at least partially, alleviated by the specialist perceiving a risk of reputational damage or being subject to codes of conduct, standard, and disciplinary actions in their own profession. I believe this expectation to be more applicable to an employed specialist rather than an engaged specialists as it appears likely, particularly in fiscal years immediately following implementation of the proposed standard, that engaged environmental specialists will represent companies whose services include more traditional environmental consulting services to industry (see related comments in Specialist Qualifications and Specialist Availability below)

Given that I have served with teams that were already conducting work exceeding the current standards and similar to the proposed standard, when these risks for moral hazard were experienced, it is unclear to me how the proposed standards will effectively address this issue, regardless of whether they are aligned with the risk assessment standards or not, unless it is anticipated that specialists will be leveraged to support quality control mechanisms (either internal firm inspections or external PCAOB inspections) to detect or deter suboptimal effort on the part of the specialist.

Professional Judgement vs. Professional Judgement

In the course of performed procedures for environmental liability estimates and AROs for several years, inevitably, we came across instances in which the assumptions of the company's specialists did not appear reasonable to the auditor's specialists but, for varying reasons, the auditor's specialists could not support their conclusions with documentation (i.e. *"If the auditor evaluates the reasonableness of a significant assumption by developing an expectation of that assumption, the auditor should have a reasonable basis for that expectation."*). For example (exaggerated for illustration purposes) a company specialist investigation estimate might include an assumption that a 300-acre industrial site with large areas of historic hazardous materials storage will require the installation of only three monitoring wells to assess the presences of contaminants in groundwater. The auditor's specialist may consider the same site and acknowledge that the theoretical minimum at nearly every site is three wells (the minimum number necessary to assess groundwater flow direction). But the auditor's specialist may further consider that because of the size and history of the assessed site and type of soils reported in the area, that, based on nothing more concrete than direct past experience with similar sites, a reasonable minimum number of wells that will be approved by the regulator is 50.

In these circumstances, where the judgment of the auditor's professional cannot be supported by documentation (any more than that of the company specialist), the audit team response has varied. Some rejected the conclusions of the auditor's specialists because they may have appeared indefensible (no reasonable basis) to the client with whom relations may (or may not) already be difficult while others have pressed management to assemble documentation that better supported the company's assumptions (if possible).



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

In some cases, this decision may have been influenced by the audit team requesting feedback from the auditor's specialist on the magnitude of the potential error. While this seems a reasonable consideration, it seems that it is more common for audit teams to ask this of the auditor's specialist than of management. In practice, this process is difficult and, to a certain extent, risky, for the auditor's specialist as it is not uncommon to have insufficient technical data to independently estimate the difference in costs. In the example above, for instance, without any wells previously drilled into the site subsurface and prior to the assessment of any documentation the company's specialist has to support technical assumptions, there may be no way for the auditor's specialist to anticipate the difficulty of installing the wells, what size and depth of wells will be necessary to withdraw groundwater, what materials the well will need to be constructed with based on the potential contaminants and soil particle size, etc. Given that the auditor's specialist does not have known values for these inputs, the range of the estimate could be so great that the estimate becomes of little use to the audit team. Complicating this assessment, typically, is the fact that the debated estimate may have itself been sampled from the larger site estimate for testing purposes thereby making the cost threshold for determining potential impacts across the estimate and the portfolio even lower.

Similar to the comments above regarding which specialist work can be relied upon, if any, without further assessment, it would be helpful to have more explicit guidance or interpretation on the role of "professional judgement" in the auditor's specialist's work and the level of reliance which can be based upon it (or not) in situations in which the other assessment characteristics (ex. relevant industry or regulatory standards, company's objectives, historical or recent experience of the company, etc.) are absent. Experience performing the procedures proposed has demonstrated to me that this dilemma will arise and guidance in this area could aid in developing consistency in these circumstances.

A Risk-based Approach

With regard to the alignment with estimate assessments to the risk identification and mitigation approaches outlined in AS 2110, though outside of my area of expertise, I would agree, in principal, that audit quality is increased when planning is based on assessed risk of material misstatement. However, in practice, at least as far as environmental liabilities and AROs are concerned, application is challenging.

Most notably, in my observation, is that the risks of material misstatement are often assessed by the audit team long before the involvement of an auditor's environmental specialist. Despite urging from Specialist leader and National Office level professionals, audit teams still involve environmental specialists in the planning phases of the audit only rarely and in the risk assessment, essentially not at all. This can prove problematic due, again, to lack of understanding by the auditor of the complexities of such estimates, and typical environmental management practices driving management's assumptions (including the systemic bias discussed previously and at length in the Appendix) and the communication gaps between the environmental (and occasionally legal) function and the financial reporting function. Each of these contributes significantly to the risks of material misstatements with regard to environmental liabilities and AROs.

"Walk-throughs" performed by the audit team with the audit client often fail to identify these risks as audit teams may not have the basis of knowledge to ask the questions that would illuminate them. Further, even with specialist participation in the walk-through, the team may not have sufficient documentation of site/estimate issues to provide the challenges to management statements during the walk-through that could also cause risks to surface. For this reason, many times, these gaps will not become apparent until the substantive procedures are performed because it is then that the auditor's specialist has access to documentation presenting information contradictory to management's statements.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor’s Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

As an example, in response to an auditor’s specialist’s question regarding the author of a remediation estimate, management responded that the file provided to the specialist and audit team was management’s documentation of an estimate originally provided by a third-party (company engaged) specialist. When this third-party document was requested and provided, it demonstrated a total cost 30% greater than that represented in the management buildup. When asked about the discrepancy, the company’s environmental management team (employed specialists) responded that they “always marked down their consultant’s estimate by 30%” before providing it to the financial reporting function. The company (employed) specialists continued by explaining that this adjustment was made because they understood from experience that the financial reporting function subsequently applied a 30% “contingency” to the estimate as it was received from the company employed environmental specialists before submitting into the financial statements. By “backing down” the estimate before delivery to the accounting office, the environmental specialists were “ensuring that it was right.” In theory, it was possible that this practice could have been identified in a “walk-through” exercise but, it had not been previously, and it would have required the audit team to consider that such an unusual practice had the potential to exist. I have experienced many other examples of similar communication gaps and significant unstated assumptions and these characteristics can form the basis for key risks of material misstatement. As noted, these risks may be difficult for the audit team to identify and assess.

In my experience, the audit teams I have supported generally have expressed surprise, upon completion procedures like those proposed, at the level of complexity, uncertainty, and judgement in environmental liability and ARO estimates; despite having performed audit-team procedures in prior years. However, once known, communication of these risks is slow to spread through the practice, even with National Office/Practice sponsorship. In the firms with which I have worked, many audit teams with clients holding such accounts have not used environmental specialists, even in the risk-assessment phase to establish that no other specialist support was necessary. As such, it is conceivable that material misstatements have occurred and will occur, regardless of the approaches proposed here by the Board, in which audits of environmental liability or ARO accounts have been inappropriately de-prioritized (“risked-away”) in the risk assessment phase.

Of the “risk factors” listed (p 94, 2017-002) proposed to be assessed during risk considerations, at least four (“susceptibility to misstatement due to error or fraud,” “accounting and reporting complexities associated with disclosures,” “exposure to losses in the account,” and “possibility of significant contingent liabilities arising from activities reflected in the account or disclosure”) represent areas in which it is possible that an audit team may not have sufficient understanding of the risk issues to appropriately prioritize or de-prioritize the account.

Evaluating the Qualifications of the Environmental Specialist

The Company’s Specialist

Current and proposed standards require the auditor to assess the professional qualifications of the company’s specialist (employed or engaged). I would offer that, in my experience, while this is a useful and necessary documentation effort, the results of these demonstrate little correlation with the conclusions made in the assessment of environmental liability and ARO estimates (valuation, completeness, obligations, etc.) and are, as such, of limited value in reducing audit risk. This may be due to a variety of reasons. The most significant of these is expected to be the systemic bias discussed previously and the related issue of specialist objectivity discussed below. Environmental liability and decommissioning estimation is typically strongly skewed toward underestimation, regardless of the degree of technical competency and qualifications.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

However, even in the absence of the issue of underestimation bias, simply identifying an environmental specialist's education, license status, and self-reported summary of experience cannot offer robust documentation of actual experience in environmental remediation or asset retirement activities. Like many other professions, only the general principles of environmental remediation and protection are offered in degree programs. A majority of required knowledge is gained from "in-field" experience and is fundamentally dependent upon time under instruction and the competence and experience of the senior field scientist acting as the instructor. Aside from checking the state licensing bodies (which simply states that a license is or is not current and, in some cases, is or is not in "good standing"), there is no consistent method to corroborate an individual or company's claims of technical competency or experience. Further, the quality of experiences is similarly undeterminable by an audit specialist or even an environmental specialist except in the highly unusual circumstance that the auditor's specialist maintains a relationship with another professional with whom the company's specialist may have worked. A similar challenge might be expected for an engineering professional to document the qualifications of a certain audit team senior manager (for example). At best, the engineer might be able to establish that the auditor holds a CPA license in good standing.

With technical firms, this is true also at the company level. While public accounting firm quality could potentially be assessed from PCAOB and SEC data, reports, and communications, the regulators for environmental response do not produce similarly public assessments and any "reputational" considerations made by audit teams or their specialists are commonly limited to characteristics like an engineering company's sales relative to another (See Engineering News Records top firms), self-reports of industry awards, or checks to determine if the specialist has been black-listed to perform work for federal entities. In some cases, particularly under the current requirements for non-fair-value estimates, these indirect reflections of competence could be leveraged to imply greater confidence in the specialist qualifications than might otherwise be possible and to avoid or diminish the performance of other procedures (see the discussion at Moral Hazard).

The qualifications and objectivity (see discussion below) assessments of company environmental specialists may have little impact in reducing the risk of using the estimates of company specialists. The Board may wish to consider, based on this perspective, if further clarification of, or elaboration on, the proposed requirements is prudent or necessary.

The Auditor's Specialist

A risk exists related to qualifications for the use of an auditor's engaged specialist as well; however the qualifications desired will include not only remediation/decommissioning experience but also an at least rudimentary set of financial auditing/accounting qualifications, as well. Specialist companies providing both qualifications are expected to be extremely limited (see Environmental Specialist Availability discussed below).

Additionally, keeping in mind that the sources used to establish an auditor's engaged specialists qualifications will typically be the same as those for the company's specialists, even though these sources only address the specialist's environmental technical qualifications. It is noteworthy that none of these sources will be impacted by or will be expected to report upon (or even follow) the quality of audit procedures performed (or not performed) by the auditor's engaged specialist. Perhaps in extreme cases, the auditors could make formal complaints to the licensing bodies (if any) of the engaged specialist but as such bodies are governing activities other than audit (ex. engineering, geology), the complaints of the audit client may not trigger censure from the licensing body as it may conclude that it has no authority to do so in some cases. As such, the Board's



**Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter
No 044 Auditor's Use of the Work of Specialists and Release No. 2017-
002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates**

hypothesis that moral hazard and poor work quality on the part of the auditor's engaged specialist may be, at least partially, alleviated by the specialist perceiving a risk of reputational damage or being subject to codes of conduct, standard, and disciplinary actions in their own profession is not, yet, particularly convincing.

This issue could be expected to also apply to the company that employs the individual environmental specialist as it is anticipated (discussed further below) that most companies employing such specialists will continue, at least in the short term, to derive more revenue from industrial clients than audit clients. As such the reputations of these companies will be reflected more in the engineering and technical venues in which the audit company (and certainly any individual audit team) holds little influence. Perhaps it will be the intention of the Board, in the performance of its regular inspection duties, to highlight specialist companies who, in the course of providing audit support work, performed sub-optimally but it is unclear how much authority, if any, the Board will have to apply sanctions for poor specialist company performance. Moreover, and perhaps more important for audit team planning purposes, there does not appear to be a mechanism by which the Board can present the specialist companies supporting inspected audits that were determined to have performed adequately.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

Evaluating the Objectivity of the Engaged Environmental Specialist

AS 1210 and the current proposals require that the auditor perform certain procedures when using the work of a company's specialist including evaluating the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity. As discussed previously, there is a very common, and I believe highly systemic, bias for underestimation of environmental liability and ARO estimates. However, beyond that, the issue of objectivity of an engaged environmental specialist (both the company's and the auditor's) may be problematic.

This conclusion is based upon the consideration that, with limited exceptions, the firms providing environmental remediation or decommissioning estimates are the same firms providing environmental remediation and decommissioning services, commonly with greater resulting gross revenue than the estimate development itself. In fact, in the most common case, the company's estimate is from a bid/ proposal to perform the services. Even where it is not, it is highly uncommon (in the 200+ estimates audited, I have observed less than four cases, each with very special circumstances) that the consultant providing the estimate for financial reporting purposes was not the provider selected for performing the services.

This is not necessarily a negative point as it would actually arouse some skepticism if the company maintained an estimate by one provider but was having the work provided by another. In this case, it could be conceivable that the company was inflating the estimate by using a more expensive provider and reserving any saved actual costs as a "cookie jar." However, it does result in a fact pattern in which the engaged specialist's company has an incentive to please the industrial client in order to win more work in the future. This risk would apply also to the auditor's engaged specialist. For instance, if "Environmental Engineering Company ABC" is contracted to provide 100 hours to an audit team but, the same or another team in ABC is delivering, or has the potential to deliver, on 10,000 hours of work on a contaminated site for the financial reporter being audited, the engaged ABC audit specialist could experience significant implicit or explicit pressure to perform sub-optimally on the financial audit (related to the Moral Hazard discussion above).

For this reason, like the assessments of specialist qualifications discussed above, it has been my experience that the audit exercises to assess objectivity are necessary from a documentation perspective but they are of limited value in reducing audit risk. Conversely, as discussed with the specialist qualification assessment, in some cases, these documentation procedures could be leveraged to imply greater confidence in the specialist's objectivity than might otherwise be possible and to avoid or diminish the performance of other procedures (see the discussion at Moral Hazard).

Environmental Specialist Availability

Regarding the potential for other unforeseen impacts, I would suggest to the Board that it is conceivable that audit delays and increased effort or costs (beyond those identified by the Board) could be experienced by audit teams finding it necessary in the first year, and perhaps subsequently, to leverage an auditor-employed or engaged environmental specialist and finding that the resources are severely constrained. For reasons discussed in these comments, and for some others, the firms with which I was employed struggled to attract and retain talent to provide audit support services. The employed resources that are present, generally, are not maintained at levels that exceed the current need, for obvious reasons. A surge in demand in the first audit season (or more) could result in delays as audit teams must wait on the same small-number resources to cycle through their work on separate engagements or the expenditure of additional time and costs to locate resources outside the firm (engaged specialists), potentially at a premium.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

In regard to environmental liabilities particularly, delays in starting procedures could prove problematic. I have observed that most companies, for reasons I won't detail here, do not prepare their annual liability estimate updates until well after the end of the third quarter. Even in a 'normal' audit season of repeat engagements, the environmental specialists are typically heavily leveraged from approximately October to March since, because of these company practices, it is often not possible to "pull the work forward." Waiting for resources, identified to be necessary, to become available could easily push audit teams up against their and their clients' reporting deadlines. To further exacerbate this issue, it is not uncommon to find in the first year performing procedures on environmental liability and ARO estimates like those the Board has proposed, that the estimate documentation prepared and provided by the company is insufficient, and in some cases, severely insufficient, to support management's assertions. Multiple rounds of document requests and estimate revisions have been observed in audits of environmental liabilities and AROs subjected to the first year of substantive procedures.

A similar shortage of resources is possible with external environmental specialists capable (and determined appropriate) to be engaged by the firm due to the objectivity concerns outlined above and the general lack of environmental specialists with a knowledge of the relevant accounting guidance and financial audit theory and practice. I would anticipate that most audit firms would at least prefer to prepare some standard contracts and, perhaps, master service agreements with specialist companies to manage consistency and costs in the contracting of engaged environmental specialists with whom they may not have previously worked. As this could be expected to require that the audit practice leadership understand how many teams may need support, which the teams themselves may not know until year-end planning in the 3rd quarter, this effort may also introduce a delay in securing resources. Audit firms lagging in entering the marketplace to secure resources may find they are no longer available. In all of the possible scenarios described above, what does the Board consider the appropriate response for an audit team that has identified that the assistance of a employed or engaged specialist is necessary but find that such assistance is unavailable?



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

APPENDIX

Background – Potential Historical Contributions to Observed Bias in Environmental Response Costs

In my experience, first as an environmental remediation consulting, providing environmental remediation estimates for corporate clients, and then as an audit environmental specialist, bias in the development of environmental liability estimates and ARO estimates is systemic and heavily skewed to underestimation.

It is my belief that this results from many aspects of the history of environmental response in the U.S. The first legislation addressing preventing and cleaning up contamination (RCRA) was passed in 1976 immediately following the recession of the mid-1970s. It can be expected that few in industry welcomed the additional overhead costs related to environmental response. Subsequently, CERCLA (“Superfund”) was passed in 1980. CERCLA imposed strict liability for environmental contamination at abandoned hazardous waste sites. Companies that had divested or abandoned facilities long before may have suddenly found themselves liable for expensive responses and facing the regulatory authority of a young agency, the USEPA. Under CERCLA, the relationship between industry and regulatory agency quickly evolved into an antagonistic, and oftentimes bitter, one. Additionally, complex and expensive legal battles played out over sites for which multiple parties were held liable.

Early in the Superfund timeline, the nascent environmental response “industry” may have found itself employed equally by USEPA and industrial respondents. However, as time passed and the Agency transitioned to having the responding parties perform the remedies, environmental consultants were more commonly hired by private industry and strongly influenced by client internal or external legal functions. In the nearly 40 years since CERCLA was passed, the role of the environmental engineering consultant hired by the respondent, has become one where the environmental consultant is largely the company’s advocate defending the company against the requirements of the regulator or the claims of another respondent. Similarly, the role of the USEPA (and the state agencies to which it grants authority) has matured into one in which the agency is responsible for detecting and refusing sub-effective response actions; not unlike other regulator-regulated relationships.

My professional career started at an environmental consulting firm that enjoyed a good reputation in the site investigation and remediation industry for quality work. Notwithstanding this, I was coached, as was all new staff, on how to present the industrial client’s site in the best light in submitted reports; how to design an investigation that most strategically limited the scope just within the bounds of professional ethics; and how to advocate for the lowest-cost remedy reasonably anticipated to “get by” the regulator or counterparty. In short, we were coached rigorously to assume the client’s objectives and priorities as our own.

Even with this commitment to provide the lowest costs possible to the client, it was (and is) not uncommon for clients, upon receiving a proposal estimate, to “shop” it with other consultants to get an even better price. Engineering/technical staff was thus coached to provide estimates low in detail, highly caveated, and unrealistically limited in cost and scope to “buy the work” or “get our foot in the door.”

While this culture does result in the most competitive prices for industry, over many years of focusing on cost cutting and estimating at the low end of the range with little interest in “realistic” or “reasonable” estimates (much less “best” estimates), environmental remediation and decommissioning professionals find it difficult, in my observation, to divest themselves of this underestimation bias when it becomes necessary for them to do



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor’s Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

so. On the other side, the culture in environmental departments at industrial clients (who may themselves come from consulting backgrounds), ever more squeezed by “lean” initiatives and budgetary constraints and focus on market performance, also are not highly incentivized to challenge their consultant’s estimates. In my observations, only an exceptionally small percentage of company environmental remediation managers have received formal training on the estimation and accounting rules relevant to their estimates, and even among those, company employed specialists and architects of internal controls often experience difficulty in identifying and mitigating the underestimation bias.

Background – “Typical¹” Environmental Clean-Up Progression at an Operating Site

1. A release is observed or strongly suspected to have occurred.
2. Emergency control and removal may be performed by site (Company) personnel or a contractor may be employed to perform emergency response.
3. Company evaluates if the release is of sufficient significance (volume/risk per the relevant law) to inform the environmental regulatory agency of the release.
4. If it is, the agency may require investigation of the release and remediation of any impacts exceeding those allowed by law.
5. The Company enters into a certain regulatory path depending on site and release circumstances.
6. The Company engages an environmental engineering contractor to investigate and, potentially remediate, contamination resulting from the release.
7. Commonly, but not always, the Company environmental consultant will be directed to collect “preliminary” or “screening” samples of media (soil, groundwater, surface water, sediment, etc.) that may be impacted by the release to help inform the size of the investigation area. **With Company input**, the environmental investigator will select both the sample locations and the contaminants for which to analyze the samples. The sample collector will also collect related data with the media samples including geological data at the soil/groundwater sampling point (ex. soil composition, layers, color, particle size, depth to groundwater, screening level of volatile organic chemicals using an appropriately-calibrated meter, water temperature, water hardness, water salinity, water turbidity, etc.) or sediment/surface water sampling point (sediment depth, sediment characteristics including particle size, presence/absence of sediment organisms, surface water depth, temperature, hardness, clarity/turbidity, etc.) These samples are then delivered to a laboratory for analysis. In most cases, but not all, the laboratory is a subcontractor independent from that which collected the field samples. The locations of the samples are typically surveyed by yet another independent contractor.
8. Once the data is received from the laboratory and the surveyor, the environmental investigator plots the contamination against as-built engineering drawings of the site. Further information may be collected or deducted by the environmental investigator related to the potential transport of contaminants including, but not limited to, groundwater flow direction, typical wind speed and direction, presence of nearby (onsite or offsite) “receptors” (human or ecological) to contaminants (ex. schools, residences, creeks, rivers, wetlands, endangered species, on-site workers, etc.), presence of nearby groundwater wells, presence of nearby potential contaminant sources (waste ponds, injection wells), etc. This information, combined with the analytical results from the samples are used to inform the potential exposure “risk” presented by contaminants released at the site.
9. Based on the results, the Company, through its environmental consultant, recommends a course of action to the environmental regulatory agency: either a request for closure of the incident or remediation with, or without, further investigation.
10. If further investigation/remediation is warranted, the Company, through its environmental consultant, will formally (investigation or remediation plan) or informally (email, conversations, etc.), depending upon the regulatory track in which the response is progressing, present an investigation plan to the regulators. In the

¹ The reader is encouraged to understand that there exists a large degree of variability in remedial progression at any given site. This description is only intended to present the most commonly observed processes across various sites and regulatory regimes. Many exceptions to this process can be observed.



Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter No 044 Auditor's Use of the Work of Specialists and Release No. 2017-002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates

example where further sampling is deemed to be required, upon agency approval, the Company, again through its environmental consultant, will repeat the sampling process, laboratory analysis, survey, and drafting effort. This is typically an iterative process and will continue until the agency concludes that the full extent of contamination above regulatory limits for each media is identified (surface area, depth, and contaminant concentration). Throughout this process the **Company may influence** the progression of the investigation, including the selection of sampling locations, contaminants to be assessed, etc. typically with the goal of reducing the scope to the minimum that will be considered acceptable to the regulatory agency. Once the data is collected, it may be formally reported in an investigation report. **The draft of this report is subject to Company input** before it is submitted to the regulator. The final draft is then presented to the agency for agency comments and subsequently revised to address these comments. In some cases, further sampling may be required by the regulator and this process repeats until the investigation is approved.

11. Once the regulator has approved the investigation results or report, the Company, through its environmental consultant, will consider the remedial alternatives available to meet the requirements of law. In some regulatory regimes these requirements will be prescriptive. That is to say that a certain acceptable numerical value has been established for each contaminant of concern in each media (ex. amount of benzene in groundwater) and a remedy proposed by a Company must remediate each of the media that are impacted above its regulatory limits regardless of whether an exposure risk exists. In others, a “risk-based” approach has been adopted in which only those contaminated media which are considered to have a “complete exposure pathway” to a receptor (human or ecological) must be remediated to their contamination limits. Again, **these evaluations are performed by the Company's environmental consultant acting as the Company's advocate**. The consultant will then draft a list of alternatives (typically in a report) that it proposes will meet the requirements under law and will specifically recommend to the agency, a desired remedial alternative (commonly the most cost efficient remedy) expected to meet the legal requirements. **The draft of this report is typically reviewed by the Company prior to submittal** to the agency.
12. Upon receipt of the remediation recommendations, the agency reviews the conclusions based on the data and may either accept the report and its recommendations, or return it with comments (including requirements for further investigation, in some cases). Acceptance of the recommendations typically constitutes authority for the Company to plan and implement the remedial alternative it recommended.
13. In some cases, the remediation recommendations communicated to the agency may contain sufficient information to implement the remedy without further study. In other cases, additional data may need to be collected to design the remedy or draft an implementation plan. This could include the further collection and analysis of samples (ex. for contaminants, soil strength, groundwater mapping/flow etc.) or planning data (location of a waste disposal site, etc.) Again, these samples may include the use of various subcontractors to collect and analyze data. If the refinement of a remedial plan was required, typically, the **results will be subject to another round of comment and approval first by the Company** and then by the regulator.
14. Typically, remediation includes one or a combination of different types of activities:
 - a. **Restrictions:** institutional or engineering methods to interrupt otherwise complete, or potentially complete, exposure pathways. Examples of the former include a restriction on property usage or a restriction to use of groundwater in contaminated areas. Examples of the latter may include fencing to keep receptors away from contaminated areas). Controls must remain in place until the exposure risk is otherwise removed.
 - b. **Construction of components of a remedy:** activities which involve earthmoving, construction of structures, physical activities to deliver soil or groundwater treatments, or installation of equipment required for remedial activities. These can include digging contaminated soil and moving it to a disposal point, injecting treatment chemicals into the soil or groundwater, building a water treatment plant, and many more. Relative to other efforts, construction activities tend to be short-lived events.
 - c. **Operation, maintenance, and monitoring (OM&M):** In many sites, the risk presented by the contamination must be monitored to insure that it is controlled by the selected remedy. Where a remedy construction has occurred, the systems may require operation and maintenance. In many cases, OM&M may continue for very long periods of time. Over the course of the OM&M period, the environmental consultant typically submits, on behalf of the Company, on routine report on



**Comments to : PCAOB Release No. 2017-003/Rulemaking Docket Matter
No 044 Auditor's Use of the Work of Specialists and Release No. 2017-
002/Rulemaking Docket Matter No. 043 Auditing Accounting Estimates**

the site conditions. **These reports are subject to review and approval first by the Company** and then by the agency. The agency is tasked with reviewing the data to ensure that the remedy continues to function as intended and is appropriately controlling the risk to human health or the environment. If the monitoring data fails to support that the remedy is protective, the agency would be expected to require that the Company perform additional procedures (or new remedies) to control exposure at the site.



August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 044

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists (the "proposed amendments") in PCAOB Release No. 2017-003 (the "release"). We commend the Board and its staff for its work to build on the feedback received on its May 2015 Staff Consultation Paper ("the staff consultation paper") and move forward with a standard-setting proposal.

Overview

We are supportive of the overall project and agree auditing standards could be enhanced related to the auditor's use of the work of specialists. We generally believe the staff consultation paper and the release appropriately characterize current practice and the ways in which auditors use the work of specialists. Our observations and recommendations in this letter are informed by the evolution of our firm's use of specialists in our audits. As highlighted in our response to the staff consultation paper, as it relates to an auditor's specialist, our engagement teams primarily use specialists employed by our firm. These employed specialists are subject to our independence requirements and our firm's quality controls. Our engagement teams may use an auditor-employed specialist to either test the process used by management to develop the estimate and/or develop an independent estimate. Our engagement teams may also engage a third-party specialist in certain circumstances. An engagement team's determination of the appropriate use of a specialist is driven by its risk assessment process and the engagement team's professional judgment regarding the most effective manner of obtaining sufficient appropriate audit evidence.

As a result, we are supportive of the proposed risk-based approach to the supervision of the work of these specialists, particularly in relation to auditor-employed and auditor-engaged specialists. In many respects, our current methodology aligns with the proposed amendments, and we do not expect that significant incremental efforts would be necessary to adopt the proposed amendments.

We also agree that the auditor's responsibilities in relation to the work of a company's specialist should be explicitly addressed in the standards and are supportive of the PCAOB's development of proposed Appendix B to AS 1105, *Audit Evidence*, to do so.

It is important the PCAOB continues to make clear in its standards that 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 and to address the auditor's responsibilities in such circumstances to evaluate the specialist's conclusions. We also observe that it would not benefit audit quality if the proposal was viewed as dissuading auditors or companies from using specialists.

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In this letter, we have included certain suggestions regarding some of the specific requirements described in, or implied by, the proposed amendments to address what we see as potential practical challenges, not only in the audit process but in the overall financial reporting process. We have organized our observations and recommendations into the following topical areas:

- Amendments to AS 1105 to address using the work of a company-engaged specialist
- Amendments to AS 1210, *Using the Work of an Auditor-Engaged Specialist*
- Amendments to AS 1201, *Supervision of the Audit Engagement*, to address supervision of the work of auditor-employed specialists
- Proposal to rescind AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*
- Other matters

I. Amendments to AS 1105 to address using the work of a company-engaged specialist

Testing and evaluating the work of a company-engaged specialist

We agree with the Board's observation that the auditor's consideration of significant assumptions and methods used by the company's specialist may be more challenging compared to equivalent procedures performed by the auditor when using an auditor's specialist with whom the auditor has an employment or contractual relationship.¹

We are supportive of the proposed language used in paragraphs .B6 and .B8 of the proposed Appendix B to AS 1105 related to evaluating the relevance and reliability of a company specialist's work and its relationship to the relevant assertion. The PCAOB has noted its intent in paragraph .B7 was to establish a risk-based approach to determining the extent of evidence that is necessary from the auditor's testing and evaluation of the specialist's work. However, as we expressed in our response to the staff consultation paper, we are concerned that if the auditor is not able to evaluate the work of a company's specialist in the manner contemplated in proposed Appendix B to AS 1105, the auditor's ability to test the process used by management to develop an accounting estimate when management engages a specialist may be limited in certain circumstances. Specifically, we believe further clarity is needed in relation to the note that follows paragraph .B8 that references complying with the requirements in paragraphs .09–.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*. In our view, the reference to AS 2501 appears likely to hinder or restrict the auditor's ability to use a risk-based approach and could be viewed as being contrary to the intent of paragraph .B7.

We also believe the way the requirements on using the work of a company specialist (whether employed or engaged) in relation to accounting estimates are structured would result in a significant change in practice from current AS 1210, *Using the Work of a Specialist*. AS 1210 focuses on obtaining an understanding of the methods and assumptions used by the specialist and making appropriate tests of data provided to the specialist. Without further clarification, we believe the proposed audit approach would not recognize the practical challenges that arise when an estimate is developed by a company-engaged specialist. For example, it may not be possible for the auditor to evaluate the method used to develop an accounting estimate when a company-engaged specialist is used to the same extent as when a company-employed specialist is utilized, in particular if the specialist uses a proprietary model to which the auditor does not have access. While footnote 2 of AS 2502 essentially requires auditors to evaluate the reasonableness of assumptions developed by the company's specialists (whether employed or engaged) as if they were

¹ See page 36 of the release.



developed by management for fair value measurements, we are concerned about the implications of extending this concept to significant assumptions for all estimates in significant accounts and disclosures (i.e., whether it will be possible for auditors to comply with the requirements in paragraphs .15-.18 of proposed AS 2501).

Nevertheless, we believe the extent to which the auditor could use the work of the specialist as audit evidence should depend upon the extent to which the auditor is satisfied the work of the specialist is relevant and reliable as well as the assessed risks of material misstatement. The requirement in paragraph .B2 clarifies the auditor's responsibility to understand the company's processes and controls regarding the work of the company's specialists. Controls over the use of company-engaged specialists, including how the company evaluates the specialist's work, can be important for the auditor to consider when evaluating the work of a company-engaged specialist that uses a proprietary model (including data and assumptions).

Assessing the specialist's relationship to the company

We believe that a focus on the objectivity of a specialist, whether engaged or employed by the company, continues to be appropriate, with the understanding that objectivity is viewed on a spectrum, taking into account threats to objectivity. We believe the concept of objectivity is addressed in the requirement to assess the specialist's relationship to the company. Accordingly, we support the proposed requirement in paragraph .B4 of AS 1105 for the auditor to assess the specialist's relationship to the company.

The proposed requirement would also extend the auditor's assessment to include the relationship between the company and the entity that employs the specialist, if the specialist is not employed by the company. We agree with the PCAOB's view that a strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. However, we believe there will be practical challenges in requiring the auditor to make an assessment of the entity that employs the specialist. In our view, the release does not adequately consider the limitations and cost and other implications of this proposed requirement.

We appreciate that paragraph B5 of AS 1105 indicates that the nature and extent of evidence necessary to assess the knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company may vary. It is unlikely that many entities that employ specialists will have existing policies, procedures, and systems to track all of the entity's relationships with individual companies to which it provides services in a manner that would support the new expectations intended by the proposal (e.g., maintaining robust documentation of employment, financial, ownership, or other business relationships, contractual rights, family relationships). Furthermore, since the auditor does not hire, direct, or oversee a company's specialist, it is unclear how an auditor would be in a position to assess such policies, procedures, and systems that do exist. While we agree the potential sources of information suggested on page A3-13 of the release may provide relevant evidence, in practice, the auditor's evidence will be primarily based on inquiry of the specialist, as the auditor will not have access to all of the relevant information from the entity employing the specialist. The auditor may also obtain representations from the company using the specialists about any relationships it may have with the entity employing the specialists.

We believe the PCAOB should perform additional outreach to understand and assess whether and, if so, how entities of varying sizes and disciplines that employ a range of specialists track the entity's relationships with its clients. In particular, we think there is a need for the PCAOB to consider an economic analysis of the costs to entities employing specialists, companies, and auditors and to gather



more evidence to evaluate whether the benefit to audit quality justifies such costs to determine whether this is an issue the PCAOB needs to address in this manner. Additionally, absent new guidance setting out expectations for management from the SEC, requiring auditors to obtain such information from an entity employing a company-engaged specialist could be viewed as establishing requirements through auditing standards in relation to a company's responsibilities for maintaining books and records and systems of internal accounting controls.

In addition, the release notes the requirement in paragraph .B2 for the auditor to understand the company's processes and controls, including the company's process for selecting and using the work of specialists, should prompt auditors to appropriately consider the interaction of the specialist's work and the company's processes in assessing and responding to risk in the related accounts and disclosures.² We agree the company should have a reasonable basis for selecting from qualified specialists, but it would be useful for the PCAOB to provide greater specificity about the nature and intent of the requirement to understand the company's process for selecting and using the work of specialists.

II. Amendments to AS 1201, *Using the Work of an Auditor-Engaged Specialist*

We support the proposed clarification of the expectations of auditors when engaging a specialist, although we primarily use auditor-employed specialists. As noted in paragraph .02, the objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion. We appreciate the PCAOB's clarification that the proposal does not require the auditor to have full access to a specialist's proprietary model or to reperform the work of a specialist, but instead to evaluate the work of that specialist in accordance with the proposed standard.³ We believe similar clarification would be warranted in relation to a company-engaged specialist.

Evaluating the objectivity of the auditor-engaged specialist and the entity that employs the specialist

We agree with the proposal for the auditor to consider the auditor-engaged specialist's relationship to the company. We support a focus on whether an auditor-engaged specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Paragraph .05 of proposed AS 1210 prohibits the use of a specialist who lacks the necessary objectivity. Consistent with current standards, we believe the auditor should not be precluded from using the work of a specialist who has relationships with the client in addition to the contractual agreement to perform the specific work the auditor intends to use. We believe the auditor should evaluate any relationships and ultimately make a decision on the significance and implications of the threats to objectivity. In our view, objectivity is a spectrum, and the auditor could potentially put safeguards in place to take into account threats to objectivity, including performing additional procedures on the work of the specialist.

Similar to a company-engaged specialist, we have concerns as to the practicality of the requirement for auditors to evaluate whether the entity that employs the auditor-engaged specialist is objective, including whether the entity has a relationship with the company or any other conflicts of interests relevant to the work performed. While we agree the potential sources of information suggested on page A3-40 of the release may provide relevant evidence, in practice, the auditor's evidence will be primarily based on

² See page A3-9 of the release.

³ See page A3-43 of the release.



inquiry of the auditor's engaged specialist (the response to which will by its nature potentially be incomplete due to limitations regarding existence of and access to policies, procedures and systems), as the auditor may not have access to all of the relevant information from the entity employing the specialist. We therefore recommend reconsidering the requirement to assess the objectivity of the entity that employs the specialist. As an alternative, the PCAOB could consider adding a note to follow paragraph .04 as follows:

Note: In considering the objectivity of the specialist, the auditor should inquire of the specialist as to whether the specialist is aware of any relationships between the entity that employs the specialist and the company.

If the PCAOB decides to retain this requirement, additional guidance about what such an assessment might entail would be necessary. We do not believe it is appropriate for the proposed standard to establish requirements that would necessitate a determination of whether the entity employing the specialist has appropriate policies, procedures, or systems in place to identify potential relationships, including with respect to financial relationships.

Additional suggestion

We support the manner in which the proposed standard articulates areas of focus in developing a mutual understanding between the auditor and an auditor-engaged specialists about the specialist's work. It might be useful to consider whether the communication with the specialist should also include matters the specialist should communicate to the auditor and set expectations regarding the nature, timing, and extent of communications between the auditor and the specialist. This comment is equally applicable to using an auditor-employed specialists.

III. Amendments to AS 1201, *Supervision of the Audit Engagement*, to address supervision of the work of auditor-employed specialists

We support the proposed amendments to AS 1201, *Supervision of the Audit Engagement*, as the proposed requirements could enhance consistency in execution. We believe proposed Appendix C largely reflects our current approach to specialists employed by our firm. We appreciate the clarification in the release that the auditor would be able to use information from the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor-employed specialists.⁴

IV. Proposal to rescind AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*

Our response to the staff consultation paper recommended the Board not rescind AI 11, as that interpretation currently serves as the sole source of authoritative guidance to assist auditors in evaluating the sufficiency of legal opinions obtained to support the assertion that transferred financial assets meet the legal isolation criterion in ASC 860, *Transfers and Servicing*.

The release states that AI 11 reflects outdated accounting requirements and banking regulations. Although AI 11 would require updating to reflect the release of Accounting Standards Update (ASU) 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, the ASU did not

⁴ See page A3-28 of the release.



fundamentally change the de-recognition model in Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, (including the legal isolation assertion) that has been in effect since 2001. Insured depository institutions that have sold financial assets that they intend to de-recognize must continue to obtain legal opinions to support the legal isolation assertion (certain amendments to the Federal Deposit Insurance Corporation’s “safe harbor rule” in 2010 notwithstanding). AI 11 provides tailored guidance to assist auditors in evaluating the sufficiency of legal opinions as audit evidence. As an example, the interpretation requires that the opinions be expressed at a “would level,” identifying certain qualifications that may call into question whether the legal analysis adequately demonstrates that the assets transferred meet the isolation assertion, and clarifying under what circumstances a substantive consolidation opinion should be obtained for entities subject to the US Bankruptcy Code. Finally, the “auditor reliance” language that appears in paragraph .18 of AI 11 addresses that an auditor can rely on counsel’s opinion for the purpose of evaluating management’s assertion, despite the absence of contractual privity between the two. We continue to believe that the PCAOB should update and retain the interpretation.

V. Other matters

Potential costs to auditors and companies

A number of our comments highlight practical considerations, which are likely to have an impact on costs. While difficult to quantify, costs are likely to increase as a result of the proposals, in particular for smaller firms that do not typically use auditor-employed specialists as frequently. Increases in costs are also likely in areas where highly specialized skills or knowledge are needed, especially if the changes to the requirements to evaluate the work of a company-engaged specialist would result in auditors more frequently determining it is necessary to use an auditor-engaged specialists to evaluate that work. This could result in strain on limited specialist resources in particular industries, or less qualified specialists being used if the view taken towards “the relationship of the company to the entity employing the specialists” is overly prescriptive. We believe there is a need for the PCAOB to gather more evidence about the implications of these practical considerations and their potential costs.

Restrictions, disclaimers, and limitations included in specialist’s reports

We support the proposed requirement in paragraph .B9 of AS 1105 to evaluate the relevance and reliability of the specialist’s work and whether the specialist’s findings support or contradict the relevant assertion. We agree that a specialist’s report may contain restrictions, disclaimers, or limitations that could cast doubt about the relevance and reliability of the information contained in the specialist’s report, but that other restrictions, disclaimers, or limitations may not affect the auditor’s ability to use the specialist’s work as audit evidence.⁵ We believe that the discussions of restrictions, disclaimers, and limitations on page A3-23 of the release are equally applicable to situations involving auditor-engaged specialists, and thus we suggest providing clarity that these same factors may be used by auditors in assessing restrictions, disclaimers, and limitation in reports from auditor-engaged specialists.

Applicability of the proposed standard

We believe the PCAOB should develop its performance standards in a way that can be scaled and tailored to any audit. Having separate performance standards for audits of emerging growth companies or audits

⁵ See page A3-23 of the release.



of brokers and dealers would be confusing and unhelpful to promoting consistency in audit quality. Accordingly, we support the PCAOB's position that the proposed amendments would apply to audits of emerging growth companies and audits of brokers and dealers and have not identified any additional areas of concern unique to those audits.

Effective date

The PCAOB has suggested an effective date for audits for fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if that approval occurs in the fourth quarter). The reasonableness of this timeframe is dependent upon how the PCAOB considers and responds to the observations and suggestions from commenters and the extent to which the final standard is consistent with current practice.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Leonard Combs (973-236-5265) regarding our submission.

Sincerely,

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP" in a cursive, flowing script.

PricewaterhouseCoopers LLP



RSM US LLP

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Suite 800
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August 30, 2017

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 044

Dear Office of the Secretary:

RSM US LLP appreciates the opportunity to offer our comments on the PCAOB's *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*. RSM US LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We appreciate the PCAOB's efforts to clarify the auditor's responsibilities with respect to the use of the work of specialists and support a more uniform, risk-based approach to supervising specialists. We agree with the core principle that the auditor is not expected to have the expertise of a specialist in another profession. However, as explained in detail below, there are certain proposed amendments that, in our opinion, are not congruent with this core principle.

Our letter explains enhancements that could be made to the proposed standard, and includes comments related to specific paragraphs of the proposal that we believe should be clarified or modified.

Proposed Amendments to Auditing Standard (AS) 1105, *Audit Evidence*

Assessing the Knowledge, Skill and Ability of the Company's Specialist and the Specialist's Relationship to the Company

The proposed amendments to paragraph .B4 of AS 1105 could be read to preclude the work performed by a company's specialist from being used by the auditor due to the specialist's relationship to the company and possible ability of the company to significantly affect the specialist's judgments about the work performed, conclusions or findings. While we agree that the specialist's relationship to the company would need to be evaluated by the auditor, we believe this should be considered within the assessment of the specialist's objectivity. This paragraph should clarify that, if the specialist is deemed to be objective, it is possible for the auditor to perform additional procedures based on the risks associated with the accounting estimate so as to be able to use some or all of the company's specialist's work in combination with other audit evidence to obtain sufficient appropriate audit evidence regarding the estimate. Such additional procedures would include considering whether the auditor should engage an auditor's specialist.

Testing and Evaluating the Work of the Company's Specialist

The proposed amendments to the following paragraphs suggest the auditor would be expected to have a specialized skill set in another profession in order to be able to perform the required procedures, which is contrary to the core principle that the auditor is not expected to have the expertise of a specialist in another profession:

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 2

- Paragraph .B6a, which states that the auditor’s testing and evaluating of the work of a company’s specialist involves evaluating whether the data was appropriately used by the specialist
- Paragraph .B8(3), which requires the auditor to evaluate whether the methods used by the specialist are appropriate and the significant assumptions used by the specialist are reasonable

Evaluating whether the data was “appropriately” used by the specialist would require an elevated level of knowledge by the auditor as compared to that required by extant AS 1210, *Using the Work of a Specialist*. If auditors had the requisite skills and knowledge to evaluate whether the data was appropriately used, there would be no need for the specialist. We believe the appropriate use of data is the responsibility of the specialist. With respect to the data used by the specialist, we believe the auditor only should be required to (a) test the accuracy and completeness of company-produced data provided to the specialist and (b) evaluate the relevance and reliability of data obtained from external sources and used by the specialist.

Likewise, the appropriateness of the methods used by the specialist should be the responsibility of the specialist. The auditor should obtain an understanding of the methods and assumptions used by the specialist.

Further, we noted that If the company’s specialist assisted the company in developing an accounting estimate, the note to paragraph .B8 would require the auditor to also comply with the requirements in paragraphs .09 - .18 of Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*. We believe that neither the nature nor extent of procedures would necessarily be the same when management uses a company-engaged specialist (i.e., external specialist) who is competent and objective, as compared to when a company-employed specialist develops an accounting estimate. Also, some of the procedures required by proposed AS 2501 (e.g., evaluating whether data and significant assumptions were “appropriately applied” pursuant to paragraph .B10) may not be practicable, given the proprietary nature of certain specialist models and the auditor’s lack of knowledge in the specialist’s field.

Proposed Amendments to AS 1201, *Supervision of the Audit Engagement*

In assessing the qualifications and independence of auditor-employed specialists as required by proposed new paragraphs .C3 and .C4 of AS 1201, we believe the auditor should be able to use the firm’s system of quality control. Therefore, we believe Appendix C of AS 1201 should note that Quality Control Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, provides for the evaluation of an employee’s independence, integrity, objectivity and performance, among other matters, and thus the firm’s system of quality control may be used to assess the qualifications of auditor-employed specialists.

Proposed Amendments to AS 1210, *Using the Work of a Specialist*

The proposed amendments to paragraph .05 of AS 1210 precludes the auditor from using work performed by an auditor-engaged specialist who lacks the necessary objectivity. We agree that the auditor would not be able to use the work of an auditor-engaged specialist who is not objective. For example, if a specialist prepared the company’s valuation, the auditor would not be able to engage that specialist to assist in auditing the valuation the specialist prepared. However, we believe the proposed amendments to AS 1210 should clarify that the evaluation of objectivity is not a “black and white” exercise – rather, the evaluation is dependent upon facts and circumstances that need to be assessed to determine whether it is possible for the auditor to perform additional procedures based on the risks associated with the accounting estimate so as to be able to use some or all of the auditor-engaged

Office of the Secretary
Public Company Accounting Oversight Board
August 30, 2017
Page 3

specialist's work in combination with other audit evidence to obtain sufficient appropriate audit evidence regarding the estimate.

Applicability

We agree that the proposed standard should be applicable to audits of the financial statements of emerging growth companies and brokers and dealers.

Effective Date

If finalized, this proposed standard will require a considerable amount of time for audit firms to develop and implement effective procedures and related training. Due to the extent of these efforts, we believe it would be prudent for the proposed standard to first be effective for audit periods ending two years after the SEC approves the final standard.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to Sara Lord, National Director of Audit Services, at 612.376.9572.

Sincerely,

RSM US LLP

RSM US LLP

From: [Olds, Dan](#)
To: [Comments](#)
Subject: comment on The Auditor's Use of the Work of Specialists.
Date: Wednesday, August 30, 2017 4:53:15 PM

Question 6: The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

Response:

The Public Company Accounting Oversight Board's proposal to amend its auditing standard to strengthen the requirements that apply when auditors use the work of specialists fails to address any practice standards that the specialist may employ in the performance of their duties. In the area of determining the volumes and cash flow projections of petroleum reserves, petroleum evaluation engineers have practices and procedures that are well established and a mature body of guidelines (U.S. Securities and Exchange Commission's (SEC) SX 4-10, Canada's NI51-101, SPE-PRMS, etc.) exist under which they develop their reserve estimates. Both the work performed under SEC SX 4-10 and Canada's NI51-101 standards are subject to strict regulatory scrutiny. Further, these practices continue to evolve as innovations and enhancements (unconventional reservoirs, increasingly complex completion technology, etc.) are introduced into the industry. Organizations or professional groups such as the Society of Petroleum Evaluation Engineers, the Society of Petroleum Engineers' Oil & Gas Reserves Committee, and other resources such as the Canadian Oil and Gas Evaluation Handbook serve as industry-wide forums for the development and dissemination of advances and peer reviewed best practices.

One of the key factors in the development of quality petroleum reserve estimates is the availability and access to all pertinent data, along with sufficient time to analyze that data. Independent reserve evaluators often work closely with staff from their clients in developing reserve estimates. In theory, the reserve estimates prepared by an independent reserve evaluator for a particular property would be the same regardless of whether the evaluator worked for the company or for the auditor. However, if the evaluator was restricted from direct access to the client, or the project was performed under a restricted time frame, the quality of the reserve evaluation may suffer.

We note that the PCAOB's concern on using the work of specialists is addressed by charging the accountants with more responsibility in their oversight of a process where their lack of expertise is acknowledged. While we cannot speak for any other group of specialists, we believe that independent petroleum evaluation specialists can meet any standards that the PCAOB (or FASB) might set for our practice. For example, Canadian companies must use certified independent evaluators to help insure that investors receive an unbiased evaluation of the assets of oil and gas companies. Such standards should be transparent and acknowledged as measurable performance items.

The PCAOB has expressed an interest in determining the potential costs of the proposed amendments. If the PCAOB requires the auditor to perform the evaluation role, it would introduce additional overhead and could potentially result in lower quality evaluations, two potential costs that would not serve the interests of the shareholders.

For this reason, we urge the PCAOB to consider the potential implications that the proposed

changes may have on the work product of the specialists. Changes that may result in an inferior work product should not be an unintended consequence.

Respectfully submitted on the behalf of Ryder Scott Company, L.P., Petroleum Engineering Consultants since 1937.

Dan Olds

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Pursuant to Texas Board of Professional Engineering statutes, any information contained herein represents PRELIMINARY work-in-progress unless otherwise noted.



August 11, 2017

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Release No. 2017-003: Proposed Amendments to Auditing Standards for Auditor's use of the Work of Specialists

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The views expressed herein are written on behalf of the PSC, which has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

Our Committee is generally in agreement with the guidance included in this proposed auditing standard. However, we do have a concern regarding a potential for a possible expansion of the use of additional specialists to review the work of other specialists. There is always the possibility that two specialists may disagree leaving the auditor with a dilemma as to which specialist to rely upon. This dilemma might cause the auditor to consider employing yet another specialist who may or may not clear up the problem. Such a situation seems most likely to impact smaller public accounting firms that don't have an ongoing relationship with specific specialists. We realize that the use of auditor judgment is required in such situations, but because we believe this is likely to be one of the most common situations leading to increases in cost, we believe the Board should consider providing further guidance on the steps an auditor should take to resolve differences of opinion between two specialists when such situations arise.

We appreciate the opportunity to provide input into the standards-setting process.

Sincerely,

A handwritten signature in black ink, appearing to read "Ken Sibley".

Ken Sibley, CPA
Chair, Professional Standards Committee



Proposed Auditing Standard – Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

ICAEW welcomes the opportunity to comment on the Proposed Auditing Standard – *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* published by the PCAOB on 1 June 2017, a copy of which is available from this [link](#)

This response of 30 August 2017 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 147,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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icaew.com

MAJOR POINTS

1. We welcome these proposals that do much to bring US standards up to date. External and internal inspections show this to be an area in need in improvement and the rationalisation and enhancement of requirements will do much to improve the efficiency as well as the quality of audit. More auditor challenge of specialists and management is needed.
2. We welcome the:
 - enhancement of requirements to deal with the data and assumptions used by company specialists;
 - elevation of the requirement for auditors to 'obtain an understanding' of specialists' methods and significant assumptions, to instead 'evaluate' whether they are appropriate and whether the significant assumptions used are reasonable;
 - alignment of requirements for auditor engaged and employed, and company engaged and employed specialists respectively - we believe this is the right cut;
 - alignment of the standard in certain respects with ISA 620 *Using the work of an auditor's expert*;
 - abandonment of the suggestion in the Staff Discussion Paper (Staff DP) that preceded this Exposure Draft (ED) that information produced by company specialists should be treated as if it was produced by the company itself;
 - acknowledgement that auditors can take account of the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor employed specialists;
 - additional requirements for auditors to 'inform' auditor employed specialists about the work to be performed and to evaluate contrary evidence developed by specialists, both of which arise from inspection findings;
 - requirements to review specialists' work, rather than simply their reports, to focus auditor attention on the detail and discourage reliance on process.
3. We would welcome a higher level view of the broad approaches and levels of competencies the PCAOB expects of auditors, which would help shape investor understanding and expectations. In our June 2017 Audit Quality Forum (AQF) event [*Believe me, I'm an expert?*](#) we explored three possibilities, ie, that auditors should be experts in:
 - financial reporting only, and should simply aggregate the opinions of other experts involved in the audit;
 - financial reporting, and in questioning and challenging other experts, in a manner not dissimilar to a judge, in forming their own conclusion on the financial statements on which they report;
 - all of the relevant specialist areas covered by the financial statements as well as financial reporting.
4. We believe that asking auditors to be experts in everything they report on is unrealistic and unnecessary. The second option was discussed by the PCAOB in the Staff Discussion Paper (Staff DP) that preceded this consultation and we suggested that auditors should not simply act as high level project managers as this would serve neither public expectations nor the public interest. It seems fairly clear that auditors should, and are expected to be experts in

questioning and challenging the experts whose work they use. We believe that this is implicit in the PCAOB's proposals but that it would do well to surface this issue in its communications with investors and others involved in the capital markets.

5. We remain concerned about the unintended consequence clearly highlighted by the PCAOB itself that might see smaller companies, in particular, cease engaging or employing their own specialists, and instead challenging auditors to prove management calculations wrong, or effectively relying on the work of the auditor's specialist.
6. We made this point in our response to the Staff DP and while it helps that the PCAOB has dropped proposals for information produced by company specialists to be treated as if it was produced by the company itself, we are not convinced that in a decade's time, inspectors will not be calling on the Board to deal with the fact that companies are poorly motivated to employ or engage specialists, that management performs its own valuations and that they leave it to the auditors to employ a proper valuation expert. This would have auditors dangerously close to taking responsibility for the valuation. This is all the more important in the light of the fact that standard setters note the particular difficulties smaller companies have in preparing compliant financial information, and that some take the view that this is compounded by unnecessarily rigid ethical requirements that prohibit auditor assistance in this area.
7. The PCAOB demands independence of auditors and auditor engaged specialists. It does not demand objectivity of company specialists. One consequence of this is that the PCAOB's requirements for company specialists fall short of those of the IAASB. The IAASB does require objectivity of company specialists. We believe that independence is a means to an end rather than an end in itself, that formal independence is no guarantee of objectivity and that without objectivity, independence has little value. Objectivity is a fundamental principle of many leading codes of professional ethics and is required by many national and international standard setters for all assurance and related services engagements. We urge the PCAOB to reconsider this issue.
8. We remain concerned about the lack of acknowledgement among standard setters generally of structural barriers and recent developments that make the evaluation of management's process, assumptions and data in developing certain types of estimate difficult. That lack of acknowledgement is short sighted.
9. Firstly, as we noted in our response to the Staff DP the PCAOB and other capital market participants should acknowledge the problems caused by assumptions and methods mandated in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date and there are many such assumptions and methods – such as those used for calculating reserves in the extractive industries – that auditors cannot be expected to question. Individual auditors cannot reasonably be expected to effectively critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.
10. Secondly, the increase in the use of fair values and developments in technology generally have made the audit of some highly complex estimates such as expected credit losses, a daunting exercise, even for well-resourced large firms, particularly where there is little accounting or auditing guidance. The PCAOB refers in the ED to academic evidence alluding to the technical challenges such estimates give rise to, and to the financial, educational and other resource constraints of auditors in this respect.
11. Thirdly, the ED dismisses concerns about the increasingly common situations in which the data and assumptions and structure of the proprietary models used by specialists, regardless of who they are employed or engaged by, are simply unavailable at any price. The PCAOB suggests that auditors do not need access to these models and that auditors should evaluate such black

boxes 'in accordance with the proposed standard'. In practice, the only way of dealing with them is by using approximations based on alternative models to assess the reasonableness of output. The PCAOB refers somewhat disparagingly to the use of heuristics (rules of thumb) in this context but auditors have no choice. Changes to auditing standards will not force the owners of those proprietary models to open them up. Even assessing inputs from pricing specialists in pricing can be prohibitively costly for smaller companies.

12. We do not disagree with the PCAOB's requirements for auditors to address such issues but we do believe it needs to go further. ICAEW's thinking on the broader but closely related area of prospective financial information (PFI) is relevant in this context. In our Corporate Finance Faculty's recent [*Consultation paper on prospective financial information*](#) we refer to three 'preparation principles' for PFI which we believe apply equally to many estimates for which specialist assistance is required, particularly in complex areas, including those based on proprietary models to which management and auditors may have no access.
13. The three basic preparation principles are the bases of sound *business analysis* which renders PFI reliable, *reasonable disclosure* of the relevant uncertainties and mitigating actions, and *subsequent validation* which renders the PFI comparable, and preparers accountable. Translated into auditing terms, this means that auditors need to challenge management's employed or engaged specialists to explain:
 - how they have obtained comfort that the estimate is actually based on a sound understanding of how the business actually works - to ensure that assumptions built into the model or background data actually reflect the business environment in which the entity operates;
 - how they have obtained comfort that the right business-specific disclosures have been made for the relevant uncertainties and mitigating factors;
 - how reliable previous estimates have turned out to be in practice, including why they were significantly different, where relevant.
14. The important point is for all concerned to acknowledge that it is not enough for management to take a 'take it or leave it' approach when challenged by auditors, and it is not enough for auditors to perform their own rough independent calculations in the hope that output is not too far away from the figures produced on behalf of management by specialists. Management, auditors and specialists need to engage more closely in these difficult areas and auditors need a better sense of management's ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.
15. Dealing with all three of the issues noted above requires the PCAOB and other standard setters to engage with the SEC and others involved the capital markets.

RESPONSES TO SPECIFIC QUESTIONS

Q 1. Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

16. We would welcome a higher level view of the broad approaches and levels of competencies the PCAOB expects of auditors, which would help shape investor understanding and expectations. In our June 2017 Audit Quality Forum (AQF) event [*Believe me, I'm an expert?*](#) we explored three possibilities, ie, that auditors should be experts in:
- financial reporting only, and should simply aggregate the opinions of other experts involved in the audit;
 - financial reporting, and in questioning and challenging other experts, in a manner not dissimilar to a judge, in forming their own conclusion on the financial statements on which they report;
 - all of the relevant specialist areas covered by the financial statements as well as financial reporting.
17. We believe that asking auditors to be experts in everything they report on is unrealistic and unnecessary. The second option was discussed by the PCAOB in the Staff Discussion Paper (Staff DP) that preceded this consultation and we suggested that auditors should not simply act as high level project managers as this would serve neither public expectations nor the public interest. It seems fairly clear that auditors should, and are expected to be experts in questioning and challenging the experts whose work they use. We believe that this is implicit in the PCAOB's proposals but that it would do well to surface this issue in its communications with investors and others involved in the capital markets.
18. The description of existing audit practice is broadly accurate although it omits to acknowledge some important extraneous factors. We note in our main points above our concern about the lack of acknowledgement among standard setters generally of structural barriers and recent developments that make the evaluation of management's process, assumptions and data in developing certain types of estimate difficult in some cases. Dealing with all three of the issues noted below requires the PCAOB (and other standard setters) to engage with the SEC and others involved in the capital markets.
19. Firstly, as we noted in our response to the Staff DP, the PCAOB and other capital market participants should acknowledge the problems caused by assumptions and methods mandated in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date and there are many such assumptions and methods – such as those used for calculating reserves in the extractive industries – that auditors cannot be expected to question. Individual auditors cannot reasonably be expected to critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.
20. Secondly, the increase in the use of fair values and developments in technology generally have made the audit of some highly complex estimates such as expected credit losses, a daunting exercise, even for well-resourced large firms, particularly where there is little accounting or auditing guidance. The PCAOB refers in the ED to academic evidence alluding to the technical challenges such estimates give rise to and to the financial, educational and other resource constraints on auditors in this respect.
21. Thirdly, the ED dismisses concerns about the increasingly common situations in which the data and assumptions and structure of the proprietary models used by specialists, regardless of who

they are employed or engaged by, are simply unavailable at any price. The PCAOB suggests that auditors do not need access to these models and that auditors should evaluate such black boxes 'in accordance with the proposed standard'. In practice, the only way of dealing with them is by using approximations based on alternative models to assess the reasonableness of output. The PCAOB refers somewhat disparagingly to the use of heuristics (rules of thumb) in this context but auditors have no choice. Changes to auditing standards will not force the owners of those proprietary models to open them up. Even assessing inputs from pricing specialists in pricing can be prohibitively costly for smaller companies.

22. We do not disagree with the PCAOB's requirements for auditors to address such issues but we do believe it needs to go further. ICAEW's thinking on the broader but closely related area of prospective financial information (PFI) is relevant in this context. PFI is about the future, as are many estimates, including those that require the involvement of specialists. Our Corporate Finance Faculty's recent [*Consultation paper on prospective financial information*](#) updates our guidance for UK directors on the subject published in 2003. In that context we refer to three 'preparation principles', for PFI which we believe apply equally to many estimates for which specialist assistance is required, particularly in complex areas including those based on proprietary models to which management and auditors may have no access.
23. The three basic preparation principles are the bases of sound *business analysis* which renders PFI reliable, *reasonable disclosure* of the relevant uncertainties and mitigating actions, and *subsequent validation* which renders the PFI comparable, and preparers accountable. Translated into auditing terms, this means that auditors need to challenge management's employed or engaged specialists to explain:
- how they have obtained comfort that the estimate is actually based on a sound understanding of how the business actually works - to ensure that assumptions built into the model or background data actually reflect the business environment in which the entity operates;
 - how they have obtained comfort that the right business-specific disclosures have been made for the relevant uncertainties and mitigating factors;
 - how reliable previous estimates have turned out to be in practice, including why they were significantly different where relevant.
24. The important point is for all concerned to acknowledge that it is not enough for management to take a 'take it or leave it' approach when challenged by auditors, and it is not enough for auditors to perform their own rough independent calculations in the hope that output is not too far away from the figures produced by specialists on behalf of management. Management, auditors and specialists need to engage more closely in these difficult areas and auditors need a better sense of management's ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.

Q 2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?

25. There is a shortfall to be addressed and the proposed amendments broadly address the reasons to improve standards as set out in the ED. However, we do not believe that the case has been made for having separate standards for auditor employed and auditor engaged specialists. ISA 620 manages to achieve the same objectives as those of the PCAOB using just one standard and we do not believe it is beyond the capabilities of the PCAOB to do the same. Of itself, we see no great mischief in having separate standards other than the potential for inefficiency and confusion arising from a great deal of avoidable repetition.

Q 3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

26. We noted in our response to the Staff DP the fact that the focus appeared to be on process at the expense of substance - on the formal relationships, the categorisation of specialists and on management's process. We also said that very little directly addresses the problem of auditors failing to challenge the substance of the assumptions or methods used by specialists.
27. We remain of the view that a sense of 'challenge' does not really come through in these proposals, and that it should do. The word 'challenge' itself is often used in this context but unless standard-setters have the courage to use it in the standards themselves – and we appreciate the obstacles to this but they should not be insurmountable – standards will remain process driven and prescriptive, seemingly avoiding the need for auditors to stand back and look at the picture as a whole, or exercise judgement except where specifically instructed to do so.
28. We also believe that the PCAOB should acknowledge the problems caused by assumptions and methods mandated in professional practice, such as the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date. Individual auditors cannot reasonably be expected to critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.

Q 4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs

Q 5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

Q 6 The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

29. We take a keen interest in PCAOB's Economic and Risk Analysis work in support of its standard setting activities. Good quality research to support all stages of auditing standard setting - from the need to develop or revise standards, through impact analyses of proposals to post-implementation review - is critical to the quality of auditing standards, the credibility of standards and confidence in the integrity of the standard setting process. Such research takes time to scope and perform, not least because it takes time for standard setters and researchers to understand and align their respective objectives. It is not cheap, and the results are often less conclusive than desired. But it is still better than an approach based solely on the beliefs of the standard setter about what will improve audit quality. We have challenged standard setters on many occasions to provide support for their belief that a given approach will improve matters. Too few standard setters have devoted resources to such research, instead relying on respondents to consultations to fill the gap.
30. We note elsewhere in this response our belief that the PCAOB should seek to engage with other capital market participants on some of the more complex issues raised by the research described in the ED. These include appropriate responses to the complete inaccessibility of proprietary models increasingly used in the development of financial instruments, including the assumptions made therein and the data on which those assumptions are based. They also

include the impact of limited resources, including the educational level of auditors, when faced with requirements to evaluate such models and the assumptions and data incorporated therein.

31. There are no other additional studies or data of which we are aware that the PCAOB should consider at this time. The potential benefits to investors, auditors and other capital market participants are well-articulated in the ED. There are no additional benefits to which we wish to draw the PCAOB's attention.

Q 7. The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

32. Complexity in accounting standards, business models and financial instruments accounts for much of the complexity in the audit of accounting estimates and for the need to use specialists. Complexity is referred to in the proposals but in a manner that does not reflect the significance of the issue. The proprietary models referred to above and expected credit losses are just two examples. There is little accounting or auditing guidance for auditors facing highly complex technical issues such as these and we believe that at the very least, the PCAOB should acknowledge the magnitude of the cost and other resource implications. It should also acknowledge that simply throwing time and money at the issue is not a solution when there are too few specialists to go around, which is not unusual, particularly outside the US, and particularly in the context of complex financial instruments.
33. There could be better cross-referencing between this proposed standard and the proposed standard on accounting estimates.
34. The costs to companies should not be underestimated, a simple example being the need for companies to provide more support for their choice of discount rate than in the past in some cases. We note in our response to the PCAOB on its proposed standard on accounting estimates our belief that the PCAOB should seek to engage with the SEC and others involved in the capital markets to ensure that companies do in fact provide the required support for their estimates on a timely basis. Asking auditors to put pressure on companies to up their game without applying similar pressure to the companies themselves is effectively asking auditors to regulate companies through the back door, through auditing standards.
35. We observe in many of our responses to standard setters the fact that while clients are willing to pay for the additional work entailed by new accounting standards, they believe that auditors should absorb the costs that new auditing standards entail. We are aware that there is little sympathy for auditors in this regard but standard setters ignore the behavioural implications of this at their peril. Simply expecting auditors to absorb additional costs - and hoping that they will not seek to compensate for this by means of making audit methodologies more efficient elsewhere - is to be wilfully ignorant of a basic fact of human and corporate behaviour. This might be an area of research for the PCAOB's Economic and Risk Analysis.

Q 8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?

36. We note above particular concerns about the risk that smaller companies in particular cease engaging or employing their own specialists, and instead challenge auditors to prove management calculations wrong, or effectively rely on the numbers the auditor's specialist produces. If companies are not motivated to employ or engage specialists and management perform its own valuations and leaves it to the auditors to employ a proper valuation expert, auditors are dangerously close to taking responsibility for the valuation.
37. On the other hand, we also note the difficulties articulated by standard setters experienced by smaller companies who find it difficult to prepare compliant financial information, a problem

some believe is compounded by excessively rigid ethical requirements which prohibit auditor assistance.

38. This is a tricky area to navigate and there are structural issues to be addressed that go beyond the PCAOB's standard setting and inspection roles. Once again, we urge the PCAOB to engage with the SEC and others involved in the capital markets on this issue.
39. The PCAOB says that it believes that companies will not cease engaging their own specialists because to do so would take control of valuations out of their hands. While we hope this is correct, hope is no basis for standard setting. We therefore reiterate our belief noted above, that the PCAOB should engage with the SEC and others involved in the capital markets to exert pressure on companies to *ensure* that this does not happen.

Q 9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

40. We note the PCAOB's concerns regarding the potential adverse impact of the proposals on competition in the audit market and in particular the ability of smaller firms of auditors that do not enjoy the economies of scale of larger firms to compete with them. This is a self-perpetuating problem and reflects structural issues in the audit market that auditing standards cannot be expected to address.
41. Even so, those smaller firms that do not currently perform work on the assumptions and methods of specialists employed or engaged by companies will need to perform that work going forward. Exempting EGCs from the requirements would simply delay the problem but phasing the requirements might mitigate some of the worst effects. Such firms' clients are the most likely to meaningfully be affected by increases in audit fees. As with all situations in which a firm has only one or two clients in a regulated or complex area, justifying the additional work now required may be difficult and such firms might withdraw from such engagements. All of this clearly has an adverse effect on competition but we do not believe that this is a valid reason, in this case, to exempt EGCs altogether. We also note that these issues are not confined to EGCs.

Q 10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

42. One of the PCAOB's standard headings in its exposures is '*Why Standard Setting Is Preferable to Other Policy-Making*'. A much better approach would be to explain *Why Standard Setting is Needed Within the Wider Regulatory Framework*. We strongly believe that standard setting alone, as a sole alternative to other approaches, is rarely, if ever, likely to be effective, simply because auditor behavior is driven to a great extent by the approach taken during audit inspections, regardless of what auditing standards may or may not say.
43. The only other alternative approach on which we comment is with regard to the objectivity of auditor engaged specialists. We agree with the PCAOB's proposed approach which is aligned with the approach taken in ISA 620. Auditors should assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. The PCAOB is right not to specify how the relevant information to make the assessment should be obtained. This is preferable to (a) applying the same independence requirements to auditor engaged and employed specialists and (b) to applying a 'reasonable investor test' within an 'enhanced objectivity' approach.

Q 11 Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

44. Other than the cost of ignoring the impact of additional costs on auditor behaviour outlined in our answer to Q 7 above, and the additional costs relating to the unintended consequences referred to in our answer to Q 9 above, there are no other economic considerations related to the proposal to which we wish to draw the PCAOB's attention.

Q 12 The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

45. We note in our answer to Q8 above the difficulties and potential unintended consequences of the proposals for smaller companies, and their auditors. One way of mitigating the risk of (a) smaller companies ceasing to engage or employ their own specialists, and (b) a reduction in competition in the audit market, might be to phase the requirements for EGCs. The impact of the proposals will undoubtedly be most marked for EGCs and their auditors and while both need to step up to the plate, asking them to do so immediately may precipitate or exacerbate the unintended consequences discussed. We also note shortages of specialists in some areas that are likely to impact EGCs most. Again, we note that these issues are not confined to EGCs.

Q 13 Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

46. We do not comment on this question.

Q 14. How much time following SEC approval would audit firms need to implement the proposed requirements?

Q 15. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

47. Some larger firms, as the PCAOB notes, are probably doing much of what is proposed already and would not need long to implement the proposals. As we note in our answer to Q12, above, it may be prudent to phase implementation for the audit of EGCs.

Q 16. Is it appropriate to retain the existing meaning of the term 'specialist' in current auditing standards? Do auditors understand the existing meaning of the term and when a person (or firm) is a specialist? If not, what changes are necessary?

Q 17. Are the other terms used in the proposal—'company's specialist,' 'auditor employed specialist,' and 'auditor-engaged specialist'—clear and appropriate for purposes of the Board's proposal? Do these terms align with the role of each of these specialists in the audit?

48. The existing meaning of the term 'specialist' is a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing, except for income taxes and information technology because they are deemed specialised areas of accounting and auditing.

49. We noted in our response to the Staff DP that while the proposed PCAOB description is the same, on the face of it, as that of the IAASB, the IAASB scopes in tax practitioners dealing with complex or unusual issues. We suggested that if the PCAOB must scope out tax specialists, the focus should be not on the nature of the tax (income tax) but on its unusual or complex nature, as in the ISAs. We also note that scoping reflects the fact that by comparison with some other jurisdictions, in the US, firms integrate their tax and IT practitioners in their audit

practices. We remain of the view that in many cases the crossover between tax and IT staff between audit and compliance/advisory practices leads of necessity to them being treated as specialists. IT in particular will continue to develop as an area in which specialist expertise will often be needed in addition to the routine IT skills and competencies needed in all auditors, including auditors who in work exclusively in IT support.

50. The PCAOB notes commentators who refer to cyber security in this context and we would add to that, artificial intelligence and Blockchain technologies. Both are set to play a major role in business development in the coming decades. With the best will in the world, auditors who work exclusively within IT support groups within a practice will struggle to provide the level of insight into and understanding of these technologies that audit will demand in the coming years.

Q 18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?

51. We note in our response to Q7 above the fact that there are insufficient numbers of available specialists in some areas, particularly outside the US, and particularly in the context of complex financial instruments. This is a matter that needs to be taken into account in the PCAOB's engagement with the SEC and others involved in the capital markets, but it is also something that PCAOB inspectors need to take account of. Simply ignoring the issue does not make it any less real.

Q 19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?

52. We note in our responses to the IAASB and the PCAOB on their proposals on estimates the fact that the smallest of companies often engage in complex arrangements. Management may have little awareness of the accounting and auditing implications of such arrangements and therefore struggle to develop, or provide support, for the estimates required by US GAAS.

53. We note in our main points above that standard setters note the difficulties experienced by smaller companies in preparing compliant financial information and that some take the view that this is compounded by excessively rigid ethical requirements which prohibit auditor assistance in this area.

54. We also note in our answer to Q12 above and elsewhere, the difficulties and potential unintended consequences of the proposals more generally for smaller companies and their auditors. We suggest that one way of mitigating the risk of (a) smaller companies ceasing to engage or employ their own specialists, and (b) a reduction in competition in the audit market, might be to phase the requirements for EGCs. The impact of the proposals will undoubtedly be most marked for EGCs and their auditors and while both need to step up to the plate, asking them to do so immediately may precipitate or exacerbate the unintended consequences discussed.

Company specialists

Q 20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.

Q 21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?

Q 22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?

Q 23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?

Q 24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

55. The PCAOB does not demand objectivity of company specialists. Paragraphs .B4 and .B5 relate to the assessment of the specialist's relationship to the company and the entity that employs the specialist in terms of employment, financial, ownership business, contractual and familial relationships. They also deal with the necessary evidence relating to this being dependent on the assessed risks associated with the relevant assertion and the significance of the specialist's work to the auditor's conclusion.
56. We acknowledge that the content of these paragraphs represents an enhancement of existing requirements. We also acknowledge that they very broadly cover the same areas as paragraphs 8a, A37, A41 and A43 in ISA 500. The PCAOB states that the term 'objectivity' is restricted to auditor engaged specialists and that the issue is covered by the paragraphs referred to above.
57. The PCAOB demands independence of auditors and auditor engaged specialists but it does not demand objectivity of company specialists. One consequence of this is that the PCAOB's requirements for company specialists fall short of those of the IAASB. The IAASB does require objectivity of company specialists. We believe that independence is a means to an end rather than an end in itself, that formal independence it is no guarantee of objectivity and that without objectivity, independence has little value. Objectivity is a fundamental principle of many leading codes of professional ethics and is required by many national and international standard setters for all assurance and related services engagements. We urge the PCAOB to reconsider this issue.
58. We have concerns about the discussion and approach to specialist reports containing restrictions, disclaimers or limitations regarding the auditor's use of the report. Such caveats vary in nature and their use is widespread. The PCAOB gives a single example of wording that would render the related report unreliable – a statement that *the values in this report are not an indication of the fair value of the underlying assets*. We suspect that that wording such as this is commonplace even where the report has been commissioned specifically for audit purposes and is analogous to specialists refusing to give consent to being named in SEC filings. The wording is included as a risk management exercise and auditors may have little choice but to accept such wording. It would be helpful for the PCAOB to acknowledge these issues and to observe that the significance of caveats generally should be taken in the context of the relevant risk assessment as a whole.
59. We take issue with the PCAOB's assertion on page A3-24 to the effect that the IAASB does not have analogous requirements to test and evaluate data provided to the company's specialist or evaluate their methods and significant assumptions. Paragraph 13(b) of ISA 540 refers in detail to the need for auditors to test how management made the accounting estimate and we refer to paragraph A48 of ISA 500 under the heading *Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))*:

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;*
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and*
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.*

60. This may not be a requirement but it is analogous to the PCAOB's proposals and we believe its omission misrepresents IAASB's position. We have drawn attention in previous responses to the PCAOB to what we believe could be much better analyses of the differences between PCAOB proposals and the requirements of other standard setters. We have no doubt that the PCAOB is aware of the paragraph referred to above and we are disappointed that it chose not to refer to it.
61. We support the proposed elevation of the requirement for auditors to 'obtain an understanding' of specialists' methods and significant assumptions, to instead 'evaluate' whether they are appropriate, and whether significant assumptions used by specialists are reasonable.

Auditor employed specialists

Q 25. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

Q 26. Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?

Q 27. Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?

Q 28. Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?

Q 29. To what extent would the proposed requirement for establishing and documenting the understanding with the specialist represent a change in current practice? If so, what is that change?

Q 30. Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

Q 31. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-employed specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

62. We support the proposals:

- that would enable auditors to use information from and processes in the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor-employed specialists;
- for additional requirements to 'inform' auditor employed specialists about the work to be performed and to evaluate contrary evidence developed by specialists, both of which arise from inspection findings;

- to require the review of specialist reports, rather than their work. This will focus auditor attention on the detail and discourage reliance on process. We do not believe that this will require auditors to reperform the work of specialists.

63. However, we believe that the PCAOB's assertion that auditors should have sufficient knowledge of the subject matter to evaluate a specialist's work is a moot point, particularly in relation to highly complex technical areas. We note elsewhere in this response the PCAOB's own observations regarding the ability of auditors, within time, educational and other resource constraints, to effectively challenge models, assumptions and data in highly complex areas and we encourage the PCAOB to engage with the SEC and others involved in the capital markets to consider this issue.

Auditor engaged specialists

Q 32. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

Q 33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

Q 34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?

Q 35. Does the proposed requirement to assess the objectivity of the auditor engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?

Q 36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?

Q 37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?

Q 38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

Q 39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits?

Q 40. Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

64. The PCAOB notes concerns expressed by respondents to the Staff DP about auditors having limited access to proprietary information, such as models, including those used by auditor engaged specialists. It goes on to assert that auditors should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the auditor's work and audit report. Significantly, the PCAOB goes on to say that it does not require auditors to have full access to a specialist's proprietary models or to reperform the work of the specialist, but instead to evaluate the work of that specialist 'in accordance with the proposed standard'. We urge the PCAOB to include a note to this effect in AS 1210.

65. We note in our answer to Q25-31 above, concerns regarding the capacity of auditors to evaluate a specialist's work in highly complex technical areas. We refer to the PCAOB's own observations regarding the ability of auditors, within the time, educational and other resource constraints to effectively challenge models, assumptions and data in highly complex areas and we encourage the PCAOB to engage with the SEC and others involved in the capital markets to consider this issue.
66. The proposed requirement to specifically require auditors to determine whether a specialist is needed to perform the audit in all cases is aligned with a proposed IAASB requirement in its ED on estimates. We questioned this proposed requirement in our response to the IAASB, and we therefore question the PCAOB's requirement. The use of specialists in smaller audits, remains the exception rather than the rule. We do not believe that a separate specific requirement for auditors to determine whether a specialist is needed is necessary, but that the PCAOB might instead include that consideration as one of issues to be covered during the mandatory team discussion of the risk assessment.

Q 41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

Q 42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?

Q 43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210? 42-43 – conforming amendments

53. We make no comment on these questions.



CENTER FOR CAPITAL MARKETS
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August 30, 2017

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Proposed Amendments to Auditing Standards for Auditors Use of the Work of Specialists (PCAOB Release No. 2017-003, June 1, 2017) (PCAOB Rulemaking Docket Matter No. 044)

Dear Ms. Brown:

The U. S. Chamber of Commerce (the “Chamber”) created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.¹ CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation.

CCMC supports efforts to improve audit effectiveness and appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB”) Exposure Draft on *Proposed Amendments to Auditing Standards for Auditors Use of the Work of Specialists* (PCAOB Release No. 2017-003, June 1, 2017; PCAOB Rulemaking Docket Matter No. 044) (the “Proposal”). The Proposal was preceded by a PCAOB Staff Consultation Paper on *The Auditor’s Use of the Work of Specialists* issued in May 2015, which CCMC commented on and since we reiterate certain matters

¹ The Chamber is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information.

Ms. Phoebe W. Brown
August 30, 2017
Page 2

discussed in that letter, it is attached and request that it be made part of the record for the Proposal.²

The Proposal distinguishes among auditor-employed specialists, auditor-engaged specialists, and company specialists (which can be either employed or engaged by the company). The Proposal would also make a number of alterations in PCAOB audit standards related to the use of these specialists. These changes include amending *Audit Evidence* (AS 1105) by adding an appendix on using the work of a company's specialist as audit evidence; amending *Supervision of the Audit Engagement* (AS 1201) by adding an appendix on supervision of the work of auditor-employed specialists; and replacing AS 1210 and retitling it as *Using the Work of an Auditor-Engaged Specialist*.

The Chamber has concerns with the current proposal, including the costs and consequences for smaller businesses and their auditors. In addition, our comments address some specific concerns regarding the Proposal and changes it would make from current guidance.

1. Smaller Business Impacts and Economic Considerations

We are particularly concerned that the proposed requirements will have a significant impact on smaller companies, as well as smaller audit firms. The Proposal appears to be a “one-size-fits-all” approach—there is no real evidence that the proposed requirements would be scalable in a meaningful way.

The Proposal recognizes that the requirements could give rise to recurring costs for auditors in the form of additional time and effort spent by specialists and engagement team members. For example, the Proposal states that:

The most significant impact of the proposal on costs for auditors is expected to result from the proposed requirements to test and evaluate the work of a company's specialist... [T]hese requirements may result in auditors who currently perform limited procedures over the work of a company specialist engaging or employing an auditor's specialist to assist in performing those procedures. This may lead to significant changes in practice for some firms, particularly smaller firms...³

² See the July 31, 2015 letter from the U.S. Chamber of Commerce Center for Capital Markets Competitiveness on PCAOB Staff Consultation Paper No. 2015-01 on *The Auditor's Use of the Work of Specialists* (May 28, 2015).

³ See the Proposal, page 41.

Ms. Phoebe W. Brown
August 30, 2017
Page 3

Most, if not all, of these costs for auditors will certainly be passed on to companies as increased audit fees. This is especially concerning for smaller companies, whose audit firms may no longer be able to use the work of company specialists as they do in accordance with current PCAOB auditing standards.

Additionally, the PCAOB recognizes that the Proposal could give rise to new recurring costs for management and company specialists. For example, management and company specialists may need to devote more time and resources to respond to auditor inquiries and requests.⁴ This is an important point for the PCAOB to consider as regressive audit and internal control costs have been cited by businesses as a disincentive to going public. We believe that those costs should be scalable and smart regulatory tools used to develop standards that achieve important goals in a balanced manner.

While the PCAOB requests comment generally on the potential costs to auditors and companies, the Proposal provides no evidence on the magnitude of the potential costs or any attempt to quantify them.⁵ It should be noted that the courts have interpreted that regulatory cost benefit analysis requires an agency to develop an analysis and release it for public comment, which was not done here. We strongly encourage the PCAOB to proactively engage in efforts to obtain such evidence through means in addition to the formal comment process on the Proposal.

For example, in our May 2015 comment letter on the Staff Consultation, we urged the PCAOB to engage in field-testing and similar-type measures before implementing any changes in auditing standards. Among other matters, field-testing could provide evidence that would facilitate quantifying the magnitude of the costs and provide insights on other potential unintended consequences for companies and smaller audit firms.

Such evidence is also important because of the likely competitive disadvantages imposed on smaller audit firms by the Proposal. The PCAOB recognizes that the Proposal may result in some smaller firms accepting fewer audit engagements that would require the use of an auditor's specialist (rather than only use the work of a

⁴ See the Proposal, page 43.

⁵ CCMC appreciates that PCAOB inspection data from 2015 find smaller audit firms generally have fewer audit engagements that use the work of a company's specialist or an auditor's specialist (see the Proposal, page 26). (The latter are more likely to be auditor-engaged specialists rather than employed.) However, these inspection data may not be representative of engagements generally. Regardless, the data indicate a meaningful use of specialists by smaller audit firms, including audits that use the work of a company's specialist but not the work of an auditor's specialist.

Ms. Phoebe W. Brown
August 30, 2017
Page 4

company's specialist under existing auditing standards) and inhibit some smaller firms from expanding their audit services for the same reasons.⁶

2. Specific Concerns Regarding the Proposal

The Proposal elevates the role of the engagement partner in regards to using the work of specialists. For example, the Proposal enumerates requirements for evaluating the work of an auditor-engaged specialist.⁷ Given the point of using the work of a specialist on an audit and the very nature of the unique expertise specialists provide, the PCAOB should ensure that the Proposal does not go too far in setting expectations for audit engagement partners in this regard.

The Proposal would rescind A1 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*. The PCAOB states this is because:

[T]he interpretation is based on outdated accounting requirements and banking regulations, and the proposed amendments set forth the necessary requirements for evaluating the work of legal specialists when auditing financial asset transfers.⁸

CCMC appreciates the importance of updating PCAOB auditing standards to recognize changes in accounting standards and regulatory requirements. Nonetheless, in this instance, we understand that the guidance in this interpretation continues to be very useful for auditors. We strongly encourage the PCAOB to retain this interpretation on the use of legal interpretations as evidential matter.

Further, the Proposal contains certain requirements that appear to present challenges for auditors to implement. For example, the Proposal calls for auditors to:

- Evaluate whether the data were appropriately used by a company specialist.⁹

However, the Proposal provides no guidance on how the auditor would go about doing so in order to meet this requirement. In addition, given other requirements in the Proposal, the need for this evaluating is unclear.

⁶ See the Proposal, page 44.

⁷ See the Proposal, page A1-23.

⁸ See the Proposal, pages A3-45 to 46.

⁹ See the Proposal, pages A1-11 and A5-15.

Ms. Phoebe W. Brown
August 30, 2017
Page 5

- Assess the knowledge, skill, and ability of company specialists and auditor-engaged specialists.¹⁰

Asking the auditor to consider whether the specialist can perform the requisite task or assignment makes sense when the auditor uses the work of specialists. CCMC appreciates that the Proposal contains some guidance for auditors in making these assessments. However, our concern is with the potential for unintended consequences down the road because of the term “and,” which implies the PCAOB intends that auditors should separately evaluate all three: knowledge, skill, and ability for each specialist. For example, we can envision PCAOB inspectors looking for documentation that the auditor has assessed all three. Put simply, the distinctions that the PCAOB has in mind in regards to this assessment are not clear.

We are concerned that the Proposal makes certain changes with existing practices that are problematic, while also placing regressive costs upon small businesses and their auditors. We hope to work with the PCAOB to resolve these issues, and stand ready to discuss them with you further

Sincerely,



Tom Quadman

¹⁰ See the Proposal, pages A1-20, A1-21, A3-10, A3-37.

U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
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August 30, 2017

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PCAOB Release No. 2017-003, *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* (June 1, 2017)

This letter provides the GAO's comments on the Public Company Accounting Oversight Board's (PCAOB) referenced proposed amendments to auditing standards. GAO promulgates generally accepted government auditing standards, which provide professional standards for auditors of government entities in the United States.

We support the PCAOB's efforts to improve the quality of financial reporting and increase the confidence users have in the audit of financial statements. Specifically, we concur with the PCAOB's view concerning the need for improvements to PCAOB standards related to use of specialists. In addition, we generally concur with the potential amendments presented in the proposed amendments. We believe that such changes would significantly improve the PCAOB standards.

The PCAOB staff consultation paper seeks comment on 43 specific questions. We have provided comment on most of those questions in an enclosure to this letter.

We thank you for considering our comments on these important issues as the PCAOB continues its effort to enhance its auditing standards.

A handwritten signature in black ink, appearing to read "James R. Dalkin".

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Enclosure

Comments on PCAOB Release No. 2017-003, *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*

The following are our responses to the questions included in this release.

1. Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

GAO audits are conducted in accordance with generally accepted government auditing standards (GAGAS). GAGAS incorporates by reference the American Institute of Certified Public Accountants' Statements on Auditing Standards. Accordingly, Public Company Accounting Oversight Board (PCAOB) standards do not apply to GAO. Nevertheless, the information presented in this release appears to reasonably characterize our understanding of current practice. Further, the discussion of the reasons to improve auditing standards sufficiently describes the nature of concerns arising from the use of the work of specialists.

2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?

The proposed amendments appropriately address the reasons to improve standards. The reasons for having separate standards for using the work of the various types of specialists are clear.

3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

We are not aware of other areas that need to be addressed.

4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

We do not offer a response to this question.

5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

We do not offer a response to this question.

6. The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

We do not offer a response to this question.

7. The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?

We do not offer a response to this question.

8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?

We do not offer a response to this question.

9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

We do not offer a response to this question.

10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

We do not believe alternative approaches are preferable to the proposed approach.

11. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

We do not offer a response to this question.

12. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

We do not offer a response to this question.

13. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

We do not offer a response to this question.

14. How much time following SEC approval would audit firms need to implement the proposed requirements?

We do not offer a response to this question.

15. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

We do not offer a response to this question.

16. Is it appropriate to retain the existing meaning of the term “specialist” in current auditing standards? Do auditors understand the existing meaning of the term and when a person (or firm) is a specialist? If not, what changes are necessary?

We believe the existing meaning of “specialist” is generally understood within the auditing community. Accordingly, we do not offer suggested changes.

17. Are the other terms used in the proposal—“company’s specialist,” “auditor-employed specialist,” and “auditor-engaged specialist”—clear and appropriate for purposes of the Board’s proposal? Do these terms align with the role of each of these specialists in the audit?

In general, “company’s specialist,” “auditor-employed specialist,” and “auditor-engaged specialist” are clear, appropriate, and align with the roles of these specialists in the audit. However, we suggest that the PCAOB consider replacing “company’s specialist” with “management’s specialist” to reflect the full range of organizations that use the work of specialists to prepare entity financial statements. The “management’s specialist” is also consistent with terminology in AU-C section 620.

18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?

We do not offer a response to this question.

19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?

We do not envision any reason that the proposed approach cannot be reasonably scaled to address audits of varying size and complexity.

20. How would the proposed requirements for using the work of a company’s specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.

Consistent with AU-C section 500, *Audit Evidence*, we consider the work of a company’s specialist as audit evidence provided by management. We believe that the work of the company’s specialist should be subject to audit procedures similar those for other audit evidence obtained from the company, and we conduct our procedures accordingly at GAO. We do not foresee any changes to current practice based on the proposed requirements.

21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company’s specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company’s information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?

In general, the proposed requirements related to obtaining an understanding of the work and report of the company's specialist and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, are clear and appropriate. However, we are unclear about how the requirements in AS 1105, *Audit Evidence*, paragraph .B3, would relate to "the entity that employs the specialist." Specifically, the considerations for assessing the specialist's knowledge, skill, and ability in bullets a., b., and c. of this paragraph are suitable for assessing an individual specialist's qualifications, but do not seem to be readily applicable to an entity. Further, we note that while the lead paragraph in .B2 refers to "related company processes and controls," bullet c. of this paragraph only refers to "the company's process" without further reference to "related controls."

We believe proposed appendix B is a reasonable location for these requirements.

22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?

In general, the proposed requirements for obtaining an understanding of and assessing the company's specialist's knowledge, skill, and ability, and relationship to the company, are clear and appropriate.

23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?

In general, the examples provided in the release are clear and helpful. However, we note that there is some redundancy in the language of paragraphs .B6, .B8, and .B9. The PCAOB could consider adding references in paragraph .B6 to the paragraphs where the related requirements are included.

24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

In general, the proposed requirements to evaluate the relevance and reliability of the company's specialist's work are clear, appropriate, and complementary to the requirements to evaluate the relevance and reliability of other audit evidence.

25. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

We are not aware of particular challenges the proposed approach poses to auditors.

26. Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?

In general, the proposed factors related to determining the necessary extent of supervision are clear. However, we note that there is some redundancy in the language of paragraphs .06 and .C2 of AS 1201, *Supervision of the Audit Engagement*. Paragraph .C1 states that the appendix supplements the requirements in paragraphs .05 through .06; however, it is unclear whether the auditor would apply the requirements in paragraph .C2 instead of or in addition to the requirements in paragraph .06 for auditor-employed specialist.

27. Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?

We do not envision any reason that the proposed approach cannot be reasonably scaled to address audits of varying size and complexity.

28. Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?

In general, the proposed requirements for establishing and documenting the understanding with the specialist are clear, are appropriate, and would foster effective communication between the parties.

29. To what extent would the proposed requirement for establishing and documenting the understanding with the specialist represent a change in current practice? If so, what is that change?

We do not foresee any changes to current practice based on the proposed requirements.

30. Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

In general, the proposed requirements for evaluating the work of the auditor-employed specialist are appropriate and clear. Further, the link between establishment and documentation of the understanding with the specialist and evaluating the specialist's work is clear.

31. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-employed specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

Revisions to PCAOB standards appear to be the most appropriate way to assist audit organizations in implementing and applying the proposed requirements. In addition, the PCAOB's concurrent efforts relating to auditing accounting estimates and fair value measurements, as discussed in its Release No. 2017-002, *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, should help address some of the issues discussed in the release.

32. Does the proposed approach pose any particular challenges to auditors?

If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?

We do not envision any significant challenges.

33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

In general, the proposed approach appropriately reflects (1) the relationship between the auditor and an auditor-engaged specialist and (2) the relationship between the auditor and an auditor-employed specialist.

34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?

In general, the proposed requirements for assessing the knowledge, skill, ability, and objectivity, as applicable for each type of specialist, are clear. However, we are unclear about how the requirements in AS 1210, *Using the Work of an Auditor-Engaged Specialist*, paragraph .03, would relate to "the entity that employs the specialist." Specifically, the considerations for assessing the specialist's knowledge, skill, and ability in bullets a., b., and c. of this paragraph are suitable for assessing an individual specialist's qualifications, but it is unclear how these considerations could be applied to an entity.

35. Does the proposed requirement to assess the objectivity of the auditor engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?

We do not envision any significant challenges.

36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?

Please see the answer to question 28. Further, we suggest that the PCAOB consider adding to AS 1210, *Using the Work of an Auditor-Engaged Specialist*, paragraph .07, a requirement that the engagement partner and other supervisory engagement team members inform the auditor-engaged specialist of the need to apply professional skepticism. This addition is consistent with paragraph .C6 of AS 1201, *Supervision of the Audit Engagement*.

37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?

Please see the answer to question 29.

38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?

We agree that the requirements are clear.

39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

Please see the answer to question 31.

40. Is rescinding AI 11 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

Rescinding AI 11 is appropriate.

41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

Rescinding AI 28 is appropriate.

42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?

The proposed conforming amendments are appropriate and clear.

43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210?

We are not aware of other conforming amendments that are necessary.



Exhibit 2(a)(D)

Alphabetical List of Commenters on Staff Consultation Paper on the Auditor's Use of the Work of Specialists

1	American Academy of Actuaries
2	American Accounting Association
3	American Bankers Association
4	American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
5	Appraisal Institute
6	Baker Tilly Virchow Krause, LLP
7	BDO USA, LLP
8	BKD LLP
9	California Society of Certified Public Accountants
10	Center for Audit Quality (2 Letters)
11	Crowe Horwath LLP
12	Deloitte & Touche LLP
13	Dixon Hughes Goodman LLP
14	Duff & Phelps, LLC
15	Eide Bailly LLP
16	Eli Lilly and Company
17	Ernst & Young LLP
18	Federation of European Accountants
19	Grant Thornton LLP

Alphabetical List of Commenters on Staff Consultation Paper on the Auditor's Use of the Work of Specialists	
20	Harvest Investments, Ltd.
21	Illinois CPA Society
22	Institut der Wirtschaftsprüfer
23	Institute of Management Accountants
24	International Auditing and Assurance Standards Board
25	KPMG LLP
26	Ken Lining, FCA, MAAA, EA, MBA, Consulting Actuary
27	McGladrey LLP
28	Moss Adams LLP
29	National Association of Real Estate Investment Trusts
30	National Association of State Boards of Accountancy
31	National Venture Capital Association
32	New York State Society of Certified Public Accountants
33	Fred J. Newton
34	Piercy Bowler Taylor & Kern, Certified Public Accountants
35	Plante & Moran, PLLC
36	PricewaterhouseCoopers LLP
37	Thomas I. Selling, PhD, CPA
38	The Institute of Chartered Accountants in England and Wales (ICAEW)
39	Towers Watson
40	U. S. Chamber of Commerce, Center for Capital Markets Competitiveness
41	U.S. Government Accountability Office
42	WeiserMazars LLP
43	Wilary Winn LLC
44	Wolf & Company, P.C.



AMERICAN ACADEMY of ACTUARIES

Objective. Independent. Effective.™

July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington DC 20006-2803
Submitted via email to comments@pcaobus.org

RE: Staff Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*

To Whom It May Concern:

On behalf of the American Academy of Actuaries¹ financial reporting committees,² we appreciate the opportunity to provide comments on the Public Company Accounting Oversight Board's (PCAOB) Staff Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*, dated May 28, 2015. We agree that the issues raised by the PCAOB are important and should be considered, and that the approach to the use of specialists in an audit can be a key factor in the quality of many audits.

In determining the degree of oversight that needs to be applied to the work of a specialist providing assistance on an audit, several key factors should be considered. These include:

- Whether the specialist is an accredited member of a recognized professional body (and is publically identified as such) and the training necessary to receive credentials from that body.
- The extent to which that body has a code of professional conduct, professional standards of both practice and qualification to perform the specialist's services, and an active disciplinary process.
- The degree to which the body requires continuing professional education and makes public whether those specialists have completed that training.

Our comments on the consultation paper reflect the perspectives of members of the relevant U.S. actuarial organizations who comply with the actuarial Code of Professional Conduct,³ the

¹ The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

² The Risk Management and Financial Reporting Council Financial Reporting Committee, Pension Practice Council Pension Accounting Committee, Casualty Practice Council Committee on Property and Liability Financial Reporting, Health Practice Council Financial Reporting and Solvency Committee, and Life Practice Council Life Financial Reporting Committee.

³ Code of Professional Conduct, American Academy of Actuaries, 2001, http://actuary.org/files/code_of_conduct.8.1.pdf. This code has been adopted by each of the U.S. actuarial organizations: the American Academy of Actuaries, Society of Actuaries, the

actuarial standards of practice (ASOPs),⁴ and the “Qualification Standards for Actuaries Issuing Statements of Actuarial Opinion in the United States” (USQS).⁵

The comments in this letter were prepared by a diverse, cross-practice group of actuaries, all of whom have experience with financial audits encompassing each of the four areas outlined in the paper. Following the response summary, the letter includes our formal responses to the specific questions raised in the consultation paper that are relevant to our work.

Response Summary

Existing Guidance

In recent years, actuarial practitioners, primarily those directly employed or engaged by audit firms, have noted a significant increase in the depth and intensity of the review of their actuarial work products by core audit teams. We believe that the concerns the PCAOB has regarding existing guidance may be more related to a lack of compliance of some, but not all, specialists with the guidance. We do not believe there are any specific problems with the guidance as it relates to actuarial services or actuarial specialists, as defined by the PCAOB consultation draft.

One-Size-Fits-All

One-size-fits-all detailed requirements for specialists are unlikely to be effective or implementable. Even within the actuarial profession, the approaches taken by pension, life insurance, or casualty actuaries may vary and impact the type of validation performed by auditors (e.g., re-performance and assumption review and methodology assessment). Audit procedures that are appropriate for one actuarial practice area may be inappropriate for another.

Compliance With Accounting Rules

We believe requiring specialist firms external from the auditors to comply with the accounting profession’s independence rules is impractical. Accounting firms involved in financial audits (audit firms) expend considerable resources to be confident in their ability to assert independence. Many external specialist firms derive a small portion of their revenue from audit-related activities. Imposing additional independence requirements on external specialist firms could result in the external specialists’ deciding it is no longer economically feasible to provide audit specialist services. The requirements could limit competition and, as a result, some audit firms could no longer obtain external specialist assistance. In the case of the U.S. actuarial profession, specialists would remain bound, due to their code of conduct and professional standards, to maintain objectivity in all of their work and disclose any conflict of interest.⁶

American Society of Pension Professionals and Actuaries, the Casualty Actuarial Society, and the Conference of Consulting Actuaries. Actuaries who are members of these organizations must follow the code.

⁴ <http://www.actuarialstandardsboard.org/standards-of-practice/>

⁵ Board of Directors, “Qualification Standards for Actuaries Issuing Statements of Actuarial Opinion in the United States,” American Academy of Actuaries, 2008, http://www.actuary.org/files/qualification_standards.pdf.

⁶ Precept 7 of the Code of Professional Conduct.

Specialists who are employed by audit firms already have to comply with these rules in order to participate as members of an audit engagement team.

Supervisory Authority

A similar issue relates to whether an audit firm is able to extend supervisory authority over an employee of another firm or that employee's work product. Relinquishing control of one's employees to an audit firm, while retaining the legal risk associated with those employees, could result in some specialist firms refusing to provide audit assistance. This issue could be mitigated if the employer includes a requirement in the engagement letter that the contracted specialist may provide the audit firm with copies of work papers and access to the preparers as appropriate.

Communication

We agree with the PCAOB's contention that thorough communication between the audit firm and its internal and external specialists is necessary. This communication could include a detailed and documented understanding of the responsibilities of each party in the audit planning process, the context in which the specialist's work will be used, and ensuring that those specialists are familiar with the relevant principles of auditing (e.g., professional skepticism). In our experience, the large and mid-size audit firms consistently communicate these items and take steps to communicate with their specialists and prepare thorough audit programs. These firms have detailed procedures to accomplish this communication with respect to internal and external specialists.

Testing Approach

For actuarially determined accounting estimates, the testing approach for estimates through complete re-performance is not practical and does not consider the reasonability of the underlying assumptions within the models. Current guidance as quoted on page 40 of the PCAOB consultation paper⁷ describes development of an independent estimate and the testing of

⁷ "For example, potential requirements related to estimates might provide that:

In addition, the Evaluating the work of an auditor's specialist should include:

- a. When the auditor's specialist develops an independent estimate, determining whether:
 - (1) The methods (which may include models) used by the specialist are appropriate, including whether those methods are (1) in conformity with the applicable financial reporting framework, (2) generally accepted within the specialist's field of expertise, and (3) applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company; and
 - (2) The significant assumptions used by the specialist are reasonable, taking into account information presented in the report or documentation of the specialist, in view of the auditor's understanding of the company, its environment, and other evidence available to the auditor.
- b. When the auditor's specialist tests the methods and significant assumptions used by the company, evaluating the conclusions of the specialist about:
 - (1) The appropriateness of the company's methods including whether those methods are (1) in conformity with the applicable financial reporting framework, (2) generally accepted within the specialist's field of expertise, and (3) applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company;
 - (2) The reasonableness of the company's significant assumptions, taking into account information presented in the report or documentation of the specialist, in view of the auditor's understanding of the company, its environment, and other evidence available to the auditor; and

methods and significant assumptions as two approaches that provide for tailoring the approach to the particular circumstance. PCAOB's Interim Standard (AU) Section 336, *Using the Work of a Specialist*,⁸ further describes the acceptability of the use of an audit approach specific to the particular circumstance that may not involve re-performance or independent testing.

The ability of audit firms to test the work of a reporting entity's internal or external actuarial specialist varies, depending on what is being tested. For example, an audit firm can test the calculation of a reserve for a specific life insurance policy. Testing of total reserves—the combination of individual claim reserves and incurred but not reported (IBNR) reserves—for a group of casualty or health insurance policies is also reasonable. However, replicating calculations for an estimate based on a complex model that simultaneously handles many different contingencies and outcomes, such as a model used to develop the valuation for an entire pension plan, a large book of life insurance policies, or asbestos obligations of a casualty insurer is a difficult, time-consuming, and costly proposition when less expensive and more efficient methods of obtaining sufficient evidence are available.

Currently, an auditor's actuarial specialist often can obtain sufficient information to prepare an estimate within the materiality requirement of an audit that will provide the auditor with additional evidence to determine whether the actuarial estimate is reasonable. This alternative test often requires the auditor's actuary to examine not just the mechanics of the model that is being tested, but also the reasonability of the assumptions made by the reporting entity's specialist. The reasonability of the assumptions are as important, if not more important, than the mechanical calculations of the reporting entity's specialist's model.

In addition, many of these models are proprietary to external firms that have developed the estimate used by the reporting entity. As a proprietary model, the details of the model are owned by the external specialist's firm and may not be transparent to the user of the results. Preparing a test that is close to re-performance after the reporting entity has completed its work may not be feasible given current reporting time constraints and may cost the reporting entity fees equivalent to or more than what was spent developing the initial estimate.

Audit Scope Procedures

We believe a distinction needs to be drawn in audit scope between the procedures necessary when the reporting entity's specialist involved in determining accounting estimates is employed by the entity and when that specialist is employed by an outside firm. The specialist employed by the reporting entity cannot reasonably be considered to be independent in the audit sense, and objectivity can be difficult to achieve in such a situation. However, objectivity is more likely

(3) The company's basis for selecting the methods and assumptions used in developing the estimate, including whether the company considered alternative methods and assumptions..."

⁸ "An audit may use the findings of the company actuaries by (1) obtaining an understanding of the methods and assumptions used by the company actuaries, (2) making appropriate tests of the data provided to the company actuaries and (3) evaluating whether the company actuaries' findings support the recorded reserves; or perform other test work such as an independent analysis. When reviewing the analysis of company actuaries, the actuary will test certain key assumptions, perform other recalculations or perform spot-checks. If the actuary determines that the findings of the company actuaries support the recorded reserve, further detailed analysis may not be required."

when the specialist is external, if for no other reason than the external specialist's employer needing to legally protect itself. In a case in which the reporting entity provides a significant proportion of the revenue of an external specialist, an auditor may need to perform additional procedures to verify the objectivity of the development of the specialist's work product used. This should not require audit procedures and rules that apply in all cases.

Revising the Standard of Audit Estimates

We believe that the revision to this standard should be performed in conjunction with any consequential or associated review of the standard on the audit of estimates, as they are inextricably linked.

Cooperation

We believe that the PCAOB and the International Auditing and Assurance Standards Board (IAASB) should cooperate in establishing standards that are as consistent as practical. Such coordination would better enable multinational audit firms or entities to operate and organize the use of specialists in a consistent manner.

Formal Responses to the Staff Consultation Paper 2015-01 Questions

1. ***Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?***

We believe the information presented in Section III accurately characterizes current practice.

2. ***Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?***

Challenges to the use of specialists in an audit include: the lack of familiarity of audit staff with actuarial methods; the complex models that are sometimes used by actuaries; and sufficient understanding of the critical data items used by actuaries in their models/methods. Those charged with selecting audit specialists should consider the ability of the specialists to communicate these methods and procedures to non-specialists.

3. ***For accounting firms that use the work of an auditor's specialist:***
 - a. ***Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit.***

This decision usually depends on audit economics and the allocation of internal resources (e.g., availability of employed specialists in the practice area in question).

- b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?***

We believe Figure 1 in Section II.A accurately describes the activities for which the firm uses the work of a specialist. Other areas of the audit in which valuation actuaries may be involved include warranty obligations, outstanding loyalty reward points, gift card breakage, net asset values of funds with securitized insurance contracts, and customer refunds.

- c. What type of work do the specialists perform? Does the type of work vary depending on whether the firm employs or engages the specialist? Does the type of work vary depending on the specialist's field of expertise?***

The type of work varies significantly by level of audit materiality; risk assessment and associated uncertainty, especially relative to the size of the entity and the size of the item being reviewed; and nature of the coverage provided. In some cases, independent estimates are necessary, while others require a review of the basis, methodology, assumptions, and documentation of management's estimates.

- d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate? Why?***

As indicated in our response to question 3.c., it depends upon the circumstances of the company and the risks involved. For actuaries it also may depend on practice area; for example:

- Actuaries practicing in the property and casualty field are more likely to produce an independent estimate given the nature of the methodologies used in this practice area.
- Actuaries practicing in the pension field are more likely to focus on the qualifications of the preparing actuary and the reasonableness of the assumptions reflected in the measurements.

4. For accounting firms that use the work of an auditor's employed specialist:

- a. Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?***

We believe that supervising the work of employed specialists in accordance with Auditing Standard (AS) No. 10 does present challenges. These include: an assessment of the credentials, knowledge, and experience of an actuary; the quality and timeliness of the communication between the specialist and supervisor; and the experience in the area of the assigned supervisor.

- b. How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?***

A great deal of communication between the auditor and specialist is required, as is a detailed review of the specialist's processes and findings by the auditor.

- c. Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?*

We do not have a response to this question at this time.

- d. How would the evaluation change if the firm engaged the specialist?*

We do not have a response to this question at this time.

- e. What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist? How does that assistance affect the auditor's supervision of the work of the employed specialist?*

We do not have a response to this question at this time.

5. For accounting firms that use the work of an auditor's engaged specialist:

- a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?*

We believe the process usually includes an interview of the individual(s) or firm expected to be involved, together with assessment of qualifications and prior similar work of the person in charge of conducting the review.

- b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Auditing Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?*

Circumstances when the auditor may perform additional procedures can include analytics, such as trends of relevant ratios of reserves or other recommended values or experience.

- c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?*

Although practice varies, procedures specified in AU 336 are followed.

- d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?*

There are times in which proprietary methods/models are used. The acceptability of this practice depends on the coverage involved, model validation procedures, a review of prior

use of the models/methods with other clients, and a review of the assumptions used in the model with respect to consistency with prior periods and overall reasonableness.

For additional details, please see our response to question 8.b. below.

6. ***For accounting firms that use the work of a company's specialist:***
- a. ***What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.***

A firm may use the work of a company's specialist if the risk of misstatement is not material, the estimate involved is a very straightforward calculation, or there has been no change made in methods/assumptions since the most recent review by the auditor's specialist was conducted.

- b. ***Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?***

Figure 1 reasonably describes the activities in which an auditor uses the work of a company specialist. In the case of some entities, a corporate actuarial department may perform its own validation of assumptions and methods used by the actuaries who provide measurements of reserves or other obligations for management.

- c. ***In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?***

We do not have a response to this question at this time.

- d. ***How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?***

We do not have a response to this question at this time.

- e. ***Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?***

Overall, there is little difference in procedures followed when the firm uses the work of a company's employed specialist and a company's engaged specialist, although the validation of the qualifications of external actuaries are performed each time these actuaries are utilized, while the qualifications of internal actuaries are assumed because of prior validation.

- 7. *This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?***

In general, we suggest adopting clearly stated principles-based standards. More explicit guidance relating to the use of an actuary as a specialist, possibly emphasizing the importance of assumptions/selection of parameters used by life and pension actuaries, and enhanced guidance with respect to the audit of the underlying data used by the actuary could be useful. We note the statement made in the consultation paper that specialists generally do not have training regarding skepticism—this may be true for certain specialists not employed by the audit firm, but an actuary's training is geared to skeptical analysis.

- 8. *When an auditor obtains an understanding of the methods used by the company's specialist:***
- a. *If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?***

In general, the auditor has access to sufficiently detailed descriptions of methods, assumptions, and audit outputs that should enable the auditor to obtain appropriate audit evidence. The time used for this purpose varies widely, depending on the auditor's experience with the risks and actuarial methods involved. The actuary should take the time to explain the procedures followed (in sufficient detail as warranted by the auditor's assessment of and experience with the risks) and assumptions made, although it depends on the significance of the item being discussed. The increased use of specialized valuation software may limit the auditor's direct access to the methods or models used by the actuary.

- b. *If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?***

Usually, the auditor discusses the trends in estimates with the actuary involved (either the auditor's actuary or management's actuary) and seeks to understand any changes between the accounting values and the actuary's audit range. The auditor also seeks to understand the factors underlying the year-over-year change in the assertion.

The actuary also may provide the auditor with a set of output exhibits when direct access to methods/models is not possible due to software licensing arrangements. The auditor may review the reasonableness of the model by sensitivity testing the key inputs into the model and examining the outputs provided by the company.

- 9. *Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?***

The revisions to PCAOB standards are appropriate to address the issues discussed in this paper. Performing an implementation review of relevant PCAOB standards similar to that made by the IAASB may provide further insight into where revisions are needed. Nevertheless, pursuing ways to enforce the current standards may be more tenable than revising current standards.

- 10. *Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?***

In general, similar procedures are applicable. However, because of prior work relationships, certain procedures regarding validating qualifications of the auditor's employed specialists do not need to be repeated, other than to validate continuing education compliance.

- 11. *Are there other considerations related to the alternatives presented that the staff should be aware of?***

We do not have a response to this question at this time.

- 12. *Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.***

We do not have a response to this question at this time.

- 13. *Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?***

We are not aware of any limitations on an auditor's ability to treat the work of an engaged specialist in the same way as that of an employed specialist.

- 14. *Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?***

We believe it is appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist. However, it should not affect the auditor's procedures.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

Auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU 336 by ensuring the specialist understands his or her role. The auditor may want to undertake a discussion of the documentation of the specialist's findings with respect to methods and assumptions made.

Audit and company specialist actuaries typically invest time helping auditors understand the material effects of various assumptions/methods, the sensitivity in the result to changes in key assumptions, and other key risks and uncertainties in the estimate. Actuaries also are required to disclose many of these items by our ASOPs in communications with the principal user of our work product.⁹

As noted on page 30 of the staff consultation paper, “[i]n cases when the auditor does not possess the specialized knowledge or skill to perform those more rigorous procedures, the auditor might need to employ or engage his or her own specialist.” This generally would be the case when reviewing a company's obligations for pensions and other postretirement benefit plans or for insurance liabilities.

In a situation in which the auditor's specialist is reviewing information provided by the company's specialist, the auditor's specialist should perform testing sufficient to confirm whether the methods, assumptions, and results are reasonable. The test of reasonableness may be accomplished by reviewing appropriately documented actuarial communications provided by the company's specialist, testing census data and assumptions, independently estimating the balance in question, etc. It should not require the auditor's specialist to reproduce the company's specialist's work in most cases.

When determining what level of testing the auditor should perform on information provided by the company's specialist, it is important to establish appropriate limits on the amount of testing required so that the testing is not unduly burdensome. For example, in reviewing a company's obligations for pensions and other postretirement benefit plans, it would be unnecessary to require the auditor to reproduce the work of the company's specialist. Instead, it would be more appropriate to require the auditor (or its specialist) to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist.

The large auditing firms already employ in-house actuarial specialists or engage actuarial specialists. These auditor's specialists generally review the methods, assumptions, data, etc. used by the company's actuary specialist to ensure that they are reasonable and appropriately documented. They also provide the audit engagement team with a detailed report summarizing their review and conclusions. The staff consultation paper does not appear to specifically address a situation in which both the company and the auditor use their own

⁹ ASOP No. 41, *Actuarial Communications*, Actuarial Standards Board, 2010, <http://www.actuarialstandardsboard.org/asops/actuarial-communications/>.

specialists, but it is a very common situation for actuarial specialists. The use of auditor's specialists may be less common among smaller auditing firms.

- 16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?**

The work of a company's specialist should be treated as audit evidence in the same way other information provided by the company is used. As risks to which companies are exposed continue to become more complex, the need for employed or engaged specialists' review will likely increase on the audit.

- 17. Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?**

We do not have a response to this question at this time.

- 18. Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?**

To the extent that the auditor does not recognize the risks involved or does not understand the description of the procedures, methods, and assumptions used by the company/company specialists, the auditor will continue to need to rely on the work of and communication with the auditor's specialists. However, the auditor needs to remain informed about the methods and assumptions used and conclusions reached. The auditor must understand the work of both the company's specialist and her/his own specialist. The auditor will need to continue to document the basis for her/his agreement or disagreement with the specialists' conclusions.

- 19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?**

The potential definitions of an auditor's specialist and a company's specialist are appropriate. We encourage definitions to be consistent with those used by the IAASB.

- 20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?**

We do not have a response to this question at this time.

21. *Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?*

We do not have a response to this question at this time.

22. *Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?*

We recommend emphasizing the importance for actuaries to hold professional credentials associated with current membership of an actuarial body, as described in our general comments.

23. *Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?*

The matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement are both sufficient and appropriate.

24. *Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?*

We have not identified any further obstacles. We emphasize that the methods of validating estimates differ by the type of estimate. For example, the re-performance of reserves for life insurance as calculated is valuable. For property and casualty insurance, independent estimates of total claim reserves may be important. In other words, the choice of method(s) used to ensure sufficient appropriate audit evidence is obtained continues to be important and vary by circumstance and the nature of the items being assessed.

25. *Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?*

We do not foresee any unintended consequences, but we are concerned about whether an audit firm is able to extend supervisory authority over an employee of another firm or that employee's work product. Relinquishing control of one's employees to an audit firm, while

retaining the legal risk associated with those employees, could result in some specialist firms refusing to provide audit assistance. This issue could be mitigated if the employer includes a requirement in the engagement letter that the contracted specialist may provide the audit firm with copies of work papers and access to the preparers as appropriate.

26. *How do accounting firms determine what information an auditor's specialist should provide to the auditor? Are there circumstances in which auditors may not retain all audit evidence obtained from the specialist?*

The auditor determines what information an auditor's specialist should provide to the auditor based on the risks and materiality involved and the nature of the item being assessed. The auditor has to determine what information is necessary to form a conclusion regarding whether the information provided forms an adequate basis to conclude whether the information provided in relation to the item being assessed constitutes sufficient appropriate audit evidence.

27. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?*

The potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate.

28. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?*

The potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions.

29. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?*

The potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist.

30. *Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?*

The potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist.

31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

The requirements for evaluating the work of an auditor's specialist should be tailored based on the risk of material misstatement and the factors outlined in our opening comments. This would include the professional accreditation of the specialist, their experience relative to the balance being tested, and their association or organization's code of conduct, standards of practice, and continuing education requirements.

32. How does the auditor evaluate relationships between an auditor's engaged specialist and a company under AU sec. 336?

We do not have a response to this question at this time.

33. Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?

Given the size, scope, and operating structure of many consulting firms, it would be impractical to establish independence in most cases. We believe that such independence requirements may be onerous in some cases, as the tracking systems may not be in place for everyone in the chain of command, reducing the willingness of certain consulting firms to make their resources available to the auditor.

It is important to establish the objectivity of engaged specialists with respect to the company. We would favor the concept of enhanced objectivity outlined in the consultation paper as it applies to the individual specialist and his or her team working on the engagement and not the specialist's employer in the circumstances noted in our response to question 35.

34. Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

Requiring independence in the accounting sense for engaged specialists is not practical. However, independence in a general sense is important, as described in annotation 6-1 in the actuarial profession's code of conduct:

“An Actuary who is not financially and organizationally independent concerning any matter related to the performance of Actuarial Services should disclose to the Principal any pertinent relationship that is not apparent.”

In the case of the auditor's engaged specialist, the Principal would be the audit firm. We also believe that objectivity is important.

- 35. Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor’s specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist’s firm?**

Some aspects of the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor’s specialist and the company may be impractical (e.g., the tracking of all business relationships with a specific company may not be possible for a non-audit firm). However, it is appropriate for the auditor to identify whether any of these relationships exist for the individual specialist in charge of the consulting assignment. One option might be a simplified approach whereby the auditor asked for consulting fees from the audited company in the last fiscal year of the consulting firm as a percentage of the specialist’s firm total consulting fees. The request could be made in broad bands (e.g., less than 5 percent, 5-10 percent, or greater than 10 percent).

- 36. Are the potential requirements for the auditor to evaluate the objectivity of an auditor’s specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist’s objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account “threats” to objectivity and “safeguards” to reduce the threats, as provided in ISA 620?**

We do not have a response to this question at this time.

- 37. Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor’s engaged specialist will not be influenced by business, employment, or financial relationships?**

If the enhanced objectivity approach is adopted, no additional rules are needed. We note that Precept 1 of the actuary’s code of conduct mandates performing engagements with integrity:

“An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession”

We believe objectivity is a key element of integrity.

- 38. Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?**

The potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information is appropriate and sufficiently clear.

- 39. Does the specialist (or his or her employer) typically have a system in place capable of tracking the information to respond to the auditor's request? If not, could a system feasibly be created?**

It is unlikely that engaged specialists (other than those employed by another audit firm) would have a system in place to track this information. It may not be feasible or cost-effective for the consulting firm to build one.

- 40. For accounting firms that use the work of an auditor's or a company's specialist for public company audits:**

- a. In how many (e.g., what percentage) of those audits is the work of specialists used? Provide details within the following categories:**

- i. Auditor's employed specialists;**
- ii. Auditor's engaged specialists;**
- iii. Company's employed specialists; and**
- iv. Company's engaged specialists.**

We do not have a response to this question at this time.

- b. For the auditor's specialists described in a.(i) and a.(ii), what is the ratio of specialist hours to total audit hours?**

The ratio of hours of a specialist to those of the total audit varies.

- c. How are the auditor's engaged specialists compensated?**

Compensation for engaged specialists can either be on a fixed fee or on a rate per hour, depending on the arrangement.

- 41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?**

We do not have a response to this question at this time.

42. To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies, and fraud?

Overall, we believe that it is more important to ensure that existing standards are applied rather than adding additional standards.

43. Would any of the potential alternatives lead to increased cost? If so, what are the estimated (i) number of audits affected and impact on audit hours and cost and (ii) effects on companies' costs?

We do not have a response to this question at this time.

44. Do the incremental costs associated with any of the potential alternatives decline as an accounting firm uses specialists more frequently?

We do not have a response to this question at this time.

45. Are the costs of the potential alternatives likely to be reduced in years after the year of initial implementation?

After the initial education of auditors on the new rules, it is possible there would be additional costs, but we do not believe they would be appreciable.

46. Are the economic impacts of the potential alternatives likely to be different for audits involving (i) emerging growth companies, (ii) brokers and dealers, (iii) companies in specialized industries, (iv) companies in certain stages of their life cycles (e.g., development stage), and (v) the use of the work of specialists in specific fields of expertise? If so, provide relevant details.

We do not have a response to this question at this time.

47. Are the economic impacts of the potential alternatives likely to affect accounting firms of different sizes differently? If so, provide relevant details. Are there other alternatives that might address the need for improvement noted in this staff consultation paper at lower cost or greater efficiency?

Smaller audit firms tend to rely on engaged specialists to a greater extent than employed specialists. However, smaller audit firms also tend to have clients that require fewer special needs. Most entities are audited by large audit firms that typically employ specialists.

48. As part of considering the need for change, the staff is analyzing academic literature that relates to the auditor’s use of the work of a specialist. Is there ongoing research or other information, other than that identified in this staff consultation paper, that the staff should consider in evaluating the economic aspects of changes in standards for the auditor’s use of the work of a specialist?

PCAOB staff should be familiar with ASOP No. 21, [Responding to or Assisting Auditors or Examiners in Connection with Financial Statements for All Practice Areas](#).¹⁰

Thank you for the opportunity to provide feedback to the PCAOB Staff Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy’s senior policy analyst for risk management and financial reporting, at 202-223-8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
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¹⁰ Actuarial Standards Board, 2011, <http://www.actuarialstandardsboard.org/asops/responding-assisting-auditors-examiners-connection-financial-statements-practice-areas/>

July 30, 2015

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street NW
Washington DC 2006-2803

Via email to: comments@pcaobus.org

Dear PCAOB Staff:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on Staff Consultation Paper No. 2015-01 *The Auditors' Use of the Work of Specialist*.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist your office. If you have any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association

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In our response we first address some of the specific questions posed in Staff Consultation Paper No. 2015-01 (hereafter, the Staff Consultation Paper). Our response to the selected questions are focused primarily on auditors' use of valuation specialists. We close with general comments to the PCAOB (hereafter, the Board) related to the use of the work of specialists (focused primarily on IT specialists) in auditing. Our comments are largely based on findings from the related literature and our knowledge of best practices.

Responses to Specific Questions

Question 1: Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?

In PCAOB Staff Consultation Paper No. 2015-01 (hereafter, the Staff Consultation Paper), the Board references the findings of recent interview-based academic studies regarding auditors' use of specialists. We wish to make the Board aware of the following concurrent studies that can provide additional insights regarding current practice and potential areas in which auditors could use more clarification and guidance. This list is not intended to be all-inclusive, but the Committee believes the Board would find the following qualitative studies focused on highly experienced auditors' use of specialists to be informative: Bauer and Estep (2015a); Bauer and Estep (2015b); Cannon and Bedard (2015); and Glover, Taylor, and Wu (2015a). In addition, the Board might find that Griffith (2015a), an experimental study on auditors' use the work of specialists, can yield insights about current practice. In the remainder of this comment letter, where relevant, the Committee cites findings from these studies in our response to specific questions.

Question 2: Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?

Following the implementation of ISA 620, the IAASB completed a post-implementation review (see IFAC 2009). The Staff Consultation Paper page 17 lists the IAASB's findings on the challenges auditors encounter when using the work of specialists. The Committee does not believe these issues noted by the IAASB are unique to accounting firms that have incorporated the standards of either the IAASB or the ASB. Recent field-based survey and interview studies, (e.g., Bauer and Estep 2015a; Glover et al. 2015a; Griffith 2015b) suggest that the same issues are present on audits that are conducted in accordance with PCAOB auditing standards.

As the Committee discusses in more detail in Question 9 below, some of the challenges auditors encounter when using the work of specialists might be mitigated with additional clarification to existing auditing standards. We recognize, however, that clarification alone is unlikely to mitigate all of the issues noted in The Staff Consultation Paper, as several experimental studies have documented that training and other practice interventions are also necessary to improve auditors' execution of complex tasks.

Question 3a: For accounting firms that use the work of an auditor's specialist: Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit.

Recent academic research based on interviews and surveys of experienced auditors find that accounting firms employ and engage valuation specialists to assist in the audits of fair value measurements (hereafter FVMs) (e.g., Cannon and Bedard 2015; Glover et al. 2015a; Griffith 2015b). Both Cannon and Bedard (2015) and Griffith (2015b) find that audit teams largely use specialists employed by the accounting firms as opposed to engaging third-party specialists to assist with audits of FVMs. Further, Glover et al. (2015a) find that there is an even greater tendency to use the accounting firm's employed specialists when the focus of the audit is a nonfinancial fair value (hereafter FV) asset compared to when the focus of the audit is a financial instrument. In terms of the decision to employ vs. engage a valuation specialist, research suggests that this decision is made at both the firm level and engagement team level. Audit partners in the Glover et al. (2015a) study indicated the factors impacting the employed vs. engaged specialist decision include: (1) the firm's available resources, cost, expertise, and efficiency, (2) the nature of the FVMs being audited, and (3) firm policies.

Current studies examining auditors' use of specialists are focused primarily on employed specialists (e.g., Boritz, Robinson, Wong, and Kochetova-Kozloski 2015; Cannon and Bedard 2015; Glover et al. 2015a; Griffith 2015b). Consistent with current audit standards allowing for accounting firm and/or engagement team discretion on whether and when to involve specialists on audit engagements, these studies find that specialists are involved at various stages of the audit (e.g., planning, risk assessment, fieldwork, and/or wrap-up). Further, the studies report that how the audit teams use specialists differ significantly depending on the engagement, and/or type of specialist (i.e., IT, valuation, tax, etc.) in question (See Bauer and Estep 2015a; Boritz et al. 2015). The existing research observes that there is inadequate authoritative guidance for auditors regarding the extent and timing of the use of specialists during the audit. As a result, accounting firms compensate for the lack of clarity in authoritative guidance by developing and relying on their own internal guidance on the nature, timing, and extent of the use of specialists (e.g., Glover et al. 2015a; Griffith 2015b). In its role as inspector, the Board has access to observe and evaluate the various approaches being adopted by the regulated accounting firms. The Committee encourages the Board to use this access to evaluate the various approaches being used by the firms, the extent to which there is commonality in accounting firm guidance/approach, and the effectiveness of firm guidance currently being utilized by the regulated firms. The Board can then to assess whether revisions or enhancements to current standards are warranted.

Question 7: This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?

Prior PCAOB Inspection reports suggest that auditors inappropriately rely on employed specialists' recommendations (PCAOB 2012a, 2012b 2014b). These perceived audit deficiencies have prompted firms to improve quality control procedures related to the use of specialists. In the absence of specific authoritative guidance from regulators, however, firms appear to be relying on precedents such as prior Board Inspection Reports to develop corrective action plans. In addition, while prior archival research suggests that regulatory discipline helps to mitigate aggressive reporting of complex estimates by preparers (e.g., Van de Poel, Maijoor, and Vanstraelen 2009; Vyas 2011), there is a paucity of research related to the effect of regulatory discipline on auditors' incentives when evaluating those estimates (Bratten, Gaynor, McDaniel, Montague, and Sierra 2013).

The Committee concurs with the view that the existing PCAOB standards related to the use of specialists should be improved. One area that we believe requires consideration is auditors' use of other third-party sources such as pricing services but the Staff Consultation Paper specifically excludes third-party pricing services in its definition of an "auditor's specialists." The Staff Consultation Paper (page 34) notes that the primary factor determining whether a third-party is considered a specialist is "whether the third-party is performing work to assist the auditor in obtaining sufficient, appropriate audit evidence, as opposed to providing information that is routinely and commercially available for a fee." However, we believe this thinking is too narrow. As the Board itself has observed, pricing services provide FV estimates that are both widely-applicable and that are customized (e.g., based on their internal proprietary valuation methodology) (PCAOB 2014a, 45).

In situations where a pricing service uses its own valuation methodology to assist auditors in evaluating the client's FV estimate, auditors essentially obtain similar audit evidence as when they use valuation specialists that are currently covered by AU 336. Thus, we believe that when a pricing service provides customized services using proprietary models, auditors should obtain an understanding of the methods and assumptions used by the pricing service as they would when using any other engaged valuation specialist (AU 336, ¶12). The Committee also notes that auditors' use of pricing services is frequently cited as a source of deficiencies in PCAOB inspection reports. These Inspection Reports tend to indirectly reference the audit requirements described in AU 336 in their justification for these observed deficiencies (see e.g., PCAOB 2011 4-7, 10, 15; PCAOB 2012a, 17-19)¹.

On the one hand, positive implications for audit efficiency arise from reliance on pricing services professionals who, like auditors, accumulate broad experience through exposures to various industries, financial instruments, and financial statement preparers. On the other hand, potential negative implications arise when preparers and auditors depend on either the same pricing service or when two independent pricing services have similar methodologies.

¹ While the inspection reports do not explicitly cite AU 336 as support for the noted deficiencies, the language on various pages of the reports is similar to the requirements of auditors set forth in this standard.

This likely creates a situation where there is a high correlation between both party's estimates, and auditors end up providing effectively a "rubber stamping" of the preparer's estimate (King 2006; PCAOB 2011; Bratten et al. 2013). Based on the above observations, the Committee recommends that the Board consider including third-party pricing services when revising standards related to use of the work of specialists. Alternatively, the Board can offer additional guidance related to use of pricing services in its revisions to the Estimates and Fair Value standards. The Committee also recommends that the Board consider clarifying when the use of pricing services requires auditors to conform with AU 336 and the recommended audit procedures in other circumstances when AU 336 does not apply.

Question 8: When an auditor obtains an understanding of the methods used by the company's specialist:

- a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?
- b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

According to AU-C Section 540, the objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable and b) related disclosures in the financial statements are adequate.

Management's use of third-party valuation specialists, especially those that utilize proprietary models, can make the audit process more difficult, given the lack of an audit trail, the underlying task complexity, and the estimation uncertainty factors related to the FVMs. PCAOB inspection reports identify a number of deficiencies related to the auditors' reliance on evidence from valuation specialists, including failure to understand the methods, the models, and the assumptions used (PCAOB, 2010b; PCAOB 2011; PCAOB 2012a; PCAOB 2012b).

Consistent with the Board's inspection findings, Cannon and Bedard (2015) report that FVMs are difficult to audit because of the "number of significant and/or complex assumptions associated with the process and the high degree of subjectivity associated with the assumptions and factors used in the process." In their survey, participants responded frequently that lack of available data to independently evaluate the client's FVM was a concern, and described company engaged specialists who did not provide sufficient detail for the inputs and assumptions used in the valuation measure. Griffith, Hammersley, and Kadous (2014) report that auditors evaluate the reasonableness of estimates by testing related internal controls, testing and evaluating the underlying data, and re-performing management's calculations. The Committee, however, does not believe such an audit approach would provide "sufficient appropriate audit evidence." We believe that lack of access to the specialist's methods (or models) inhibits the auditor's ability to obtain sufficient appropriate audit evidence. For example, because the ultimate FV estimate is entirely dependent on the valuation model selected, and the subjective inputs and assumptions underlying the model, when auditors do not have access to these

measurement inputs they cannot appropriately evaluate the reasonableness of the balance reported in the financial statements.

Christensen, Glover, and Wood (2012) find that FV estimates reported by public companies that are based on subjective models and inputs can contain estimation uncertainty or imprecision that can be many times greater than materiality. Their findings underscore the importance of auditors' having access to the models and methods used by specialists to determine FV estimates. However, access is not sufficient because recent research finds that many in-charge level auditors lack understanding of the measurement assumptions and inputs that underlie valuation models and methods (e.g., Griffith et al. 2014; Glover et al. 2015a; Brown et al. 2015). Similarly, Glover et al. (2015b) indicate that audit partners also question the audibility of estimates with extreme measurement uncertainty and Christensen et al (2012) argue that "no amount of auditing can remove the extreme uncertainty inherent in reported values derived from management's valuation models based on unobservable inputs subject to estimation uncertainty" (page 143).

The Committee believes that conveying to financial statement users that there is a high level of measurement uncertainty and lack of auditor and management access to the methods used to calculate the FV estimate might be the best approach. The Board might want to consider providing guidance to auditors on how to convey to financial statement users that they have relied on specialists but were unable to evaluate certain aspects of the specialists' work when the balance under consideration is material. Further, the Board might want to consider cooperation with the Securities and Exchange Commission to provide guidelines to filers on how to report the high level of uncertainty surrounding FVMs and the filers' reliance on models for which they do not have access.

Question 9: Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

The Staff Consultation Paper lists possible alternatives that include: (1) practice alerts that provide additional staff guidance and (2) devote additional resources to inspections and enforcement of existing standards. The Committee is in agreement with the Board that "these alternatives would not solve the underlying issues with the standards" (p. 26). Importantly, the Committee notes that research suggests that these alternatives might not be the most effective way to address the challenges auditors encounter when using the work of specialists. With respect to the first alternative (using practice alerts), Joe, Vandervelde, and Wu (2015) examine the effectiveness of a regulatory alert on (1) auditors' tendency to inappropriately allow the degree of quantification in the company specialist's report to influence auditors' planned substantive testing, and (2) overall audit effort designated to test the company's FVMs. They find that while the practice alert increased auditors' overall planned audit hours allocated to testing the FV estimate, it did not mitigate the underlying issue they had identified - auditors' tendency to allow the degree of quantification in the specialist's report to influence the nature of planned substantive testing. Joe et al.'s (2015) results suggest that while practice alerts can have a "work harder effect," they are not an efficient or effective way to mitigate audit deficiencies that are rooted in cognitive tendencies or have other systematic root causes. Instead, prior research

suggests that restructuring the audit task can be a more effective alternative to influence how auditors perform on an audit task (e.g., Earley, Hoffman, and Joe 2008).

Regarding the second alternative (increased inspection activity), recent commentary and academic research also suggests that this alternative might not be effective because the level of scrutiny associated with the regulatory inspection environment can have unintended consequences for audit quality (e.g., Peecher, Solomon, and Trottman 2013; Glover, Taylor, and Wu 2015b). Using a survey of practicing audit partners and national-level partners, Glover et al. (2015b) find that audit partners report instances where audit strategies are driven by “inspection risk” instead of by audit risk. Such a strategy is problematic in instances where inspection risk and audit risk are not sufficiently correlated because focus on inspection risk is likely lead auditors to devote less attention to areas that have a truly higher audit risk. Both Glover et al. (2015b) and Griffith et al. (2014) find that experienced auditors expressed concerns that changes in practice are often being driven by the inspection process instead of appropriately through changes to existing auditing standards.

The Committee believes that revision to PCAOB standards is the more fruitful avenue to address challenges auditors encounter when using the work of specialists, and, in part, addresses practitioners’ concerns. The Committee, however, would like the Board to pay close attention to how it revises the standards because Maksymov, Nelson, and Kinney (2014) provide evidence that how audit procedures are framed (positive or negative) in auditing standards or firm guidance can unknowingly influence auditors’ planning judgments. Specifically, when audit procedures are presented in the negative frame, auditors budgeted more hours than when presented in the positive frame, particularly so for the audit procedures which auditors perceived to be less verifiable.

Lastly, authoritative guidance is unlikely to cover all possible situations that auditors encounter in practice, particularly in areas of greater complexity and uncertainty (e.g., Salterio 1996). Results of recent studies suggest that firms have developed internal guidance regarding use of specialists when clear authoritative guidance is not available (e.g., Glover et al. 2015a; Griffith 2015b). Moreover, prior research suggests that firm guidance, including precedents (i.e., prior examples of similar situations) provided by the national office, can affect auditors’ judgments in the absence of authoritative guidance (Salterio 1996; Salterio and Koonce 1997). Therefore, the Board might want to consider ways that it can encourage and support improved firm guidance and effective consultation processes as another alternative to mitigate some of the issues auditors encounter when using the work of specialists.

Question 10: Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

Academic research finds that auditors typically use valuation specialists employed by their firm as opposed to engaging the services of third-party specialists (Canon and Bedard 2015; Griffith 2015b). The Staff Consultation Paper (page 29) highlights a concern that an engaged specialist is different from an employed specialist (e.g., an engaged specialist would not be subject to the “accounting firm’s training, resources, and QC system”). However, even though employed specialists might be subject to similar quality control training and resources as auditors,

research finds that specialists are unfamiliar with auditing requirements and documentation standards (Griffith 2015b). This finding suggests that valuation specialists employed by accounting firms might not be significantly different from engaged specialists. Further, in contrast to auditors, valuation specialists are specifically trained to view fair values in a market and economic context (Griffith 2015b), which can lead employed and engaged specialists to be more similar than different in their approach to valuations.

While employed specialists might face different incentives from engaged specialists, which, might motivate increased effort in order to establish reputational capital within the firm, the Committee recommends that auditors perform similar supervisory procedures as outlined in Auditing Standard No. 10 (PCAOB 2010a) when using the work of an engaged specialist as when using the work of an employed specialist. Ensuring that specialists are aware of their responsibilities and the scope of the work to be performed, and reviewing specialists' work to ensure it was adequately performed and documented should be aspects of the audit that are consistently applied regardless of whether the specialist is employed or engaged.

Question 13: Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

The specialist's independence with regard to the client can be a factor that limits the auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist. PCAOB Release 2007-010 highlights instances where auditors used the services of specialists who had a relationship with the issuer that might have had an effect on the specialist's objectivity (PCAOB 2007b). Whereas the PCAOB has outlined general independence guidance for the use of employed specialists on the audit (AU Section 336), there is a paucity of such guidelines as it pertains to engaged specialists. In AU Section 336, footnote 2 suggests that auditors should consider the "effect...that using the work of a specialist employed by the auditor's firm has on independence." Auditors are likely to have greater access to information about employed specialists' relationships with the client to make an independence determination. However, such information related to engaged specialists might not be as accessible by the auditor and might be based more on self-reports with varying degrees of verifiability.

Question 14: Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

Similar to a company's specialist, a company's internal audit function is employed by the company to perform services that typically have an impact on the company's financial statements. Company specialists, whether employed or engaged by the company, use discretion and judgment to interpret and develop complex and subjective estimates that can have a material impact on the company's financial statements (Canon and Bedard 2015; Griffith 2015b). PCAOB auditing guidelines in AU 322 (The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements) require auditors to evaluate the competence and objectivity (quality) of the company's internal audit function before auditors rely on the work of or coordinate work with the internal auditors. Therefore, in the same way that it is appropriate

for auditors to consider the competence and objectivity of a company's internal audit function when determining the quality of the internal auditor's work product for reliance decisions, so too would it be appropriate for auditors to consider these factors when evaluating the reliability of information provided by a company specialist.

Auditing regulations permit auditors to "use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons" (PCAOB 2007a). Using the work of others has benefits to the financial statement audit process. Academic research finds that when auditors are able to use the work of internal auditors, there are audit efficiencies and reduced audit delays (e.g., Pizzini, Lin, and Ziegenfuss 2014), improved financial reporting and audit quality (Asare, Davidson, and Gramling 2008), and greater identification of internal control deficiencies (Lin, Pizzini, Vargus, and Bardhan 2011). The proposed alternative No. 1 for revising AU sec 336 in The Staff Consultation Paper (30; Amend the Requirements of AU sec. 336 for Evaluating the Work of a Company's Specialist), would remove provisions that "may be considered to limit the auditor's responsibilities to evaluate the work of a company specialist." For example, removing language that states that the "appropriateness and reasonableness of methods and assumptions and their application are the responsibility of the [company] specialist..."

By adopting this alternative, the Committee believes that the standard would allow for a more consistent evaluation of information produced by the company and its agents (e.g., internal auditors, company specialists). Therefore, similar to auditors' evaluation of the company's internal auditors, auditors should perform an evaluation of the company's specialist and the specialist's work. Performing such an evaluation would allow auditors to evaluate the reasonableness of significant assumptions and methods used by the company's specialist in a manner that is consistent with how auditors evaluate the work of others in the company. In this way, the proposed alternative can provide a more effective and streamlined process for the auditor's evaluation of the work produced by company specialists and others in the company.

Question 15: How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

Recent academic research provides important insights on current practice (Glover et al. 2015a; Griffith 2015b). Glover et al. (2015a) survey audit partners with significant experience auditing FVMs and find that the three most frequently mentioned approaches reported by audit partners are (1) to obtain audit evidence for the data used in the model from internal and external sources, (2) to involve specialists employed by the accounting firm to evaluate the appropriateness of assumptions, and (3) to gain an understanding of key assumptions with assistance from specialists employed by the accounting firm. One observation is that auditors' evaluation of significant assumptions can vary, for example the audit team evaluates some assumptions while others require assistance from the accounting firm's specialist. For instance, the reasonableness of assumptions related to the company's activities and or operations are typically tested by the audit team, while assistance from the accounting firm's employed specialists are needed for other assumptions, such as WACC (weighted average cost of capital), discount rates and other direct valuation inputs. Similarly, Griffith (2015b) reports that audit

partners and managers generally permit specialists to evaluate assumptions that require more valuation knowledge and expertise (e.g., discount rate, risk premiums, and industry conditions).

AU sec. 336 states that “the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist” (PCAOB 2003, ¶12), which would seem to suggest that all assumptions are the responsibility of the specialist (Griffith 2015b). However, research suggests that, in practice, the audit teams often assume the responsibility of evaluating the reasonableness of some assumptions (Glover et al. 2015a; Griffith 2015b). The Committee recommends that the new standard provide additional guidance regarding the division of responsibility between audit team and its specialists when evaluating the appropriateness and reasonableness of assumptions and methods used by a specialist under AU sec 336. Further, the new standard could clarify auditors’ responsibility to test assumptions that have already been evaluated by specialists employed by the accounting firm.

Question 16: Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

Extant research suggests that management can “opinion shop” for specialist reports in order to obtain management’s preferred estimate (Salzsieder 2015). Under such circumstances, estimates prepared by the company’s employed or engaged specialist can be susceptible to management bias, consequently such audit evidence from a company’s specialist should not be treated any differently than information provided by company management. In addition, research finds that in some cases, accounting professionals are likely to side with management preferences when making subjective accounting evaluations (Hackenbrack and Nelson 1996), and can be more lenient when making subjective judgments (Bamber and Iyer 2007). Moreover, Joe et al. (2015) find that the degree of quantification in the company’s specialist report, particularly in a high client risk scenario, unknowingly and inappropriately influenced auditors’ planned substantive testing in terms of the nature and extent of audit procedures to test the subjective inputs of management’s estimate. Their results suggest that auditors might not be considering the client’s or the company engaged specialist’s motivation/incentives when they decide, which, and how much information to provide to the auditor in the specialist’s report.

Further, the PCAOB inspection reports note numerous instances where auditors placed too much reliance on the work of the company’s specialists when auditing FVMs (e.g., PCAOB 2010b; PCAOB 2012b; PCAOB 2014b). One potential source of over reliance on companies’ specialists might be due to auditors’ lack of the requisite knowledge and expertise to understand complex business processes, transactions, and valuation methods (e.g., Boritz et al. 2015; Bratten et al. 2013; Martin, Rich, and Wilks 2006; Smith-Lacroix, Durocher, and Gendron 2012). Pyzoha, Taylor, and Wu’s (2015) recent experimental study suggest that the tendency to over rely on a company’s specialist can exacerbate confirmatory bias in auditors’ thinking, which makes the auditors less likely to incorporate contradictory evidence that is readily available. They find that it is more difficult to mitigate the auditors’ tendency to engage in confirmatory thinking when the client engages a third-party specialist. Based on the extant

academic research, the Committee believes that audit evidence provided by a company's specialist should be treated the same as other information provided by the company and be subjected to the same standard of testing.

Question 19: Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

We believe the use of the terms auditor's employed, auditor's engaged, company's employed, and company's engaged specialist are appropriate ways to distinguish the various types of specialists, the work they performed, and their affiliation. The Board should also note that many accounting firms and some academic studies (e.g., Joe et al. 2015; Glover et al 2015a) use the term in-house specialists as an alternative to auditor employed specialist and some academic studies (e.g. Brown-Liburd et al. 2015) use the term management-hired specialists as an alternative to client engaged specialist. Griffith 2015b uses the term internal valuation specialist to refer accounting firm specialists who have fair value expertise.

Question 20: Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

The Committee agrees that there is a need to update the definition of a specialist from AU sec. 336 to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing. A recent release from the PCAOB, motivated by the number of audit deficiencies related to Internal Controls Over Financial Reporting (ICFR), specifically cited inappropriate reliance on IT due to lack of communication between financial and IT auditors as a root cause of these deficiencies (PCAOB 2012a).

Between 1990 and 2005, the number of computer assurance specialists (also referred to as IT specialists and IT auditors) employed by each Big 4 accounting firm increased from 100 to 5,000 (Brazel and Agoglia 2007). Janvrin, Bierstaker, and Lowe (2009) report that use of IT specialists by audit engagement teams varies greatly dependent on firm size and client complexity. Specifically, Big 4 firms use IT specialists at a higher frequency than national or regional firms (90.9 percent vs. 27.6 percent and 38.5 percent, respectively). Despite this growth in usage of IT specialists, IT auditors, while possessing sufficient technical and IT-focused education, often have an insufficient background in accounting. There is also a general lack of audit training or knowledge for IT specialists (Brazel and Agoglia 2007). Further, both financial and IT auditors have expressed concern over the current lack of mutual understanding when working together (Bauer and Estep, 2015a).

Financial auditors also likely lack sufficient knowledge and expertise in IT-related domains. For example, Brazel and Agoglia (2007) find that financial auditors with lower levels of self-perceived IT expertise rate client control risk lower than financial auditor who had higher levels of self-perceived IT expertise. Wolfe, Mauldin, and Diaz (2009) find that financial auditors are susceptible to management persuasion tactics for IT control deviations, but not manual control

deviations. It is reasonable to expect that because of their IT expertise, IT auditors are likely to be less susceptible to this effect (Shelton 1999; Selby 2010).

The Committee engaged in discussions with practitioners and observed that many auditors consider Tax and IT professionals to be specialists and that often they are not considered to be members of the audit team. Based on the literature and discussions with auditors the Committee believes that the definition of specialists should be expanded to include other professionals employed by the accounting firms to assist auditors in the evaluation of their client's balances and procedures.

Question 21: Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

A survey of the accounting literature suggests there is ambiguity about what constitutes a specialized area of accounting and auditing. Accounting firms mostly organize the audit practice according to industry lines and the benefits of such organization are well documented in recent academic literature (e.g., Gramling and Stone 2001, Reichelt and Wang 2010). Solomon et al. (1999) define industry specialists as auditors whose training and practice experience is mainly within a particular industry and find that industry-specialist auditors have greater specialized knowledge of financial statement errors for the industry of their specialization. In addition, there are accounting specialists in larger accounting firms who act as advisors and consultants to auditors and who focus on technical accounting and auditing issues (Griffith 2015b; Salterio 1996; Salterio and Denham 1997). More recent literature on specialists used in the audit process defines specialists as non-audit professionals who provide specialized consulting services to the audit team e.g., IT, tax, forensics, valuation (Boritz et al. 2015; Bauer and Estep 2015a; Griffith 2015b). These studies suggest that auditors consider these non-financial statement auditors to be subject matter experts.

In addition, these subject matter experts (e.g., forensics, valuation) often perform some auditing procedures when engaged by the financial statement audit team (e.g., Griffith 2015b) that further adds to the ambiguity of the definition and classification of "specialists" relative to the audit. This implied definition of "specialists" in practice, as portrayed by the literature, appears inconsistent with the way that specialists are defined in The Staff Consultation Paper. The Staff Consultation Paper (page 34) defines a specialist as "a person with specialized knowledge or skill in a field of expertise other than accounting or auditing" and further clarifies that since "income taxes and information technology, as they relate to the audit, are specialized areas of accounting and auditing, this definition does not apply to a person with specialized knowledge or skill in those areas." Based on the prior literature's report of current practice, it is not clear what constitutes a specialist, a specialized area of accounting and auditing, or when a third party falls within the scope of the definition of an auditor's specialist. Therefore, the Committee suggests that the Board consider providing clarification of these definitions.

Question 22: Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

The Committee believes there should be more specific guidance for evaluating the knowledge and skill of an auditor's specialist (whether engaged or employed). Recent PCAOB Inspection reports claim that auditors inappropriately rely on to specialists' recommendations or accept them with limited or no testing (PCAOB 2012a, b). A recent study, Boritz et al. (2015), also reports that while almost all auditors assess the competence of engaged specialists few assess the competence of employed specialists. Boritz et al. (2015) also report that specialists believe auditors are not qualified to evaluate the specialist's competence beyond a low-level assessment of the specialist's academic training, years of experience, and professional certifications (Boritz et al. 2015).

The Committee, therefore, recommends enhancing the authoritative guidance to include minimum assessment and documentation guidelines to guide auditor's evaluation of the specialist's qualifications. Boritz et al (2015) reports that many firms believe they have improved their internal policies related to the use of specialists in response to the PCAOB inspection reports citing audit deficiencies in quality control procedures related to the use of specialists. However, absent specific authoritative guidance from regulators, firms must rely on subsequent Inspection Reports to intuit whether or not their improvements meet the standards as interpreted by the Board².

The Committee further believes that AU 322, which regulates the use of the work of internal auditors, is a similar standard to AU336, and more clearly communicates 1) how the auditor should evaluate competence (including professional qualifications) (paragraph .09), objectivity (paragraph .10), prior experience with the Internal Audit Function (IAF; paragraphs .04, .05, .07), the effectiveness of the work provided by the IAF (paragraphs .24 - .26) and coordination of the audit work (paragraph .23). We also believe that the prior literature examining how auditors evaluate and rely on their client's in-house (i.e. employed) internal auditors versus out-sourced internal auditors can offer insights on how company employed vs. company engaged specialists might be evaluated and perceived. For example, Bame-Aldred, Brandon, Messier, Rittenberg, and Stefaniak (2013) find that the nature and extent of reliance on the IAF is influenced many factors such as account risk, inherent risk, and whether or not the IAF is outsourced, and other research finds that auditors rely more on outsourced internal auditors because they consider them to be more objective and independent (e.g., Ahlawat and Lowe 2004; Glover, Prawitt, and Wood 2008).

² We also discuss changes in audit firm internal guidance related to the use of specialists in Question 3A and PCAOB Inspection related issues in Question 7 of this Comment Letter

Question 23: Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

Prior research reports that auditors and specialists often have conflicting views about the nature, extent, and timing of the work to be performed by the specialists (Boritz et al 2015). Academic research cited in The Staff Consultation Paper (Griffith 2015a) and further discussed in Question 30 of this Comment Letter, and the audit deficiencies noted in prior PCAOB Inspection Reports (2012 a, b) support the PCAOB's recommendation that auditors sufficiently document the agreed upon procedures specialists will perform and the documentation they will provide. Whereas, AS No. 10 relates to engagement team members in general, we suggest that the PCAOB: 1) establish a separate standard that addresses the points in Section VII Paragraph A2 and other factors discussed in this comment letter and 2) ensure that specific guidance is provided for employed vs. engaged specialists. As we indicate in our responses to other questions in this Comment letter, enhancements to audit firm guidance is also another way to mitigate issues auditors encounter, which are beyond the scope of authoritative guidance (Salterio 1996; Salterio and Koonce 1997; Glover et al. 2015a; Griffith 2015b). The Committee believes these recommendations could also address perceived expectation gaps between PCAOB inspections and audit performance as it relates to audits of complex estimates (Glover et al. 2015b).

Question 25: Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?

There is no precedent in the literature to support the view that the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions would result in unintended consequences. We believe that establishing a written agreement of responsibilities such as those referred to on pages 37 and 38 of the Staff Consultation Paper will be helpful in mitigating the risks of such unintended consequences. Further, recent studies (e.g., Bauer and Estep 2015a; Boritz et al. 2015) indicate there is a lack of communication and shared understanding between auditors and specialists. Therefore, documenting the potential requirements might serve to improve understanding and communication between auditors and the engaged specialists.

Question 30: Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?

The Committee agrees with the need to improve Auditing Standard No. 10 (Para. 5.c). Specifically, page 41 of The Staff Consultation Paper provides "the potential requirements for evaluating the results and conclusions of the specialist are intended to address issues related to the failure of the auditor to consider contradictory evidence or to resolve discrepancies, differences, or other concerns that the specialist identified." This observation is consistent with prior PCAOB Inspection findings that auditors inappropriately rely on or accept unquestioningly the employed specialists' recommendations (PCAOB 2012a, b). A recent

experimental study, Griffith (2015a), finds that if specialists provide a caveat in their report auditors will be more likely to question management's biased estimate when management is perceived to have low source credibility. However, when auditors perceive management has higher source credibility they discount the caveat and judge a biased estimate to be more reasonable. These findings illustrate that while caveats or other features in specialist's reports can improve audit judgment on complex estimates, other trait and environmental factors in auditing must also be considered. The Committee recommends that revisions to the standard include additional guidance regarding not only how auditors evaluate the competence and independence of, and the appropriateness of, conclusions provided by specialists, but also consider how auditor's cognitive processing and auditor-client relationships can impact the way specialists reports are used and relied upon.

Question 31: Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

The Committee believes certain aspects of the potential requirements discussed in The Staff Consultation Paper apply broadly to all types of specialists used in audits. Current field-based accounting studies that examine the use of non-valuation specialists (e.g., tax and IT) suggest the ways audit teams use specialists can differ significantly by engagements and/or type of specialists (i.e., IT, tax) (Bauer and Estep 2015a; Boritz et al. 2015). These studies focus on non-valuation specialists and observe similar gaps in expectations between auditors and employed specialists as those observed in other field-based studies also focused on valuation specialists (e.g., Cannon and Bedard 2015; Glover et al. 2015a; Griffith 2015b). Consequently, we believe that Section VII A related to the evaluation of specialists' skills and knowledge (§1), informing specialists of their responsibilities (§2), and evaluating the work of specialists (§3) could apply to any type of specialist. Enhancements to internal firm guidance on an on-going basis, as previously described, is also another alternative to expanded regulatory intervention, and can also limit any unintended consequences that might arise from increased regulatory requirements (Salterio 1996; Salterio and Koonce 1997; Glover et al. 2015a; Griffith 2015b).

Question 34: Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

The Committee believes that the provisions of Rule 2-01 should apply only if the auditor's engaged specialist were to be considered a member of the audit team. Considering that engaged specialists are not audit team members, we believe that complying with the requirements of Rule 2-01 runs the risk of being too costly for the engaged specialist firms (and their employees) who might have a small direct financial interest in the auditor's client. In many instances auditors use engaged specialists for a finite amount of time (e.g., two weeks or less). Thus, it is likely that the engaged specialist's firm (and its employees) will perceive the requirement to divest of any direct financial interests in order to comply with Rule 2-01 to be too high a cost of business for such limited engagements. As a result, auditors' ability to obtain qualified and available engaged specialists might become constrained. Consequently, we believe that auditors should exercise professional judgment when retaining engagement specialists and only bear responsibility for

engaging specialists who can provide objective audit evidence. Auditors should also exercise professional skepticism when using the work of engaged specialists and determine audit procedures necessary to evaluate the objectivity and reliability of audit evidence obtained from these specialists.

Question 39a: For accounting firms that use the work of an auditor's or a company's specialist for public company audits: In how many (e.g., what percentage) of those audits is the work of specialists used? Provide details within the following categories:

- i. Auditor's employed specialists;
- ii. Auditor's engaged specialists;
- iii. Company's employed specialists; and
- iv. Company's engaged specialists.

According to Cannon and Bedard (2014), auditors use valuation specialists more frequently than clients, and a key factor driving the auditor's use of a specialist is whether or not the client employs a specialist. Approximately 84% of audit teams consult with an employed valuation specialist. In contrast, about 60% of audit clients consult an engaged specialist. When the client has a specialist, the auditor also uses a specialist 96.6% of the time, versus only 65% of the time when the client does not employ a specialist. For audit engagements using valuation specialists, auditors use audit firm employed specialists 99% of the time and engage specialists only 5.1 percent of the time. This finding suggests auditors might be also using a combination of employed and engaged specialists. Clients predominately (91.5% of the time) use company-engaged specialists (e.g., third-party providers). Research also indicates (i.e., Griffith 2015a) that there are differences in whether auditors use employed vs. engaged specialists (or a combination of the two) between Big4 vs. non-Big4 firms because of differences in resource availability.

Current qualitative studies observe that auditors consider factors such as the features of the account being audited, client, specialist, and audit team when determining whether or not to use a specialist. Boritz et al.'s (2015) participants report that over 50% of audits require the use of at least one type of specialist while Griffith's (2015b) participants report that over 60% of audits require the use of valuation specialists. Specialists can be engaged at various stages of the audit (e.g., client acceptance, risk assessment) (Selley 1999). In addition, 1) both auditors and valuation specialists expect the use of specialists to continue due to expansion of assets and liabilities which require disclosure of fair value estimates (PCAOB 2009) and 2) auditors expect an increased focus on better integration of the specialists into the audit team (Boritz et al. 2015). Auditors primarily use employed specialists (e.g., Cannon and Bedard 2015; Glover et al. 2015a; Griffith et al. 2014).

General Comment to the Board on the Need to Broaden the Definition of Specialists to Include IT Audit, Taxation, and Healthcare Specialists

Increasingly, businesses demand integration of digital technologies (e.g., social, mobile, analytics, cloud) into business models and evaluation of the impact digital business transactions on financial reporting and the integrated audit. While information technology (IT) paves the way toward digital businesses, it also creates complexity that can contribute to increased financial misstatement risk and audit risk. Considering this growth in digital technology in business

transactions and auditors' reliance on IT specialists, AU 336 (Footnote 1) appears out of step when it states: "because income taxes and information technology are specialized areas of accounting and auditing, this section does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Auditing Standard No. 10, Supervision of the Audit Engagement, applies in those situations."

Currently, cyber hacking and security breaches of critical information systems are a harsh reality for companies with highly computerized systems (e.g., Sony, Target, Morgan Chase, Home Depot, Quicken).³ For such companies, auditors must assess IT risks and evaluate the IT controls in place at their client's to ensure the integrity, quality, and reliability of financial statements. These challenges make it increasingly essential for auditors to use the work of IT specialists and to incorporate IT expertise in order to effectively plan and conduct integrated audits. Further, these cyber-crime and enterprise-wide risks, which receive significant media coverage, can pose significant threats, not only to companies, but also to their auditors' reputation and business risks. The Committee recommends that the Board considers how auditors use and rely on the work of IT specialists to address these digital technology risks that can have both direct and indirect impact on companies' financial reporting and reports of internal controls over financial reporting. In particular, the Board should consider how IT specialists are used and whether increased guidance is warranted in the following areas:

- 1. Assessing cyber security risks.*
- 2. Assisting their clients in establishing and maintaining proper internal controls to manage the IT risks.*
- 3. Incorporating IT and cyber security risks into the audit risk model.*
- 4. Performing tests of IT controls.*
- 5. Using IT tools when performing substantive tests of electronic/XBRL-related financial statements.*

We believe that taxation and healthcare are specific areas that require significant expertise to assess companies' compliance on the integrated audit, and where auditors are likely to seek assistance from professionals with specialized knowledge. These areas can have direct and indirect effects on financial statements, and noncompliance with U.S. government regulations can lead to significant financial misstatements. The Committee believes that the Board should consider offering guidance on the use of taxation and healthcare specialists as regulatory compliance and financial reporting related to these transactions pose significant challenges for businesses large and small.

³ Last year, over 1,000,000,000 data records were stolen, and less than four percent of these were encrypted, giving hackers immediate access to personal information on millions of customers. (2014 Breach Level Index Annual Report)

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July 28, 2015

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Via website submission: comments@pcaobus.org

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

To Whom It May Concern:

The American Bankers Association¹ (ABA) appreciates the opportunity to comment on the Staff Consultation Paper – *The Auditor’s Use of the Work of Specialists* (Consultation Paper). Reflecting the complexity and judgmental nature of many aspects of our industry, banks employ and engage a vast array of specialists. In addition to areas that indirectly impact bank financial statements, such as asset/liability management, credit analysis, and risk management, the use of specialists is pervasive throughout bank financial statements. The Board’s Staff Consultation Paper on *Auditing Estimates and Fair Value Measurements*, issued in 2014, heightens the significance of this Consultation Paper as the usage of specialists by banks is frequently related to estimates and fair value measurements. Further, the Financial Accounting Standards Board (FASB) is expected to approve revisions to impairment standards (for loans and debt securities) that will likely increase bank reliance on specialists. Therefore, any revision to the auditing standards related to the use of specialists will have a significant impact on audits of banking institutions.

Cost-effectiveness must be the overriding principle that guides the Board as it evaluates the issues discussed in the Consultation Paper. Both alternatives being considered for revising performance requirements related to the auditor’s use of the work of a company’s specialists require more rigorous procedures than are currently performed. Although the Consultation Paper notes anecdotal evidence of audit deficiencies related to the use of specialists, it is unclear whether there are problems with the adequacy of the existing standard or compliance with the standard. If it is the latter (and the current standard is not deemed inadequate), auditors will be required to unnecessarily increase audit procedures that will not lead to better audits. If the Board decides to proceed with a formal proposal, we recommend these important guiding principles:

- A formal proposal to revise auditing standards should clarify the systemic problems that the proposal is meant to address. Enforcement of current auditing standards should be considered prior to creating new standards.

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$14 trillion banking industry and its two million employees.

- The definition of a specialist must be clarified, given the extensive use of specialists within the banking industry.
- Auditing standards should meet the cost-benefit test, looked at holistically, in light of many considerations.
- Standards addressing specialists must be flexible enough for audit firms of all sizes.

These principles are described in more detail below.

A formal proposal to revise auditing standards should clarify any systemic problems that the proposal is meant to address. Enforcement of current auditing standards should be considered prior to creating new standards.

While there may currently be inconsistency in audit practice related to the use of specialists and related procedures around that use, the Consultation Paper does not identify how such inconsistency is leading to material restatements. The Consultation Paper refers to four specific instances in which the auditor's use of the work of a company's specialist contributed to error or fraud (Footnote 45) and generally refers to PCAOB enforcement cases (Footnote 55). However, the cases cited in the Consultation Paper describe the auditors' lack of compliance with existing auditing standard AU sec. 336 in that the auditor did not perform the procedures required under that standard. This standard requires the auditor to, among other things, assess the specialist's qualifications and relationship to the client, make appropriate tests of data provided to the specialist, obtain an understanding of the methods and assumptions of the specialist, and evaluate whether the specialist's findings support the related assertions in the financial statements – all of which are important and reasonable requirements.

Additionally, the Consultation Paper asserts that more rigor may be necessary than is currently required under the standard because the company's specialist may 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. We believe this assumption is unnecessary. Circumstances that might impair the specialist's objectivity are already required to be considered by the auditor, as within AU sec. 336 as noted above. In other words, the real issue is not the need for a new standard, but rather, enforcement of the existing standard should be a focus of the PCAOB.

The definition of a specialist must be clarified, given the extensive use of specialists within the banking industry.

The Consultation Paper lists the following potential definitions:

Specialist – A person (or entity) with specialized knowledge or skill in a field of expertise other than accounting or auditing. Because income taxes and information technology, as they relate to the audit, are specialized areas of accounting and auditing, this definition does not apply to a person with specialized knowledge or skill in those areas.

Auditor's specialist – A specialist who performs work to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's specialist may be either employed by the auditor ("auditor's employed specialist") or a third party engaged by the auditor ("auditor's engaged specialist").

Company's specialist – A specialist who performs work to assist the company in its preparation of the financial statements. A company's specialist may be either employed by the company ("company's employed specialist") or a third party engaged by the company ("company's engaged specialist").

We believe that compliance with (and enforcement of) AU 336 allows for a distinction between the level of work required when a company's specialist is employed by the company, as opposed to when the specialist is merely engaged by the company. Therefore, we believe a distinction in definition is helpful.

Banking institutions use specialists in a broad array of activities.² Even when excluding income taxes and information technology, the distinction between a specialist and non-specialist is unclear in regards to many of the specialists used, because work they perform can be directly or indirectly related to preparation of the financial statements, or may otherwise be considered critical aspects of accounting analyses (i.e., classification or measurement). For example:

- Property appraisers are normally involved in the underwriting process, but also can be involved in the measurement of certain assets on the balance sheet.
- Pricing and valuation experts work on an array of fair value measurement services that range from simple data retrieval for level 1 inputs to providing complex proprietary models for level 3 inputs.
- Credit analysts can be involved in the underwriting process, but also can be involved in the classification of certain assets on the balance sheet and in measuring impairment of those assets.
- Work by specialists related to bank asset/liability management is sometimes used to base prepayment assumptions for amortizing loan and security discounts. In the future, the assumptions may be used to estimate loan portfolio lives under the FASB's proposed CECL accounting standard. The portfolio life will be a critical assumption within the CECL standard.

² Banks of all sizes use specialists. Due to increased regulation of the industry as a whole, community banks are finding it more difficult to find and attract employees in various fields. Therefore, we expect the use of both employed and engaged specialists to increase.

- Actuarial consultants: Similar to companies in other industries, actuarial consultants are often used to address key issues in pension accounting and certain insurance-related products.

We are concerned that the effect of the Consultation Paper will be the elimination of specialists because the level of audit work required will be the same, no matter the specialist's employment status. This will be prohibitively costly for banks and smaller auditing firms. We do not believe that this is PCAOB's intent. As a result, ABA recommends that the final definition, rather than focusing on whether the specialists have knowledge in fields "other than accounting", focus on aspects of the activity that may involve specialized professional accreditation and other aspects of quality control.

Auditing standards should meet the cost-benefit test, looked at holistically, in light of many considerations.

Bankers and investors want audits that are *both* reliable and cost-effective. This must be emphasized and explained in any final auditing standard. As previously noted, it appears that the problems noted in the Consultation Paper resulted mainly from noncompliance with the current standard (AU 336) and not from any deficiency in AU 336. Further, we believe that investors in banks understand that the significant issues that require the use of specialists (namely, estimates and fair value measurements) are judgmental in nature. Investors often prefer to use their own assumptions and methods and compare their models to the recorded balance. In these cases, use of specialists and the reasonableness of their methods and assumptions are of little concern to them. Considering these things, in any final proposal on this topic, there must be a better explanation of benefits that will be received as a result of the new standard.

Further, auditors must not consider the work of specialists in a vacuum. They need to analyze this work holistically, considering a full range of factors within their risk analysis. For example:

- The level of work required should be proportionate to the materiality of the related balances being audited. In other words, the level of work should be responsive to risk analysis.
- The level of work should be responsive to regulatory requirements over financial models³ and the management of 3rd party vendors.⁴ Such guidance in the banking industry goes beyond most criteria for internal control effectiveness.

³ See OCC Bulletin 2011-12 Sound Practices for Model Risk Management -- Supervisory Guidance on Model Risk Management <http://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-12.html>

⁴ See OCC Bulletin 2013-29 Third Party Relationships – Risk Management Guidance <http://occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html>

Public Company Accounting Oversight Board
Washington, DC
PCAOB Staff Consultation Paper *The Auditor's Use of the Work of Specialists*
July 28, 2015
Page 5

- The level of work should consider the regulatory examination process that normally provides an independent level of testing for compliance with the requirements just mentioned.
- The level of work should also recognize that, as the level of subjectivity increases in the estimation process (for example, in a fair value measurement or an estimate of the allowance for loan and lease losses), the incremental value of additional procedures to understand the methods and assumptions used by the specialist will often decrease rapidly. This is the nature of auditing estimates.

The new standard must be clear as to “how far does the auditor need to go?” in determining whether to treat the related work, and any underlying data used by the specialist, as though it was produced by the company. The answer to that question will affect how bankers procure such services, as they may naturally seek the most cost-efficient path. This will likely affect community banks and their auditors the most, as the availability of qualified auditing firms and third-party sources are often limited (due to the somewhat specialized nature of the business of banking).

Standards addressing specialists must flexible enough for audit firms of all sizes.

We are concerned about the impact of the requirements on banks of all sizes. We also fear that further requirements put on smaller auditing firms will have an adverse impact on the audits of community banking institutions. Because of increasing complexity of accounting standards that require significant modeling, the use of specialists by both community banks and their auditors has grown over the past several years and is expected to increase over the next several years. In some geographic areas, the universe of available auditors competent to serve community banks is limited. New standards that require additional audit procedures, especially those that essentially disregard the impact of the regulatory examination process, will only serve to unnecessarily add costs to banks and further limit the number of accounting firms that are able to serve them.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,



Michael L. Gullette

American Federation of Labor and Congress of Industrial Organizations



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July 29, 2015

Sent via Electronic Mail: comments@pcaobus.org

Office of the Secretary
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Re: Staff Consultation Paper No. 2015-1 on the Auditor's Use of the Work of Specialists

Dear PCAOB Members:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") Staff Consultation Paper on the Auditor's Use of the Work of Specialists dated May 28, 2015. The AFL-CIO commends the efforts by the PCAOB to consider improvements to its standards for auditors' use of the work of specialists in conducting audits of public companies.

The AFL-CIO is the umbrella federation for U.S. labor unions, including 56 unions, representing 12.5 million union members. Union-sponsored and Taft-Hartley pension plans hold \$587 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate and public-sector employers. The retirement savings of America's working families depend, in part, on companies having reliably audited financial statements.

The risks of a material misstatement arising from an auditor's use of the work of specialists varies according to the type of specialist and the subject matter. For example, an actuary who measures pension plan liabilities according to professionally proscribed actuarial standards may pose relatively less risk to an audit. In contrast, a valuation specialist who uses a proprietary model to price illiquid securities or complex derivative instruments may pose relatively greater risk of fraud or error.

Office of the Secretary
July 29, 2015
Page Two

Given the potential risks related to the use of the work of specialists, Auditing Standard No. 10 should be strengthened as proposed by the Staff Consultation Paper. Auditors should be required to evaluate the knowledge, skill, and objectivity of their specialists. Engagement partner supervision of specialists in an audit should require that the specialist be informed of the specialist's responsibilities. And finally, the engagement partner should evaluate the assumptions and methods used by specialists.

Furthermore, the requirements of Auditing Standard No. 10 and the PCAOB's Independence Rule should be extended to cover specialists that are engaged by the auditor. The applicable standards should not vary depending on whether the audit firm employs a specialist in-house or if the audit firm engages an outside specialist. Employed specialists and engaged specialists perform the same type of work, and therefore the use of this work by auditors should be subject to the same standards.

In addition, AU sec. 336 should be amended to require that auditors evaluate information received from a company's specialists in the same manner that auditors are required to evaluate information produced by others in the company. The standards that auditors are required to assess company provided information should not vary based on whether the information is provided from a specialist. More rigorous testing of the work of company specialists will reduce the risk of material misstatements.

Thank you for the opportunity to comment on PCAOB Staff Consultation Paper on the Auditor's Use of the Work of Specialists. Investors will benefit from enhanced auditing standards to govern the use of the work of specialists. If I can provide any additional information on the AFL-CIO's views, please contact me at 202-637-5152.

Sincerely,



Brandon J. Rees
Deputy Director
AFL-CIO Office of Investment

BJR/sdw
opeiu #2, afl-cio



July 31, 2015

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

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

To Whom It May Concern:

On behalf of the largest professional association of real estate appraisers in the world, thank you for the opportunity to comment on *Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists*.

The Appraisal Institute supports the review and enhancement of standards related to auditor use of the work performed by specialists. Many Designated members of the Appraisal Institute are employed or retained by auditors or companies for audit preparation and support. Generally, we believe that enhanced attention to and understanding of the valuation profession by the audit community would help increase confidence in audit results. As a leading education provider, the largest publisher of appraisal related texts in the world, and the holder of the body of knowledge in real estate valuation, we stand committed to working with the audit community to enhance their understanding of valuation processes, procedures and standards, and methodologies.

Included in this is a vast body of knowledge that has been developed by the Appraisal Institute relative to the review of appraisals. This includes courses, seminars, textbooks and credentialing programs that are directly applicable to the work of auditors. Such programs would be beneficial to demonstrating an understanding of valuation methods and techniques used by valuation specialists. We stand committed to working with the audit community to enhance its understanding of the valuation profession.

The PCAOB has asked many questions related to the use of specialists, including several highlighted below:

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists***July 31, 2015****Page 2**

When an auditor seeks to hire a valuation specialist, the Appraisal Institute strongly suggests a review of the *qualifications* and *competency* of the appraiser or valuation profession. The competency of the appraiser is imperative to be evaluated by an auditor in assessing the knowledge and skill of the appraiser. The first step of this process should confirm that the appraiser or valuation specialist has earned a professional designation, such as the MAI, SRA, AI-GRS and AI-RRS, from an organization like the Appraisal Institute. Professionals who have earned such designations have met rigorous education, experience, testing, demonstration of knowledge and peer review requirements. The demonstration of knowledge requirements, in particular, help prepare appraisers or valuation specialists to defend their results before those who might scrutinize their work, including auditors and accounting regulatory authorities. We strongly encourage the PCAOB to emphasize a thorough review of the appraiser's or valuation specialist's qualifications and credentials, including the competency of the appraiser or valuation specialist undertaking the appraisal assignment.

With regard to whether the potential requirements for evaluating the work of an auditor's specialist is appropriate for all types of specialists used in audits, we generally believe that the requirements should be principles-based, as every profession is unique and has different regulatory and professional credentialing programs. However, we would encourage the PCAOB to require the disclosure of the appraiser's or valuation specialist's qualifications, and in particular, the professional designations that have been earned.

Disclosure of the appraiser's or valuation specialist's qualifications is common in footnotes of financial statements and would be appropriate for audit reportsⁱ. Further, we believe that it would be beneficial to disclose any applicable appraisal or valuation review standards that were used to evaluate the work of the appraiser or valuation specialist. Many appraisal standards include standards related to appraisal reviewⁱⁱ, and we strongly believe that the use of such standards by auditors would strongly enhance the reliability and credibility of audit reports.

Thank you, again, for the opportunity to comment. Should you have any questions, please contact Bill Garber, Director of Government and External Relations, at 202-298-5586, bgarber@appraisalinstitute.org or Brian Rodgers, Manager of Federal Affairs, at 202-298-5597, brodgers@appraisalinstitute.org.

Sincerely,

Appraisal Institute

ⁱ For example, see 8-K filing of CNL Lifestyle Properties, March 6, 2015. Available at <http://finance.thedailyreview.com/filing/8-k/0001193125-15-085420/cik-1261159/>

ⁱⁱ The Appraisal Institute's Standards of Valuation Practice contain Standard B relating to appraisal review, for example. Available at http://www.appraisalinstitute.org/assets/1/29/SVP_effective_1-1-20151.pdf



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July 24, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

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

Dear Office of the Secretary:

We are pleased to provide comment to the Board and Staff on the recently issued Office of the Chief Auditor's (the Staff) of the Public Company Accounting Oversight Board (the Board) *Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists* (AU 336). We believe that the Staff's efforts in this area as well as issues related to auditing estimates and fair value measurement are vital to improving audit quality. Providing enhanced clarity to the public company auditors enables them to apply their judgment in a reasonable and consistent manner, based on risk assessments and clear guidance.

Baker Tilly Virchow Krause, LLP (Baker Tilly), is a large regional accounting firm operating primarily in the Midwest and Mid-Atlantic regions. We have approximately 2,500 total staff and 300 partners. We have recently crossed the 100 issuer mark and will become an annually inspected firm. Our issuer practice consists primarily of smaller, non-accelerated filers in various industries along with a substantial complement of 11-K audits. Although we will be an annually inspected firm, our organization is substantially different from a big four firm.

Overview:

Baker Tilly welcomes the Staff Consultation Paper (CP) on AU 336. We agree that the use of specialists has become more prevalent as a result of the need for more complex estimates and fair value measurements in preparing financial statements. We encourage the Staff to carefully consider enhancements to AU 336 but do not agree with rescinding the standard. AU 336 and the principles therein have been a cornerstone of the auditing profession for many years, in particular, the concept contained in paragraph .06 "*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.*" When applied properly, AU 336 enables smaller auditing firms to conduct high quality audits that may include complex measurements and estimates. Therefore any revisions to AU 336 should be made in a way that is operational, sustainable, and scalable for smaller auditing firms. We believe retaining this flexibility in the auditing standard should be an important public policy consideration when the Staff is developing any potential new standard.

We recommend that the Staff consider the approach taken by the International Audit and Assurance Standards Board (IAASB) in their audit standard, ISA 620, *Using the Work of an Auditor's Specialist*, which was also adopted by the U.S. Auditing Standards Board. ISA 620 retained the basic concepts enabling the auditor to use the work of the specialists, which are:

- Evaluating the competence, capabilities, and objectivity of the specialist
- Understanding the expertise of the specialist
- Establishing a written agreement with the specialist
- Evaluating the adequacy of the work of the specialist

Within these basic concepts, the ISA standard provides robust requirements and application guidance which enables the auditor to apply judgment in the context of the related risks associated with the particular estimate.

Specific observations:

- Revisions to AU 336 should align with the risk assessment standards, recognizing that the risk associated with estimates will vary over a continuum. In many cases the auditor can effectively evaluate the work of a company employed specialist and, based on the associated risk, determine that it is reliable evidence. Other estimates may be so critical to the financial statements and have such a high level of inherent risk that the auditor should employ his own (employed or engaged) specialist to develop an independent estimate to validate management's.
- As such, requiring that management specialists be subject to the same level of evaluation of required information as other management produced information is not necessary. Maintaining a principle based approach enables the auditor, based on risk, to determine the extent of procedures required to validate the work of the management specialist. These procedures should include: evaluating the competence and capabilities of the specialist, evaluation of the internal control over financial reporting that management applies to the work of its specialist, testing the inputs used by the specialist, and the application of appropriate auditor's skepticism to the work of the specialist, acknowledging the potential inherent biases.
- When the auditor engages a specialist the basic concepts of AU 336 can be effectively employed. However, improved guidance as provided in ISA 620 would be helpful in assisting auditors to comply with the basic concepts.
- We believe the suggestion in the CP that specialists engaged by the audit firm should be subject to the independence rules in Section 2.01 of Regulation S-X, is not a feasible operational concept. The infrastructure and training required for external specialists to enable them to comply with such requirements would be exceptionally costly and would require other disciplines to apply concepts with which they are not completely familiar. Frankly, the CPA firms themselves have a difficult task in applying all of the rules and interpretive guidance inherent in the SEC rules. We do believe that the auditor can effectively evaluate the objectivity of the engaged specialists through appropriate inquiries both of the specialists' firm and the individuals on the engagement.

- With respect to auditor employed specialists, we believe that the audit firm's quality control system can provide adequate controls over the competencies and objectivity of the firm specialists. We do agree, however, that the standard should promote enhanced communication with these specialists as to the level of risk and other audit considerations related to the estimates where the specialist is involved in providing audit evidence. In other words, the auditor employed specialist should be considered part of the engagement team and be fully informed as to the relevant aspects of the engagement. Additionally, the workpapers of the auditor employed specialist should be part of the engagement files and subjected to the appropriate level of supervision and review in accordance with the firm QC guidelines.
- We agree that income taxes and information technology are specialized areas for accounting and auditing and should continue to be excluded from the definition of specialists.
- We suggest that Staff consider with its enhancements to AU 336, adding an Appendix in a manner that was used in AS #18, to provide additional guidance when applying the standard. Appendix A in AS #18 has been very helpful to our firm's implementation.

Use of third party pricing services:

The CP has concluded that the use of third party pricing services generally would not be included in the definition of a specialist. However, much the same as specialists, the use of third party pricing services by issuers and auditors is common and the ability to rely on these services is critical for the smaller firms in enabling them to provide high quality audits.

While we reluctantly agree that these pricing services do not strictly meet the definition of a specialist, we believe that the concepts in AU 336 can be reasonably employed by the auditor in assessing the reliability of audit evidence in accordance with AS #15. Notably, the procedures used to evaluate the objectivity and competency requirement in AU 336 would be similar to procedures an auditor might use in concluding on: "*Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.*"

As such we recommend the following:

- Provide additional guidance possibly in the form of a Staff Audit Practice Alert specifically directed to third party pricing services. Or perhaps within AS #15 or the forthcoming new AS on auditing fair value measurements.
- Consider situations and additional guidance where the issuer uses the same pricing services as the auditor, perhaps requiring additional procedures to suitably evaluate management's ICFR over such pricing services.
- Recognize that risk assessments should be applied when making a decision to use a third party pricing service or when relying on management's use of third party pricing services.

We believe providing such guidance will be beneficial in enabling auditors to more properly use and document the reliability of evidence obtained from third party pricing services.

Once again, we appreciate the opportunity to provide comments on this important consultation paper, and look forward to further dialogue as the standard setting process evolves.

Sincerely yours,

Baker Tilly Virchow Krause, LLP

Baker Tilly Virchow Krause, LLP



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July 31, 2015

Via E-mail: comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Staff Consultation Paper: *The Auditor's Use of the Work of Specialists*

Dear Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting Oversight Board's (the PCAOB or the Board) *Staff Consultation Paper: The Auditor's Use of the Work of Specialists* (the Consultation Paper). We support the Board's consideration of amendments to extant PCAOB standards to clarify the way in which auditors use the work of specialists. This is of particular importance because of the increasing use of specialists in accounting for certain complex transactions that are difficult to measure and are frequently outside the field of expertise of auditors.

Our comments below align with the topical sections set out within the Consultation Paper, and as such, our responses to the specific questions posed are addressed, as applicable, within those sections.

Current Requirements and Current Practice

As noted in the Consultation Paper, the relevant PCAOB standards that apply when an auditor uses the work of a specialist in performing an audit include AU Section 336, *Using the Work of a Specialist* (AU sec. 336), and Auditing Standard No. 10, *Supervision of the Audit Engagement* (AS 10). However, the application of these standards varies, depending on whether a specialist is employed or engaged by the auditor or the specialist is a company specialist. Given the different ways in which a specialist may be used, practice among firms in the application of these standards may be inconsistent. For this reason, we support certain amendments to these standards to enhance consistent application with respect to supervision and the evaluation of audit evidence while providing flexibility for use by auditors of issuers of varying size and complexity. Our views on the Consultation Paper's specific proposals are set out below.

In our practice, we more often use the work of employed specialists rather than engaged specialists, although we do engage a limited number of preapproved specialists on a regular basis for the valuation of certain financial instruments. Such preapproved vendors are subject to extensive due diligence procedures annually and certain protocols have been established with such vendors to facilitate communication. Whether an auditor's specialist is employed or engaged, many of the same procedures are performed by the auditor to



Office of the Secretary
Public Company Accounting Oversight Board
Page 2 of 6

determine whether that work is adequate for the auditor's purposes. However, when an engaged specialist is used, additional or different procedures may be performed, in large part, because the engaged specialist is not subject to the firm's quality control policies and procedures.

The type of testing an auditor's specialist may perform varies based on the type of activity being audited (e.g., goodwill impairments, assets acquired and liabilities assumed in a business combination or complex financial instruments). For example, in a valuation report, the specialist will often review the process and model used by management to ensure that it is a valid approach. As it relates to financial instruments, where models may not necessarily be available to the auditor, the specialist may prepare a separate estimate and compare the results to that recorded by management.

When we use the work of an employed specialist, that specialist is considered part of the engagement team and, accordingly, supervision is conducted in accordance with AS 10. To facilitate communication between employed specialists and the rest of the engagement team, policies have been established that encourage open communication on a frequent basis. Established policies address assignment of responsibilities, the form of documentation, and the process for resolving issues in a timely manner, among others. Supervision occurs throughout the audit, starting in the planning phase where responsibilities are discussed and assigned, continuing through the performance of the audit, including review of working papers and the assessment of the adequacy of the work of the specialist.

Potential Need for Improvement

Oversight of an Auditor's Specialist

We believe oversight of an auditor's employed specialist in accordance with AS 10 is appropriate, since they are considered a member of the engagement team. However, we do not believe it is appropriate or practical to extend the requirements of AS 10 to engaged specialists, because they are not subject to PCAOB rules and standards, in particular those relating to firm quality control standards. We believe a practical approach to ensuring the objective of AS 10 is met, such that the work performed by the engaged specialist is performed as directed and supports the conclusions reached, can be met in an equally effective way, by amending AU sec. 336 to incorporate the concepts from International Standards on Auditing (ISA) 620, *Using the Work of an Auditor's Expert (ISA 620)*. These concepts include procedures to obtain agreement with the auditor's specialist about (1) the nature, scope, and objectives of the work to be performed, (2) the respective roles and responsibilities including agreement about access to working papers, and (3) the nature, timing and extent of communication between the auditor and the specialist. Furthermore, additional procedures to evaluate the adequacy of the work of the employed specialist could include procedures such as making periodic inquiries of the specialist, reviewing working papers and reports on an interim basis, and observing the work of the specialist, among others.



Office of the Secretary
Public Company Accounting Oversight Board
Page 3 of 6

Objectivity of an Auditor's Engaged Specialist

Objectivity is one of the more important factors that affects whether or not an auditor can use the work of an auditor's specialist. As explained in AU sec. 336, paragraph 10, objectivity may be impaired when the specialist has a relationship to the client, including situations in which the client has the ability - through employment, ownership, contractual right, family relationship, or otherwise - to directly or indirectly control or significantly influence the specialist. While employed auditor specialists are covered by a firm's independence rules, by virtue of the fact that they are an employee of an accounting firm, and therefore considered to be objective, we do not believe that an engaged specialist needs to be 'independent' in accordance with PCAOB rules in order for the auditor's engaged specialist to also be considered to be objective. For example, we believe that certain procedures, as set forth in ISA 620, relating to a threats and safeguards approach to assessing objectivity provides sufficient specificity to permit such an evaluation.

The Consultation Paper has suggested as part of its Enhanced Objectivity Approach that an auditor would be required to obtain information about the process the auditor's engaged specialist uses to formulate responses to the auditor's request for information regarding business, employment, and financial relationships between the auditor's engaged specialist and the company. We do not believe such a requirement is meaningful because processes among specialist firms could vary greatly due to differences in governance structure, size and complexity, among others, and be equally effective. Instead, we believe the guidance in paragraph A20 of ISA 620 may be helpful; this guidance explains that it may be relevant, in evaluating the objectivity of an auditor's engaged specialist, to inquire of the entity about any known interests or relationships that may affect the expert's objectivity and discuss with that expert any applicable safeguards, including any professional requirements that apply to that expert.

Alternative Regulatory Approaches

The Consultation Paper describes various alternatives to standard setting relating to using the work of a specialist, one of which includes rescinding AU sec. 336. The proposed alternatives are in response to Board observations relating to the implementation of AU sec. 336 and AS 10 that, in their view, suggest the need for change. Overall, we believe that when implemented as intended, AU sec. 336 appropriately sets out the auditor's responsibilities to evaluate the competence, capabilities, and objectivity of specialists and to evaluate the adequacy of their work. Furthermore, we support retaining the premise that underlies AU sec. 336 - that the auditor is not expected to have the expertise of a person trained or qualified to engage in the practice of another profession or occupation. As a result, when an auditor encounters matters during the audit, outside the field of accounting or auditing, that require special skill or knowledge, the auditor may use the work of a specialist to obtain appropriate evidential matter.

Additionally, we note, as it relates to using the work of a company's specialist, one alternative in the Consultation Paper would require the auditor to look to other applicable PCAOB standards, whereby evidence provided by a company's specialist would be evaluated



Office of the Secretary
Public Company Accounting Oversight Board
Page 4 of 6

in a similar manner to any other evidence provided by the company. However, we believe such an approach is inconsistent with the basic premise of AU sec. 336, in that the auditor is not expected to have the expertise of another profession, and has the potential to increase costs without realizing a corresponding benefit. Rather, we suggest that the approach used in ISA 500, *Audit Evidence*, paragraph 8, including applicable application guidance, could provide an effective option that we believe would avoid some of the disadvantages highlighted in the Consultation Paper relating to this alternative, while still ensuring that the auditor designs procedures responsive to identified risks for the purpose of obtaining sufficient appropriate evidence. In particular, we believe the addition of the application guidance that explains how the auditor would evaluate the appropriateness of the company specialist's work as audit evidence for the relevant assertion would achieve the objectives of AU sec. 336.

Potential Amendments

Definitions

We support the definitions as proposed in the Consultation Paper for specialist, auditor's specialist, and company's specialist. Furthermore, we believe that income tax and information technology are specialized areas within the field of accounting and auditing, and are appropriately excluded from the definition of a specialist.

Evaluating the Knowledge and Skill of an Auditor's Specialist

We agree with the position set out in the Consultation Paper that the objectives of an evaluation are the same whether a specialist is employed or engaged by the auditor, recognizing that differences exist in the manner in which the auditor obtains the information. When an auditor employs a specialist, the auditor is able to rely on the firm's system of quality control to assist in evaluating a specialist's skill and knowledge, whereas when an auditor engages a specialist other means of making this evaluation are necessary. We believe the potential requirements the staff is considering are appropriate, which include an evaluation of:

- Professional qualifications and whether the expert's work is subject to technical performance standards, including ethical standards and other membership requirements of a professional body
- Relevant experience, including any areas of specialty
- Reputation and standing in the view of peers and others familiar with the capability and performance of the specialist.

Informing an Auditor's Specialist of His or Her Responsibility

We support the proposed requirement within the Consultation Paper for the auditor to reach an agreement with the auditor's specialist in writing. However, we believe the guidance in footnote 74 on page 38, which states 'evidence of the agreement between the auditor and the auditor's specialist might be in the planning memoranda, separate memoranda, audit



Office of the Secretary
Public Company Accounting Oversight Board
Page 5 of 6

programs, or other related work papers' should be included within the new guidance to clarify the form of the written agreement.

Evaluating the Work of an Auditor's Specialist

We believe that AU sec. 336 provides an appropriate approach to evaluating the work of an auditor's specialist, whether employed or engaged, such that the auditor evaluates whether the specialist's findings support the related assertions in the financial statements. It is unclear why the Consultation Paper proposes that an auditor would perform a different evaluation depending on whether the specialist develops an independent estimate or tests the methods and significant assumptions used by the company, since in both circumstances the auditor would have concluded that the specialist was competent, objective, and had an appropriate understanding of his or her responsibilities.¹ For this reason, we do not support requiring what on the surface seem to be two different types of evaluations requiring different levels of auditor effort.

Additionally, in evaluating the findings of the auditor's specialist, we believe the guidance in ISA 620, paragraph 13, would clarify the auditor's response when the work of the specialist is determined not to be adequate for the auditor's purposes. In this circumstance, paragraph 13 states that 'the auditor shall: (a) agree with that expert on the nature and extent of further work to be performed by that expert, or (b) perform additional audit procedures appropriate to the circumstances.'

Evaluating the Objectivity of an Auditor's Specialist

We recognize the importance of assessing the objectivity of an auditor's specialist, and support enhancing the guidance in AU sec. 336 relating to how an auditor evaluates the objectivity of a specialist and how that evaluation impacts the auditor's assessment of the reliability of the evidence obtained from the specialist. However, we do not believe it is necessary for a specialist to be independent of the company in order for that specialist to be objective. Rather, we believe that a threats and safeguards approach, as set out in ISA 620, paragraphs A18 to A20, is more appropriate. Similarly, we do not believe an engaged auditor's specialist should be required to comply with the requirements of Rule 2-01 of Regulation S-X adopted by the SEC (Rule 2-01). Under such an approach, we are concerned that there may be unintended consequences, the more significant of which is that engaged specialists would be unable or unwilling to comply with the level of quality control processes and procedures necessary for the monitoring and evaluation of relationships that might impair that specialist's independence.

* * * *

¹ The Consultation Paper explains that when an auditor's specialist develops an independent estimate they would be required to 'determine whether' the methods used by the specialist were appropriate and the significant assumptions reasonable, whereas when the auditor's specialist tests the methods and significant assumptions the auditor is required to 'evaluate the conclusions.' See page 40 of the Consultation Paper.



Office of the Secretary
Public Company Accounting Oversight Board
Page 6 of 6

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Chris Smith, National Accounting & Auditing Professional Practice Leader at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP

July 24, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

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

Dear Office of the Secretary:

This letter is submitted by **BKD, LLP** in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*, May 28, 2015.

BKD, LLP (BKD) is a national CPA and advisory firm with 34 offices in the U.S. We work with closely held businesses, publicly traded companies, governmental entities, not-for-profit organizations and individuals. BKD and its subsidiaries offer clients a variety of services in accounting, audit and assurance, tax, risk management, technology, corporate finance, forensic and valuation services and wealth management.

We are pleased to provide our observations regarding the potential revisions to PCAOB auditing standards addressed in the Staff Consultation Paper. We agree with the PCAOB's assessment that the use and importance of specialists has increased in recent years, due to additional fair-value requirements and the complexity of business transactions. It is reasonable and appropriate that the PCAOB review and update auditing standards as needed to reflect changing conditions. BKD supports targeted improvements that would be both operational and scalable for all accounting firms.

BKD believes a principle-centered approach that is scalable based on the Board's previously issued Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and auditor's judgment, is important in developing any new or enhanced standard concerning use of a specialist. A principle-based standard allows appropriate adaptation of audit procedures in a dynamic marketplace and recognizes that a specialist's work varies significantly based on the subject matter evaluated. We believe the PCAOB staff should consider which objectives outlined in the Staff Consultation Paper could be accomplished through further clarification of extant standards instead of prescribing new rule-based standards. Previous Staff Audit Practice Bulletins and Staff Questions and Answers have provided meaningful clarifications on how to implement standards, and we encourage the Board to continue providing this type of guidance alongside any enhancement to standards concerning the use of a specialist.

Office of the Secretary
Public Company Accounting Oversight Board
Page 2
July 24, 2015

Auditor's Specialist

In the Staff Consultation Paper, the Board proposed two alternative approaches to a new or revised standard on auditor's specialists. The first alternative considers developing a separate standard for using the work of an auditor's specialist.¹ The second alternative proposes to extend the supervision requirements in Auditing Standard (AS) No. 10 to an auditor's engaged specialist.² The Board also provides examples of potential amendments to standards, including:³

- Evaluating the knowledge and skill of the auditor's specialist
- Enhancements to communication between the auditor's specialist and the auditor
- Reviewing the work and conclusions of the auditor's specialist

We believe the Board's objectives are best accomplished by developing a separate standard for the work of an auditor's specialist. Recently issued standards from the AICPA (AU-C 620) and the IAASB (ISA 620) have provided meaningful enhancements over previous guidance concerning auditor's specialists in their respective jurisdictions. These standards could help improve the PCAOB's efforts to clarify the requirements of auditors when using an employed or engaged specialist without imposing some of the practical difficulties of extending the supervision requirements of AS 10 to an auditor-engaged specialist.

When evaluating the work of an auditor's specialist, we believe auditor-engaged specialists are distinct from auditor-employed specialists, due to limitations in the level of control the auditor can exercise in a nonemployee relationship. Engaged specialists cannot be supervised under the quality control system of the auditor, which inhibits the ability to supervise the work being produced and to access every detailed component of models that often are proprietary. We do not suggest these factors should preclude reliance on audit evidence obtained from engaged specialists. Rather, we suggest that subsuming the guidance into AS 10, even with additional specific guidance, could impose unrealistic requirements on the auditor. We believe the auditor's evaluation of the knowledge and skills of the engaged specialist, evaluation of the inputs provided, agreement on the methods and assumptions used and open communication throughout the audit process are aspects an auditor should consider when determining the level of additional audit evidence needed to reduce audit risk to an acceptably low level.

We are supportive of the Board recommendations enhancing the auditor's responsibility to evaluate the knowledge and skills of an auditor's specialist.⁴ Evaluation of an auditor's specialist's professional qualifications, experience and reputation all should be relevant factors

¹ Page 27 of the Staff Consultation Paper.

² Page 28 of the Staff Consultation Paper.

³ Page 35 of the Staff Consultation Paper.

⁴ Page 36 of the Staff Consultation Paper.

Office of the Secretary
Public Company Accounting Oversight Board
Page 3
July 24, 2015

influencing an auditor's judgment on the reliability of the information provided by the specialist and determining the nature and extent of additional auditing procedures to be performed.

BKD believes clear and open communication between the auditor and the specialist regarding all relevant terms for the work to be performed is important in ensuring the work of a specialist is appropriate and consistent with the audit's procedures and objectives. We support further clarification and agree that written communication informing the specialist of his or her responsibilities is an appropriate means to initiate an open dialogue between the two parties.

Evaluating the Objectivity of an Auditor's Engaged Specialist

The Staff Consultation Paper proposes two alternatives to evaluating the objectivity of an auditor's engaged specialist. The first extends Rule 2-01 of Regulation S-X to an auditor-engaged specialist, treating a specialist's company as Rule 2-01 treats an "accounting firm" and applying the rules of "covered persons" to analogous roles in the specialist's company.⁵ The second alternative would establish a framework to evaluate financial, employment or business relationships between the specialist's company and the client.⁶

We disagree with both proposed alternatives relating to evaluating the objectivity of the auditor's specialist. Engaged specialists, which are outside of the audit firm's quality control system, likely do not have an established independence monitoring system as rigorous as required by public accounting firms. Even if a quality control system is in place to monitor independence, we believe the auditor would have practical difficulties testing the system to obtain adequate assurance that the information produced is reliable.

Applying the requirements of Rule 2-01 of Regulation S-X to engaged specialists raises concerns regarding how the auditor would apply specific defined terms used in the auditing profession to other professionals not familiar with such definitions. We believe it is impractical for an auditor to require a specialist to implement a system to evaluate independence as required by an "accounting firm" or to monitor which professionals are determined to be "covered persons." The resources and efforts of the auditor to evaluate such a system appear to be significant considering the multiple types of specialists engaged. These added costs would appear to be higher for noninternational firms that, for economic reasons, typically engage rather than employ specialists utilized in their audit engagements. Specialists may refuse to comply with either alternative or refuse to accept engagements due to the added costs and constraints. These situations could lead to limitations on the auditor's ability to engage specialists when necessary.

We agree that evaluating the objectivity of the auditor's engaged specialist is an important part of concluding on the specialist's work product. We support further PCAOB clarification on how

⁵ Page 46 of the Staff Consultation Paper.

⁶ Page 47 of the Staff Consultation Paper.

Office of the Secretary
Public Company Accounting Oversight Board
Page 4
July 24, 2015

objectivity should be evaluated, whether developed in a new standard or enhanced in the extant standard. Examples of potential enhancements include inquiry or written representation from the specialist concerning relationships with the client, as well as discussion about and evidence from systems the specialist has in place to monitor relationships and transactions with current or potential clients.

Company's Specialist

The first alternative proposed in the Staff Consultation Paper regarding standard-setting relating to using the work of a company's specialist would eliminate language from AU 336 that might be construed to limit the auditor's responsibility for the methods and assumptions used in the specialist's work.⁷ The Staff also proposed rescinding application of AU 336 to a company's specialists, instead requiring auditors to evaluate evidence provided by a company's specialist similarly to any other evidence provided by the company's management.⁸

We are concerned the proposed alternatives might create a framework where it would be difficult for auditors to rely in any way on the work of a company's specialist. We support additional clarification on the appropriate evaluation of a company's specialists based on the factors mentioned below. We do not believe that standards should preclude an auditor from relying on a company's specialist's work. We believe it is important to recognize and value the knowledge outside of accounting and auditing that specialists contribute to the audit process.

We believe that, when applied appropriately, the extant standard (AU 336) requires the auditor to gain sufficient evidence that the methods and assumptions being used by the company's specialist are reasonable and appropriate. The auditor is required to "evaluate whether the specialist's findings support the related assertions in the financial statements."⁹ In this evaluation, the auditor must determine if the work provided by the specialist is reasonable for the circumstances. We believe the auditor's judgment on the nature and extent of additional auditing procedures for evidence provided by management's specialists should vary significantly based on:

- Whether the specialist is employed or engaged by the company
- The department within the company that engages or employs the specialist, *e.g.*, business development or accounting
- The level of oversight by the company and the competence of those overseeing the project

⁷ Page 30 of the Staff Consultation Paper.

⁸ Page 32 of the Staff Consultation Paper.

⁹ See AU 336.12.

Office of the Secretary
Public Company Accounting Oversight Board
Page 5
July 24, 2015

- The evaluation of skills and knowledge of the specialist based upon the criteria outlined in the Staff Consultation Paper¹⁰
- The objectivity of the specialist, *e.g.*, if engaged, the number of clients the specialist represents and the financial significance of the billings from the company to the specialist
- Degree to which assumptions used by the specialist are supported by verifiable information, *e.g.*, the extent that assumptions can be corroborated in a marketplace, and generally accepted within their field
- Assessment of the appropriateness of the model
- The auditor's risk assessment of the relevant assertions

Requiring auditors to evaluate evidence provided by a company's specialist in a similar way to any other evidence provided by the company's management generally would require the auditor to employ or engage an auditor's specialist to evaluate the company's specialist's work. There are multiple dissimilar situations in which a company's specialists may be utilized in an audit. Based on evaluating the factors listed above, the auditor may conclude an auditor's specialist is needed; however, we believe there are circumstances where utilizing an auditor's specialist does not align with the risk for the relevant assertions. We believe any standard concerning a company's specialists should recognize the importance of the auditor's judgment in determining a risk-based audit approach and be scalable to ensure the appropriate audit procedures are performed to address the level of risk identified.

We agree that enhancements to AU 336 and additional guidance from the PCAOB are needed. We would encourage the Board to consider recent enhancements made by the AICPA for the use of management specialist in AU-C 500 in the Board's standard-setting process.

Economic Considerations

BKD has concerns about potential unintended consequences resulting from the views expressed in the Staff Consultation Paper. If AU 336 is rescinded for use of a company's specialist and the objectivity or supervision requirements for engaged specialists are not scalable based on auditor's judgment, we believe the challenges of complying with new or enhanced standards could result in a de facto interpretation of guidance where the only feasible reliance of a specialist comes from those employed by the auditor. Only the largest national firms have the resources and scale to retain the variety of in-house specialists needed for multiple types of complex business transactions. Accounting firms outside the top bracket will be challenged to

¹⁰ Page 36 of the Staff Consultation Paper.

Office of the Secretary
Public Company Accounting Oversight Board
Page 6
July 24, 2015

economically employ and professionally develop the wide range of specialists needed. Higher audit fees and decreased auditor availability could limit companies' access to capital markets. We recommend that the practicability of complying any new or enhanced standard as it relates to all four classifications of specialists be considered carefully as the Board moves forward in the standard-setting process. We also recommend the economic impact of any proposed new standard be analyzed carefully, especially on accelerated filers, nonaccelerated filers and small reporting companies where a significant portion of the market share of audits are performed by noninternational firms.

BKD supports the PCAOB's endeavors to further audit quality. Additional specificity and clarity around the use of specialists benefits the profession given their increasing importance. The scalability of enhancements to auditing guidance is critical to ensuring a sustainable playing field for all public accounting firms without compromising audit quality. In addition to standard-setting updates, the PCAOB should continue to issue additional guidance when the inspection process reveals consistent departures from the current guidance on the use of specialists.

We appreciate the opportunity to express our views for the Board's consideration. If you have any questions or would like to discuss these matters further, please contact Doug Bennett at 417.831.7283 or by email at dbennett@bkd.com or Peter Kern at 412.364.9395 or by email at pkern@bkd.com.

Sincerely,

Handwritten signature in black ink that reads "BKD, LLP". The letters are stylized and slanted.

BKD, LLP



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PCAOB STAFF CONSULTATION PAPER NO. 2015-01
THE AUDITOR'S USE OF THE WORK OF SPECIALISTS
May 28, 2015

The Accounting Principles and Assurance Services Committee (the "Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the referenced proposal. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 43,000 members. The Committee consists of 57 members, of whom 43 percent are from local or regional CPA firms, 30 percent are from large multi-office CPA firms, 13 percent are sole practitioners in public practice, 9 percent are in academia and 5 percent are in international CPA firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee has provided responses for each of the questions set forth in the Paper in order to allow the PCAOB Staff to integrate and analyze the comments with those of other respondents. However, we are presenting a summary so that our overall views are clearly set forth.

The Committee believes the PCAOB has not established a compelling need for an exhaustive overhaul of AU Section 336 along the lines suggested by the Paper that is likely to create substantially different audit responsibilities under AU-C Section 620 and ISA 620. Accounting firms have adequately integrated the requirements set forth in AU Section 336 within the broader supervision requirements of AS No 10 to insure the work of the firm's employed or retained specialists or a client's retained specialists who are used to establish critical fair value and other accounting estimates are adequately supervised and reviewed for technical adequacy. The Committee does believe that additional guidance would be useful in (1) evaluating the work of a client's employed specialist as that situation is becoming more frequently encountered in practice, and (2) what constitutes a specialized area of accounting and auditing. That additional guidance could be communicated in the form of supplemental interpretive guidance without the need to withdraw AU Section 336.

For example, the Committee believes the proposed expansion of the requirements to establish the independence of the specialist in accordance with Rule 2-01, or the proposed expansion of the level of inquiry into the methods by which the specialist might be subjected to “threats” to objectivity is wholly unnecessary and will clearly lead to increased audit costs through higher audit fees and fees charged the audit client by the engaged specialist.

Current Requirements and Current Practice

1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff’s consideration of potential standard setting in this area?

The Committee believes the information accurately reflects the state of current practice for both large and smaller CPA firms and represents a reasonable starting point for an evaluation of the relevant PCAOB auditing standards.

2. Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?

Committee members from the larger firms generally have adopted reasonably consistent audit guidance, programs and checklists related to the use of specialists that are applied to audit engagements performed under both current ASB and PCAOB standards. Committee members have limited experience in performing audit engagements under the IAASB standards. Should the PCAOB significantly revise its standards in a way which more closely aligns the performance standards in evaluating the independence and work of the auditor’s specialist and the company’s specialist, the Committee believes that smaller accounting firms will incur significant training and implementation challenges should the ASB chose not to consider revising its standards in a similar manner. In the interim, it is possible that firms that perform both PCAOB and ASB audits would develop firm guidance regarding the use of specialists using the revised PCAOB standard and apply it to ASB audits as well, since it would represent the then current “best practice”. This will cause an unnecessary increase in audit costs as we discuss in our response to Question 41 below.

3. For accounting firms that use the work of an auditor’s specialist:

a. Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit,

The Committee members note the decision to employ specialists is generally based on two primary considerations: First, is it economically feasible to offer the services performed by the specialists to the accounting firm’s existing or prospective clients, and two, what is the volume of consultation work available from the accounting firm’s existing clientele. If a practice leader can financially grow the specialty practice, it would be justified. For accounting firms with a smaller volume of business for a specialist, it would be more practical and cost effective to hire an outside specialist when the need arises.

Generally, larger firms employ specialists who can perform business valuation and complex equity instrument valuation services. However, actuaries, real estate and other specialty appraisers are more likely to be engaged as needed.

An employed or engaged specialist is generally used on an audit engagement to determine the reasonableness of accounting estimates developed by the client, or it's employed or engaged specialists.

b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?

The activities set forth in Figure 1 represent the majority of the primary uses for employed or engaged specialists.

c. What type of work do the specialists perform? Does the type of work vary depending on whether the firm employs or engages the specialist? Does the type of work vary depending on the specialist's field of expertise?

As we stated in our response to Question 3.a. above, the primary reason to use an employed or engaged specialist is to test the reasonableness of the client's estimates that require specialized skills not ordinarily possessed by the audit engagement team. For example, the audit engagement team members may have a basic understanding of the process of developing the income approach to valuation, but would use the services of an employed or engaged specialist to evaluate the reasonableness of the "valuation science" applied in determining the reasonableness of the build-up method of determining the discount rate which is applied to the client's cash flow or income forecast. The type of work the specialist would be called upon to perform, under a given set of circumstances related to an audit engagement, would not be expected to change regardless of whether the specialist was employed or engaged.

d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate? Why?

The answer to this question could depend on the volume of client-related transactions that are encountered in the audit. For example, an investment company or REIT that applies fair value measurements to its primary assets on a recurring basis will require the auditor to evaluate the design and operating effectiveness of the ongoing process applied in developing the fair values as a key internal control, as well as actually testing the reasonableness of such estimates. However, an auditor of another client that infrequently encounters the need to develop a fair value estimate, or where the related fair value estimate is not that material might just focus on developing an independent estimate as a form of substantive test of the client's estimate.

4. For accounting firms that use the work of an auditor's employed specialist:

a. Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?

The Committee's members that employ specialists typically have written firm policies and checklists that are designed to clearly identify the respective role of the specialist and the engagement team members, and to establish the timing of the employed specialist's involvement with the engagement, the employed specialist's budget and other factors. Such guidance generally specifies the audit engagement team takes final responsibility for the conclusions of the specialist (regardless of whether employed or engaged) so do not really present any challenges under current AS No. 10 regarding supervision.

b. How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?

Many firms have a template that sets forth the elements that need to be considered by the employed specialist in the review of client developed estimates. The senior members of the audit engagement team are responsible for reviewing the specialist's report and any underlying calculations for overall reasonableness and to ask any questions as needed. It is also typical during the engagement itself to have the firm's employed or engaged specialist contact the client or client's employed or engaged specialist to directly discuss any issues raised. In this way, the two sets of specialists can work out any differences prior to the audit firm finalizing its conclusion. This process has worked well in the past, and the Committee does not see any obvious flaws in the current application of the AS No. 10 supervision requirement to the work of the firm's employed or engaged specialists.

c. Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?

The engagement partner and accountant in charge are expected to have sufficient industry expertise to be able to understand and evaluate the use of data provided by the client's employed or engaged specialists that are material to the client's financial statements. However, it would be expected that in certain situations such as the need to use the services of an actuary, geologist or lawyer, the degree of evaluation might have to place more reliance on the expertise of the specialist. In an employed specialist role, the engagement team would place reliance on the firm's ability to hire qualified employed specialists.

d. How would the evaluation change if the firm engaged the specialist?

In an engaged specialist role, the engagement team would have to possibly expand the evaluation of the engaged specialist's credentials to include references and other means to verify both the skills and independence of the engaged specialist.

e. What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist? How does that assistance affect the auditor's supervision of the work of the employed specialist?

In many larger firms, a practice leader in the specialty is responsible for the assignment of individual specialists to specific audit engagements based on the nature, complexity and timing involved. In many situations the assigned specialist will submit the preliminary findings to the practice leader or other senior specialist for review before the report is submitted to the

engagement team for their review. In this case, the engagement team shares its overall supervision of the employed specialist with the practice leader or other senior specialist.

5. For accounting firms that use the work of an auditor's engaged specialist:

a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?

The firm is likely to spend considerable time evaluating the engaged specialist's credentials, past experience and any history of prior employment with the firm, or any of the firm's audit clients in assessing the engaged specialist's knowledge and skills. Many firm's have developed the use of an independence representation template to be used to document the engaged specialist's independence. In many cases, the audit firm may engage a specialist it has worked with on non-audit assignments. Some audit firms may establish a list of preferred specialists for use by engagement teams whose qualifications for specific activities have been previously established. In that case, it would be expected the audit engagement team would document that understanding in the engagement work papers.

b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Auditing Standard No.10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?

The firm generally considers the detailed requirements specified in AU Section 336 as a subset of the umbrella AS No.10 Supervision of the Audit Engagement standard. AU Section 336 has generally been considered adequate in practice by the firms represented by the Committee as most have developed firm practice aids that specify the roles of in-firm specialists vs. the audit engagement team in allocating responsibilities.

c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?

Typically firm's audit planning process policy guidelines specifies the early need for identification of the account assertions (such as valuation of derivatives, impairment analyses, etc.) that might require the use of an engaged specialist. If the client has obtained the services of an engaged specialist, the firm would identify the early need to evaluate the qualifications of the engaged specialist. In many, if not most cases, the underlying account assertions (valuation, for example) are likely to be considered as requiring considerable judgment, and therefore, would be considered to be assessed as having higher audit risk. At that point, any in-firm-specialist(s) would be notified, and typically invited to participate in the engagement team discussion regarding developing the overall audit plan.

d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?

In the Committee's experience, it has found that most engaged specialists will provide access to all underlying valuation methods/models which may supplement their written report, if not included as a direct exhibit to that report. Engaged specialists will generally make themselves

available to respond to any questions posed by the audit engagement team or in-firm specialists.

6. For accounting firms that use the work of a company's specialist:

a. What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.

The audit firms will utilize the work of a company's specialist if the client chooses to engage one. Such information is evaluated as would any client-supplied audit evidence considered during the audit process. Many audit firms encourage their audit clients to engage specialists in formulating complex valuation estimates. The audit firm's use AU Section 336 guidance and place particular emphasis in evaluating the independence of the company's specialist. We do note that most, if not all, appraisal and business valuation standard-setters such as the ASA, NACVA and the Appraisal Institute require their members to disclose whether they have any financial or other interest in the client or subject of their opinion of value. The Committee does not have any direct knowledge of the requirements of organizations that other specialists may belong to, such as actuaries, but would assume that disclosure of independence is a benchmark of those organization's professional standards regarding the formation of an opinion and the related report preparation.

b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?

The Committee believes the examples of activities are sufficiently comprehensive for the PCAOB's purposes.

c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?

In the event the firm concludes the findings of the company's specialist are "unreasonable" the firm would engage with the client and their specialist to understand the process used, assumptions made, etc. to identify the specific variables that create the difference of opinion. In the experience of the larger firms represented within the Committee, creating a candid and open dialogue under such circumstances will facilitate an acceptable revised result.

d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?

The Committee believes its response to question 5.c. above is applicable.

e. Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?

Since a company's employed specialist is essentially a member of management and is deemed not to be independent, greater emphasis is placed on documenting and evaluating the employed specialist's background, training and experience. It is also likely, the report or other conclusion of value (if not expressed in a formal report) will be subjected to a higher degree of evaluation as to its technical merits, and possibly reperformance.

Potential Need for Improvement

7. This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?

The Committee believes that additional guidance would be useful in evaluating the work of a client's employed specialist as that situation is becoming more frequently encountered in practice. This is noted in situations where private equity firms have expanded their acquisition of operating entities. However, the Committee does believe that the current application of AU Section 336 within the subsequently developed AS No. 10 is not as problematic as set forth in the Paper. The Committee believes that both large and smaller PCAOB registered firms have established sufficient internal guidance to deal with the supervision and review of the work of a firm's employed specialist as well as the evaluation of a client's employed specialist.

8. When an auditor obtains an understanding of the methods used by the company's specialist:

a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?

The Committee's experience with the described situation has not been problematic for the reasons stated in the Committee's response to question 6.c. above.

b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

If the auditor was unable to obtain the information needed to properly evaluate the conclusions expressed by a specialist, and the matter was brought before the client's management and/or audit committee without resolution, it could rise to the level of a disagreement. In the Committee's view such situations would be very rare.

Alternative Regulatory Approaches

9. Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

The Committee believes that revisions to current PCAOB standards should be limited to a consideration of the use of the work of a client's employed specialist. However, the development of implementation guidance to the current AU Section 336, rather than a complete revision, might accomplish the same objective.

10. Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

Essentially yes. However, there is a need to clarify the supervisory role of the auditor's employed specialist. As the Committee stated previously, we understand the larger firms employ partner-level specialists who supervise the work of non-partner specialists. Alternatively, if the auditor's employed specialist was not a partner; an increased supervisory role would have to be undertaken by the audit engagement partner. Emphasis on the independence of the auditor's engaged specialist would need to be considered and carefully documented during the pre-engagement hiring process. The training and ability of the audit engagement partner to perform the supervisory role would also have to be considered.

11. Are there other considerations related to the alternatives presented that the staff should be aware of?

None the Committee is aware of.

12. Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.

The Committee is not aware of any.

13. Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

The Committee is not aware of any practical distinctions encountered in practice that would be problematic between the two types of specialists.

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

A distinction needs to be made between a company's employed or engaged specialist regarding the inherent lack of independence of the employed specialist. Therefore, potentially more evaluative work is likely to be undertaken under this situation. This distinction ought to be included in any revisions' to the PCAOB's audit standards or other interpretive guidance regarding the use of specialists.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

The auditor obtains an understanding of the assumptions and methods employed by the specialist by critically reviewing the specialist's documentation underlying the conclusions reached. Verification of any historical financial information used, and establishing the reasonableness of any financial forecasts, etc, must be carefully reviewed and documented. In addition, all critical technical assumptions such as might be employed in developing a test for impairment of goodwill, valuation of a derivative or actuarial calculations must be evaluated for overall reasonableness. It is important in evaluating the reasonableness of the valuation estimate to determine whether the specialist's conclusion falls within a reasonable range. The auditor, or the audit firm's employed or engaged specialist, might undertake a sensitivity analysis using slightly different key assumptions.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

As we previously stated, evaluating the work of a company's employed specialist is likely to require more rigorous testing than the work of a client's retained specialist due to the obvious lack of independence.

17. Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?

None the Committee is aware of .

18. Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

As the Committee stated previously, the core guidance set forth in AU Section 336 has worked in practice. Therefore, other than the need to provide additional guidance in the use of a client's employed specialist, we do not find a compelling need to rescind it.

Potential Amendments - Definitions

19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

The proposed definitions are considered adequate.

20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

The Committee believes that income tax and IT specialists should not be expressly incorporated within a revision of AU Section 336 as their use as employed specialists within accounting firms is closely interwoven with the audit process and the interaction with the audit engagement team. Accounting firms have generally developed sufficiently strong supervisory processes for reviewing the work of income tax and IT specialists, and in considering the work of these specialists within the overall audit process.

21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

The Committee believes that firms which undertake the audit of unique or specialized industries need to have sufficiently developed the needed expertise within the audit engagement team, or through the use of the firm's employed specialists. We do agree that additional discussion regarding this topic of sufficient expertise is relevant to the PCAOB's objectives and should be included.

Potential Amendments – Auditor's Employed or Engaged Specialist

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

The Committee believes the requirements are clear and appropriate and are consistent with the types of inquiries that are being made in current practice.

23. Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

The Committee believes the requirements are sufficient and appropriate and are reasonably consistent with current practice.

24. Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?

The Committee does not believe there are any significant obstacles that would impact obtaining compliance with the suggested requirements. The Committee notes that external client specialists are generally more than willing to cooperate with the client's audit firm in the process of evaluating their work.

25. Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?

Not that the Committee is aware of.

26. How do accounting firms determine what information an auditor's specialist should provide to the auditor? Are there circumstances in which auditors may not retain all audit evidence obtained from the specialist?

As the Committee stated in our responses to the prior questions, auditors obtain all relevant information necessary to adequately review the underlying work which supports the specialist's conclusions. The extent and nature of that information varies with the type of conclusion provided by the specialist, how the client utilizes that information in the preparation of its financial statements, and the nature and complexity of the matter. The Committee believes the current requirements of AU Section 336 have not been problematic in practice responding to the evaluation of a specialist's work product.

27. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

The Committee believes the PCAOB has not established a compelling need for an exhaustive overhaul of AU Section 336 that is likely to create substantially different audit responsibilities under AU-C Section 620 and ISA 620. Potential new requirements for PCAOB audit engagements are suited to the audit of issuers and need not necessarily mirror the AICPA's codified AU-C Section 620. The Committee is not in a position to comment on the relationship to ISA 620 in practice as the Committee's members do not undertake audits under ISA audit standards.

28. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Yes. As stated in the Committee's response to Question 27 above, the potential new requirements for PCAOB engagements need not necessarily mirror the AICPA's codified AU-C Section 620. However, there is not a compelling need in the Committee's view to discard AU Section 336.

29. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Yes, same response as Question 28 above.

30. Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?

Yes.

31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

The Committee believes the potential requirements are sufficiently flexible to allow for the exercise of professional judgment under varying circumstances. However, including a specific statement to that effect in any proposed new revision or amendment of AU Section 336 would be appropriate.

32. How does the auditor evaluate relationships between an auditor's engaged specialist and a company under AU sec. 336?

The Committee believes an engaged specialist should clearly establish their independence from the audit client. This does not mean the specialist could never have been previously employed as an engagement specialist on behalf of the client. However, as the Committee previously stated, most professional organizations that credential specialists do require the specialist to affirmatively state their independence from the client in their report. Therefore, the auditor would need to carefully evaluate all prior relationships. These inquiries are clearly implied by the current requirements under AU Section 336, but can be clarified under any proposed revision or amendment of AU Section 336.

33. Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?

Yes they are.

34. Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

The Committee believes this more rigorous requirement bears further study as specialists (as defined) have not previously been defined as "experts" subject to the SEC's strict independence criteria. The Committee believes compliance with Rule 2-01 is beyond the basic needs of the audit process, once the specialist's objectivity has been established under AU Section 336 or the proposed new requirements set forth in the Paper and should not be adopted.

35. Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor's specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist's firm?

The Committee considers such inquiries appropriate, as most standard setting bodies that credential specialists provide for the disclosure of such relationships under the organization's reporting standards.

36. Are the potential requirements for the auditor to evaluate the objectivity of an auditor's specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account "threats" to objectivity and "safeguards" to reduce the threats, as provided in ISA 620?

The Committee believes that extending the evaluation of the specialist's independence to include the reasonable investor test as being wholly unnecessary for many of the reasons set forth in the Committee's response to Question 34 above. It would become readily apparent from a review of an engaged specialist's prior work for the audit client whether there were any threats to the basic independence and objectivity requirements already in place under AU Section 336. There is no need to go any further. The Committee is unaware of any situations within its constituent member's experience where an audit client's prior relationship with an engaged specialist was a threat to the specialist's objectivity.

37. Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor's engaged specialist will not be influenced by business, employment, or financial relationships?

As the Committee has previously stated, there is no perceived need in practice for implementing the suggested enhanced objectivity approach.

38. Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?

The Committee does not believe the potential requirement to expand the auditor's evaluation of the process used by the engaged specialist to formulate their responses to the auditor's request for information is necessary under the circumstances and will lead to incrementally increased audit costs

39. Does the specialist (or his or her employer) typically have a system in place capable of tracking the information to respond to the auditor's request? If not, could a system feasibly be created?

The Committee believes consideration of such a system is unnecessary in order to establish the independence and objectivity of the specialist and will add to the cost of the audit.

Questions Related to Economic Impacts and Implications

40. For accounting firms that use the work of an auditor's or a company's specialist for public company audits:

a. In how many (*e.g.*, what percentage) of those audits is the work of specialists used? Provide details within the following categories:

- (i) Auditor's employed specialists;
- (ii) Auditor's engaged specialists;
- (iii) Company's employed specialists; and
- (iv) Company's engaged specialists.

The Committee is unable to provide a response to this question based on empirical data.

b. For the auditor's specialists described in a.(i) and a.(ii), what is the ratio of specialist hours to total audit hours?

The Committee is unable to provide a response to this question based on empirical data. However, one of the Committee member's firms (an annually inspected mid-size national firm) reports the following ranges:

- a. Auditor's employed specialists: 5-8%
- b. Auditor's engaged specialists: Less than 5% but not commonly encountered

c. How are the auditor's engaged specialists compensated?

Typically on a specified fixed fee or fee range for the defined assignment.

41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?

The Committee supports a reevaluation of the existing AU Section 336 standard to develop guidance in evaluating the work product of a client's employed specialists but does not consider the need to modify the existing auditing standard with respect to the auditor's employed or retained specialists or an audit client's retained specialists. As discussed in the Committee's response to Question 27 above, we see no compelling need for a comprehensive revision as suggested by the PCAOB Staff. For example, the Committee believes the proposed expansion of the requirements to establish the independence of the specialist in accordance with Rule 2-01, or the proposed expansion of the level of inquiry into the methods by which the specialist might be subjected to "threats" to objectivity is wholly unnecessary and will clearly lead to increased audit costs through higher audit fees and fees charged the audit client by the engaged specialist.

42. To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies, and fraud?

The Committee believes the potential alternatives, if fully implemented, will not significantly improve audit quality as the current AU Section 336 standard is reasonably adequate as currently drafted.

43. Would any of the potential alternatives lead to increased cost? If so, what are the estimated (i) number of audits affected and impact on audit hours and cost and (ii) effects on companies' costs?

The Committee is unable to provide a response to this question based on empirical data. However, one of the Committee member's firms (an annually inspected mid-sized national firm) has suggested the imposition of the proposed enhancements to establishing the external specialist's objectivity and independence is likely to impact the majority of the firm's issuer clients (approximately 110) audit engagements by 2-3% and would likely lead to incremental increased costs incurred by the applicable external specialists who bill their client.

44. Do the incremental costs associated with any of the potential alternatives decline as an accounting firm uses specialists more frequently?

Possibly, assuming the same external specialist is employed in successive years.

45. Are the costs of the potential alternatives likely to be reduced in years after the year of initial implementation?

See the Committee's response to question 44 above.

Page 15

46. Are the economic impacts of the potential alternatives likely to be different for audits involving (i) emerging growth companies, (ii) brokers and dealers, (iii) companies in specialized industries, (iv) companies in certain stages of their life cycles (e.g., development stage), and (v) the use of the work of specialists in specific fields of expertise? If so, provide relevant details.

EGC's typically employ specialists to value derivatives and to develop purchase price allocations under the acquisition method of accounting, among other needs. Thus, the Committee believes audit costs will increase for this group. Brokers and dealers commonly use pricing services as valuation specialists and are also likely to see an increase in audit costs. Companies in the extractive and insurance industries and investment companies (including REIT's) all typically use the work of external specialists and are likely to see an increase in audit costs. Development stage companies engage in substantial stock-based compensation and complex debt/equity transactions requiring the use of valuation specialists, and will see an increase in audit costs. In summary, any company with material fair value estimates will likely face increased audit costs if the majority of the Staff's proposals are ultimately implemented.

47. Are the economic impacts of the potential alternatives likely to affect accounting firms of different sizes differently? If so, provide relevant details. Are there other alternatives that might address the need for improvement noted in this staff consultation paper at lower cost or greater efficiency?

Firms that are large enough to employ specialists will likely experience lower incremental costs, excluding initial year implementation and training. Smaller firms will likely experience greater incremental costs, as they may need to engage a specialist to assist in reviewing the work of the audit client's employed or engaged specialist.

48. As part of considering the need for change, the staff is analyzing academic literature that relates to the auditor's use of the work of a specialist.¹⁰⁴ Is there ongoing research or other information, other than that identified in this staff consultation paper, that the staff should consider in evaluating the economic aspects of changes in standards for the auditor's use of the work of a specialist?

The Committee is unable to respond to this question.

The Committee would be glad to discuss our responses further should the Staff have any questions or require additional information.

Very truly yours,



A.J. Major, Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants



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July 31, 2015

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

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on the staff of the Office of the Chief Auditor (the Staff) of the Public Company Accounting Oversight Board's (PCAOB or the Board) *Staff Consultation Paper 2015-01 – The Auditor's Use of the Work of Specialists* (the Consultation Paper). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ concurs with the Staff's observations in the Consultation Paper that the use and importance of specialists have increased in recent years, in part due to the increasing complexity of business transactions and the information needed to account for those transactions.¹ We commend the Staff for acknowledging that careful deliberation and extensive outreach to key stakeholders² is needed in considering enhancements to existing auditing requirements and guidance, including consideration of the views expressed in response to the Staff's previous consultation paper titled *Auditing Accounting Estimates and Fair Value Measurements*. We believe any enhancements to existing auditing standards and guidance should promote audit quality, be operational and adaptable to changes in the evolving capital markets, and continue to recognize that auditors will likely need to use the work of a specialist when audit matters require specialized knowledge and subject matter expertise in a field other than accounting or auditing. We continue to believe that both this project and the project on Auditing Accounting Estimates and Fair Value Measurements are closely linked and any enhancements to the related standards should be considered in concert.

¹ Page 3, the Consultation Paper.

² For instance, the PCAOB discussed the auditor's use of the work of specialists at its Standing Advisory Group meeting on June 18, 2015.

In this letter, we offer for the Board's and Staff's consideration our views regarding certain topics outlined in the Consultation Paper, including the Staff's suggested amendments to the related auditing standards (the potential amendments or potential requirements). Our views are organized into the following sections:

- I. General Views on the Staff's Consultation Paper
 - a. Importance of Retaining the Principles of AU336
- II. Using the Work of an Auditor's Specialist
 - a. Extending the Auditor's Supervision Requirements
 - b. Evaluating the Knowledge and Skill of an Auditor's Specialist
 - c. Informing an Auditor's Specialist of His or Her Responsibilities
 - d. Evaluating the Work of an Auditor's Specialist
 - e. Evaluating the Objectivity of an Auditor's Specialist
- III. Using the Work of a Company's Specialist
 - a. Evaluating the Objectivity of a Company's Specialist

I. General Views on the Staff's Consultation Paper

The Consultation Paper discusses certain operational challenges related to the auditor's use of the work of specialists, and presents potential amendments to PCAOB auditing standards that govern the auditor's use of the work of specialists. These potential amendments could affect certain aspects, or potentially rescind all, of AU sec. 336, *Using the Work of a Specialist* (AU336), and could affect certain aspects of Auditing Standard No. 10, *Supervision of the Audit Engagement* (AS10). We support the Staff's consideration of amendments to existing auditing standards, and believe any such amendments related to the auditor's use of the work of specialists should, at a minimum: i) align with the Board's risk assessment standards, ii) include an evaluation of the impact of the potential enhancements on the existing standards related to accounting estimates, including fair value measurements, and iii) generally retain the principles in AU336, as discussed further below.

The CAQ supports the potential definitions of *specialist*, *auditor's specialist* and *company's specialist* that are included in the Consultation Paper.³ With respect to the definition of a specialist, we support the continued recognition of income tax and information technology as specialized areas of accounting and auditing, and the exclusion of those persons from the definition.

The CAQ believes that enhancements to the existing auditing standards should be principles-based and recognize the relationship between the auditor's risk assessment and the audit procedures designed to sufficiently and appropriately respond to those risks. Any enhancements should allow for auditors of issuers of different complexities and compositions to apply the auditing standards consistently, without limitations or restrictions.

We have focused our suggestions below on auditing matters, but believe that many of the potential amendments could have a significant effect on issuers and specialists. Therefore, we believe a holistic approach that examines opportunities for improvement in the roles and responsibilities of all members of the financial reporting supply chain with respect to use of specialists, including obtaining additional feedback from specialists, would best meet the needs of investors and other stakeholders.

a. Importance of Retaining the Principles of AU336

The Consultation Paper identifies observations from Board oversight activities that the Staff believes indicate a potential need for change to the auditing standards.⁴ We support the consideration of potential changes, and believe such changes would be better accomplished through enhancing, as opposed to rescinding, AU336. The CAQ believes that AU336, when applied properly, places an appropriate amount of responsibility on the auditor to evaluate the work of a specialist. In particular, we believe any potential amendments should retain the core

³ Page 34, the Consultation Paper.

⁴ Page 23, the Consultation Paper.

principle of AU336: that 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 and based on auditor judgment, may encounter matters that require such specialized skill.⁵ The auditor's ability to utilize the framework in AU336 in arriving at this judgment should be maintained and ultimately strengthened by certain clarifying enhancements, which are discussed in detail below.

As we expressed in our comment letter on the Staff's previous consultation paper titled *Auditing Accounting Estimates and Fair Value Measurements*, of particular concern with the suggested amendment to rescind AU336⁶ is that a potential new requirement to evaluate information provided by a company's specialist in the same manner as information produced by others in the company would be required for all accounting estimates. The Staff acknowledges that this potential new requirement would likely result in additional testing by the auditor.⁷ Paragraph 12 of AU336 supports the core principle that the auditor is not expected to have the expertise of another profession and states that "the appropriateness and reasonableness of the methods and assumptions used and their application are the responsibility of the specialist." We are concerned that this additional testing effort, when coupled with the potential consequences of the suggested requirements in the Consultation Paper regarding the evaluation of an engaged specialist's objectivity,⁸ could be significant, especially in situations where the auditor may not possess the required knowledge or skills related to certain audit matters and may need to engage a specialist.

II. Using the Work of an Auditor's Specialist

a. Extending the Auditor's Supervision Requirements

The auditor's determination of whether to use the work of a specialist in the audit is driven by the auditor's risk assessment process, which includes considering the complexity of the estimate or fair value measurement, its significance to the audit, and the knowledge, skill, and ability of the engagement team members.

When a specialist is employed by an accounting firm, we believe the specialist should continue to be considered a member of the engagement team and be subject to the same supervision and review requirements as any other engagement team member in accordance with AS10. However, the potential amendment to extend the supervision requirements of AS10⁹ (which would include ensuring compliance with all PCAOB standards, including the Quality Control and Ethics and Independence standards) to an engaged specialist could be difficult to apply and, in some cases, compliance by the engagement partner may not be possible given that engaged specialists are not a part of the accounting firm's training, resource monitoring, or overall system of quality control.

b. Evaluating the Knowledge and Skill of an Auditor's Specialist

An auditor's employed specialist is subject to the firm's overall system of quality control which, under Quality Control Section 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC20), includes evaluation of an employee's independence, integrity and objectivity, personnel management, engagement performance, and monitoring, among other things. This system of quality control is intended to provide a firm with reasonable assurance that employees are independent (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.¹⁰ QC20 provides engagement teams that use the work of an employed specialist with the appropriate basis to evaluate an employed specialist's knowledge, skills, and objectivity. As such, we believe that any enhancements to the auditing standards should continue to recognize the value and

⁵ Paragraph 6, AU336.

⁶ Page 32, the Consultation Paper.

⁷ Page 30, the Consultation Paper.

⁸ As discussed further below in Using the Work of an Auditor's Specialist section, the potential requirements relating to evaluating the objectivity of an engaged specialist could result in a diminished population of available specialists being able, or wanting, to provide services to audit firms.

⁹ Page 28, the Consultation Paper.

¹⁰ Paragraph 9, QC20.

importance of a firm's system of quality control in assessing the knowledge, skills, and objectivity of employed specialists.

In instances where the auditor uses the work of an engaged specialist, the auditor should continue to evaluate the specialist's knowledge and skill. Consistent with the requirements of International Standards on Auditing 620, *Using the Work of an Auditor's Expert* (ISA620), as well as many of the suggested amendments in the Consultation Paper, the auditor could continue to consider the following factors in evaluating the engaged specialist's knowledge and skill:

- Whether the engaged specialist's work is subject to technical performance standards or other professional or industry requirements;
- The engaged specialist's experience and reputation in the field in which the auditor is seeking evidence;
- The engaged specialist's knowledge of and experience in the entity's industry;
- The relevance of the engaged specialist's competence to the matter for which the specialist's work will be used, including any areas of specialty within the specialist's field;¹¹ and
- The specialist's competence with respect to relevant accounting and auditing requirements.

In addition, we question the language in the Consultation Paper that states "for an employed specialist, the auditor may take into account information available from the accounting firm (e.g., information contained in the firm's QC system, results of internal and external inspections, and results of the firm's performance reviews) to assist him or her in [evaluating the specialist's knowledge and skill]."¹² When using the language "take into account," it is unclear whether the Staff is considering changing current practice by having each engagement team obtain the relevant information, or the engagement team could, for example, rely on input from the firm's specialist group and the firm's QC systems to make this determination. Consistent with International Standards on Auditing 220, *Quality Control for an Audit of Financial Statements*, we believe that unless information provided by the accounting firm or other parties suggest otherwise, the engagement team should be able to rely on the firm's system of quality control in evaluating the competence of its personnel. In addition, we believe that engagement teams must also ensure that an evaluation of the competence, capabilities, and objectivity necessary for the purposes of the audit, are met.¹³

c. Informing an Auditor's Specialist of His or Her Responsibilities

We support the potential requirement within the Consultation Paper for the auditor to reach an agreement with the auditor's specialist on certain matters that are the responsibility of the specialist "in writing."¹⁴ The Staff's language within the Consultation Paper, which does not appear to be included in a potential requirement, suggests that "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs, or other related workpapers."¹⁵ We believe this footnote provides an appropriate amount of flexibility to the auditor and should be explicitly stated within a potential requirement.

d. Evaluating the Work of an Auditor's Specialist

We continue to believe that AU336 provides the auditor with the appropriate framework to evaluate the work of an auditor's specialist, whether employed or engaged, and we are concerned with the potential requirement within the Consultation Paper to evaluate the work of an auditor's specialist differently (i.e., "determine whether"¹⁶ versus "evaluate the conclusions"¹⁷) depending on whether the specialist (i) develops an independent

¹¹ For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.

¹² Page 36, the Consultation Paper.

¹³ Paragraph 9, ISA620.

¹⁴ Page 37, the Consultation Paper.

¹⁵ Page 38, footnote 74, the Consultation Paper.

¹⁶ As outlined in item a. on Page 40, the Consultation Paper.

¹⁷ As outlined in item b. on Page 40, the Consultation Paper.

estimate or (ii) tests the methods and significant assumptions used by the company. This potential amendment could be interpreted as requiring the auditor to re-perform the work of the auditor's specialist by developing an independent conclusion on the audit matter when the auditor's specialist develops an independent estimate. However, if the auditor has concluded that a specialist is competent, objective, and has an understanding of his or her responsibilities, the auditor should be able to rely on the execution of the procedures and evaluate the reasonableness of the specialist's conclusions. By requiring a level of effort that goes beyond evaluating the specialist's conclusions, the alternative would mandate a level of expertise that auditors do not, and are not expected to, possess. We believe the requirements for the auditor in both situations should only include an evaluation of the specialist's conclusions about the items outlined in the potential amendments.

Currently, when the auditor believes the findings are unreasonable, AU336 requires the auditor to apply additional procedures, which may include obtaining the opinion of another specialist, in order to use the work of the auditor's engaged specialist. We believe potential enhancements could adopt an approach similar to ISA620. Under that guidance, in situations where the auditor believes that the findings of the specialist are not adequate (e.g., because the findings are not consistent with other audit evidence), the auditor should agree with the specialist on the nature and extent of further work to be performed by the auditor's specialist, perform additional audit procedures appropriate to the circumstances, or engage another specialist to resolve the matter.

e. Evaluating the Objectivity of an Auditor's Specialist

The CAQ recognizes that evaluating the objectivity of an auditor's specialist is an integral part of determining the nature, timing, and extent of the specialist's procedures and the reliability of the specialist's work as audit evidence. For an employed specialist, as discussed above, we believe an audit firm's system of quality control provides the auditor with the appropriate basis to evaluate the objectivity of the specialist. However, we are concerned with potential limitations on the ability of an auditor to engage a specialist that could arise from the potential amendments regarding the evaluation of the objectivity of an auditor's engaged specialist, discussed in detail below. Further, we question why the Consultation Paper links whether a specialist is independent of the company to whether that specialist is capable of exercising objective and impartial judgment in his or her work. Rather than indirectly imposing specific independence requirements on specialists, we believe the existing requirements in AU336 could be enhanced to provide additional specificity around how the auditor evaluates the objectivity of an auditor's engaged specialist, as well as how that evaluation would affect the auditor's assessment of the reliability of the evidence obtained from the specialist, as further discussed in detail below within our suggestion in the Enhanced Objectivity Approach.

Rule 2-01

The Consultation Paper outlines a potential amendment that would require an auditor-engaged specialist to comply with the requirements of Rule 2-01 of Regulation S-X adopted by the SEC (Rule 2-01). As discussed further below, we believe that there are significant unintended consequences to this alternative, including the potential that engaged specialists would be unable or unwilling to comply with the level of quality control processes and procedures necessary for the monitoring and evaluation of relationships that might impair that specialist's independence. Such changes could result in certain specialists no longer being able, or wanting, to provide certain services to audit firms, which could diminish the population of available specialists. Accordingly, accounting firms that do not have employed specialists on staff may determine that they are unable to engage specialists necessary to their audits that enable them to comply with these requirements, which would limit their ability to continue to audit public companies.

As acknowledged in the Consultation Paper, Rule 2-01 was written primarily for accounting firms and not for other organizations, such as specialist entities, that are not structured similarly, and specialist entities and individual specialists may have considerable challenges in complying with this rule.¹⁸ We question whether

¹⁸ Page 47, the Consultation Paper.

the potential requirements could be effectively monitored and enforced for entities and individuals that are otherwise not subject to the SEC's independence rules.

Enhanced Objectivity Approach

Under this alternative, we support the potential amendment for the auditor to identify certain business, financial, and employment relationships that might impair an engaged specialist's objectivity.¹⁹ However, we do not believe that the auditor should be required to "obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's request for information."²⁰ The processes and procedures that a specialist's firm has in place to maintain independence and objectivity, including how information related to potential independence conflicts is obtained and compiled, could vary greatly in practice. Further, the approach used by accounting firms seeking to obtain information about the specialist firm's processes and procedures could also vary greatly in practice. Alternatively, we believe the requirements for the auditor to obtain information as to the specialist's relationships with the issuer should be similar to those provided for under ISA620,²¹ which require, for example, corroborating inquiries of the specialist and the issuer.

Impaired Objectivity

In addition to the concerns discussed above, we do not agree that if a specialist's objectivity is impaired, the auditor should automatically be precluded from using the work of that specialist. The potential amendment effectively removes the ability of the auditor to apply additional audit procedures and continue to use the work of the specialist, for example, when certain relationships are identified. Objectivity should be viewed as a continuum that affects the nature, timing, and extent of audit procedures, based on the auditor's judgment. Therefore, any amendments to the standards should acknowledge the importance of auditor judgment and the auditor's overall risk assessment when evaluating whether a specialist's objectivity is impaired.

III. Using the Work of a Company's Specialist

The PCAOB's oversight observations identified in the Consultation Paper²² might be indicative of opportunities for enhancements to expand the requirement to obtain an understanding of the nature of the work to be performed by the specialist²³ and clarify what is needed to obtain sufficient appropriate audit evidence under the existing standards. The auditor should assess the risks of material misstatement, and design and implement responses to the risks of material misstatement²⁴ when using the work of a company's specialist. We believe the Staff should consider potential enhancements to AU336 that are consistent with paragraph 8 of International Standards on Auditing 500, *Audit Evidence* (ISA500), which describes how the auditor should evaluate information prepared using the work of a company's specialist and the extent to which the information can be used as sufficient appropriate audit evidence. Therefore, we also support considering relevant guidance included in the Application and Other Explanatory Material section of ISA500,²⁵ which would provide the auditor with a framework to continue to apply auditor judgment and evaluate the related assessed risks when determining which of those procedures should be performed based on specific facts and circumstances of an audit engagement.

We recognize the need for additional guidance to enhance compliance with AU336, and propose that the Staff retain and enhance the extant guidance in AU336 that states the appropriateness and reasonableness of the methods and assumptions used and their application are the responsibility of the specialist.²⁶ These

¹⁹ Ibid.

²⁰ Page 50, the Consultation Paper.

²¹ Paragraph A20, ISA620.

²² As noted on Page 23, the Consultation Paper.

²³ Paragraph 9, AU336.

²⁴ Paragraph 3, AS12.

²⁵ Paragraphs A35 – A49, ISA500.

²⁶ Consistent with paragraph 12, AU336.

enhancements could include the following, many of which are proposed amendments in the Consultation Paper for the auditor's specialist:

- Require evaluation of the knowledge and skill of the company's specialist, including the Staff's proposal to add additional emphasis to that evaluation;²⁷
- Clarify that the auditor's evaluation of the appropriateness and reasonableness of methods and significant assumptions could include consideration of whether assumptions and methods are:
 - Generally accepted within the field of the specialist;
 - Consistent with the requirements of the applicable financial reporting framework;²⁸ and
 - Dependent on the use of specialized models.
- Focus the auditor's efforts on the assumptions that are significant to the development of the estimate and consider management controls over the estimation process.

a. Evaluating the Objectivity of a Company's Specialist

Assessing the objectivity of a company's specialist is not a simple "yes-no" question, but rather more appropriately reflects a continuum that impacts the auditor's consideration of the appropriateness of the evidence obtained from the specialist. When evaluating the objectivity of a company's specialist, an auditor could consider, among other things:

- Any interests and relationships that create threats to the specialist's objectivity, such as self-interest threats, advocacy threats, familiarity threats, self-review threats, intimidation threats, and any applicable safeguards, including any professional requirements that apply to the specialist, and evaluation of whether such safeguards are adequate;
- Threats to a specialist's objectivity posed by an employment relationship and whether there is any direct reporting by the specialist;
- The terms of the agreement to engage the specialist, including whether, and if so, how, the payment structure is tied to a particular outcome;
- Whether management has the ability to suggest or require revisions to the specialist's results before finalization;
- The significance of the relationship between the engaged specialist and management (i.e., whether the specialist has an extensive relationship with management, and whether the fees charged by the specialist are material to the specialist); and
- The nature of other services provided by the specialist to the company.²⁹

If the auditor believes the specialist's objectivity might be impaired, the auditor would use knowledge of the risks related to the particular accounting estimate to determine what additional procedures should be performed with respect to some or all of the specialist's assumptions, methods, or conclusions, including whether the auditor should consider engaging an auditor's specialist for that purpose.³⁰ The auditor should perform additional procedures when, in the professional judgment of the auditor, such procedures are needed as a result of risk assessment procedures or as a result of evaluating the audit evidence obtained in order to reach a conclusion.

These enhancements would provide the auditor with additional guidance on how to evaluate reliability and relevance of the audit evidence provided by the company's specialist and would allow the auditor to use the work of company's specialist as evidential matter in performing substantive tests.

²⁷ Page 36, the Consultation Paper.

²⁸ Pages 40 – 41, the Consultation Paper.

²⁹ Consistent with paragraphs A38 – A44, ISA500.

³⁰ Consistent with paragraph 11, AU336.

The CAQ is supportive of the Staff's consideration of developing potential revisions related to the auditor's use of the work of specialists, and commends the Board and its Staff for advancements made in this important area. Given the wide range of accounting estimates, including fair value measurements, that benefit from the expertise of valuation specialists, appraisers, actuaries, and other specialists, enhancements to the auditing standards and guidance will require careful deliberation and extensive outreach with key stakeholders to ensure the development of guidance that promotes audit quality, is operational and adaptable to changes in the evolving capital markets, and continues to recognize that auditors may need to use the work of a specialist when the audit requires specialized knowledge and subject matter expertise in a field other than accounting or auditing. The CAQ appreciates the opportunity to comment on the Consultation Paper and would be pleased to discuss our comments or answer any questions that the Staff or the Board may have regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

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December 1, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Staff Consultations Papers: *Auditing Accounting Estimates and Fair Value Measurements and No. 2015-01, The Auditor's Use of the Work of Specialists*

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

This is an addendum to our comment letters to the PCAOB in response to recent Staff Consultation Papers regarding auditing accounting estimates, including fair value measurements, and using the work of specialists.¹ As stated in those letters, the CAQ is supportive of enhancements to the auditing standards related to accounting estimates that align with the PCAOB's risk assessment standards, promote audit quality by narrowing, or at least not expanding, any potential stakeholders' expectation gaps, and allow for auditors of entities of all different sizes to be able to apply the requirements consistently, while providing for flexibility in approaches.

The appendix to this letter, *Auditing Accounting Estimates and Fair Value Measurements: A Framework* (the Framework), represents a collaborative effort by members of the profession to provide the Public Company Accounting Oversight Board (PCAOB or the Board) with our views as it relates to the current standard-setting projects of the Board on auditing accounting estimates and fair value measurements as well as the use of specialists. This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

In developing the Framework, the CAQ considered the views in each of the Staff Consultations Papers, as well as discussions with PCAOB staff as part of its outreach

¹ See November 3, 2014 comment letter in response to Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*, and July 31, 2015 comment letter in response to Staff Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*.

efforts regarding auditing estimates and fair value measurements, as well as the use of specialists. The Framework also reflects input received from CAQ member firm representatives that have participated in recent PCAOB Standing Advisory Group discussions on this important topic.²

The Framework is principles-based. We believe this is critical in order to be operational under the current construct of (and sustainable to changes within) the capital markets and sensitive to the availability of data and information from specialists, pricing services and other relevant market participants.

Within the Framework, we offer suggestions for auditing accounting estimates that build upon the overarching principles described in our comment letters. Those principles state that any enhancements to existing auditing standards should:

- Recognize the relationship between the auditor's risk assessment and the audit procedures designed to sufficiently and appropriately respond to that risk;
- Consider the range of accounts (and elements of accounts) that involve varying levels of estimation uncertainty and the varying levels of complexity in measurement and risk associated with different accounting estimates;
- Recognize that accounting estimates may be subject to a significant degree of measurement uncertainty, and such inherent uncertainty will exist irrespective of the level of effort involved in auditing the accounting estimate (e.g., not imply that a level of precision exists in an inherently imprecise measurement exclusively as a result of an audit of that measurement); and
- Continue to recognize that auditors may use the work of a specialist when situations arise that require specialized knowledge and subject matter expertise in a field other than accounting or auditing.

Again, we appreciate the opportunity to share our views regarding auditing accounting estimates and fair value measurements and the use of specialists. We stand ready to assist you in any way we can, including participation in any future meetings or roundtables.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Attachment

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

cc:

PCAOB

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Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
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²The PCAOB held Standing Advisory Group meetings on October 2, 2014, June 18, 2015, and November 13, 2015 to discuss matters related to auditing accounting estimates and fair value measurements and the use of specialists.

SEC

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Luis A. Aguilar, Commissioner

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**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

Index

1 OverviewA-2

 1.1 Background A-2

 1.2 Design of the Framework..... A-2

2 Alignment with the Auditor’s Risk Assessment Process.....A-3

 2.1 Consideration of Thematic Elements of ISA 540..... A-3

 2.2 Performing a Risk Assessment for Accounting Estimates..... A-4

 2.3 Consideration of Management’s Process A-6

 2.4 Accounting Estimates with a High Level of Estimation Uncertainty..... A-7

 2.5 Consideration of Management Bias..... A-8

 2.6 Revisions of Risk Assessment..... A-9

3 The Auditor’s Responses to the Assessed Risks of Material MisstatementA-10

 3.1 Testing Controls for Accounting Estimates A-10

 3.2 Substantive Testing Approaches..... A-11

 3.3 Considerations for Evaluating Audit Evidence A-12

 3.4 Evaluating the Company’s Method Used to Develop an Accounting Estimate A-13

 3.5 Evaluating the Reasonableness of Significant Assumptions A-14

 3.6 Developing a Reasonable Range for an Accounting Estimate A-16

 3.7 Accounting Estimates with Significant Risks A-17

4 Using the Work of an Auditor’s SpecialistA-19

 4.1 Evaluating the Knowledge, Skill, and Objectivity of an Auditor’s Specialist A-19

 4.2 Informing an Auditor’s Specialist of His or Her Responsibilities..... A-21

 4.3 Evaluating the Work of an Auditor’s Specialist..... A-22

5 Using the Work of the Company’s Specialist.....A-23

 5.1 Evaluating the Knowledge, Skill and Objectivity of a Company’s Specialist A-24

 5.2 Evaluating the Work of a Company’s Specialist..... A-25

6 Use of Third-Party Pricing Sources Not Acting as a SpecialistA-25

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

1 Overview

1.1 Background

- Over the past decade, changes in financial reporting frameworks have led to an increase in the use of accounting estimates (and, in particular, fair value measurements)¹ in the preparation of financial statements. The complexity associated with certain accounting estimates also has increased during this time, as has the subjectivity that can be associated with their underlying assumptions.
- Given the many different types of accounting estimates, the varying nature of the related estimation processes, and the underlying inputs and assumptions, there may not be a ‘one-size-fits-all’ solution that enhances existing auditing standards relating to accounting estimates. It is important that any improvements to existing auditing standards result in scalable requirements and guidance that audit firms of all sizes can apply to issuers of all sizes.

1.2 Design of the Framework

- This framework is intended to enhance and clarify the existing auditing standards by:
 - Improving the linkage between the performance requirements in the PCAOB’s existing auditing standards² and the auditor’s risk assessment process when determining an appropriate audit response (e.g., PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AS 12) and PCAOB Auditing Standard No. 13, *The Auditor’s Responses to the Risks of Material Misstatement* (AS 13));³
 - Clarifying the objectives and scope of the standards to reduce any perceived inconsistencies in expectations for substantive testing of fair value measurements versus other accounting estimates, including instances in which the auditor uses the work of a specialist when auditing accounting estimates; and
 - Providing supplemental or application guidance to promote greater consistency and more effective application across the audit profession.
- Because of the variety of accounting estimates, this framework includes examples to illustrate key aspects of the framework. These examples are highlighted throughout this document to facilitate identification of what could be considered supplemental or application guidance. This framework also includes explanatory narrative descriptions that elaborate on the thought process behind a

¹ This framework acknowledges and adopts an approach similar to that outlined in footnote 1 of the Staff Consultation Paper on Auditing Accounting Estimates and Fair Value Measurements (Estimates Staff Consultation Paper), in that it generally uses the term “accounting estimate” to mean both accounting estimates and fair value measurements, unless noted otherwise. When discussing existing requirements of extant standards, this framework generally uses the terms “accounting estimate” and “fair value measurement” to have the same meaning as those terms have in AU sec. 328, Auditing Fair Value Measurements and Disclosures (AU 328) and AU sec. 342, Auditing Accounting Estimates (AU 342).

² When auditing accounting estimates, including fair value measurements, performance requirements are currently included in AU 328, AU 342, AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU 332), and, when a specialist is involved, AU sec. 336, *Using the Work of a Specialist* (AU 336).

³ We agree with the view in the Estimates Staff Consultation Paper that any changes to the auditing standards related to accounting estimates should build upon the principles in the PCAOB’s risk assessment standards, particularly AS 12 and AS 13. In this framework we provide specific suggestions to demonstrate how auditors may apply the risk assessment requirements in the context of auditing accounting estimates and when using the work of a specialist.

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

requirement to facilitate the application of auditor judgment to a variety of facts and circumstances.

- We recognize that PCAOB auditing standards typically do not include such guidance; however, we believe doing so would provide clarity in the objectives of certain aspects of the standards and lead to greater consistency in application.
- We believe this framework will help to improve audit quality regardless of how enhancements ultimately are codified in the standards (i.e., the creation of one or more new standards or enhancements to existing standards).

2 Alignment with the Auditor’s Risk Assessment Process

- The CAQ believes that many of the performance requirements in the PCAOB’s existing auditing standards for auditing accounting estimates and using the work of specialists are appropriate. We therefore start with the objectives of these existing auditing standards, and recommend enhancements to both better align these standards with the PCAOB’s risk assessment standards and emphasize the importance of the auditor obtaining an understanding of management’s processes, including management’s use of specialists and other third-party sources, and system of internal control. In providing these recommended enhancements, we considered views expressed in the Staff Consultation Papers and concepts from relevant International Standards on Auditing (ISA), in addition to the existing PCAOB auditing standards.
- This framework is designed to apply to audit procedures performed over all accounting estimates, regardless of whether the auditor or the company uses the work of a specialist. The auditor’s risk assessment, which includes an evaluation of the knowledge, skill, and objectivity of a company’s specialist(s), will assist the auditor in designing and implementing appropriate responses to risks of material misstatement.

2.1 Consideration of Thematic Elements of ISA 540

- ISA 540,⁴ which builds upon the risk assessment guidance in ISA 315⁵ and ISA 330,⁶ illustrates thematically how the risk assessment standards could be aligned with the standards relating to accounting estimates. Similarly, revisions to PCAOB standards could build upon the principles of AS 12 and AS 13 and include incremental considerations specific to accounting estimates to guide the auditor’s consideration of the subjectivity of accounting estimates, the susceptibility of accounting estimates to fraud, and other factors when performing a risk assessment.⁷
- The following are concepts from ISA 540 specific to accounting estimates that could be incorporated or enhanced within the PCAOB’s risk assessment standards.⁸

⁴ ISA 540, *Auditing Accounting Estimates, Including Fair Value Estimates, and Related Disclosures*. Although the International Auditing and Assurance Standards Board is considering changes to ISA 540, the concepts in the standard as currently written provide a general basis for consideration of enhancements to PCAOB auditing standards.

⁵ ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*.

⁶ ISA 330, *The Auditor’s Responses to Assessed Risks*.

⁷ ISA 540 illustrates the type of considerations we believe should be incorporated into the auditing standard(s) related to accounting estimates, all of which are already embodied in the PCAOB’s risk assessment standards (i.e., AS 12 and AS 13).

⁸ We acknowledge that some of these items are already contained in the PCAOB’s risk assessment standards.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- Obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:
 - The applicable financial reporting framework;
 - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates (including how management monitors and identifies changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates); and
 - How management makes the accounting estimates, and an understanding of the data on which they are based, including:
 - The method or model used in making the accounting estimate;
 - Relevant controls;
 - Whether management has engaged a specialist;
 - The assumptions underlying the accounting estimates;
 - Whether there was or should have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - Whether, and if so, how management has assessed the effect of estimation uncertainty.
- In addition to considering conditions specific to accounting estimates in the auditor's risk assessment, supplemental guidance would serve to further clarify the auditor's expected performance in assessing risk and appropriately designing audit procedures to obtain sufficient relevant audit evidence.

2.2 Performing a Risk Assessment for Accounting Estimates

- AS 12, paragraph 59 addresses how the auditor determines which risks of misstatement represent risks of material misstatement at the financial statement and assertion level, and those risks of material misstatement that are significant risks. AS 12, paragraph 59(e) states that, in identifying and assessing risks of material misstatement, the auditor should identify significant accounts and disclosures and their relevant assertions.
- In addition, consistent with paragraph 16 of PCAOB Auditing Standard No. 9, *Audit Planning* (AS 9), based on the nature of accounting estimates contained in significant accounts and disclosures, the auditor determines whether specialized skill or knowledge in relation to one or more aspects of the accounting estimates is required to:
 - Perform an effective risk assessment;
 - Plan or perform audit procedures; or
 - Evaluate audit results.
- Generally speaking, accounting estimates are present in most accounts and disclosures in the financial statements. Risks related to the data, model, method and assumptions used exist for all accounting estimates, and the relative significance of those risks vary across the many types of accounting estimates.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- It is not appropriate to presume that every relevant assertion associated with an accounting estimate represents a significant risk. Similarly, it is not appropriate to presume that every accounting estimate gives rise to a significant risk.
- Rather, in order to perform an appropriate risk assessment, the auditor considers the following with respect to management’s process for determining the estimate:
 - The relevant inputs;
 - The complexity of those inputs and the subjectivity of the judgments related to them; and
 - Alternative methods that may support the reasonableness of the accounting estimate in the auditor’s consideration of the risk(s) relevant to a particular significant account or disclosure.
- In addition, the auditor considers management’s ability and expertise to determine an accounting estimate (including whether management has used a specialist to assist with this determination), as well as whether the knowledge and skills of an auditor’s specialist may be needed.
- The auditing standards acknowledge that “the components of a potential significant account or disclosure might be subject to significantly differing risks.”⁹ This is particularly true for accounting estimates, and may result in the need for the auditor to disaggregate a significant account in order to perform an effective risk assessment.
- The auditing standards could expand upon the concepts in AS 12¹⁰ to clarify that the auditor considers the potential sources of risk of material misstatement within a significant account at a sufficiently disaggregated level based on auditor judgment in order to enable the auditor to appropriately determine the nature of audit procedures to perform. In other words, the auditor completes the risk assessment at a disaggregated level within the components of an account in order to design appropriate audit procedures. In determining the appropriate level at which to assess the risk of material misstatement for a particular account or components of an account, the auditor could consider the information presented in the footnote disclosures related to that particular account.
 - While we suggest the auditor disaggregate components of an account when performing a risk assessment, we do not suggest requiring disaggregation to the lowest possible unit of account level (e.g., individual security basis by CUSIP number). In many cases, after considering factors such as the similarity of the nature of the accounting estimates, the consistency of management’s process for determining accounting estimates, and the sources of risk, the auditor may conclude that certain components are sufficiently similar based on their risk, such that they do not need to be disaggregated further for purposes of designing appropriate audit procedures.

⁹ AS 12, paragraph 63.

¹⁰ Specifically the concepts in paragraph 59 regarding the identification and assessment of risks of material misstatement at the financial statement level and the assertion level.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework****Illustrative Example 1: Performing a Risk Assessment: Disaggregation**

In order to perform an assessment of risk over a company's allowance for loan losses (ALL), it may be necessary for the auditor to identify individual components of the accounting estimate and assess the risks relevant to each component.

An ALL typically includes a general loss reserve and a specific loss reserve. Accordingly, it may not be appropriate to view the ALL as if it were a single accounting estimate or account. The risks associated with the general loss reserve may include inaccurate inputs (e.g., historical losses by loan type) and inappropriate qualitative adjustments to the historical loss rates. The risks associated with the specific loss reserves may include unreasonable cash flow projections, inappropriate discount rates, and stale appraisals. The significance of these risks may differ for a particular company and would be addressed through individual planned audit responses.

Illustrative Example 2: Performing a Risk Assessment: Disaggregation

As it relates to investments measured and disclosed at fair value, while the materiality of the account balances are driven by the quantity and value of the underlying securities, the valuation risk associated with investments often is driven by the characteristics of the investments held (e.g., similar valuation models, significant inputs to a valuation model, nature and source of significant assumptions for a type of investment), the observability of pricing inputs and the complexity of valuation models used to estimate fair value. Individual securities within a particular category of investments may share common characteristics with other securities in another category of investments. In those situations, the auditor determines as part of understanding management's estimation process which securities contain sufficiently homogenous characteristics such that the auditor can draw conclusions about them from testing them as a group. Once that is determined, disaggregation of the significant account to a level that includes homogenous securities into a single group would be sufficient to perform an effective risk assessment. This would lead to a more effectively executed risk-based approach in which the auditor plans procedures that are designed to obtain more persuasive audit evidence that corresponds to the auditor's assessment of risk (as discussed in AS 13, paragraph 9(a)).

2.3 Consideration of Management's Process

- Assessing management's process for determining accounting estimates is an important element of the auditor's risk assessment process. In preparing accounting estimates, management selects or develops assumptions that represent their judgment of the most likely circumstances and events with respect to the relevant factors.¹¹ The significance of management's assumptions, along with other factors such as the sensitivity of the assumptions to variability, affects the

¹¹ AU 342, paragraph 05(d).

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

auditor's determination of the risk of material misstatement associated with a particular accounting estimate.¹²

- In some cases, events that occur after the balance sheet date may provide more persuasive audit evidence than the auditor's consideration of information used to corroborate management's assumptions used to derive an accounting estimate. In certain of these cases, the related estimation uncertainty may be substantially reduced by the recent information available to the auditor.

2.4 Accounting Estimates with a High Level of Estimation Uncertainty

- Part of the auditor's risk assessment process includes evaluating the degree of estimation uncertainty associated with an accounting estimate. Certain accounting estimates may include a level of estimation uncertainty that exceeds the auditor's established materiality threshold; two appropriately qualified and objective professionals may arrive at different results based on the same facts because they apply different but equally reasonable assumptions. We believe it is important that the auditing standards acknowledge this and emphasize that, in those circumstances, both a comprehensive evaluation in light of the circumstances and facts involved and specific documentation regarding conclusions are important.
- For accounting estimates with a high level of estimation uncertainty, the range of reasonable outcomes may exceed the auditor's established materiality threshold. In such cases, the level of estimation uncertainty may not be able to be reduced to an amount less than the auditor's established materiality threshold regardless of the amount of relevant and reliable audit evidence accumulated. In those circumstances, the auditor evaluates whether management's disclosures adequately describe the estimation uncertainty inherent in the accounting estimate in accordance with the applicable financial reporting framework.
 - Supplemental guidance that acknowledges that there is variability and imprecision in accounting estimates having high estimation uncertainty would be beneficial. This guidance could remind auditors of their responsibility to perform sufficient appropriate procedures to be able to reasonably conclude that the accounting estimate has been determined (a) in accordance with the applicable financial reporting framework, (b) using a consistent approach from period to period (if appropriate) and (c) that there is adequate disclosure (in accordance with the applicable financial reporting framework) regarding the methods and assumptions such that the estimation uncertainty is transparent to the user. Auditors would continue to assess the facts and circumstances through the date of the auditor's report.

¹² AU 342, paragraph 05.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

Illustrative Example 3: Accounting Estimates with a High Level of Estimation Uncertainty

Certain long-term contracts that are developmental in nature are inherently complex and have high estimation uncertainty. When accounting for such contracts using the percentage of completion method, management's accounting estimate of the estimated costs of completion could have a range of outcomes that exceeds the auditor's established materiality threshold. This may be due, in part, to technological specifications within the contract. In that situation, it may not be possible to develop a reasonable range for the accounting estimate that is less than the auditor's established materiality threshold.

2.5 Consideration of Management Bias

- When evaluating management's judgments and decisions in their determination of accounting estimates as part of the auditor's risk assessment process, the auditor applies professional skepticism when identifying whether there are any indicators of management bias.
- When evaluating potential bias, including that of a company's specialist, it is important for the auditor to consider the incentives and pressures on management to manipulate the financial statements, and opportunities to do so.
- When a risk of material misstatement due to fraud has been identified related to an accounting estimate, the auditor applies AU sec. 316, *Consideration of Fraud in a Financial Statement Audit* (AU 316), in addition to this framework.
 - Examples of incentives and pressures may include the level of pressure or focus by management or investors on key performance indicators, the structure of executive compensation arrangements, and economic or industry conditions.
 - Examples of opportunities may include the susceptibility of the company's accounting systems to manipulation due to inherent risks from management override, collusion, or poorly designed or implemented internal control structures.
- When evaluating potential bias, the auditor evaluates the qualitative aspects of the company's accounting practices, including potential bias in management's judgments about the amounts and disclosures in the financial statements. In addition to applying the guidance in paragraphs 24-27 of PCAOB Auditing Standard No. 14, *Evaluating Audit Results*, and paragraphs 63-65 of AU 316, the auditor considers performing the following risk assessment procedures:
 - Review the accuracy of prior year accounting estimates to assess whether there is any indication of bias in management's estimation process.
 - Evaluate whether there is a pattern of bias in management's accounting estimates (e.g., whether management's rationale to use the various assumptions in an accounting estimate(s) is driven by its bias for a particular result).
 - When the applicable financial reporting framework does not prescribe a specific methodology, consider whether the accounting estimate typically is developed using an estimation methodology that is an industry standard or is a generally applied approach (regardless of the industry). If the auditor determines that management's method used to determine the accounting estimate is not a generally applied approach or, when

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

applicable, is not consistent with methods used in the company's industry, the auditor evaluates how that compares to the facts and circumstances specific to the company and whether management's rationale to use the unique methodology is driven by its bias for a particular result.

- The auditor also should be alert to contradictory evidence when evaluating management's estimation process, and should not ignore significant assumptions within management's estimate that contradict other information known to the auditor. If contradictory evidence is identified, the auditor gives appropriate consideration to whether that evidence is indicative of management bias or could result in a material misstatement.
- If indicators of management bias are identified, the auditor evaluates how those indicators may affect the auditor's conclusion as to whether his or her risk assessment and related responses remain appropriate with respect to the affected accounting estimates. The auditor also considers whether those indicators of bias have implications for the other areas of the audit.
 - In these situations, the auditor also communicates to the audit committee the results of the auditor's evaluation of accounting estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management. This is consistent with paragraph 13 of PCAOB Auditing Standard No. 16, *Communicating with Audit Committees*.

2.6 Revisions of Risk Assessment

- This framework recognizes the iterative nature of the planning process and allows for the auditor to modify or tailor the substantive testing approach from the planned audit procedures to obtain sufficient appropriate audit evidence and document his or her rationale for doing so in light of changes in facts and circumstances.¹³
- This is particularly relevant in instances where the auditor obtains evidence during the course of the audit that is contradictory to the audit evidence on which the auditor originally based his or her risk assessment, or that indicates the existence of management bias that was not previously identified as part of the risk assessment process. If the auditor obtains evidence that contradicts the original risk assessment, the auditor revises the related risk assessments and modifies the planned nature, timing, or extent of substantive procedures as necessary.¹⁴

¹³ This concept is consistent with paragraph 74 of AS 12.

¹⁴ AS 13, paragraph 46.

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

Illustrative Example 4: Revisions to Risk Assessment

An auditor initially determines that he or she will substantively test an accounting estimate by reviewing and testing the process used by management to develop the accounting estimate. If the auditor identifies errors or other flaws in management's process for determining the accounting estimate (e.g., income projections that are not supported by historical results and current trends in the company's business results), the auditor may determine that reviewing and testing management's process alone would not provide sufficient appropriate audit evidence about the reasonableness of management's estimate as recorded in the financial statements. If that is the case, the auditor would revise his or her planned audit approach to include other procedures, such as developing an independent expectation of the accounting estimate to corroborate the reasonableness of management's accounting estimate or reviewing subsequent events or transactions occurring prior to the date of the auditor's report.

An auditor who initially plans to substantively test an accounting estimate by reviewing and testing management's process or developing an independent expectation may revise his or her approach to review subsequent events if reliable evidence becomes available as a result of a transaction occurring after the balance sheet date.

3 The Auditor's Responses to the Assessed Risks of Material Misstatement

3.1 Testing Controls for Accounting Estimates

- As part of the risk assessment process (as discussed in section 2), the auditor obtains an understanding of management's process for determining the accounting estimate, including understanding whether and, if so, how management has used a specialist.
- If the auditor plans to rely on controls to reduce the amount of substantive procedures to perform, the auditor identifies the relevant controls for each risk of material misstatement at the relevant assertion level, and assesses the effectiveness of their design and implementation. In addition, the auditor also tests the operating effectiveness of those controls.
- If the auditor does not plan to rely on controls to reduce the amount of substantive procedures to be performed, or if the auditor determines that the controls necessary to sufficiently address the assessed risks of material misstatement for relevant assertions are missing or ineffective, the auditor assesses control risk at the maximum level.
- With regard to accounting estimates that give rise to a significant risk, the auditor should evaluate the design of the company's controls that are intended to address risks of material misstatement due to fraud and other significant risks, and determine whether those controls have been

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

implemented, if the auditor has not already done so when obtaining an understanding of internal control.¹⁵ Examples of these procedures could include an evaluation of:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- Controls related to the review and approval of accounting estimates, including the assumptions or inputs used in their development, by sufficiently competent and experienced members of management or those charged with governance.
- The segregation of duties between those committing the company to the underlying transactions and those responsible for developing and reviewing the accounting estimates, including whether the assignment of responsibilities appropriately takes into account the nature of the company and its products or services (e.g., relevant segregation of duties may include an independent function responsible for estimation and validation of fair value whose remuneration is not explicitly tied to such estimates of fair value).¹⁶

3.2 Substantive Testing Approaches

- This framework retains the three substantive testing approaches included in the existing standards.
- When determining a substantive testing approach (or combination of approaches) to address the identified risks of material misstatement, the auditor takes into account his or her understanding of the company and its environment, including its internal control, his or her understanding of management's estimation process, and the results of the auditor's risk assessment. In making this determination, the auditor assesses whether it is appropriate to use of the work of an auditor's specialist to address the identified risks of material misstatement.
- Audit procedures should be designed to address the assessed risk of material misstatement at both the overall financial statement level and at the relevant assertion level. With appropriate consideration to the above factors, the auditor uses one or a combination of the following three substantive testing approaches:
 - (a) Review and test management's significant assumptions and the model and underlying data used to develop the accounting estimate.
 - The nature, timing and extent of testing management's assumptions, the valuation model and the underlying data should be commensurate with the assessed level of risk and the relevance and reliability of the audit evidence that can be obtained through such testing.
 - (b) Develop an independent expectation of the accounting estimate to corroborate the reasonableness of management's accounting estimate.
 - Develop a point estimate or a range to evaluate management's point estimate. For this purpose:

¹⁵ Consistent with AS 12, paragraph 72.

¹⁶ Consistent with the themes in ISA 540.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- The auditor may choose to develop an independent accounting estimate to compare to management’s estimate by either (1) using management’s assumptions or (2) developing his or her own independent assumptions. When the auditor’s independent accounting estimate uses assumptions or methods that differ from those used by management, the auditor nevertheless understands management’s assumptions. The auditor uses that understanding to verify that his or her independent accounting estimate takes all significant variables into consideration and to evaluate any significant difference from management’s accounting estimate.¹⁷ This understanding should be obtained at the level of disaggregation determined by the auditor’s risk assessment procedures, and the depth of understanding and rigor of substantive testing should be commensurate with the associated level of risk for that disaggregated group.
- (c) Review subsequent events and transactions occurring prior to the date of the auditor’s report.
- Determine whether events occurring up to the date of the auditor’s report provide relevant and reliable audit evidence for the recorded accounting estimate.

3.3 Considerations for Evaluating Audit Evidence

- The auditor applies PCAOB Auditing Standard No. 15, *Audit Evidence* (AS 15), for purposes of designing and performing procedures to obtain sufficient appropriate audit evidence. In doing so, the auditor considers evidence obtained in other areas of the audit that contradicts evidence provided by the company to support an accounting estimate. This includes situations where the auditor has chosen to develop an independent expectation of an accounting estimate. Regardless of the nature of planned audit procedures, the auditor understands management’s process for developing the accounting estimate and considers whether the auditor is aware of potentially contradictory audit evidence, either related to the estimate or from evidence obtained elsewhere in the audit.
- The existence of contradictory evidence does not necessarily indicate that management’s accounting estimate is unreasonable. The nature, relevance and source (e.g., internal management representations as opposed to an external source such as published industry data) of contradictory evidence should be considered in conjunction with other evidence obtained, including evidence corroborating management’s conclusion. The reasonable expectations of the auditor also should be considered (e.g., if variances within a certain threshold are expected, they may not be considered contradictory evidence).

¹⁷ AU 328, paragraph 40.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- A wide range of reasonableness for an accounting estimate does not necessarily represent contradictory evidence. It may, however, reflect a higher level of estimation uncertainty, which may be an indicator of a significant risk.
- The auditor also gives appropriate consideration to information known to the auditor that contradicts management's conclusion. Once an appropriate consideration has been made, if the auditor concludes that there is sufficient corroborative evidence to support management's conclusion, the auditor documents those considerations. While the auditor considers alternative methods or assumptions not used by management, an auditor is not required to perform an exhaustive search for contradictory evidence.

3.4 Evaluating the Company's Method Used to Develop an Accounting Estimate

- When evaluating a company's method used to develop an accounting estimate, the auditor determines whether the method used by management in developing the accounting estimate is appropriate in the context of the applicable financial reporting framework. In doing so, the auditor reviews management's model, significant assumptions and other inputs and data used to develop the accounting estimate. The nature, timing and extent of these procedures should correspond with the assessed level of risk, as determined based on the process discussed in section 2, and the relevance and reliability of the audit evidence that can be obtained through such testing.
- Specifically, based on the assessed risk of material misstatement as described in section 2, the auditor evaluates whether:
 - Management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate;
 - The method(s) for making the accounting estimate(s) is appropriate and have been applied consistently from period to period, if consistency is appropriate; and
 - Changes, if any, in the accounting estimate(s) or in the method(s) for making the estimate from the prior period are appropriate in the circumstances.
- When the applicable financial reporting framework does not prescribe a particular method of measurement to be used for developing an accounting estimate, the auditor could consider the methods used within a company's industry in determining whether management's method is acceptable, if doing so is determined to be appropriate in response to the associated risk. In these instances, the auditor considers:
 - How management considered the nature of the asset or liability being estimated when selecting a particular method.
 - Whether the company operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.¹⁸
 - Additionally, this framework acknowledges the impact on the risk of material misstatement when management uses a method not commonly used in a particular industry or segment (and that method is unique to the issuer's industry). For example, there may be greater risks of material misstatement when

¹⁸ Consistent with the concepts in paragraph A25, ISA 540.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

management is departing from a method commonly used in a particular industry or environment.¹⁹

- If the auditor determines that management’s method used to determine the accounting estimate is not consistent with methods used in the company’s industry, the auditor considers why the method selected is being used and whether the selection of that method is an indication of management bias.
- The auditor also evaluates the adequacy of management’s disclosure about the method used to determine the accounting estimate, including whether it is in conformity with the applicable financial reporting framework. In doing so, the auditor also considers whether the applicable financial reporting framework contemplates the use of more than one estimation method, as Accounting Standards Codification Topic 820, *Fair Value Measurement*, acknowledges will be appropriate in some cases.²⁰ Evaluating whether management uses more than one estimation method – and the reasons for doing so (or not doing so) – could be useful in evaluating the range of reasonableness for accounting estimates with significant estimation uncertainty.

3.5 Evaluating the Reasonableness of Significant Assumptions

- Auditors plan and perform audit procedures to address the identified risks of material misstatement related to accounting estimates, which can arise from a variety of sources, including external factors (e.g., conditions in the company’s industry and environment) and company-specific factors (e.g., the nature of the company, its activities, and internal control over financial reporting).
- The auditor’s response to risks of material misstatement related to accounting estimates includes considering the sensitivity of the accounting estimate to its underlying significant assumptions and determining whether any significant assumptions are not supported by sufficient appropriate evidence. Although these procedures may be planned and performed at the relevant assertion and significant account level, the auditor determines whether the overall approach is responsive to the risks of material misstatement for the financial statements taken as a whole (see detailed discussion within section 2).
- This framework considers a description of significant assumptions that recognizes that “an assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.”²¹
 - The determination of which significant assumptions are inherently sensitive (i.e., those for which a reasonable variation in the assumption would materially affect the accounting estimate) will be informed by the auditor’s risk assessment process, including the understanding of management’s method for determining the accounting estimate, and the evaluation of the inherent estimation uncertainty within a particular accounting estimate. In other words, an auditor determines through its risk assessment procedures

¹⁹ Consistent with the concepts in paragraph A26, ISA 540.

²⁰ Paragraph 820-10-35-24B.

²¹ Consistent with the concepts in ISA 540, paragraph A107.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

the level of estimation uncertainty within an accounting estimate and the drivers of that uncertainty.

- Consistent with AU 328 paragraph 33, we believe the auditor should focus on the assumptions that management has identified as significant to the accounting estimate. AU 328 paragraph 34 states that if management has not identified particularly sensitive assumptions, the auditor considers whether to employ techniques to identify those assumptions.
- Matters that auditors may consider in evaluating the reasonableness of significant assumptions include:²²
 - Whether individual significant assumptions appear reasonable.
 - Whether the significant assumptions are interdependent and internally consistent.
 - Whether the significant assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
 - Whether the significant assumptions appropriately reflect observable marketplace assumptions (when applicable based on the accounting estimate's applicable financial reporting framework).
 - Whether significant assumptions that reflect management's expectations of the outcome of its objectives and strategies are consistent with:
 - The general economic environment and the company's economic circumstances.
 - The plans of the company.
 - Significant assumptions made in prior periods, if relevant.
 - Experience of, or previous conditions experienced by, the company, to the extent this historical information may be considered representative of future conditions or events.
 - Other assumptions used by management relating to the financial statements.
 - Whether significant assumptions that depend on management's ability and intent to carry out certain actions are reasonable in light of:²³
 - Management's history of carrying out its stated intentions.
 - Written plans and other documentation, including, where applicable, formally approved budgets, authorizations or minutes.
 - Management's reasons for a particular course of action.
 - The auditor's review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
 - Where relevant, management's ability to carry out a particular course of action given the company's economic circumstances, including the implications of its existing commitments.

²² Consistent with the concepts in ISA 540, paragraphs A77-A81.

²³ Depending on the nature of the accounting estimate and the requirements of the applicable financial reporting framework, appropriate consideration should be given to a market participant's ability and intent by applying these factors from a market participant perspective (as opposed to entity-specific).

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

- When considering the matters listed above, the auditor remains alert to contradictory evidence and does not ignore evidence that contradicts other audit evidence known to the auditor. If contradictory evidence is identified, the auditor gives appropriate consideration to whether that evidence is indicative of management bias or an error, and performs further procedures, as appropriate.
- The auditor considers his or her understanding of management’s method for determining the accounting estimate when evaluating whether any significant assumptions may exist; however, the auditor need not necessarily consider all assumptions used by management in developing their accounting estimate. To do so might focus undue attention on individual assumptions rather than their impact on the development of the accounting estimate as a whole. Existing auditing standards, and this framework, require the auditor to focus his or her efforts on the assumptions that are significant to the development of the accounting estimate.
- For accounting estimates with a high level of estimation uncertainty that give rise to a significant risk, the auditor considers how management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate (refer to Section 3.7).

3.6 Developing a Reasonable Range for an Accounting Estimate

- The auditor may develop a reasonable range for the accounting estimate as a primary audit procedure or in combination with other procedures, as described in AU 342. There are a variety of complex accounting estimates where the results of the auditor’s procedures indicate a range of ‘reasonable’ accounting estimates,²⁴ which could exceed the auditor’s established materiality threshold. If the auditor concludes that it is appropriate to develop a range, the auditor narrows the range, based on available audit evidence, until all outcomes within the range are considered reasonable.
 - Narrowing the range to a point where all outcomes within the range may be considered reasonable is achieved by:
 - Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and
 - Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.²⁵
- While a wide range may confirm that higher estimation uncertainty exists and may indicate that an accounting estimate contains a significant risk, this does not preclude the auditor, after performing sufficient appropriate procedures and obtaining sufficient appropriate evidence, from concluding that management’s accounting estimate is reasonable in accordance with the applicable financial reporting framework. Certain accounting estimates, based on their size

²⁴ As an example, ASC 275-10-50-15 identifies examples of estimates that are particularly sensitive to change in the near term, and thus could result in a range of “reasonable” accounting estimates.

²⁵ ISA 540, paragraph A95.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

and/or subjectivity, may inherently have a relatively wide range of reasonableness. The auditor considers these situations; however, not all accounting estimates can be estimated within a range smaller than the auditor's established materiality threshold simply by performing additional procedures. An auditor's assessment of certain other factors could include the following:

- Assessing evidence of management bias or lack thereof;
 - Assessing whether there were changes in the methodology used to develop the estimate and, if so, the reasons for that change. A change in the methodology can be an indicator of management bias. Similarly, a lack of a change in the methodology used to develop the accounting estimate, when facts and circumstances indicate that there should have been a change, could also be an indicator of management bias;
 - Assessing whether there were changes in significant assumptions period over period without a triggering event;
 - Evaluating the point within the reasonable range (e.g., high end vs. low end) at which the client's accounting estimate falls as compared to prior periods. Significant movement within the range may be an indicator of management bias;
 - Evaluating whether management's assumptions are inconsistent with its peers and competitors (to the extent known by the auditor);
 - Reviewing management's history of executing on its stated course of action and meeting its forecasts (e.g., budgeted operating cash flow) to evaluate the effectiveness of management's forecasting process;
 - Evaluating whether the auditor is aware of contradictory evidence related to management's accounting estimate;
 - Considering whether a specialist was used by management in developing its own accounting estimates and our assessment of the specialist's knowledge, skill, and objectivity;
 - Evaluating the transparency of management's disclosures in the financial statements regarding the estimation uncertainty of the accounting estimate and how it was derived.
- The above considerations are not applied as a checklist. The importance of each is weighed according to the particular set of facts and circumstances and the related risk assessment of the accounting estimate.

3.7 Accounting Estimates with Significant Risks

- After performing the risk assessment procedures discussed in section 2, the auditor may determine that an accounting estimate (or some component thereof) gives rise to a significant risk. When this determination is made, the auditor performs substantive procedures, including tests of details, that are specifically responsive to the risk of material misstatement. This is consistent with current requirements for significant risks in AS 13, paragraph 11.
- With respect to audit evidence for accounting estimates that give rise to significant risks, in addition to the requirements in AS 15, the auditor obtains sufficient appropriate audit evidence about whether the following are in accordance with the applicable financial reporting framework:

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and
- The selected measurement basis for the accounting estimates.
 - For example, when auditing a complex fair value measurement that is determined using a discounted cash flow analysis that includes highly sensitive management judgments, an auditor may identify this as a significant risk and would likely perform additional procedures to gather evidence to support projections prepared by the company. Additional focus also may be placed on the selected discount rate to ensure it reflects the higher level of uncertainty in the projections.
- When an accounting estimate that has a high level of estimation uncertainty is assessed as a significant risk, the auditor performs substantive procedures to meet the requirements of AS 13. These include procedures to determine whether management has assessed how the estimation uncertainty impacts the accounting estimate and related disclosures.
- The auditor's procedures should consider whether management has appropriately addressed estimation uncertainty. Examples of how management addresses estimation uncertainty could include one or more of the following:
 - Considering alternative assumptions or outcomes, and, if so, why it has rejected them;
 - Performing sensitivity analyses for significant assumptions; or
 - Considering different valuation models.
- This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of estimation uncertainty needs to be conducted through a detailed process supported by extensive documentation. Rather, it is how management has assessed estimation uncertainty in selecting the method(s) and developing the assumption(s) that is important.
 - For example, management may have documentation that supports the assumptions used, but does not explicitly list all other potential assumptions that were not used. In this case, the auditor would perform procedures to understand the process management went through when identifying the assumptions used and how management determined they were the most appropriate (i.e., how management determined not to use other assumptions).
 - Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has considered the effects of estimation uncertainty on the accounting estimate.
 - In addition, the auditor's procedures also could include evaluating:
 - Whether the significant assumptions used by management are reasonable;
 - Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so; and

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- The adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework or regulatory disclosure requirements. The auditor’s evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality.

4 Using the Work of an Auditor’s Specialist

- A specialist is a person with specialized knowledge or skill in a field of expertise other than accounting or auditing. Because income taxes and information technology, as they relate to the audit, are specialized areas of accounting and auditing, this definition should not apply to a person with specialized knowledge or skill in those areas.
- 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.²⁶ During the audit, the auditor may encounter matters that, in the auditor’s judgment, require such specialized skill in the audit.
- The auditor’s determination of whether to use the work of a specialist in the audit is driven by the auditor’s risk assessment process, as described in section 2 above. This includes considering the complexity of the accounting estimate and its significance to the financial statements, as well as the knowledge, skill, and ability of the engagement team members.
- An auditor’s specialist is a specialist who performs work to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor’s specialist may be either employed by the auditor (“auditor’s employed specialist”) or a third party engaged by the auditor (“auditor’s engaged specialist”).

4.1 Evaluating the Knowledge, Skill, and Objectivity of an Auditor’s Specialist

- If the auditor decides to use the work of an auditor’s specialist (whether engaged or employed), the auditor evaluates the knowledge, skill, and objectivity of the auditor’s specialist and supervises the auditor’s specialist’s activities. Based on this assessment, the auditor determines the nature, timing, and extent of the specialist’s involvement in the audit.
- The auditor should have sufficient knowledge of the subject matter to be addressed by the auditor’s specialist to enable the auditor to:
 - Communicate the objectives of that person’s work;
 - Determine whether that person’s procedures meet the auditor’s objectives; and
 - Evaluate the results of that person’s procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor’s report.²⁷
- As it relates to evaluating the knowledge and skill of an auditor’s specialist, the auditor should consider the following:

²⁶ AU 336, paragraph 6.

²⁷ Consistent with AS 9, paragraph 17.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- When a specialist is *engaged* by the auditor, the auditor performs an evaluation of the knowledge and skill of that auditor’s engaged specialist in order to determine the reliability of the auditor’s engaged specialist’s work.
- Factors considered by the auditor include:
 - Whether the auditor’s engaged specialist is subject to technical performance standards or other professional or industry requirements;
 - The auditor’s engaged specialist’s experience and professional reputation in the field relevant to the accounting estimate;
 - The auditor’s engaged specialist’s knowledge of and experience in the company’s industry, when relevant to the accounting estimate;
 - The auditor’s engaged specialist’s competence in the matter for which the specialist’s work will be used, including any areas of specialty within the specialist’s field;²⁸ and
 - The auditor’s engaged specialist’s competence with respect to relevant accounting and auditing requirements.²⁹
- When a specialist is *employed* by the auditor, the specialist is considered a member of the engagement team and is supervised in accordance with Auditing Standard No. 10, *Supervision of the Audit Engagement*.
 - Under Quality Control Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC 20), an auditor’s employed specialist is subject to the firm’s overall system of quality control, which includes an evaluation of an employee’s independence, integrity and objectivity, personnel management, engagement performance, and monitoring, among other things.
 - This system of quality control is intended to provide a firm with reasonable assurance that employees are independent (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.
 - QC 20 provides engagement teams that use the work of an employed specialist with the appropriate basis to evaluate an employed specialist’s knowledge, skills, and objectivity. Accordingly, the auditor can determine that their employed specialist has sufficient knowledge, skill and objectivity by concluding that the employed specialist is subject to the firm’s overall system of quality control.
- As it relates to evaluating the objectivity of an auditor’s specialist, the auditor considers the following:
 - For an auditor’s employed specialist, as discussed above, an audit firm’s system of quality control provides the auditor with the appropriate basis to evaluate the objectivity of the specialist.

²⁸ For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.

²⁹ These requirements are consistent with those listed in the PCAOB’s Staff Consultation Paper No. 2015-01, *The Auditor’s Use of the Work of Specialists* (Specialists Staff Consultation Paper) and in ISA 620.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- An auditor's engaged specialist is not a part of the accounting firm's training, resource monitoring, or overall system of quality control. Accordingly, in evaluating the objectivity of an auditor's engaged specialist, the auditor views objectivity as a continuum that, based on the auditor's judgment, affects the nature, timing, and extent of the auditor's procedures and the reliability of the specialist's work as audit evidence. In evaluating the objectivity of an auditor's engaged specialist, the auditor:
 - Obtains information regarding business, employment, and financial relationships between the auditor's specialist and the company;
 - Determines, based on an evaluation of that information, whether there are any threats to the specialist's objectivity (e.g., due to an identified relationship between the specialist and the company); and
 - If threats to the specialist's objectivity are identified, the auditor evaluates the impact of the relationship on the nature timing and extent of the audit procedures, taking into consideration whether the relationship has a significant bearing on the ability of the specialist to perform his or her work objectively.
 - For example, as the auditor evaluates the objectivity of the auditor's engaged specialist along the continuum, the auditor may determine that there is a relationship between the company and the auditor's engaged specialist that may appear to impair the objectivity of the auditor's engaged specialist. In response, the auditor would perform additional procedures to further understand the relationship. The auditor also could perform additional procedures related to the estimate his or herself, such as further evaluation of the reasonableness of some or all of the assumptions, methods, or findings of the auditor's engaged specialist. If the auditor determines that the objectivity of the auditor's engaged specialist is impaired (e.g., the auditor's engaged specialist has prepared the company's valuation), the auditor would not use the work of that auditor's engaged specialist.

4.2 Informing an Auditor's Specialist of His or Her Responsibilities

- Communication (agreement) with the auditor's specialist, whether engaged or employed, is an important element in ensuring the sufficiency and appropriateness of the audit procedures performed. The auditor agrees, in writing, with the auditor's specialist about their responsibilities, which could include:
 - The responsibilities of the auditor's specialist, including: (1) the objectives of the work that the specialist is to perform; (2) the nature, timing, and extent of the work that the specialist is to perform; and (3) matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues related to areas in which the auditor plans to use the work of the specialist;

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- When the work of the auditor’s specialist relates to an accounting estimate, whether the work of the specialist will assist the auditor in: (1) developing an independent estimate, including how the specialist’s work will use methods (which may include models) or significant assumptions; or (2) testing the methods and significant assumptions used by the company;
 - The nature of company-provided or third-party information to be used by the auditor’s specialist, including the source of the information and whether the specialist is responsible for performing work to assist the auditor in evaluating the: (1) accuracy and completeness of company-provided information; and/or the (2) relevance and reliability of third-party information;
 - Requirements of the applicable financial reporting framework that are relevant to the work of the auditor’s specialist;
 - The nature and extent of audit documentation the auditor’s specialist will provide and, if applicable, the form of report to be issued by the auditor’s specialist;
 - The nature, timing, and extent of communications between the engagement partner or other engagement team members performing supervisory activities and the auditor’s specialist, including any changes in the scope of the work of the specialist or any other changes to the matters addressed in the agreement; and
 - The importance of professional skepticism in an audit and the need to consider contradictory information.³⁰
- In communicating the responsibilities of the auditor’s specialist, the auditor also includes confirmation of the auditor’s responsibilities that are relevant to the work being conducted by the auditor’s specialist.
- This agreement between the auditor and the auditor’s specialist can be evidenced in a memorandum or other relevant workpaper documentation in the audit workpapers.

4.3 Evaluating the Work of an Auditor’s Specialist

- Once the auditor concludes that the auditor’s specialist is knowledgeable, capable, objective, and has reached an agreement regarding his or her responsibilities, the auditor evaluates the reasonableness of the specialist’s conclusions.
- The auditor’s evaluation of the work of an auditor’s specialist includes:
 - a) When the auditor’s specialist assists the auditor in developing an independent estimate or testing the methods and significant assumptions used by the company, evaluating the conclusions of the specialist about:
 - 1) The appropriateness of the methods including whether those methods are (1) in conformity with the applicable financial reporting framework, (2) generally accepted within the specialist’s field of expertise, and (3) applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company;

³⁰ These requirements are consistent with those listed in the Consultation Paper.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- 2) The relevance and reasonableness of the significant assumptions and methods in the circumstances, taking into account information presented in the report or documentation of the specialist, in view of the auditor’s understanding of the company, its environment, and other evidence available to the auditor; and
 - 3) When testing the company’s methods and significant assumptions, the basis for selecting the methods and assumptions used in developing the estimate, including whether the company considered alternative methods and assumptions.
- b) Determining whether the procedures performed and the results and conclusions of the specialist’s work:
- 1) Support or contradict the relevant financial statement assertions or conclusions regarding the design or operating effectiveness of the company’s controls;
 - 2) Are consistent or inconsistent with evidence obtained from other audit procedures performed;³¹ and
 - 3) Are consistent or inconsistent with the work agreed upon between the auditor and auditor’s specialist.
- c) In situations where the auditor believes that the results and conclusions of the specialist are not adequate for the auditor’s purposes, the auditor agrees with the specialist on the nature and extent of further work to be performed by the auditor’s specialist or perform additional audit procedures appropriate to the circumstances.³²
- As an example, the conclusion of an auditor’s specialist might indicate that the cash flow assumptions used by management in an impairment evaluation support management’s conclusion that its goodwill balance is not impaired. However, if the output of the specialist’s calculation indicates that the calculated implied fair value of a reporting unit approximates its carrying amount, the auditor may request that the specialist perform additional procedures (e.g., a sensitivity analysis) or the auditor may perform additional audit procedures appropriate to the circumstances.

5 Using the Work of the Company’s Specialist

- As noted in section 4 above, a specialist is a person with specialized knowledge or skill in a field of expertise other than accounting or auditing.
- A company’s specialist is a specialist who performs work to assist the company in its preparation of the financial statements. A company’s specialist may be either employed by the company (“company’s employed specialist”) or a third party engaged by the company (“company’s engaged specialist”).
- When the work of a company’s specialist will be used as audit evidence for an accounting estimate, the auditor performs the procedures in the following sections in addition to

³¹ These requirements are consistent with those listed in the Consultation Paper.

³² Consistent with the requirements in ISA 620, paragraph 13.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

performing risk assessment procedures, as discussed in section 2, and performs procedures to respond to the assessed risks of material misstatement, as discussed in section 3.

- As part of assessing a company's specialist, the auditor evaluates management's internal controls related to the accounts or components of accounts in which the specialist is involved, as discussed in section 3.1. The auditor also assesses the knowledge, skill and objectivity of the company's specialist and the work performed by the company's specialist, as discussed further below. The auditor may obtain information about the knowledge, skill, and objectivity of the company's specialist as part of the risk assessment procedures, when obtaining an understanding of management's process and identifying controls for testing, or through other means.

5.1 Evaluating the Knowledge, Skill and Objectivity of a Company's Specialist

- The auditor assesses the risks of material misstatement, and designs and implements audit responses that address the risks of material misstatement when using the work of a company's specialist.
- When evaluating the knowledge and skill of a company's specialist, an auditor considers, among other things:
 - Whether the company's specialist is subject to technical performance standards or other professional or industry requirements;
 - The company's specialist's experience and professional reputation in the field relevant to the accounting estimate;
 - The company's specialist's knowledge of and experience in the company's industry, where relevant to the accounting estimate;
 - The company's specialist's competence in the matter for which the specialist's work will be used, including any areas of specialty within the specialist's field; and
 - The company's specialist's competence with respect to relevant accounting and auditing requirements.
- Evaluating the degree of objectivity of a company's specialist should be viewed as a continuum that affects the nature timing and extent of audit procedures. An auditor considers, among other things:
 - Any interests and relationships that create threats to the specialist's objectivity, such as self-interest threats, advocacy threats, familiarity threats, self-review threats, intimidation threats, and any applicable safeguards, including any professional requirements that apply to the specialist, and evaluation of whether such safeguards are adequate;
 - Threats to a specialist's objectivity posed by an employment relationship and whether there is any direct reporting by the specialist;
 - The terms of the agreement to engage the specialist, including whether, and if so, how, the payment structure is tied to a particular outcome;
 - Whether management has the ability to dictate revisions to the specialist's results before finalization (with or without the agreement of the specialist);

Appendix: Auditing Accounting Estimates and Fair Value Measurements: A Framework

- The significance of the relationship between the engaged specialist and management (i.e., whether the specialist has an extensive relationship with management, and whether the fees charged by the specialist are material to the specialist); and
- The nature of other services provided by the specialist to the company.

5.2 Evaluating the Work of a Company's Specialist

- The nature, timing and extent of the auditor's procedures over the work of a company's specialist should be based on auditor's professional judgment, and responsive to the auditor's assessment of risk and the specific facts and circumstances of an audit engagement.
- In addition to those substantive procedures listed within section 3 above, when evaluating the adequacy of the work of the company's specialist, the auditor also:
 - Considers whether significant assumptions, inputs, and methods used to develop the estimate are dependent on the use of specialized models, and;
 - Focuses his or her efforts on the assumptions that are significant to the development of the estimate and consider management controls over the estimation process.

6 Use of Third-Party Pricing Sources Not Acting as a Specialist

- We agree with the distinction made in the Estimates Staff Consultation Paper that there are different types of third-party pricing sources, some of whom provide information "that is developed for, and widely available to, the public" and some of whom provide information "that is generated specifically for the auditor" or for management, and we agree with the staff that an approach in the potential new standard that could recognize some of these differences would be appropriate. Our comments in this area focus on the former.
- The relevance and reliability of evidence obtained from third-party pricing sources³³ should be evaluated for appropriateness under AS 15. For example, in general:
 - Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.
- Generally, third-party pricing sources are knowledgeable and provide independent pricing information that is free of influence from any one company and is broadly used by market participants (e.g., the same price is released to all customers, buyers and sellers, without bias).
 - Additionally, given that the pricing information provided by a third-party pricing source is used every day by market participants, and is subject to price challenges by these same market participants, there appears to be an element of monitoring inherent in the process.
- When auditors obtain independent pricing information from third-party pricing sources that is widely available for accounting estimates for which the auditor's risk assessment is determined to be of lower risk, the relevance and reliability of that information is evaluated to assess its appropriateness as audit evidence in accordance with AS 15.

³³ While this section focuses on the use of third-party pricing sources, our proposed framework could be applied to other third parties that possess skill or knowledge that is not accounting or auditing when they are not acting as a specialist.

**Appendix: Auditing Accounting Estimates and Fair Value Measurements:
A Framework**

- When auditors obtain audit evidence from third-party pricing sources not acting as a specialist, tests for relevance and reliability could include:
 - Performing due diligence over the third-party pricing source's general methodology, including how outliers may be identified in a security group (e.g., setting a range to evaluate pricing differences outside of a reasonable range);
 - Obtaining an understanding of the pricing source's price-challenge process (e.g., the frequency of price challenges, the extent to which pricing challenges are affirmed);
 - Evaluating the competence and objectivity of the pricing source;
 - Considering the quality of the pricing source (e.g., its historical accuracy and level of experience);
 - Reviewing pricing data obtained and considering the information in relation to the financial instrument; and
 - Considering inconsistent observable market information regarding the pricing assertion (i.e., contradictory evidence).
- For securities selected for testing, when the auditor determines that the third-party pricing source's methods or assumptions reflect increased subjectivity or estimation uncertainty due to a higher risk assessment, in addition to the procedures listed above for accounting estimates of lower risk, additional procedures for relevance and reliability could include:
 - Comparing the reported price with evidence of a recent transaction for the security;
 - Comparing the reported price to other relevant observable market information; and
 - Assuming a lack of observable market information, determining the need to test management's process for determining fair value, including testing the valuation model, underlying data and the reasonableness of significant assumptions, or developing an independent estimate of the fair value of the securities selected for testing for corroborative purposes.



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July 31, 2015

Office of the Secretary
 Public Company Accounting Oversight Board
 1666 K Street, N.W.
 Washington, D.C. 20006-2803

RE: Staff Consultation Paper No. 2015-01, “The Auditor’s Use of the Work of Specialists”

Dear Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board’s (“PCAOB”) Staff Consultation Paper No. 2015-01, “The Auditor’s Use of the Work of Specialists” (the “Consultation Paper”).

We concur with the Staff’s observations that the use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions. Also as noted, the Financial Accounting Standards Board (“FASB”) has issued standards that increasingly require the use of estimates such as fair value measurements causing an increase in the use of the work of specialist for financial reporting and thus auditing.

In this letter, we provide for the Board and Staff’s consideration, our views regarding the Consultation Paper in four sections, as follows:

- I. General Overview of the Concept Release
- II. Utilizing the Work of a Company’s Specialist
- III. Utilizing the Work of an Auditor’s Specialist
- IV. Other Matters

I. General Overview of the Concept Release

Auditors are responsible for conducting an audit which gathers sufficient appropriate audit evidence to provide a reasonable basis for their opinion. As noted above, business transactions have become more complex, accounting standards require more use of estimates and fair value measurements are far more prevalent within financial reporting. The Consultation Paper, Figure 1 provides examples of activities that involve the work of specialists, all of which impact financial reporting as well as audit procedures. Our principle belief is that using specialists assists management in accounting for complex transactions and assists the auditor in obtaining sufficient appropriate audit evidence. As a result, we believe using specialists, particularly in today’s financial reporting environment, is a necessary and effective approach for both management and the auditors to help manage financial reporting risk as well as audit risk. This is reinforced through AU336, “Use of Specialist” which states: “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 and base on auditor judgment, may encounter matters that require such specialized skill.” This expectation is essential to managing financial reporting as well as audit risks. We encourage the PCAOB to recognize this point when amending the standard regarding the use of a specialist.

The Consultation Paper identifies various observations from Board oversight activities in which auditors did not fulfill their responsibilities under the current audit standard AU336. These observations likely indicate a need for clearer guidance on the use of specialists, possibly matching the risk assessment

process with suggested procedures to be performed. As noted above, we believe the use of specialists reduces the risk associated with complex transactions and significant estimates, but we also recognize how specialists are engaged or employed, and their qualifications may impact the risk assessment process as well. See more on this under Section IV Other Matters within this letter.

II. Utilizing the Work of a Company's Specialist

The Staff identified various observations from Board oversight activities which clearly articulate opportunities exist to either clarify current guidance in AU336 or draft a new standard. We recommend revising the current AU336 standard to provide additional guidance when utilizing management's specialist whether employed or engaged would provide significant improvement to auditors. We believe there would also be significant benefits by correlating the risk assessment process associated with the use of a specialist to qualifications and objectivity of the specialist.

The risk assessment associated with the use of a specialist may vary depending on whether the specialist is employed or engaged by the company. However, the standard for fair value, AU 328, "Auditing Fair Value Measurements and Disclosures", paragraph 5, footnote 2 states: "For purposes of this section, management's assumptions include assumptions developed by management under the guidance of the board of directors and assumptions developed by a specialist engaged or employed by management." As noted above, we believe the utilization of a specialist typically reduces audit risk, therefore, building on this point is consistent and aligned with the broader risk assessment principles.

Footnote 2 of AU328 differs from AU336, as the latter provides that the appropriateness and reasonableness of methods and assumptions used, and their application are the responsibility of the specialist. AU328, footnote 2 requires the auditor to test specialist assumptions for reasonableness as if they were management's assumptions. AU336 indicates the assumptions are the responsibility of specialist and the auditor should evaluate whether the assumptions and methodology are unreasonable. We recommend revising AU328, to include consideration of the risks associated with the use of specialists in the areas of competence and objectivity and eliminate the concept that assumptions developed by management's engaged or employed specialists are the same as management's assumptions. This clarification could be helpful in improving audit quality and providing more consistency with PCAOB risk based standards.

III. Utilizing the Work of an Auditor's Specialist

The Staff noted in the Consultation Paper that the requirements for using the work of an auditor's engaged specialist are the same as those for using the company's employed or engaged specialist except when the company's specialist develops assumptions used in a fair value measurement (see comments in Section II above). Consistent with our observation for the use of a company engaged or employed specialist, we believe any revision to AU336 should begin with a clear risk assessment process consistent with the PCAOB risk based standards. We encourage the Staff to consider differentiating guidance and requirements based on the risk assessment process, which reflects a likely change between an auditor's engaged specialist and a company's engaged specialist as well as a company's employed specialist procedures.

The Staff also introduced the concept of AS10, "Supervision of the Audit Engagement," for an auditor's engaged specialist. The comparison was made to that of a specialist that is employed by the auditor. Specialists that are employed by the auditors are subject to independence and ethics requirements as well as supervision and quality control requirements based on being associated with an accounting firm. This requirement should not be imposed upon specialists who are engaged by the accounting firm (audit team). As noted in AU336, "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 and based on auditor judgment, may encounter matters that require such specialized skill." Given auditors do not possess the requisite

skills, which is why the specialist is engaged, supervision of the specialist's work does not seem appropriate. If AS 10 is applied to an auditor engaged specialist, auditors may be required to either employ multiple specialists so they can leverage them to supervise; or engage a second specialist to supervise the first engaged specialist all at a cost that seems to significantly surpass any benefit. By analogy, AU336 requires auditors to assess the objectivity and competence of company employed or engaged specialist. We believe that assessment should be used in the overall risk assessment process which would also help identify the procedures that need to be performed but these would not include supervision as defined by AS10.

The Staff introduced the concept of applying requirements similar to those in the SEC's Independence Rule (Rule 2-01 of Regulation S-X) to auditor's engaged specialist. We do not agree with this concept and believe it could have unintended consequences that could have a negative impact on audit quality. Specialists are not required to follow Regulation S-X. Therefore, it is unclear how the PCAOB would require this concept nor is it clear as to the auditor's responsibility to audit a specialist's assertion that they are independent. Finally, use of a company's specialist does not require declaration of independence, therefore this would likely cause confusion based on very different requirements (since independence and objectivity are not the same). By making independence a requirement, auditors may also be limited as to which specialists they might be able to engage. This could increase risk and potentially reduce audit quality and or financial reporting quality. Rather, we believe documentation of objectivity (consistent with a company specialist) is sufficient for an auditor engaged specialist.

An alternative approach to document enhanced objectivity was also noted in the Consultation Paper by the Staff. The Staff noted this enhanced approach would require auditors to document from specialists and the company information regarding business, employment, and financial relationships between the specialist and the company, then evaluate this information and determine if the specialist's objectivity is impaired. A revision to AU336 would need to be very clear on how to determine impairment of objectivity.

Both the potential objectivity enhancement and the independence concept noted above appear to discourage the engagement of a specialist by the auditor which we view to be a significant unintended consequence. We believe objectivity is represented as a continuum and the determination of the objectivity on this continuum represents a risk assessment that should impact the nature, timing and extent of additional procedures to be performed rather than simply eliminating the ability to utilize the work of the specialist. We encourage the Staff to consider this concept of a continuum as revisions to AU336 are contemplated since the elimination of specialists might have unintended consequences of increasing financial reporting and audit risks as fewer specialists are used.

IV. Other Matters

As the Staff noted in the Consultation Paper, there may be bias by the company's specialist caused by the same factors that may cause bias in other personnel of the company who are involved in preparing the company's financial statements. We understand the Staff's view, however, auditing standards already address bias in estimates and require auditors to address this potential bias by performing procedures. The Staff appear to include company employed specialists and company engaged specialists in the same general category regarding bias. We believe this bias can be addressed through documentation of objectivity and therefore do not believe bias should be evaluated in the same manner as other information produced by the company as the Staff suggested.

We believe the development of a flow chart similar to Figure 2 of the Consultation Paper should be incorporated into a revision of AU336. This flow chart could be useful for auditors to understand which specialist they are relying upon and in turn what sections of the standard are applicable. For example, general guidelines about objectivity for Specialist 2, 3 and 4 from Figure 2 could refer to specific paragraph references and potential enhanced procedures might be noted for Specialist 2. In addition, risk assessment procedures would be applicable to all situations in which specialists are utilized so some sections would be noted as applying to all. Essentially, the flow chart would serve as the road map for

the auditor to the various sections of the standard that apply and it would likely improve the auditor's understanding as to why there are differences between the requirements. We believe such a flow chart would be very helpful for auditors and improve their understanding when using specialists.



Crowe Horwath LLP supports the Board's efforts to improve its auditing standards. We believe the comments and observations in this letter will assist the Board in its consideration of the matters in the Consultation Paper and ultimately result in improved audit quality. If the Board has questions on the above comments, please contact Michael G. Yates or James A. Dolinar.

Sincerely,

Crowe Horwath LLP

Crowe Horwath LLP

Cc: Sydney K. Garmong, Crowe Horwath LLP



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July 30, 2015

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Re: Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*

Deloitte & Touche LLP (“D&T” or “we”) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Staff Consultation Paper — The Auditor's Use of the Work of Specialists* (the “consultation paper” or the “paper”), which addresses potential changes to several auditing standards (specifically, PCAOB AU 336, *Using the Work of a Specialist* (PCAOB AU 336) and PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (PCAOB AS 10)).

We support the Board's efforts to consider the need for improvement of PCAOB auditing standards relating to the auditor's use of the work of a specialist. We acknowledge and appreciate the PCAOB staff's efforts in this area to date, including their commitment to seek further input through the issuance of the consultation paper. We also commend the PCAOB staff for devoting a significant portion of the June 18, 2015, Standing Advisory Group meeting (“SAG Meeting”) to discussing matters relevant to the consultation paper and hearing input from a variety of stakeholders.

We are also supportive of the PCAOB's efforts in considering potential clarifications and amendments to the standards addressing the use of specialists in tandem with the PCAOB's project on Auditing Accounting Estimates and Fair Value Measurements. These matters are closely related, and new or amended guidance in either area therefore needs to be coordinated. We believe that close coordination of these two projects, including concurrent exposure of proposed changes to the PCAOB standards, will allow commenters to better evaluate and analyze the impact of such proposed amendments, individually and collectively. In addition, coordination of the two projects will facilitate improved economic analysis by the PCAOB staff. We believe it will be important that any resulting final standards pertaining to these two related projects become effective at the same time.

Further, as the PCAOB staff addresses the requirements regarding the auditor's use of specialists and auditing accounting estimates, we believe that it would be helpful to develop holistic and comprehensive standards that incorporate risk assessment, consideration of relevant controls, and substantive procedures, as well as relevant supervision and review considerations. While it may be possible to address these aspects or concepts by making reference to relevant requirements in the PCAOB's other auditing standards, we believe that the expectations for auditors would be more clearly set forth by addressing the relevant requirements directly in the specialists and accounting estimates standards. In addition, we recommend that the concept of professional skepticism and its application in these areas be included in any new or amended standards as opposed to solely making

reference to the concept or to other auditing standards.

In this letter, we present our views regarding the topics outlined in the consultation paper, including the suggested changes to the related auditing standards presented therein. In summary:

- Given the differences between auditor’s specialists and company’s specialists, while we support the PCAOB staff’s approach in considering these topics simultaneously, we think that these topics ought to be addressed separately in the issuance of any new or revised requirements or guidance.
- We believe any new or amended standards should closely align with the PCAOB’s risk assessment standards and provide additional clarity regarding the auditor’s responsibilities when using the work of specialists. Further, we believe the requirements should be flexible and allow for the application of professional judgment, in recognition of the increasing complexity of business transactions and business environments and the resulting, ever-changing ways auditors and companies use the work of specialists in determining and auditing financial statement balances.
- We support increased requirements and guidance related to the supervision and review of the work performed by an auditor’s engaged specialist, particularly matters related to (1) assessing the engaged specialist’s objectivity, (2) reviewing and retaining an engaged specialist’s work product supporting their procedures, and (3) assessing the relevance and reasonableness of an engaged specialist’s findings. However, we believe changing the objectivity requirements to align with auditor independence requirements will be costly and challenging to auditing firms and specialist entities.
- We believe that it is important for new or amended standards to recognize that the auditor is not be expected to have the expertise of the specialists, but rather would have sufficient knowledge of the subject matter to plan the auditor’s specialist involvement and evaluate the adequacy of the work of the auditor’s specialist for the auditor’s purposes.
- We support enhanced guidance to assist the auditor when using information prepared by a company’s specialist. We suggest an approach that results in such information being treated as audit evidence and therefore the requirements should be included in PCAOB AS 15, *Audit Evidence* (PCAOB AS 15).

Additional context, detailed comments, observations, and recommendations are provided in the remainder of this letter.

BACKGROUND AND CURRENT PRACTICE

We agree with the PCAOB staff that there has been an increase in the use of the work of specialists by companies and auditors due to the increasing complexity in both business transactions and financial reporting requirements. This increased complexity often results in the identification of new risks of material misstatement or the designation of identified risks as significant risks. Auditors, in turn, seek the assistance of specialists to appropriately respond to these risks. As indicated in the consultation paper and discussed further at the SAG Meeting, we also acknowledge that the PCAOB’s inspection

findings and those of other audit regulators or audit oversight bodies continue to include a number of audit deficiencies related to the auditor's use of the work of specialists. In addition to the efforts that firms have taken and continue to take to address these deficiencies, we also believe amendments to the PCAOB's auditing standards would assist auditors in performing more effective audits.

Given the complexity of business transactions and financial reporting requirements, we use specialists to assist with performing audit procedures in most of the audits we perform in accordance with the PCAOB's standards. Our auditors have access to thousands of employed specialists that regularly provide assistance to auditors covering a wide range of disciplines. These employed specialists provide millions of audit service hours annually. In performing our audits, we primarily use employed specialists in the areas of information technology (IT), tax, and valuation. In terms of valuation specialists, the specialist's work is often focused on assessing the appropriateness of the methods and assumptions used in the valuation, developing independent estimates, assessing subsequent events, and/or testing management's processes. We also use the work of an auditor's specialist in addressing other specialized or pervasive risks (e.g., in response to known or suspected fraud). Given the depth and breadth of available employed specialists, we rarely find the need to engage third-party specialists to assist us with our audits; however, we acknowledge that engaging third-party specialists may be more likely to occur in smaller auditing firms and, therefore, it is important that the PCAOB standards address the use of engaged specialists.

Both the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB) have updated their standards related to using the work of specialists. Because of the differing objectives between (1) the auditor's use of a specialist to assist with the performance of audit procedures and (2) the use of a company's specialist's work as audit evidence, the IAASB and ASB separated the audit requirements and guidance related to these two distinct activities. Separate auditing standards address the auditor's use of a specialist to assist with the performance of audit procedures,¹ and auditing requirements associated with information to be used as audit evidence that has been prepared using the work of a company's specialist are separately stated in the audit evidence standards.² The audit evidence standards provide guidance regarding how the auditor evaluates the relevance and reliability of information to be used as audit evidence that has been prepared using the work of a company's specialist. These standards and the related guidance are principles-based and dependent upon appropriate risk assessments and the exercise of professional judgment.

We agree with the approach of having separate standards for using the work of auditor's specialists and using the work of company's specialists. Consistent with the IAASB's and ASB's updated standards, our audit methodology separates the requirements and guidance related to the auditor's use of the work of a specialist from the requirements and guidance related to information to be used as audit evidence that has been prepared using the work of a company's specialist. In general, we approach the assessment of work performed by the company's specialist from the perspective of evaluating the sufficiency and appropriateness of the evidence that it provides. We are therefore supportive of enhancing guidance to assist the auditor in evaluating whether information to be used as audit evidence prepared by a company's specialist is sufficiently reliable. As stated previously, given

¹ The requirements and guidance relating to use of specialists by an auditor are addressed in the IAASB's ISA 620, *Using the Work of an Auditor's Expert*, and in the ASB's AU-C 620, *Using the Work of an Auditor's Specialist*.

² The requirements and guidance relating to management's use of specialists are addressed in the IAASB's ISA 500, *Audit Evidence* and the ASB's AU-C 500, *Audit Evidence*.

the differences between an auditor's specialists and the company's specialists, while we support the PCAOB staff's approach in considering these topics simultaneously, we think that these topics ought to be addressed separately in the issuance of any new or revised requirements or guidance.

Over the past several years, we have improved our audit methodology by adding and refining requirements related to the auditor's use of the work of specialists. These requirements extend beyond those prescribed by PCAOB AS 10 and PCAOB AU 336 and are the same for all of the auditor's employed specialists, regardless of their area of expertise (i.e., they are applicable to specialists with expertise within the field of accounting or auditing and outside the field of accounting or auditing). We have found that it has been most effective to apply the same supervision and review model to all of our employed specialists. Our methodology also includes separate requirements for engaged specialists used by an auditor, which are currently in line with the requirements prescribed by the ASB in AU-C 620, *Using the Work of an Auditor's Specialist*, and the IAASB in ISA 620, *Using the Work of an Auditor's Expert*, with certain additional requirements. However, as mentioned previously, we rarely engage third-party specialists to assist with our audits.

In addition to enhancements to our methodology, we have also focused on creating and providing training and other tools to further develop the competence and expertise of our employed specialists, including specific training and tools related to the PCAOB's auditing standards. As a result of these enhancements and other activities, we believe we have improved our overall audit quality regarding the use of specialists. Many of our recent changes to the requirements and guidance within our audit methodology align with the potential amendments under consideration by the PCAOB staff and set forth in the consultation paper, particularly regarding the responsibilities for the engagement partner to take responsibility for the direction, supervision, performance, and review of work performed by an employed specialist.

Further, as it relates to an auditor's engaged specialist, we believe that any new or amended standards should closely align with the risk assessment standards and provide additional clarity regarding the auditor's responsibilities. We are supportive of increased requirements and guidance related to the supervision and review of the work performed by an auditor's engaged specialist, particularly matters related to assessing the engaged specialist's objectivity, reviewing and retaining an engaged specialist's work product supporting their procedures, and assessing the relevance and reasonableness of an engaged specialist's findings. We also acknowledge that there may be practical and legal challenges with respect to applying the same supervision model to an auditor's engaged specialists. While we support increased requirements and guidance for the use of an auditor's engaged specialists, we also continue to support sufficient flexibility to allow for appropriate application of these requirements and guidance to the various types of specialist arrangements and structures.

COMMENTS BY TOPIC

Potential Amendments to Specialist Definitions

We agree with the PCAOB staff that, under any of the potential alternatives in the consultation paper, definitions would be required to distinguish between the different roles of an auditor's specialist and a company's specialist. Specifically, the auditor's specialist assists the auditor with planning, performing, and evaluating the results of audit procedures to obtain sufficient appropriate audit evidence; whereas the company's specialist performs work to assist the company in determining or

supporting amounts or disclosures reflected in its financial statements. While we are generally supportive of the potential definitions outlined in the consultation paper, we further suggest the following:

- Provide a clear distinction between a specialist (whether used by the auditor or the company), and a third-party information provider that provides information routinely and commercially available for a fee (e.g., a third party pricing service). Similarly, we believe that auditors would benefit from further clarification as to the relevant audit requirements that are applicable when information from a third-party information provider that is not considered a specialist is used as audit evidence.
- Eliminate the distinction between being “in the field of accounting and auditing” or “outside the field of accounting and auditing” as it pertains to the auditor’s specialist and clarify how the difference pertains to the company’s specialist. The potential definition of a specialist included in the paper excludes individuals with specialized knowledge or skill in the field of accounting and auditing (e.g., income tax and IT). We believe that there is a need to update the definition to reflect the increased use of the work of individuals with specialized knowledge or skill in accounting and auditing. For instance, the use of individuals with specialized knowledge or skill in the areas of income tax or IT by auditors today may extend further than the traditional income tax and IT matters (e.g., foreign income tax laws, cybersecurity, data analytics). While these “specialties” seem to be found more frequently at all auditing firms, they are more akin to other specialists than auditors. Fitting loosely into the field of accounting and auditing, the work often performed by these individuals is complex and frequently outside the expertise of the auditor, similar to an actuary or an environmental specialist. Therefore, the work of these individuals with specialized knowledge or skill in the field of accounting and auditing should be treated the same as those outside the field of accounting and auditing. As such, we recommend the definition of a specialist be inclusive of all individuals with specialized skill or knowledge irrespective of this specialized skill being inside or outside the field of accounting and auditing. We believe that the same logic should be applied to company’s specialists. In other words, a specialist is a specialist under the PCAOB’s standards regardless of whether their field of expertise partially relates to accounting and auditing.
- Clarify the internal control implications of the company’s use of a specialist. The potential definition of a company’s specialist included in the paper is helpful in describing specifically that the specialist may be engaged or employed by the company to assist in the preparation of the company’s financial statements. However, we believe that auditors would further benefit from additional clarity in describing how to evaluate the internal control over financial reporting (ICFR) implications when a company uses a specialist, as described further in the “Company’s Specialist Standard-Setting Matters” section below.

Auditor’s Specialist Standard-Setting Matters

The consultation paper provides two alternatives for how the requirements for using the work of the auditor’s specialists could be set forth in PCAOB standards as follows: (1) developing a new standard or (2) extending the supervision requirements in PCAOB AS 10 to an auditor’s engaged specialist. Our understanding is that the requirements would generally be the same for using the work of employed or engaged specialists under either approach.

Under either approach, it is critical that the requirements for supervision are sufficiently flexible to address the various types of specialist arrangements. For example, the nature of the auditor's supervision of an employed specialist under the same quality control network may differ from that of an engaged specialist outside of the audit firm. Therefore, it would be beneficial for the PCAOB staff to provide additional clarity on the application of the supervision requirements to both an auditor's engaged and an auditor's employed specialist.

Further, the supervision requirements should be scalable, consistent with the associated risk of the underlying account balance, accounting estimate, or business transaction. As such, we recommend that the requirements be flexible and allow for the application of professional judgment, in recognition of the increasing complexity of business transactions and business environments and the resulting, ever-changing ways auditors and companies use the work of specialists in determining and auditing financial statement balances.

Supervision of an Auditor's Specialist. We have the following observations and recommendations relating to the three areas where the PCAOB staff indicated that more specific requirements are being considered:

Evaluating the knowledge and skill of an auditor's specialist. While we agree with the need to evaluate the knowledge and skill of an auditor's specialist, we believe it would be more beneficial to provide a requirement setting the objective of this evaluation that is similar to the approach taken by the ASB³ and IAASB⁴ rather than listing prescriptive matters that must be considered in **all** circumstances for **each** specialist involved. This approach would allow for a principles-based requirement and the use of professional judgement in determining the necessary audit procedures to meet the objective. The more prescriptive matters currently included in the paper as a potential requirement would be more helpful as guidance to be considered by the auditor in applying the requirement.

Informing an auditor's specialist of his or her responsibilities. We agree with the potential amendments for the auditor to inform the auditor's specialist of his or her responsibilities when participating in an audit. This understanding is foundational to the ability of the specialist to carry out appropriate audit procedures that will meet the auditor's objectives and enable the auditor to effectively supervise the work of the specialist.

In addition to the items specifically listed in the potential amendment regarding matters on which the auditor and auditor's specialist should reach an agreement, we recommend the PCAOB staff also consider including the following matters: (1) specialist objectivity expectations for engaged specialists or independence expectations for employed specialists, (2) the process for resolving any specialist findings collectively by the auditor and specialist, and (3) expectations regarding the content and completeness of the specialist's work product for inclusion in the audit documentation in compliance with PCAOB AS 3 and PCAOB AS 15. By reaching agreement on these matters, both auditors and their specialists will have better clarity on the role and responsibilities of the specialist and the importance of collaboration between the auditor and the specialist throughout the audit process.

³ See AU-C Section 620, *Using the Work of an Auditor's Specialist*, paragraph 9.

⁴ See ISA 620, *Using the Work of an Auditor's Expert*, paragraph 9.

Evaluating the work of an auditor's specialist. We agree with the PCAOB staff that it is important for the auditor who reviews the work of the auditor's specialist to focus on the risks associated with the assumptions and models used in the specialist's work. We further agree with the objective of strengthening audit performance standards in this area. However, while PCAOB standards require the auditor to have knowledge of the industry, subject matter (including subject matter to be addressed by auditor's specialists), and requirements of the applicable financial reporting framework, the requirements in the potential standards need to recognize that auditors are not experts in the areas where auditor's specialists are used. As a result, there are certain limitations to the nature and extent of the review that auditors can perform over auditor's specialists, particularly an auditor's engaged specialist. The requirements need to be scalable and recognize that not all specialists are the same and, therefore, a "one-size-fits-all" approach will not suffice.

For example, we may engage specialists with expertise in valuing precious metals when the nature of the company's activities is such that this expertise is necessary to effectively audit an accounting estimate. In this scenario, the expertise is so specialized and technical that we likely would not have sufficient knowledge in the specialist's area to enable us to supervise that specialist in the same manner that we supervise other members of the engagement team in accordance with PCAOB AS 10. Specifically, while we would need to have the knowledge of the industry, subject matter, and framework as required by current PCAOB standards, we may not have the expertise to fully understand all of the technical information contained in their analyses or work product. Therefore, after having performed a robust evaluation of the competence and capabilities of the specialist and the sufficiency and appropriateness of the specialist's expertise for our purposes, we believe it would be appropriate for the auditor to rely on the specialist's expertise when gathering audit evidence to evaluate management's assertions.

We recommend that the requirements for supervision of an auditor's specialist be principles based, whereby the auditor may determine the appropriate level of supervision based on their risk assessment and professional judgement. As stated above, it is important for the standards to recognize that the auditor should not be expected to have the expertise of the specialists, but rather would have sufficient knowledge of the subject matter to plan the auditor's specialist involvement, sufficiently vet the specialist's knowledge and skills, and evaluate the adequacy of the work of the auditor's specialist for the auditor's purposes similar to the matters included in AU-C 620 paragraphs 12 and 13.

With respect to matters the auditor should evaluate when the auditor's specialist develops an independent estimate and tests the methods and significant assumptions used by the company, specific commentary was requested regarding views as to whether the potential new requirements being considered in this area are consistent with current practices. We have the following observations and suggestions in this respect:

- Our audit methodology for addressing the use of an auditor's specialist is consistent with the potential requirements as it relates to evaluating the methods and assumptions used in a management estimate. Specifically, our audit methodology allows for the evaluation of the relevance and reasonableness, in the circumstances, of significant assumptions and methods used by the auditor's specialist giving consideration to the rationale and support provided by the specialist and in relation to the auditor's other findings and conclusions. Such evaluation is often accomplished through a review of the specialist's work and, if necessary, further audit

procedures as determined by the auditor based on professional judgment.

When it has been determined by the auditor that specialist involvement is needed to assist in testing certain areas of the audit, or to assist the auditor in making such determination, it may be helpful and may enhance audit quality for an auditor's specialist to be involved in (1) the risk assessment process for that audit area, and (2) the identification of relevant controls and related assessment of their design and operation. While we do not believe that this should be required in all circumstances as it is often dependent on the assessed level of risk, we believe it would be helpful for the proposed standard to include guidance to this effect.

Regarding the evaluation of the results and conclusions included in a specialist's work, currently the potential requirements state that the auditor should determine whether the specialist's work "support(s) and corroborate(s) or contradict(s) relevant financial statement assertions or conclusions...[and such work is] consistent or inconsistent with evidence obtained from other audit procedures performed." While we generally agree with this potential amendment, we believe it is also important that the auditor's specialist have a role in the evaluation of results and resolution of any findings. It is important for the auditor and the specialist to understand, collaborate, and agree with the resolution of any findings raised by the specialist. As mentioned earlier, specialist involvement in certain complex areas may be necessary to effectively perform procedures that will result in gathering sufficient appropriate audit evidence, as auditors alone may not have the appropriate skills or expertise to perform such procedures. In turn, the auditor may not have the appropriate expertise to resolve issues raised by the specialist without the assistance and agreement of the specialist, and the amended guidance should reflect this fact.

- We have concerns regarding the view, as we understand it, that testing management's significant assumptions and methods is a less preferable substantive approach to either developing an independent estimate or reviewing subsequent events when auditing accounting estimates or fair value measurements⁵ for the following reasons:
 - In integrated audits, auditors are required to understand management's process as part of (1) assessing risk and (2) evaluating the design of internal controls. Therefore, many times it is more efficient and likely more effective to test management's process after gaining that understanding, evaluating the risk of management bias and understanding how that bias is managed and controlled.
 - Based on assessed risks, testing management's assumptions and methods may be just as effective as performing an independent estimate and more efficient to perform. For example, after we assess (1) the nature of a company's employee benefit obligation, (2) the risks associated with the plan and methods and significant assumptions used in the estimate, and (3) the nature and extent of information available from the company, we may determine that testing management's assumptions and methods is the most effective approach to obtain sufficient appropriate audit evidence.
 - Further, there are circumstances where performing an independent estimate may not be

⁵ June 18, 2015, PCAOB SAG Meeting materials, "Auditing Accounting Estimates and Fair Value Measurements: Project Update and Discussion."

possible or practical and there are no subsequent events that can be used for testing. For example, certain environmental liabilities may require the involvement of several different types of specialists who perform various studies that extend over a significant period of time. In these circumstances, it may not be possible for the auditor's specialist to recreate the studies at the necessary time to appropriately develop an independent estimate.

While we agree that tests of subsequent events and development of independent estimates are useful methods to obtain reliable substantive audit evidence, tests of management's process are prescribed by other standards (e.g., PCAOB AS 5, PCAOB AS 18) and we believe it is not appropriate to discount the value of these procedures in auditing accounting estimates, including those areas in which the work of a company's specialist is used. As such, we believe that auditors should select the audit procedures that they believe will most effectively accomplish the objectives and address the risks.

Evaluating the Objectivity of an Auditor's Specialist. The two potential alternatives included in the paper would result in significantly changing the objectivity requirements relating to engaged auditor's specialists. Although we do not typically use engaged specialists, we believe that implementation of new requirements under either of the alternatives will likely prove both challenging and costly to auditors who use engaged specialists and the specialist entities themselves. Under either alternative, specialist entities would be required to establish new processes and controls and incremental effort would also be required by auditors to evaluate the specialist's compliance with the new requirements.

Company's Specialist Standard-Setting Matters.

In the consultation paper, the PCAOB staff presents two potential alternatives for revising the current performance requirements for the auditor's use of the work of a company's specialist as follows: (1) amending PCAOB AU 336 or (2) rescinding PCAOB AU 336. We suggest an approach that results in addressing company's specialists within PCAOB AS 15.

Information Provided by Company's Specialist as Audit Evidence. Overall, we believe PCAOB standards should address the work of a company's specialist through the lens of audit evidence. Simply put, information received from the company's specialist, whether employed or engaged, is audit evidence, and its sufficiency and appropriateness should be evaluated by the auditor in the context of the particular circumstances and the related risks of material misstatement. However, audit evidence received from a company's specialist has unique characteristics and therefore it is appropriate that it require unique consideration by auditors.

As mentioned in the consultation paper and discussed previously in this letter, both the IAASB and the ASB have addressed the requirements for evaluating a company's specialist in their respective "Audit Evidence"⁶ standards. Specifically, the IAASB and ASB standards⁷ require the auditor, considering the significance of that work for the auditor's purposes, to evaluate the competence, capabilities, and objectivity of the specialist, to obtain an understanding of the work of that specialist, and to evaluate the appropriateness of the work as audit evidence for the relevant assertion.

⁶ See ISA 500, *Audit Evidence*, and AU-C 500, *Audit Evidence*.

⁷ See ISA 500, paragraph 8 and AU-C 500, paragraph 8, and related application material.

We continue⁸ to believe that including the requirements for evaluating the use of the work of a company's specialist (similar to those prescribed by the IAASB's and ASB's audit evidence standards) should be within PCAOB AS 15, and that such an approach would appropriately provide the foundational principles needed for the auditor to assess the sufficiency and appropriateness of such evidence rather than the potential requirement to test the information as if management produced it. In doing so, the nature, timing, and extent of audit procedures necessary to perform on this audit evidence would be based on the associated risk assessment and the auditor's professional judgment, which may include determining the need to validate or recalculate the amount determined by the company's specialist but would not necessarily be required in all circumstances (e.g., a consideration point may be that the company's specialist is subject to professional standards and is appropriately credentialed, such as an actuary).

Internal Control over Financial Reporting (ICFR) Considerations. Currently, the consultation paper does not address the implications of the potential changes on the auditor's assessment of ICFR. As the PCAOB staff considers the potential amendments related to using the work of a company's specialist, we recommend the PCAOB staff consider management's responsibilities under current SEC guidance and whether there are any ICFR implications for auditors that require PCAOB staff guidance.

Other Matters

Evaluation of PCAOB AU 9336. The consultation paper does not address the consideration of PCAOB AU 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*, specifically the topic of "The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140." We recommend the PCAOB staff assess the requirements and guidance included in this interpretation and update as necessary as part of the auditor's use of the work of specialists project.

Implications for PCAOB's Quality Control Standards. The consultation paper indicates that as part of evaluating the knowledge and skill of an employed specialist, an auditor may use information contained in the firm's quality control system. We agree this is an important consideration in making this evaluation; however, we note that the implications for the necessary procedures relating to an employed specialist (who would be subject to a firm's system of quality control) would differ from those related to an engaged specialist (who would not be subject to the firm's system of quality control). The PCAOB's quality control standards do not currently specifically address the auditor's use of a specialist; accordingly, we recommend that consideration be given to the need for making appropriate updates in this regard.

ECONOMIC IMPACT AND IMPLICATIONS

We support the PCAOB staff's efforts to obtain information and views regarding economic implications of the alternatives addressed in the paper. We encourage the PCAOB staff to continue to conduct additional research and analysis as alternatives are considered, and as they develop the proposed

⁸ Refer to comments included in our letter dated November 3, 2014, regarding *Staff Consultation Paper – Auditing Accounting Estimates and Fair Value Measurements*.

standards or amendments related to an auditor's use of specialists.

Expanded requirements for auditors will result in increased audit effort and related costs. For example, requirements for auditors to test information produced by a company's specialist "as if it was produced by management" or requiring an engaged specialist to be independent in accordance with the requirements of Rule 2-01 of Regulation S-X will drive incremental audit effort. It is critically important that new auditor responsibilities be consistently aligned with clear expectations or requirements for companies, especially as they relate to financial reporting controls and the extent to which management can use or rely on work performed by a company's specialist. Disproportionate increases in audit costs will likely result if the requirements for auditors are not aligned with those of management.

Outreach to and collaboration with others, including preparers, investors, the FASB, SEC, and especially the specialist professions is an essential element of this project and key to developing approaches for the initiative to not only address the issues relating to the use of specialists by auditors as discussed above, but also in connection with assessing the economic impact and implications of proposed alternatives to amending the PCAOB's auditing standards.

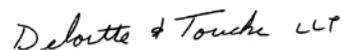
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D&T appreciates the opportunity to provide our perspectives on these important matters. Our comments in this letter are intended to assist the PCAOB staff in analyzing the relevant issues and potential effects of PCAOB standard-setting activities related to the use of specialists. We have attempted to provide comprehensive input which we hope will be helpful to the PCAOB staff in moving forward to the next stage of this very important project. We encourage the PCAOB to continue to engage in active and transparent dialogue with commenters and other stakeholders as any proposed standards are developed and alternatives are considered.

Notwithstanding our recommendations for addressing issues and challenges related to using the work of an auditor's specialist and a company's specialist, given the significance of these areas we believe it is important for the PCAOB to take action in moving this initiative forward in tandem with its efforts regarding auditing accounting estimates and fair value measurements. We welcome the opportunity to continue to assist in whatever way we can.

If you have any questions or would like to discuss these issues further, please contact Thomas Omberg at 212-436-4126, John Fogarty at 203-761-3227, or Dave Sullivan at 714-436-7788.

Very truly yours,



Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
 Lewis H. Ferguson, PCAOB Member
 Jeanette M. Franzel, PCAOB Member
 Jay D. Hanson, PCAOB Member

Steven B. Harris, PCAOB Member

Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards

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Brian T. Croteau, SEC Deputy Chief Accountant

July 31, 2015

VIA E-MAIL: comments@pcaobus.org

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street N.W.
Washington, D.C. 20006-2803

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

Dear Members of the Board and Staff:

Dixon Hughes Goodman LLP ("DHG") welcomes the opportunity to comment on the staff of the Office of the Chief Auditor's (the "Staff") of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") *Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists* (the "Consultation Paper").

Headquartered in Charlotte, NC, DHG ranks among the top 20 public accounting firms in the nation, with more than 1,800 professionals and staff in 12 states, and is a member of Praxity, a global alliance of independent firms. This letter includes our views, observations, and recommendations on the Consultation Paper. Our responses are framed by our experiences serving middle-market public issuers and nonpublic broker-dealers, and the potential impact certain alternatives outlined in the Consultation Paper could have on both our client base and similar-sized accounting firms.

Overview

Overall, DHG is generally supportive of the Staff's consideration of developing potential revisions related to the auditor's use of the work of specialists, and commend the PCAOB for developing the Consultation Paper, and holding a special Standing Advisory Group meeting, to solicit stakeholder feedback prior to proposing formal amendments to the auditing standards. We believe certain concepts considered in the Consultation Paper could strengthen audit evidence in the auditor's use of the work of specialists; however, we have reservations regarding some of the alternatives suggested that we believe would significantly increase the efforts (and costs) of an auditor's use of the work of specialists without a commensurate reduction in audit risk.

We also commend the Staff for acknowledging within the Consultation Paper the auditor's ability to use the work of a specialist in situations that require knowledge and subject matter expertise not possessed by the auditor. An auditor cannot be expected to have the expertise of a person trained for or qualified to engage in the practice of a profession not related to accounting and auditing, and the continuation of this general premise is critical to effectively enhancing the existing auditing standards. We believe the ability of the auditor to access such expertise must not be limited to specialists employed by the audit firm. In



our view, certain proposed requirements within the Consultation Paper could diminish an audit firm's ability to utilize engaged specialists, yet provide no demonstrated enhancement to audit quality.

For instance, requiring the auditor to evaluate an engaged specialist similar to an employed specialist (i.e., applying supervision requirements of Auditing Standard No. 10, *Supervision of the Audit Engagement* ("AS 10")) or requiring the auditor's engaged specialist to comply with the provisions of Rule 2-01 of Regulation S-X ("Rule 2-01") could result in significant increases in costs to engage specialists, and potentially reduce the number of specialists willing to be engaged by audit firms. Either outcome would create barriers to audit firms that cannot employ specialists in all professions they may need to access. Such barriers could result in audit firms deciding, or being forced, to exit auditing certain types of public issuers, and could prevent audit firms from enhancing their expertise in existing industries, or limit their ability to develop expertise in emerging industries and markets. We believe such barriers would particularly affect smaller and medium-size audit firms (and their clients) that may face challenges in employing specialists in a wide variety of disciplines.

In addition, although we support the consideration of potential changes to the existing auditing standards, we do not support the Staff suggestions to rescind AU Section 336, *Using the Work of a Specialist* ("AU 336"),¹ and require the auditor to evaluate evidence provided by a company's specialist similar to other evidence provided by the company to the auditor.² AU 336 is built upon a core premise that 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 and, based on auditor judgment, certain matters may require specialized skill or knowledge in order to obtain appropriate evidential matter in the audit.³ This fundamental premise provides a framework for the auditor to evaluate the work of an auditor's engaged specialist or management's specialist (whether engaged or employed) without having to replicate it. Alternatively, we believe AU 336 should be strengthened (not diminished) by supplementing the principles of AU 336 through certain clarifying standard-setting enhancements and the development of application guidance.

We have provided certain comments and recommendations below that we believe will assist the Staff in considering potential enhancements to the auditor's responsibilities regarding using the work of a specialist. In considering our recommendations, as well as recommendations provided by other stakeholders, any amendments to the existing auditing standards should, at a minimum, (i) align with the Board's risk assessment standards, recognizing the relationship between the auditor's risk assessment and the audit procedures designed to sufficiently and appropriately respond to those risks, and (ii) retain the general concepts in AU 336 to continue to allow, and not limit, the auditor's ability to utilize specialists in instances where the auditor lacks the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.

Use of an Auditor's Specialist

Extension of the Auditor's Supervisory Requirements

The Consultation Paper contemplates a potential extension of the supervision requirements of AS 10 to engaged specialists, which would integrate an engaged specialist into the engagement team, and require

¹ Page 32, the Consultation Paper.

² Ibid.

³ Paragraph 6, AU 336.



the auditor to supervise and evaluate the specialist's compliance with PCAOB standards (e.g., Quality Control, Ethics and Independence standards) consistent with other members of the engagement team.⁴

We acknowledge the auditor's responsibility for assessing the qualifications and objectivity of the specialist and believe that AS 10 provides appropriate requirements regarding the auditor's responsibilities to supervising the audit engagement, including supervising of the work of the auditor's employed specialist. However, we do not believe it is appropriate (or practical) to expand these supervisory requirements to an auditor's engaged specialist. There are recognized differences between an employed specialist, who is considered an employee of the audit firm, and an engaged specialist, who is essentially a contractor specifically engaged to provide specialized services and skills to the audit and not considered a member of the audit engagement team, and therefore, not subject to the audit firm's system of quality control. Further, an engaged specialist typically maintains their own internal systems, models, and data to assist in developing or assessing the specialist's work product or conclusions. Some of these systems, models, and data may be proprietary to the specialist or otherwise not accessible to the auditor. Therefore, it is unclear how the auditor would be able to provide supervision consistent with the requirements of AS 10 to an engaged specialist.

We believe these differences are important in determining the auditor's supervisory responsibilities, and such differences have been acknowledged by other international auditing standard-setters (i.e., the International Auditing and Assurance Standards Board). Therefore, rather than extend the supervisory requirements of AS10 to the auditor's engaged specialist, we believe it is more appropriate to acknowledge within the auditing standards that an engaged specialist is not a member of the engagement team and develop supervisory responsibilities that take into account this general premise. For instance, the Staff could consider a framework similar to International Standard on Auditing No. 620, *Using the Work of an Auditor's Expert* ("ISA 620"), which specifically acknowledges that an auditor's external expert (i.e., engaged specialist) is not a member of the audit team and therefore not subject to the audit firm's quality control policies and procedures,⁵ and requires the auditor to take this into consideration in determining the nature, timing, and extent of audit procedures in using the work of an external specialist.⁶

Evaluating the Knowledge and Skill of the Specialist

The Staff is considering within the Consultation Paper whether specific enhancements are needed to improve the auditor's evaluation of whether an auditor's specialist (whether engaged or employed) has the necessary knowledge and skill to perform the assigned tasks related to the audit.⁷ These potential requirements would expand upon the auditor's current responsibilities under AU 336⁸ to evaluate the professional qualifications, experience, and reputation and standing of an auditor's specialist, and are generally consistent with ISA 620 and AU-C Section 620: *Using the Work of an Auditor's Specialist* ("AU-C 620").⁹

⁴ Page 28, the Consultation Paper.

⁵ Paragraph A12, International Standard on Auditing 620, Using the Work of an Auditor's Expert.

⁶ Paragraph 8(e), ISA 620.

⁷ Page 36, the Consultation Paper.

⁸ Paragraph 8, AU 336.

⁹ Footnote 73, Consultation Paper.



We agree with, and generally support, the Staff's suggested enhancements to evaluating the knowledge and skill of an auditor's specialist (whether employed or engaged), and believe these enhancements are generally consistent with ISA 620 and AU-C 620. However, the Staff's suggestion in evaluating the knowledge and skill of an employed specialist that, "*the auditor may take into account information available from the accounting firm (e.g., information contained in the firm's quality control system, results of internal and external inspections, and results of the firm's performance reviews)*"¹⁰ may imply that an auditor is obligated to prepare a performance evaluation any time a specialist is utilized on an audit engagement, rather than rely on the evaluation(s) of the specialist contained in the firm's system of quality control. Further, the suggested linkage to inspection results (both internal and external) could imply that the auditor's evaluation of the knowledge and skill of the specialist should be narrowly focused on inspection considerations.

We believe, in instances where the specialist is subject to the audit firm's system of quality control (i.e., employed specialist), unless information provided by the audit firm or other parties suggest otherwise,¹¹ the auditor's evaluation should be based on information contained within the firm's system of quality control. However, the auditor is still required to evaluate whether an auditor's specialist (whether employed or engaged) has the necessary knowledge and skill, and we believe ISA 620 provides an appropriate basis for this evaluation. Specifically, paragraph 10 of ISA 620 requires the auditor to obtain a sufficient understanding of the specialist's field of expertise to enable the auditor to determine the scope and objectives of the specialist's work, and evaluate the adequacy of specialist's work.

Further, as engaged specialists are not subject to the audit firm's system of quality control, we believe there are opportunities for the auditor to expand his or her evaluation of the knowledge and skill of the engaged specialist. For instance, ISA 620, in particular paragraph 9 and the related application guidance in paragraphs A15 through A17 provides guidance, including potential sources of information the auditor could obtain and other matters that the auditor could consider, in evaluating the engaged specialist's knowledge and skill. Therefore, we encourage the Board to consider similar guidance in advancing the auditor's responsibilities in this area.

Informing the Specialist of His or Her Responsibilities

We support the Staff's potential requirement for the auditor to reach an agreement with the auditor's specialist, in writing, on certain matters that are the responsibility of the specialist.¹² However, we believe flexibility in the approach to matters covered and methods of evidencing the agreement will foster more effective two-way communication between the auditor and the auditor's specialist, and the auditor should be allowed to comply with these requirements in various forms (e.g., engagement letter, as part of planning procedures, audit programs, separate memorandum, or other documentation). In particular, footnote 74 of the Consultation Paper provides the auditor with flexibility in evidencing such agreements and we believe similar language should be explicitly stated within the enhanced auditing standards.

¹⁰ Page 36, the Consultation Paper.

¹¹ Consistent with the general application guidance within International Standard on Auditing 220, Quality Control for an Audit of Financial Statements and paragraph A13 of ISA 620.

¹² Page 37, the Consultation Paper.



Evaluating the Work of the Auditor's Specialist

We appreciate the Staff's efforts in considering the need for specific requirements for evaluating the work of an auditor's specialist (whether employed or engaged), to ensure alignment with the requirements of paragraph 5(c) of AS 10.¹³ However, requiring the auditor, in instances where the specialist develops independent estimates, to "*determine whether*"¹⁴ the methods (and possibly models) used by the specialist are appropriate, and the significant assumptions used by the specialist are reasonable, could result in the auditor re-performing the specialist's work and developing an independent conclusion on the audit matter, notwithstanding that this may be the very reason the auditor engaged the specialist. Further, if the auditor has concluded that a specialist is competent, objective, and has an understanding of the specialist's responsibilities, it is unclear to us why the auditor should not be able to rely on the specialist's execution of the procedures and evaluate the reasonableness of the specialist's conclusions. Additionally, requiring the auditor to validate the specialist's conclusions (i.e., re-perform the specialist's work) could impose a mandate that the auditor must have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. This goes against the core premise of AU 336, in which the auditor is not expected to possess the expertise of another profession.

We continue to believe it is necessary for the auditor to evaluate the significant methods and assumptions used by, and findings or conclusions reached by the specialist, taking into account the relevance and reasonableness of the findings and conclusions and their consistency with other audit evidence, regardless of whether the specialist develops an independent estimate or tests the methods and assumptions used by management. However, the auditor should not be required to re-perform the specialist's work or validate a specialist's models. Further, consistent with ISA 620, in situations where the auditor believes that the findings of the specialist are inconsistent with other audit evidence, the auditor should agree with the specialist on the nature and extent of further work to be performed by the auditor's specialist or perform additional audit procedures appropriate to the circumstances.¹⁵

Evaluating Objectivity

Evaluating the objectivity of an auditor's specialist (whether employed or engaged) is important in determining the reliability of the work provided by the specialist as audit evidence. We support the Board's intention to enhance the auditor's responsibilities to evaluate the objectivity of an auditor's specialist. However, there are certain suggestions in the Consultation Paper that we believe could significantly affect the auditor's ability to engage specialists, and we do not support any suggested amendments to the auditing standards that would result in significant additional efforts (and costs), or create barriers for smaller to medium-size audit firms to continue to audit public companies. We also do not support any amendments that could potentially diminish the population of engaged specialists, who may decide to forego working with audit firms due to extensive compliance and monitoring requirements.

A specialist's objectivity is a factor that significantly affects whether the work of the specialist will be adequate for the auditor's purpose, and the auditor should assess matters that would be relevant to the specialist's objectivity. Below we have provided our views and recommendations regarding the alternative

¹³ Page 39, the Consultation Paper.

¹⁴ Page 40, the Consultation Paper.

¹⁵ Paragraph 13, ISA 620.



approaches considered by the Staff in potentially enhancing the auditor's evaluation of the objectivity of an engaged specialist.

- Compliance with Rule 2-01 of Regulation S-X

We do not support the Staff's potential alternative of requiring the auditor's engaged specialist to comply with the provisions of Rule 2-01. As noted earlier, an engaged specialist is not considered a member of the engagement team, and therefore, would not be subject to the audit firm's system of quality control, including the audit firm's compliance with (and monitoring of) the Securities and Exchange Commission's independence rules. As Rule 2-01 was written primarily for accounting firms (i.e., audit firms), it is unlikely that specialists not associated with an audit firm would have adopted policies and systems of quality controls to assess compliance with the rule. Accordingly, for a specialist to comply with (or provide reasonable assurance to the audit firm that the engaged specialist has complied with) Rule 2-01, the specialist would have to adopt new policies, procedures, and controls, some of which the specialists may not be able to adopt without undue burden and significant costs.

It is also unclear from the Consultation Paper who would ultimately be responsible for evaluating the specialist's compliance with Rule 2-01, as many specialists may not have quality control systems designed to ensure compliance with independence requirements. This could potentially result in audit firms being required to evaluate and monitor compliance with regulations of individuals and entities outside the auditing profession, of which we adamantly oppose. Audit firms that do not employ specialists may also not find it cost-beneficial to establish an infrastructure to evaluate and monitor engaged specialist's compliance with Rule 2-01, which could limit audit firms' ability to continue to audit certain public companies, particularly for smaller and medium-size audit firms. Further, some specialists could decide not to accept engagements with audit firms due to the compliance and monitoring requirements of Rule 2-01. This would diminish the population of available specialists and could have a significant impact on the quality of an audit; particularly in situations where there is a limited number of specialists that possess a particular skill.

In essence, Rule 2-01 was written for audit firms and not for other organizations; specialist entities and individual specialists may have considerable challenges in complying with this rule. Requiring engaged specialists to comply with Rule 2-01 likely will also impose significant limitations on an auditor's ability to engage a specialist willing to implement processes and procedures necessary to demonstrate compliance with Rule 2-01. Therefore, we strongly recommend the Board not pursue this alternative.

- Enhanced Objectivity Approach

We generally support the Staff's consideration of an enhanced objectivity approach that would expand upon the current requirements of AU 336, but not impose direct compliance with Rule 2-01 that could limit the auditor's ability to engage a specialist or hinder the specialist's ability (or desire) to provide services to audit firms. In particular, we support the identification of certain business relationships, financial relationships, or employment relationships that could impair a specialist's objectivity, and generally, auditors today perform certain inquiries of engaged specialists in order to assess this. However, it is unclear to why the auditor should be required to "*obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's request for information*,"¹⁶ as we do not believe the audit evidence obtained would be of sufficient benefit to the audit to warrant the potential

¹⁶ Page 50, the Consultation Paper.



costs to accumulate such information. We believe a more appropriate approach is for the Staff to consider guidance similar to ISA 620, which requires, in instances where the auditor is evaluating the competence, capabilities, and objectivity of an external expert (i.e., engaged specialist), inquiries regarding interests and relationships that may create a threat to that expert's objectivity.¹⁷

Finally, we do not agree with the Staff's suggestion that if a specialist's objectivity is impaired, the auditor should not use the work of a specialist,¹⁸ as this would remove the ability for the auditor to apply additional procedures and could limit the auditor's ability to use the work of the specialist when certain relationships are noted. For instance, there may be situations where there are very few specialists that possess a particular skill, which could limit the auditor's ability to engage a qualified secondary specialist.

AU 336 provides an appropriate framework¹⁹ for responding to situations in which the auditor believes a relationship with the company might impair the specialist's objectivity. This includes the auditor performing 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 engaging another specialist for that purpose, and we encourage the Staff to consider maintaining and incorporating enhancements to strengthen this framework. For instance, AU 336 could be enhanced to provide additional clarification around the auditor's objectivity evaluation, including how this evaluation affects the auditor's assessment of the reliability of the evidence obtained from the specialist.

Use of a Company's Specialist

In evaluating the alternatives contained within the Consultation Paper, we recognize the need for additional guidance to enhance practice, due to potential varying interpretations of AU 336. However, as previously mentioned, we do not support the Staff suggestions to rescind AU 336, as we believe rescinding AU 336 could limit the auditor's ability to exercise professional judgment in determining the sufficiency of audit evidence based on risk, and inadvertently create a requirement for the auditor to now possess expertise in areas and professions outside of accounting and auditing. Ultimately, this would be costly to both audit firms and issuers, and would not provide a correspondingly significant increase in audit quality.

The auditor's ability under AU 336 to utilize the work of a company's specialist, if it is responsive to the auditor's assessment of risk, should be maintained and strengthened through certain clarifying guidance, and we support enhancements to AU 336 that would allow the auditor to continue to exercise professional judgment in response to assessed audit risks. International Standard on Auditing 500, *Audit Evidence* ("ISA 500") includes specific consideration for information that has been prepared using the work of a company's specialist ("management's expert" in ISA 500) and used as audit evidence. In particular, paragraph 8, and related application guidance (i.e., paragraphs A34 – A48), of ISA 500 notes that the auditor should take into account the competency, capabilities, and objectivity of the specialist, obtain an understanding of the specialist's work, and evaluate the appropriateness of the specialist's work as audit evidence. We believe this guidance provides an appropriate framework for the auditor to apply professional judgment and retain the flexibility in evaluating the risk and responding accordingly.

¹⁷ Paragraphs 9 and A20, ISA 620.

¹⁸ Page 47, the Consultation Paper.

¹⁹ Paragraph 11, AU 336.



Finally, we recognize the need for additional clarity; however, we do not believe it is appropriate to eliminate language in AU 336 that states, “*the appropriateness and reasonableness of the methods and assumptions used and their application are the responsibility of the specialist*”²⁰ as this statement specifically supports the core principle that the auditor is not expected to have the expertise of another profession. Therefore, we encourage the Board to consider retaining and enhancing this extant language. For instance, implementing similar guidance to paragraph 8 of ISA 500 would provide a better path for the auditor to evaluate the specialist and understand the specialist’s work, while maintaining the notion that the methods and assumptions are the responsibility of the specialist.

Testing Specialist Information as it Came from Management

We agree an auditor should evaluate the significant assumptions and inputs used by a company’s specialist similar to evaluating information produced by the company’s management. However, imposing a requirement for the auditor to evaluate the reasonableness of the methods (and models) used by a company’s specialist in the same manner as the auditor evaluates information produced by the company’s management could result in the application of audit procedures that are inconsistent with the assessed risk of material misstatement. Such a requirement would also substantially limit the reliance an auditor could place on the specialist’s work, and the auditor (or the auditor’s engaged or employed specialist) would have to re-perform the work of the company’s specialist, regardless of the auditor’s assessment of risk of material misstatement.

The Staff acknowledges that in cases when the auditor does not possess the specialized knowledge or skill to perform the more rigorous procedures that would result from implementing either suggested alternative noted within the Consultation Paper, the auditor may need to employ or engage their own specialist.²¹ We agree this is appropriate when the auditor’s risk assessment indicates such a response is warranted. However, if required to test all of the company’s specialist information as if it came from management, this could result in the auditor employing or engaging their own specialist in situations where such a response may not be supported or reflective of the auditor’s risk assessment. The auditor’s specialist would essentially be performing similar tasks as the company’s specialist, which could result in duplication of efforts, and create potential audit inefficiencies, without any evidence of a corresponding benefit to financial statement users or consideration of the auditor’s assessed risk to the financial statements.

We believe that the auditing standards should continue to be responsive to the auditor’s assessment of risk of material misstatement, and allow the auditor to design an audit approach responsive to risk. While in some cases using an auditor’s engaged or employed specialist to evaluate the work or conclusions of a company’s specialist is appropriate (when the auditor’s risk assessment indicates such a response is warranted), we caution against considering amendments to the auditing standards that would make this a requirement in all cases.

²⁰ Page 30, the Consultation Paper.

²¹ Ibid.



Definitions

We support the Staff's suggested specialist definitions,²² including the continued recognition of income tax and information technology as specialized areas of accounting and auditing and the exclusion of those persons from the definition of a specialist. We also commend the Staff for acknowledging that the definition of an auditor's specialist should not include all third parties that an auditor might use, particularly, a third party that provides prices of financial instruments to the auditor that it routinely makes available for a fee,²³ and believe this important distinction should be acknowledged in the auditing standards.

* * * *

DHG is supportive of the Staff's consideration of developing potential revisions related to the auditor's use of the work of specialists and commends the Board and its Staff for advancements made in this important area. We appreciate the opportunity to comment on the Staff's Consultation Paper and are pleased to discuss any questions the Board and its Staff may have concerning our comments. Please direct any questions to Dave Hinshaw, Managing Partner, Professional Standards Group at 704.367.7095 (dave.hinshaw@dhgllp.com) and Jeffrey Rapaglia, Partner, Professional Standards Group at 704.367.5914 (jeff.rapaglia@dhgllp.com).

Sincerely,

Dixon Hughes Goodman LLP

Dixon Hughes Goodman LLP

²² Page 34, the Consultation Paper.

²³ Ibid.

Mr. Martin F. Baumann
Chief Auditor
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

July 30, 2015

Re: Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialist*

Dear Mr. Baumann,

We welcome your invitation to comment on your Staff Consultation Paper No. 2015-01: *The Auditor's Use of the Work of Specialist* (the "SCP"). As the leading provider of independent valuation support to public registrants and investment company managers, we have unique insight and experience with respect to the rigor and support preparers of financial statements utilize in estimating fair value and the scrutiny auditors apply in auditing fair value measurements.

Our comments herein are derived from years of experience supporting management with their valuation estimates and echo the opening remarks of Jouky Chang as panelist in the June 18, 2015 meeting of the PCAOB's Standing Advisory Group. Further, our personnel support industry efforts to enhance consistency and transparency, including participation on FASB's Valuation Resource Group, various AICPA and TAF (The Appraisal Foundation) task forces and working groups, and other industry bodies such as the International Private Equity and Venture Capital Valuation Board, and the International Valuation Standards Council.

Our goal in responding to your invitation to comment is to provide our expertise and experience as you consider changes to audit standards which, in turn, will guide the accountability of auditors in exercising their role in capital markets - ensuring that financial information meets the needs of investors and is provided on a reliable, high-quality, consistent, transparent and cost-effective basis.

Comments

We have fashioned our comments to be collectively responsive to the issues raised in SCP questions 8b, 14, and 15, which we believe are questions that are most relevant to and addressable by specialists. Further, our comments are specific to our unique role in the financial reporting process.

Question 8: *When an auditor obtains an understanding of the methods used by the company's specialist:*

b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

Office of the Secretary
July 30, 2015
Page 2 of 3

Question 14: *Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?*

Question 15: *How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?*

We are encouraged by the distinctions made in the SCP of the differing roles that specialists may have in the financial reporting process (see SCP Figure 2) and remind the PCAOB to fully consider them in any rulemaking or standard setting initiatives.

Duff & Phelps predominantly support management teams to enhance their internal control process with respect to estimating fair value and/or we assist management teams with fair value analyses that serve as an input for consideration by management in preparing their financial statements. We are most often in the role of the specialists engaged by the company, as described in the SCP.

Management is responsible for the assertions contained in the financial statements and cannot abdicate this role to a third party. However, management can enhance their process by obtaining support from experienced independent valuation professionals. For example, it has become best practice of the largest Private Equity and Hedge Fund investment managers to validate fair value estimates using a qualified, experienced third party. Investors have come to rely on enhanced internal control systems which appropriately include specialized valuation expertise. Further, traditionally management has sought assistance from third party valuation specialists in complying with financial reporting requirements related to business combinations, impairment testing and share-based compensation, among others. In either case, the valuation professional is engaged to assist management in fulfilling management's responsibility of preparing financial statements.

Cognizant of our role in the financial reporting process, we have put in place an organization structure that brings together seasoned valuation professionals with the requisite technical and industry experience to address the needs of the client, that is complimented by systems and procedures that are designed to maintain independence and objectivity, identify potential conflicts, and protect confidentiality.

A bespoke work plan is thus developed for each engagement that considers our historic experience with that client and its audit team and the nature and complexity of the underlying transaction; incorporates procedures to independently test the reasonableness of management provided projections and assumptions against relevant market data and our industry experience; and provides for the continual involvement of key personnel from the client and the audit team. These steps ensure our team has properly interpreted the information provided by management and for management to understand the basis for the assumptions being applied in our methods. Further, it is of paramount importance that management is fully informed as to our valuation process and conclusions so they can take appropriate ownership and responsibility for preparation of the financial statements.

Office of the Secretary
 July 30, 2015
 Page 3 of 3

Our firm's quality control (QC) process is a critical component of and is embedded into our overall work plan. It starts with the careful selection of key personnel with the needed product and market disciplines that understand not only the subject assets / liabilities, but also the appropriate models and market factors to take into consideration in their work.

During the project execution phase, we use industry best practice guides as a primary reference to maintain the consistency and quality of our valuations. Further, we will model varying scenarios / alternative assumptions that impact underlying cash flows to assess sensitivities and key valuation parameters. Our executive review process by MDs and directors pays close attention to market comparable intelligence, unique asset / liability attributes, and the sensitivities modeled by our colleagues before forming their tentative conclusions. The models are also subject to at least one full tic and tie validation by D&P professionals that are independent of the engagement team.

Before our work product is shared with the client, an independent review of the analysis and findings is conducted by the Concurring Managing Director. The review includes an assessment of work paper defensibility, comparability to and consistency with other engagement work products, an assessment of market conditions considered, and the uniqueness of the asset / liability.

Our work product is presented in the form of a written report accompanied by supporting exhibits. Our experience shows that the combination of auditor involvement at the onset and throughout the engagement, the contents of the written report and the exhibits, and our responses to the auditor's queries has provided the auditors with sufficient basis upon which to conclude and sign off on our work product.

We appreciate the opportunity to provide the Staff our thoughts on this important initiative. Our comments have been, by design, relatively brief and high level. We would welcome the opportunity to provide the Staff with additional information on how management uses third parties to assist in their fair value estimates and the multitude of ways that auditors evaluate such enhancements to managements control process.

Please let us know how we can be of further assistance.

Best regards,



Paul F. Barnes
 Managing Director
 Leader – Valuation Advisory Services



Jouky Chang
 Managing Director
 Valuation Advisory Services



July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Staff Consultation Paper 2015-01

Eide Bailly LLP welcomes the opportunity to comment on the PCAOB's *Staff Consultation Paper 2015-01 – The Auditor's Use of the Work of Specialists* (the Consultation Paper). Eide Bailly is a registered public accounting firm serving mid-sized and smaller issuers and broker-dealers. We have provided general comments, followed by more specific comments on certain topics raised in the Consultation Paper.

General Comments

We concur with the Staff's observations regarding the increasing complexity of business transactions, and thus the increased challenges in auditing those transactions. Accordingly, we support the Staff's consideration of amendments to existing auditing standards, and where appropriate, additional guidance related to those standards. We believe that any such amendments to existing standards regarding the auditor's use of a specialist be appropriately aligned with the Board's existing risk assessment standards, allow for appropriate use of auditor judgment, and be scalable to auditors of issuers of varying size and complexity.

We have concerns that certain of the approaches under consideration will have a disproportionate effect on smaller firms. As noted in the Consultation Paper, smaller firms tend to use auditor-engaged specialists, rather than auditor-employed specialists, to appropriately address certain risks of material misstatement. Accordingly, we encourage the Staff to carefully consider the impact that proposed amendments may have on the ability of smaller firms to continue to engage specialists when appropriate and necessary.

We also encourage the Board and Staff to consider whether the objectives of the Consultation Paper can be achieved through clarification of the extant standards, rather than the development of new standards, by providing additional guidance in the form of a Staff Practice Alert or other similar resources. We believe that the past use of Staff Practice Alerts have provided effective guidance in areas offering auditing challenges and encourage the Board to continue to provide this type of guidance.

We support the proposed definitions of *specialist*, *auditor's specialist*, and *company's specialist* that are included in the Consultation Paper. We support the inclusion of income tax as a specialized area of accounting and auditing, and thus the exclusion of this area within the definition of a specialist. We also support the inclusion of information technology as a specialized area of audit and accounting under certain circumstances; i.e. for information technology applications similar to the example in the Consultation Paper; however also acknowledge that certain information technology considerations in an audit engagement may extend beyond the skills of the typical engagement team member; and accordingly suggest that the Staff further consider this particular area.

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Using the Work of an Auditor's Specialist

The Consultation Paper offers two potential standard-setting alternatives related to the use of an auditor's specialist; (1) development of a separate standard for using the work of an auditor's specialist; and (2) extending the supervision requirements of Auditing Standard No. 10 to an auditor's engaged specialist.

Should the Board conclude that its objective to improve audit quality in this area cannot be achieved by providing guidance to support existing standards, we believe this objective will then be most effectively accomplished by the development of a separate standard related to the use of an auditor's specialist. If the Board proceeds with such an approach, we encourage the consideration of convergence, to the extent possible, with the standards adopted by the IAASB (ISA 620) and AICPA (AU-C 620). We believe that this approach would effectively accomplish the objectives of the Board, while also aligning the Board's standards with those of other standard setters.

As an alternative to the development of a separate standard, we also believe that the Board's objectives would be accomplished by targeted enhancements to extant AU 336, *Using the Work of a Specialist* (AU 336). While the Consultation Paper referred to evidence of deficiencies identified in the inspection process related to auditors use of specialists, as well as referring to auditors use of specialists potentially contributing to material misstatements, there does not appear to be compelling evidence to suggest that these results were the result of a flawed auditing standard, rather the improper application by auditors of the existing standard. Accordingly, we would be supportive of an approach to enhance and clarify extant AU 336 where necessary.

We do not support the approach of extending the supervision requirements of Auditing Standard No. 10 to an auditor's engaged specialist. In addition to the supervision and review requirements of AS No. 10, such an extension would also require compliance with existing PCAOB standards related to Quality Control, Independence and Ethics, which we believe would be difficult, if not impossible, in certain circumstances to comply with as they relate to an auditor's engaged specialist. We do not suggest that the auditor should not apply appropriate quality control considerations to an auditor-engaged specialist; however believe that the extending the requirements designed for engagement team members that are employees of a registered public accounting firm to non-employees could result in unrealistic expectations of the auditor. As the use of auditor-engaged specialists is predominant in smaller firms, such a requirement would result in a disproportionate effect on those firms, including the possibility that certain specialists may decide to not offer services to public company auditors, thus potentially resulting in an overall negative impact on audit quality.

We are supportive of the recommendations in Consultation Paper with respect to the engagement team's consideration of the knowledge and skill of an auditor's specialist. The auditor's evaluation of a specialist's qualifications and experience should always be considered in the auditor's determination of the use of the specialist, as well as to what extent the evidence provided by the specialist may be relied upon and/or what additional auditing procedures may need to be performed.

We are also supportive of the potential requirement in the Consultation Paper for the auditor to reach an agreement with the specialist of his or her responsibilities "in writing". However, we question whether the intention of this potential requirement was to have the agreement documented in a formal engagement letter or whether the agreement could be documented less formally in the audit documentation; i.e., as stated in the Consultation Paper as "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs or other related workpapers." We believe that the latter would provide sufficient evidence of an agreement; however in either case, suggest that such a requirement be made clear in a proposed standard.

Evaluating the Objectivity of an Auditor's Engaged Specialist

The Consultation Paper offers two potential standard-setting alternatives related the evaluation of the objectivity of an auditor's engaged specialist; (1) application of the requirements of Rule 2-01 of SEC Regulation S-X (Rule 2-01); and (2) the application of an "enhanced objectivity approach".

The requirements of Rule 2-01 were written for accounting firms, and therefore were never intended to be implemented by other professional services firms. As such, even if the principles of Rule 2-01 could be effectively applied to an entity employing specialists, the necessary quality control and monitoring systems do not likely exist in those entities. To the extent that such entities may be unwilling to adopt such quality control and monitoring systems, such a requirement may result in the unintended consequence of these entities choosing to discontinue providing services to auditors of issuers. Consistent with our comments above related to extending the requirements of Auditing Standard No. 10 to auditor-engaged specialists, we believe that this proposed requirement would also result in a disproportionate effect on smaller firms, as they are more dependent upon the use of an auditor-engaged specialist.

While we support the general principles of the Enhanced Objectivity Approach, we believe that the proposed requirements are too restrictive; i.e., to "obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's request for information." Similarly, we do not agree that an auditor should be automatically prohibited from using the work of a specialist if that specialist's objectivity is determined to be impaired in some manner. We agree that considerations such as these and others must be evaluated by the auditor, but that they be done so within the context of a principles-based approach that takes into account the auditor's overall risk assessment and consideration of the risk of material misstatement specific to the audit area for which the specialist is being utilized.

Using the Work of a Company's Specialist

Consistent with our comments regarding proposed changes to standards regarding the use of an auditor's specialist, we believe the Board's objectives with regard to auditor's use of a company's specialist can be accomplished by enhancing the extant standard with additional clarifying requirements and application material. Specifically, we encourage the Board to consider the standards adopted by the IAASB (ISA 500) and AICPA (AU-C 500). Similar to our comments above, we believe that such an approach would effectively accomplish the objectives of the Board, while also aligning the Board's standards with those of other standard setters. We also believe that certain existing requirements in extant AU 336 are also applicable to the use of a company's specialist and recommend that the requirements for use of an auditor's specialist and a company's specialist be consistent to the extent possible.

Eide Bailly commends the Board's ongoing commitment to the improvement of audit quality and we appreciate the opportunity to comment on this Consultation Paper. We would be pleased to discuss our comments with the Board or its staff. Please direct any questions on our comments to Brian Bluhm, Partner, National Assurance Office, at 612.253.6590 or by email at bbluhm@eidebailly.com.

Sincerely,



Eide Bailly LLP

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Date: August 25, 2015

Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Staff Consultation Paper: The Auditor's Use of the Work of Specialists

Dear Ms. Brown:

Eli Lilly and Company ("Lilly") is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on the Staff Consultation Paper No. 2015-01 — The Auditor's Use of the Work of Specialists. We appreciate the PCAOB seeking input on this potential standard-setting initiative with a staff consultation paper. Lilly is a multinational pharmaceutical and animal health company with legal entities in over 50 jurisdictions.

Lilly supports the PCAOB's efforts to evaluate the effectiveness of the existing standards on the auditor's use of specialists and identify areas for improvement. We encourage standards that will do the following:

- Align the nature, timing and extent of audit procedures with the auditor's risk assessment.
- Retain the general objectives of PCAOB AU Sec. 336 (Using the work of a specialist) while providing better guidance for auditors.
- Allow companies to utilize specialists without essentially requiring duplication of effort on the part of the audit process.

Our views focus primarily on the third section, "Using the work of a company's specialist". As background for our response, when using specialists to develop estimates, we believe that it is important to keep in mind that there is no "right" answer. Different specialists will undoubtedly arrive at different estimates and it is likely that none of them will be precisely correct. Therefore, we believe that the emphasis should be on ensuring that the estimate determined by the specialist is reasonable. We do not see a lot of value in having multiple estimates prepared by multiple parties and attempting to reconcile the estimates as this presumes a precision in the estimate that does not exist.

The Board proposes to eliminate the language in AU Sec. 336 that states "the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist." We can support this proposal as the auditor needs to have the responsibility for evaluating the reasonableness of the estimate. We agree the auditor may need to hire their own specialist if the auditor does not possess the specialized knowledge or skill to audit the estimate. The focus should be on evaluating the reasonableness of the estimate developed by the specialist hired by the company. The nature and extent of the work performed by auditor should reflect the auditor's risk assessment. We agree the auditor's evaluation of the specialist may affect the auditor's assessment of risk of

material misstatement and the nature, timing and extent of the auditor's procedures related to the specialist's work.

Similarly, the Board proposes to eliminate the provisions that (i) "ordinarily the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances" and (ii) "[i]f the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained." We have concerns about the elimination of these provisions. Our belief is that the objective of the audit work should be to determine that the financial statements are not materially misstated because of an error in the estimate and that to accomplish this, the auditor should evaluate whether or not the estimate developed by the company's specialist is reasonable. We believe both these provisions are consistent with this objective.

Following are the responses to certain of the questions addressed in the exposure draft.

Question 14

Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

Yes, this is appropriate as it should impact the auditor's assessment of the risk of material misstatement. Where the risk is assessed as high, the auditor should apply more rigorous procedures. Where the risk is assessed as low, audit procedures should be reduced.

Question 16

Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

No, the work should not be treated the same way as other information provided by the company. The effort to review the work of a specialist should take less time than a review of information provided by the company. Additionally, models used by specialists are frequently proprietary which limits the auditor's access. Limited access to the work and increased audit rigor could lead unnecessarily to increased auditor development of independent estimates. As a result, the company pays for duplication of an estimate plus the reconciliation of multiple estimates. Standards based on risk would help.

Question 18

Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in

specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

We have concerns with this approach. We believe AU sec 336 provides a good model and modifications will provide a better solution than replacement. AU sec 336 is established with auditors and there is consistency in application. A new model will likely cause much more diversity in practice. It is unclear to us if auditors will be allowed to consider, as part of their risk assessment, that the company has utilized an experienced and skilled specialist in the development of their estimate. As a result, more work may be required of the auditors as if the company had done all the work themselves. We don't believe the cost of this extra work justifies the potential benefit.

We appreciate the opportunity to express our view and concerns regarding this staff consultation paper. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 651-2310.

Sincerely,

ELI LILLY AND COMPANY

/s/Donald Zakrowski
Vice President-Finance and
Chief Accounting Officer



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31 July 2015

Re: Staff Consultation Paper: The Auditor's Use of the Work of Specialists

Dear Ms. Brown:

Ernst & Young LLP is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on the *Staff Consultation Paper – The Auditor's Use of the Work of Specialists* (the Consultation Paper). We commend the PCAOB for initiating this potential standard-setting initiative with a staff consultation paper, which we believe is a constructive way to seek stakeholder input earlier in the standard-setting process.

We support the PCAOB's efforts to evaluate whether existing standards on the auditor's use of the work of specialists can and should be improved. We believe efforts to improve PCAOB standards in this area should seek to do all of the following:

- ▶ Provide requirements that are scalable and that recognize the differences between the auditor's specialists and the company's specialists, as well as the types of activities for which auditors and companies use specialists
- ▶ Retain, in general, the objectives of AU sec. 336,¹ while providing enhanced guidance for auditors
- ▶ Align them with the risk assessment standards so that the nature, timing and extent of audit procedures are based on the auditor's risk assessment
- ▶ Align them with any standards resulting from the staff's separate project on auditing accounting estimates and fair value measurements

Our views on the staff's consideration of possible changes to the existing auditing standards are included below in three general sections: (1) using the work of an auditor's specialist, (2) using the work of a company's specialist and (3) other matters.

¹ PCAOB AU section 336, *Using the work of a specialist* (AU sec. 336)

Using the work of an auditor's specialist

Extending the auditor's supervision requirements of AS 10

The Consultation Paper describes an alternative to extend the supervision requirements in AS 10² to all arrangements involving an auditor's engaged specialist.³ We do not support this alternative. When a specialist is employed by an accounting firm, we believe he or she should be considered a member of the audit team and be subject to the same supervision and review requirements as any other audit team member, in accordance with AS 10.

The potential amendment to extend the supervision requirements of AS 10 (which would include ensuring compliance with all PCAOB standards, such as the Quality Control and Ethics and Independence standards) to an engaged specialist would be difficult (if not impossible) to apply. Engaged specialists are not subject to the audit firm's training, independence monitoring or other aspects of the overall system of quality control. The audit firm may not have access to the quality control policies and procedures of the engaged specialist's firm, including the results of ongoing monitoring.

As discussed further below, we would prefer that the Board develop a separate standard (similar to ISA 620⁴ or AICPA AU-C 620⁵) that outlines the requirements for using the work of an auditor's engaged specialist and incorporates the supervision and review principles inherent in those standards.

Development of a separate standard for an auditor's specialist

The Consultation Paper also describes an alternative to develop a separate standard for using the work of an auditor's employed or engaged specialist similar to the approach used by the International Auditing and Assurance Standards Board (IAASB) in ISA 620 and the Auditing Standards Board (ASB) in AICPA AU-C 620.⁶

We support the approach of developing a separate standard that encompasses requirements for employed and engaged specialists. The requirements outlined in ISA 620 and AICPA AU-C 620 represent an appropriate model for using the work of an auditor's specialist as audit evidence. We believe this approach could be beneficial in promoting consistency in how the auditor evaluates the work performed by the specialist. It is generally our understanding that many auditors currently apply the principles of ISA 620 and AICPA AU-C 620 when using the work of employed or engaged specialists.

² PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement (AS 10)*

³ Consultation Paper, page 28

⁴ International Standard on Auditing (ISA) 620, *Using the work of an auditor's expert (ISA 620)*

⁵ American Institute of Certified Public Accountants (AICPA) Clarified Statement on Auditing Standards (AU-C) Section 620, *Using the work of an auditor's specialist (AICPA AU-C 620)*

⁶ Consultation Paper, page 27

We believe that any potential standard should, at a minimum:

- ▶ Recognize the distinction between an auditor’s employed specialist and an engaged specialist, specifically, an auditor’s engaged specialist should not be considered a member of an engagement team
- ▶ Require that the nature, timing and extent of the procedures performed by the auditor using the work of a specialist be based on the auditor’s assessed level of risk, consistent with the Board’s risk assessment standards
- ▶ Retain, in general, the concepts of AU sec. 336 with respect to evaluating the qualifications and work of a specialist, evaluating the relationship of the specialist to the client and using the findings of the auditor’s specialist

We believe that the potential requirements outlined in the Consultation Paper⁷ relating to the areas in AU sec. 336 mentioned above would be appropriate to include in the new standard. We have outlined some proposed recommendations for the staff’s consideration below.

Under this alternative, the Consultation Paper states that the “principles of supervision set forth in Auditing Standard No. 10 (AS 10) would continue to apply when the auditor uses the work of an employed specialist, and the potential new standard would provide specific requirements for how an auditor applies those principles when supervising an auditor’s employed specialist.”⁸ The Consultation Paper also indicates that these requirements would also “apply to the auditor’s use of the work of an engaged specialist.”⁹

We agree that the staff would need to provide specific requirements for an auditor’s engaged specialist that are scalable and acknowledge that there are differences between the auditor’s engaged and employed specialist. We encourage the staff to consider the framework of ISA 620 and AICPA AU-C 620, which do not have a separate section on supervision and review but include the principles of supervision and review inherently achieved through the requirements of the standards. Examples of the requirements in ISA 620 and AICPA AU-C 620 that we believe achieve the principles of AS 10 include the following:

- ▶ AS 10 describes the matters that an auditor should take into account when determining the extent of supervision necessary for the engagement team. One of those matters is the “risks of material misstatement.”¹⁰ ISA 620 and AICPA AU-C 620 have a similar requirement for the auditor to consider the “risks of material misstatement in the matter to which the work of the auditor’s specialist relates”¹¹ when determining the nature, timing and extent of procedures necessary in using the work of a specialist.

⁷ Outlined in the Consultation Paper on pages 36 to 42

⁸ Consultation Paper, page 27

⁹ Ibid

¹⁰ AS 10, paragraph 6

¹¹ ISA 620, paragraph 8 and AICPA AU-C 620, paragraph 8

- ▶ Another matter that AS 10 describes is “the knowledge, skill and ability of each engagement team member.”¹² ISA 620 and AICPA AU-C 620 describe the requirement for the auditor to consider whether the auditor’s specialist has the necessary competence, capabilities and objectivity for the auditor’s purpose.¹³

In the Consultation Paper, the staff indicates that under both proposed alternatives (i.e., develop a separate standard for an auditor’s specialist or extend the supervision requirements of AS 10), it would be necessary to provide potential enhanced requirements for evaluating the knowledge, skill and objectivity of an auditor’s specialist, informing an auditor’s specialist of his or her responsibilities and evaluating the work of an auditor’s specialist. While we support some of the potential requirements described in the Consultation Paper,¹⁴ we have several concerns and recommendations related to them. Our concerns and proposed alternatives for the staff’s consideration are outlined below.

Evaluating the knowledge and skill of an auditor’s specialist

We agree that the auditor should be required to evaluate whether the specialist has the requisite knowledge and skill to perform the assigned tasks. The auditor’s employed specialist is subject to the firm’s overall system of quality control under PCAOB standards, including Quality Control Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC 20). QC 20 includes an evaluation of an employee’s independence, integrity and objectivity, personnel management, engagement performance and monitoring, among other things. We believe that the engagement teams should be able to rely on the firm’s system of quality control.

Alternatively, in instances where the auditor uses the work of an engaged specialist, the auditor should still be required to evaluate the specialist’s knowledge, skill and objectivity. We agree with the Consultation Paper that information regarding the engaged specialist’s knowledge and skill can be obtained from a variety of sources, for example, the firm’s prior experience with the work of the specialist, discussions with the specialist and others who have used the specialist and published papers or books written by the specialist. In addition, the auditor should consider the following when evaluating the specialist’s knowledge and skill (mostly consistent with ISA 620 and AICPA AU-C 620):

- ▶ The engaged specialist’s qualifications, including whether he or she is subject to certification and renewal (including education, experience and examination requirements)
- ▶ Whether the engaged specialist’s work is subject to technical performance standards or other professional or industry requirements
- ▶ The engaged specialist’s experience and reputation in the field in which the firm is seeking evidence

¹² AS 10, paragraph 6

¹³ ISA 620, paragraph 9 and AICPA AU-C 620, paragraph 9

¹⁴ Outlined in the Consultation Paper on pages 36 to 42 and 46 to 51

- ▶ The engaged specialist's knowledge of and experience in the entity's industry
- ▶ The relevance of the engaged specialist's competence to the matter for which his or her work will be used, including any areas of specialty within the specialist's field
- ▶ The specialist's competence with respect to relevant accounting and auditing requirements
- ▶ The engaged specialist's relationship to the entity, if any

Informing an auditor's specialist of his or her responsibilities

We support the potential requirement for the auditor to reach an agreement in writing with the auditor's specialist on certain matters that are the specialist's responsibility. However, the staff's language within the Consultation Paper, which does not appear to be included in a potential requirement, suggests that "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs or other related workpapers."¹⁵ We believe this footnote provides appropriate flexibility to the auditor and should be incorporated in a potential requirement.

We also have a concern about potentially requiring the auditor to be responsible for advising the specialist about "matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues related to areas in which the auditor uses the work of the specialist."¹⁶ We recommend that the potential requirement be narrower and limited to matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment and its internal control over financial reporting. This would limit the auditor's responsibility to communicate matters specific to the company of which the specialist may not be aware (as opposed to general industry considerations of which a qualified specialist would understand).

Evaluating the work of an auditor's specialist

The Consultation Paper discusses potential requirements for evaluating the work of an auditor's specialist depending on whether the specialist performs work related to either (1) developing an independent estimate or (2) testing the methods and significant assumptions used by the company.

We believe that the nature and extent of the audit procedures to be performed to evaluate the work of the auditor's specialist should reflect the auditor's risk assessment. Fundamentally, the use of specialists is necessary when the auditor does not have the requisite knowledge of the subject matter and there are limitations to the auditor's knowledge about appropriate methods and assumptions.

¹⁵ Consultation Paper, page 38, footnote 74

¹⁶ Consultation Paper, page 37

We are concerned about the potential requirement to evaluate the work of an auditor's specialist differently (i.e., "determine whether"¹⁷ versus "evaluate the conclusions"¹⁸) depending on whether the specialist (1) develops an independent estimate or (2) tests the methods and significant assumptions used by the company. This could be interpreted as requiring the auditor to reperform the specialist's work by developing an independent conclusion on the estimate, despite the fact that the auditor does not possess the necessary expertise and therefore engages a specialist. If the auditor has concluded that a specialist is competent and objective and has an understanding of his or her responsibilities, the auditor should be able to rely on the execution of the procedures by the specialist and evaluate the reasonableness of the specialist's conclusions.

Auditors are not expected to possess the expertise of another profession and may use the work of specialists in certain circumstances to provide the auditor with evidential matter about a particular audit matter, consistent with the core principle of AU sec. 336. By requiring a level of effort that goes beyond evaluating the specialist's conclusions, the alternative would mandate a level of expertise that auditors do not possess. We believe that the requirements for the auditor in both situations should necessarily be more limited to requiring an evaluation of the appropriateness and reasonableness of the specialist's conclusions and findings, consistent with the objectives of AU sec. 336. The guidance in paragraph 12 of AU sec. 336 could also be considered.

In situations where the auditor believes that the specialist's findings are inconsistent with other audit evidence, the auditor should agree with the specialist on the nature and extent of further work to be performed by the specialist, perform additional audit procedures appropriate for the circumstances or obtain the another specialist's opinion to gain additional audit evidence to support the conclusion, consistent with the principles of AU sec. 336.

Evaluating the objectivity of an auditor's specialist

We believe the auditor should evaluate the relationship between the auditor's engaged specialist and the company, including the circumstances that might impair the specialist's objectivity. As described in AU sec. 336, "when a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability."¹⁹ The alternatives discussed in the Consultation Paper suggest that for the auditor to evaluate the engaged specialist's objectivity, the auditor would be required to obtain information about and evaluate the specialist organization's policies and procedures.

We are concerned that the potential amendments may not be operational given the limitations on the ability of an auditor to have access to this information, including the related monitoring. Further, we believe that any amendments should reflect that the determination about whether the work of the engaged specialist is reasonable should be made by the auditor, who is required to be independent under the most restrictive standards of the PCAOB and Securities and Exchange Commission (SEC).²⁰

¹⁷ Consultation Paper, page 40, item a

¹⁸ Consultation Paper, page 40, item b

¹⁹ AU sec.336, paragraph 11

²⁰ PCAOB Rule 3520 *Auditor Independence* and Rule 2-01 of Regulation S-X adopted by the SEC

We believe that rather than placing specific independence requirements on specialists, the existing requirements in AU sec. 336 could clarify how the auditor evaluates the objectivity of a specialist, as well as how that evaluation would affect the auditor's assessment of the reliability of the evidence obtained from the specialist.

Rule 2-01

We believe that the potential requirement requiring an auditor's engaged specialist to comply with the requirements of Rule 2-01 of Regulation S-X adopted by the SEC (Rule 2-01) may not be the best alternative and could result in unintended consequences.

We believe that requiring the auditor's engaged specialist to comply with the full requirements of Rule 2-01 likely would impose significant limitations on an auditor's ability to engage a specialist willing to implement processes and procedures necessary to demonstrate compliance with Rule 2-01. These proposed changes could result in certain specialists no longer providing certain services to accounting firms, which could diminish the population of available specialists, including those with unique skill sets. Consequently, accounting firms that do not have employed specialists on staff may determine that they are unable to comply with these requirements, which would limit their ability to continue to audit public companies.

As acknowledged in the Consultation Paper, Rule 2-01 was written primarily for accounting firms and not for other organizations, such as specialist entities, that are not structured similarly, and specialist entities and individual specialists may face considerable challenges in complying with this rule.²¹ As a result, we question whether compliance with the potential requirements would be beyond the reasonable reach of accounting firms and unnecessarily expose auditors, the companies they audit and users of the financial statements to unnecessary risk should the specialist not be in compliance with Rule 2-01.

Enhanced objectivity approach

We support identifying certain business, financial and employment relationships that might impair a specialist's objectivity,²² and it is generally our experience that auditors make certain inquiries of engaged specialists and of the entity, review the specialist's credentials, including his or her reputation in the industry, and perform other procedures to assess this.

The PCAOB staff is proposing a "reasonable investor test" as part of the enhanced objectivity approach. We believe such a test would present certain challenges in assessing an engaged specialist's objectivity, particularly regarding the auditor's ability to verify the information required under this approach.

²¹ Consultation Paper, page 47

²² Consultation Paper, page 47

Lacking the context of how the specialist entity is organized, an auditor would not be able to fully evaluate whether the process is effective, which appears to be implicit in this requirement. Further, the processes and procedures that a specialist's organization has in place to maintain independence and objectivity with respect to its work could vary greatly in practice. In addition, while some of these specialist organization's processes may be effective, they may not be formalized and documented in sufficient detail.

We encourage the staff to consider the application guidance under ISA 620 when identifying potential revisions to the requirements for the auditor to obtain information on the specialist's relationships with the client. ISA 620 requires inquiries of the specialist and the client, and in some circumstances, based on auditor judgment, written representations from the specialist.

Finally, we also believe that objectivity should be viewed as a continuum that affects the nature, timing and extent of audit procedures, based on the auditor's judgment. The auditor should weigh all evidence (both positive and negative) that may affect the objectivity of the engaged specialist and adjust procedures as deemed appropriate. The potential objectivity amendments would effectively remove the ability for the auditor to apply additional procedures and continue to use the work of the specialist when certain relationships are noted. The auditor, who is required to be independent under the most restrictive standards, should be allowed to exercise judgment and ultimately be the one making the determination about whether there are additional procedures that would provide sufficient audit evidence.

Using the work of a company's specialist

Amending the requirements in AU sec. 336

The Consultation Paper discusses the potential alternative to amend the requirements in AU sec. 336 relating to the auditor's use of the work of a company's specialist. We believe that the objectives related to management's use of the work of a specialist in AU sec. 336 represent an appropriate model when using the work of a company's specialist as audit evidence and therefore, support the staff's alternative on amending the requirements in AU sec. 336.

The Staff proposes to eliminate the language in AU sec. 336 that states "the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist."²³ We believe this sentence, when considered in the context of the entire paragraph, was not intended to suggest that the auditor does not have any responsibility for auditing the estimate. We believe that this was intended to highlight the core principle of AU sec. 336 that 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.

²³ Consultation Paper, page 30

We encourage the staff to consider ISA 500, *Audit Evidence*, when identifying potential revisions to AU sec. 336. ISA 500 includes the core requirements of AU sec. 336 and also provides additional application guidance for the auditor. We believe that the potential revisions to the requirements in AU sec. 336 should incorporate the following:²⁴

- ▶ The concept that a company's failure to employ or engage specialists when it requires expertise in a field other than accounting or auditing increases the risk of material misstatement.
- ▶ An evaluation of the knowledge and skill of the company's specialist (including the staff's proposal to add additional emphasis to that evaluation) should be required.
- ▶ The clarification that the auditor's evaluation of the appropriateness and reasonableness of methods and significant assumptions could include consideration of the following:
 - ▶ The relevance of the competence of the company's specialist on the matter for which that specialist's work will be used, including any areas of specialty within that specialist's field
 - ▶ The competence of the company's specialist with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework
 - ▶ The use of specialized models
- ▶ The auditor's efforts should focus on the assumptions that are significant to the development of the estimate and consider management controls over the estimation process.

We believe that certain of the staff's potential requirements for evaluating objectivity of the auditor's engaged specialist would also apply to the evaluation of objectivity of a company's engaged specialist including:²⁵

- ▶ Requiring the auditor to "obtain information, from the specialist and the company regarding business, employment or financial relationships between the specialist and the company"
- ▶ Requiring the auditor to "evaluate that information and determine whether any relationships impair the specialist's objectivity"

We also recommend that potential requirements that auditors would follow as a part of their evaluation of the objectivity of a company's specialist include:²⁶

- ▶ Any interests and relationships that create threats to the specialist's objectivity, such as self-interest threats, advocacy threats, familiarity threats, self-review threats, intimidation threats and any applicable safeguards, such as any professional requirements that apply to the specialist, and evaluation of whether such safeguards are adequate

²⁴ Consultation Paper, pages 36 and 47 and ISA 500, paragraphs A34 and A40

²⁵ Consultation Paper, page 47

²⁶ ISA 500, paragraphs A41-A43

- ▶ Threats to a specialist's objectivity posed by the employment relationship and whether there is any direct reporting by the specialist to the audit committee or another independent source
- ▶ The terms of the agreement to engage the specialist, including whether, and if so, how, the payment structure is tied to the outcome of the determination of the accounting estimate
- ▶ Whether management has the ability to suggest or require revisions to the specialist's results before those results are finalized
- ▶ The significance of the relationship between the engaged specialist and management (i.e., whether the specialist has an extensive relationship with management, and whether the fees charged by the specialist are material to the specialist)
- ▶ Provision of other services by the engaged specialist to the client

If the auditor believes that the objectivity of the company's specialist might be impaired, the auditor would use knowledge of the risks related to the particular accounting estimate to determine what additional procedures should be performed with respect to some or all of the specialist's assumptions, methods and findings, including whether the auditor should consider engaging an auditor's specialist for that purpose.²⁷ The auditor should perform additional procedures only if, in the professional judgment of the auditor, such procedures are needed as a result of planning risk assessment or as a result of evaluation of audit evidence obtained in order to reach a conclusion in the audit area.

Rescinding the requirements in AU sec. 336

We do not support the staff's alternative on rescinding the requirements of AU sec. 336 and having the auditors follow other applicable PCAOB standards when the work of company's specialist is used. Under this approach, evidence provided by a company's specialist would be evaluated similarly to any other evidence provided by the company to the auditor.²⁸ Consistent with our views expressed in the Staff's Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements*, we have concerns about the unintended consequences of the alternative to rescind AU sec. 336 and the auditor ultimately treating the work of a company's specialist like any other information produced by the entity.

One concern about the suggested requirement to evaluate information provided by a company's specialist in the same manner as information produced by others in the company is that it would discourage the use of specialists by not recognizing the reduction in the resulting risk. The use of a qualified specialist is frequently necessary to develop various accounting estimates and fair value measurements due to the specialized nature of the subject matter.

²⁷ AU sec. 336, paragraph 11

²⁸ Consultation Paper, page 32

We believe that management's decision to use a specialist in these circumstances generally results in a more accurate application of the relevant financial reporting framework and a corresponding decrease in risk of material misstatement in the financial statements. It would then be expected that the nature and extent of the audit procedures to be performed would reflect this decreased risk. ISA 500 recognizes this by including the concept that a company's failure to employ or engage specialists when requiring expertise in a field other than accounting or auditing increases the risk of material misstatement.

We also anticipate substantial application challenges in testing the information provided by external specialists as if it were produced by the company. The models used by specialists frequently are proprietary, which limits the auditor's access to certain information. As a result, auditors would be less able to test management's process for developing the accounting estimate or fair value measurement and would have to develop their own independent estimate. This would be a significant undertaking. As a result, the company would incur both the costs of engaging the specialist to develop the accounting estimate and the auditor's costs to engage or employ a separate specialist to develop an independent estimate, perhaps without a corresponding increase in audit quality. We encourage the staff to perform outreach to issuers to better understand the implications to issuers if AU sec. 336 were rescinded.

Other matters

We support the potential definitions of specialist, auditor's specialist and company's specialist that are included in the Consultation Paper.²⁹ With respect to the definition of specialist, we support the continued recognition of income taxes and information technology as specialized areas of accounting and auditing and the exclusion of these individuals from the definition.

We also agree with the staff's position in the Consultation Paper that the definition of an engaged specialist should exclude third parties that provide information that is routinely and commercially available for a fee. As indicated in our comment letter on the staff's Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements*, we believe that a definition aimed at excluding certain third parties from the definition of a specialist should focus on those parties that generally provide independent pricing information free from the influence from any one issuer (e.g., the same price is released to all customers without bias). It is this absence of management bias that we believe increases the relevance and reliability of the information and would be considered sufficient appropriate audit evidence.

* * * * *

²⁹ Consultation Paper, page 34



We would be pleased to discuss our comments with members of the Board or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

cc:

PCAOB

James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor

SEC

Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
James Schnurr, Chief Accountant
Wesley R. Bricker, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie Erhardt, Deputy Chief Accountant



Office of the Secretary
PCAOB

Submitted via email:
comments@pcaobus.org

27 July 2015

Dear Sir or Madam,

Re: FEE comments on the PCAOB Staff Consultation Paper: “The Auditor’s Use of the Work of Specialists”

FEE (the Federation of European Accountants) welcomes the opportunity to comment on the PCAOB Staff Consultation Paper: “The Auditor’s Use of the Work of Specialists” (hereafter referred to in this letter as “Consultation Paper”). Our main comments are summarised hereafter.

General Comments

Given the increasing complexity of business processes and transactions, and the heightened risk of material misstatements in financial statements, the use of specialists has become imperative both for auditors and their respective clients. FEE welcomes the initiative to address the need for improvements in this area, and has provided answers to the questions included in the Consultation Paper in an Appendix to this letter.

FEE would like to highlight that it would be helpful if the revised PCAOB standard could remain on the same line as the IAASB standard ISA 620, *Using the Work of an Auditor’s Experts*. In general, the right balance needs to be found between applying principles and requiring auditors to undertake certain detailed procedures. The priority should be that both standards remain consistent with each other. FEE has been consistently advocating for the alignment of auditing standards globally to the maximum extent possible, which enhances both the quality of audits and the acceptance of audit work globally.

FEE notes that some of the potential requirements identified in the Consultation Paper reflect the application material included in ISA 620, *Using the Work of an Auditor’s Expert*. To the extent that the PCAOB’s inspections programme reveals weaknesses in this area, we would suggest the Board undertake a root cause analysis, as new or stricter requirements will not address misunderstanding or misinterpretation of the PCAOB’s current standards.



As per the consultation, in order to use the opinion and work of a specialist engaged or employed by the client, the auditor may need to engage their own specialists. FEE believes that a risk-based approach is essential in this context and is concerned about unintended consequences of the proposed PCAOB approach: if auditors are required to treat the information prepared by these specialists as if prepared by the audited company, companies may stop engaging their own specialists and just rely upon the numbers that the auditor's specialist produces which, for instance for independence reasons, cannot be the intension.

Our detailed responses to the questions stated in the Consultation Paper are set out below. For further information on this FEE¹ letter, please contact Hilde Blomme on +32 (0)2 893 33 77 or via email at hilde.blomme@fee.be or Noémi Robert on +32 (0)2 893 33 80 or via email at noemi.robert@fee.be from the FEE team.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Petr Kriz', written over a light blue horizontal line.

Petr Kriz
FEE President

A handwritten signature in blue ink, appearing to read 'Olivier Boutellis-Taft', written over a light blue horizontal line.

Olivier Boutellis-Taft
FEE Chief Executive

¹ FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 47 professional institutes of accountants and auditors from 36 European countries, including all 28 EU member states. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 800,000 professional accountants working in different capacities in public practice, small and large firms, government and education – all of whom contribute to a more efficient, transparent and sustainable European economy.



Appendix: Responses to Questions

Questions 1-6: Current Requirements and Current Practice

The information included in the Consultation Paper satisfactorily reflects the current practices in larger audit firms. FEE agrees with the PCAOB that in the areas covered by the PCAOB standards relating to *Auditing Accounting Estimates, Auditing Fair Value Measurements and Disclosures, and Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, the use of specialist knowledge or skill in relevant areas has increased in recent years.

The Consultation Paper classifies specialists into four groups. FEE would support a practice which is in line with ISA 620, *Using the Work of an Auditor's Expert*, where evidence provided by a specialist employed/engaged by the client ('management's specialist') should be treated differently than the one obtained by an independent expert or an expert engaged or otherwise employed by the audit firm ('auditor's specialist'). This is based on the fact that a specialist who is engaged or otherwise employed by the client is working on behalf of the client. Whereas we appreciate the need for a distinction in categories for the purposes of a scalable approach, we question the need to consider four different categories.

Questions 7-8: Potential need for improvement

FEE welcomes the continuous evaluation of standards, and identification of issues to be addressed and improved. We note that it is discussed in the Consultation Paper that, in order to use the opinion and work of a specialist engaged or employed by the client, the auditor may need to engage their own specialists to evaluate this work. We believe that a risk-based approach is essential in this context, because a requirement in every case would result in an additional cost without significant increases in audit quality; this could have a more far-reaching effect for Small Medium Practices (SMPs) than for larger audit firms, and could also drive client behaviour in terms of the selection of specialists.



Questions 9-18: Alternative regulatory approaches

We support the PCAOB view that the Board should be proactive in addressing auditors' dealings with specialists by means of its standard setting activities as an alternative to devoting additional resources to inspections and enforcement of existing standards. In terms of investor protection, action to prevent weaknesses occurring in the conduct of the audit is far more appropriate than the retrospective identification of weaknesses that have already occurred. However, this does not imply that every issue is susceptible to resolution through auditing standards; those that are not should be addressed by other means.

With regards to auditor's specialists, FEE supports the first alternative to develop a standard for using the work of an auditor's specialist, as similar to the approach used by the IAASB in ISA 620. We see the benefit of a scalable approach, taking into account practical differences between an engaged specialist and an employed specialist. In our view, a principle-based approach recognising practical differences, but setting a common objective, is appropriate.

With regards to company's specialists, FEE concurs with the alternative whereby the Board would rescind the parts of AU sec 336 that relate to company specialists, and then mirror the approach taken in ISA 500, *Audit Evidence*. FEE firmly believes that the auditor's risk assessment in the area of assessing the objectivity and competence of a company's specialist should determine the need for, and nature of, further audit procedures. Even if it is standard practice for auditors to perform specific procedures to evaluate the work of specialists, requirements need to be drafted in a way that allows flexibility to accommodate individual audit circumstances.

Questions 19-21: Potential Amendments - Definitions

Whilst FEE considers the exclusion of income tax and IT from the work of specialists as the right approach, based on the premise that these individuals are always part of the engagement team, we believe that consideration should be given to widening this to other specialists and making it more principle based. For example, on all insurance audits actuaries are key members of the engagement team and would be seen as no different from tax or IT specialists.



Questions 22-39: Potential Amendments - Auditor's Employed or Engaged Specialist

We agree that any revisions to the PCAOB standards should continue to require the auditor to evaluate the knowledge, skill and objectivity of an auditor's specialist; inform the specialist of his or her responsibilities; and evaluate the specialists work and conclusions. As per ISA 620, the auditor needs to assess the extent of the procedures against a number of factors using professional judgment. We favour this approach. Further consideration is needed from the PCAOB with regards to the differences between employed and engaged specialists so as not to disadvantage audit firms which do not employ specialists, which are likely to be SMPs in particular. Some requirements about obtaining information from engaged specialists to determine the auditor's specialist's skills and knowledge, as put forward on page 36 of the Consultation Paper, would be impractical.

FEE agrees that the Board should adopt a principles-based "enhanced objectivity approach". We note that the potential requirements set forth in the Consultation Paper are far more prescriptive than the requirements of ISA 620, and in many cases, mirror the application material in that standard. It should be noted that in some jurisdictions and/or fields of expertise, there may be a limited number of specialists; the balance between professionalism and inconsequential threats to independence need therefore to be balanced.

Questions 40-48: Questions Related to Economic Impacts and Implications

When dealing with the degree and level of evaluation of the specialist's work required by the auditor, costs need to be considered for a proportionate and realistic approach. The degree and level of evaluation of the specialists' work required by the auditor should not be prescribed to the extent that the increased costs outweigh the incremental increase in audit quality.

There also needs to be due consideration of the impact to SMPs, as the currently stated practice as described in the Consultation Paper holds true predominantly for larger network firms. In some jurisdictions and in specific areas, there may be a limited number of suitable specialists for auditors to employ or engage. The Board needs to be sensitive to the fact that specialists may not be willing to comply with some of the potential requirements considered in the Consultation Paper, e.g. requirements for specialists to provide a written description of the process used, to formulate responses to the auditor's inquiries about business employment, or financial relationships to the company (page 50). As such, the fact that SMPs will be disproportionately affected by these new requirements could ultimately deny auditors access to the required level of expertise.



July 31, 2015

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

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* ("Consultation Paper") developed by the staff of the Office of the Chief Auditor ("staff") of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). We agree with the staff that the use of specialists has increased over the years and many of the areas in which they are utilized have grown in complexity. We commend the staff's efforts on this topic as well as the Board's outreach activities thus far. We support the staff's proceeding with this project in conjunction with the auditing accounting estimates and fair value project since these two topics are so interrelated.

Potential need for improvement

While we agree improvement could be made to AU Section 336, *Using the Work of a Specialist* ("AU 336"), we see a common theme in the Board's observations of failure to comply with the current standard as opposed to an indication that the standard itself is fatally flawed.

We also note that many of the observations discussed at the Standing Advisory Group meeting held on June 18, 2015 ("June SAG meeting") and in previous meetings tend to relate to fair value accounting and in particular fair value accounting matters related to financial instruments. While we recognize this is a critically important area of financial reporting, we also would highlight, as the Consultation Paper also notes, that specialists are used in many capacities by management and the auditor, and it is important to remain cognizant of that in considering any potential changes.

With respect to supervision and review of the auditor's specialist, we acknowledge the comments in the Consultation Paper regarding issues that may have arisen with respect to insufficient oversight and lack of coordination, among other issues. However, we do not believe that the issues suggest the need to propose new requirements that would be prescriptive for each estimate within an engagement where an internal or external auditor specialist is used.

With regard to the Consultation Paper's discussion as to possible revisions to the standards, we have summarized our views on key concepts that we believe should be considered in those proposed changes:

- Any proposed changes should be driven by the need to improve audit quality and the auditor's identification of and response to risks of misstatements; essentially, the methods used, key assumptions, use of appropriate inputs, and alternatives considered particularly in situations with high measurement uncertainty. We would be concerned that adding multiple procedures in other areas for all engagements (for example enhanced communication protocols) may result in losing focus on addressing the important areas noted above.
- We believe AU 336 should be retained and any enhancements should remain principles-based and allow for auditor judgment and scalability. We believe it is important to retain this standard to broadly address the various auditor specialists that could be used in a particular engagement and also to differentiate the supervision and review responsibilities between an engaged versus employed auditor specialist.
- We agree with the notion highlighted in the Consultation Paper (from extant AU 336) that the auditor is not expected to have the same degree of expertise as the specialist. We believe this is an important point for the staff to consider in deliberating revisions, in particular those related to comments in the Consultation Paper regarding an auditor "evaluating" the work of the specialist versus "understanding" the specialist's work. We are concerned that "evaluating" could be taken to mean that the auditor would need to have the same skillsets as the specialist to be able to conclude on the reasonableness of the specialist's work (which could imply an approach requiring one specialist to evaluate another specialist's work) and result in duplicative efforts. We believe the concept of "evaluating" in this circumstance should be clear that the auditor is evaluating the judgments and conclusions reached by the specialist, for example, the assessments of key assumptions and sensitivity implications of those assumptions on an estimate, and the contradictory evidence that may have been identified and considered by the specialist, in the context of potential misstatements- not in the context of a corroborating the methods and assumptions used as appropriate..
- We encourage the staff to continue to monitor and consider how other profession initiatives (e.g. the AICPA's projects to develop valuation certifications) may impact the nature and extent of any proposed changes to the standards. As discussed at the June SAG meeting, the valuation industry is currently not tethered by licensure or certifications, which if implemented could support the reliability of the work product provided by such specialists.

We have provided detailed comments below to address certain of the questions posed in the Consultation Paper.

Current practice

The Consultation Paper provides a reasonable characterization of current practice. We also believe that the International Standards of Auditing (“ISAs”) or auditing standards generally accepted in the United States (“US GAAS”) are well understood and provide a solid foundation and relevant application guidance for designing audit procedures regarding the use of auditor specialists and addressing situations where management has employed a specialist.

With respect to our use of audit specialists, Grant Thornton LLP both employs and engages specialists depending on the subject matter. For example, the firm employs actuaries and valuation specialists that provide support to audit teams. The firm will engage specialists for investment fair value pricing and for estimates unique to specialized industries, such as oil and gas derivative instruments or certain real estate appraisals. The firm will also use the work of the company’s specialists (whether employed or engaged) in instances where testing management’s process is deemed to be the appropriate audit response.

The Consultation Paper seeks information relative to firms’ use of specialists; following is a brief summary addressing certain of the staff’s questions.

Company’s specialists

The work of company specialists (whether employed or engaged) is typically utilized in situations where audit teams test management’s process. Generally, audit teams use the requirements of AU 336 as a baseline when using the company specialist’s work in developing an appropriate audit response. However, the facts and circumstances of the engagement may take the audit team beyond the requirements in AU 336 as allowed by paragraph 12 of the standard. For example, the audit team may determine there is a heightened risk with respect to a company’s employed specialist, especially if that individual participated in a bonus or profit-sharing program, since this could impact that specialist’s objectivity. Further, the assessed misstatement risk associated with accounting information developed by an engaged company specialist may increase if the auditor’s past experience with the work product of that specialist was unfavorable.

Determining the appropriate audit response in situations involving using the work of company specialists is driven by the audit team’s risk assessment; further procedures may be performed when the risk warrants it. This could include asking management for additional support beyond that provided by the company’s engaged specialist. In rare cases, the firm has recommended that the company consider replacing an engaged specialist based on a determination that the initial specialist engaged was not deemed competent.

Auditor’s employed specialists

While operational issues may occur with regard to communication (scope, addressing exceptions, etc.) between the auditor and the employed specialist, we believe that Auditing Standard No. 10, *Supervision of the Audit Engagement* (“AS 10”) provides sufficient principles-based requirements. In addressing these execution issues, the staff may rather consider other forms of guidance that could potentially alleviate such issues.

Specialists often participate in the risk assessment and fraud brainstorming meetings. These meetings are typically where the audit team will communicate the scope, expectations, and responsibilities of the specialist. This often includes which party is responsible for testing the completeness and accuracy of management's data. Communication continues at various points in the audit process as deemed necessary by the audit team. Generally, the specialist provides the audit team with a memo that highlights the procedures performed and conclusions reached. The audit team then considers whether additional work needs to be performed in order to conclude that they have obtained sufficient appropriate audit evidence. In most public company audit situations, the work of the specialist will also be subject to a review by a senior valuation specialist employed by the firm. The level of senior specialists' review is determined based on the risk associated with the unit of audit and the relative experience of both the specialist and the audit team.

Auditor's engaged specialists

The firm will engage outside specialists in circumstances where the skills/expertise cannot be found in-house. Due diligence on the more commonly used specialists is performed at the national level and includes centrally assessing the qualifications of the specialist and the typical methodologies used. Individual audit teams then supplement this global assessment with an assessment in the context of the facts and circumstances of the engagement.

The rigor of procedures performed on the engaged specialist's work is driven by the risk assessment, and generally we believe audit teams perform the requirements as set forth in AU 336. The firm is granted access to methods and models in many situations, but not always. In situations where access is not provided, firm specialists will usually assist in evaluating the key inputs and inquire as to the general workings of the model. We have noted that occasionally a "shadow calculation" may be performed by the firm's specialist to provide further evidence as to the reasonableness of the estimate. However, as noted above, this is typically done when the risk warrants it.

Company's specialists

Alternative for revising standards

With respect to company's specialists, we continue to be supportive of clarifying enhancements as opposed to changes in the current requirements. We note that for certain companies that do not employ staff with expertise in various specialty areas, the company's use of third party specialists may serve to reduce the assessed risk of material misstatement (for example the use of an experienced external specialist to perform a business combination purchase price allocation as opposed to less qualified internal personnel). We acknowledge the staff's concern with respect to the notion in the current standards that the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. However, we believe teams typically approach these situations with the recognition that an auditor specialist would assist in evaluating the competency of the company's specialist as well as the reasonableness of the conclusions reached. In those situations, the teams will not simply accept the amounts put forth by the company's specialist. Depending on the risk assessment, the auditor will determine the nature and extent of testing the audit team and their specialist will

perform. We believe paragraph 12 of AU 336 provides the auditor with the ability to do a “deeper dive” in instances where the perceived risk related to the specialist’s work is heightened.

We are concerned that certain potential changes highlighted in the Consultation Paper would result in more prescriptive requirements to test a specialist’s models and completeness and accuracy of other data with the same rigor in all circumstances, rather than aligning with a risk-based audit approach. Rather, we believe the focus generally should be on the inputs. As discussed at the June SAG meeting, models are usually very similar and the variations of an output are driven more by the inputs. For example, in a derivatives valuation, the auditor is typically familiar with the generally accepted method of valuation and therefore focuses their tests on the inputs and agreeing management’s financial information to the underlying records; the auditor would typically not test the yield curves used by the specialist or other industry-specific data widely used in valuations unless the misstatement risk warrants such scrutiny (e.g., a complex derivative transaction with more judgment involved in selecting the models to use).

Auditor’s specialists

Alternatives for revising standards

We are supportive of creating a separate standard for the use of auditor’s specialists that retains AU 336’s existing requirements with certain enhancements, such as aligning with the PCAOB’s risk assessment standards. We believe this will enable the staff to adequately address the differences in requirements when using an auditor’s employed specialist as opposed to an auditor’s engaged specialist. However, we caution against being too prescriptive in the requirements and encourage the staff to retain a principles-based construct. As noted above, prescriptive requirements around matters such as communications and other potential requirements may be viewed as not scalable and result in additional effort without a commensurate benefit to audit quality.

Auditors currently apply two standards (AU-C Section 220 and AU-C Section 620) when performing an audit under AICPA standards, with no significant operational issues; therefore, we don’t believe it would be burdensome to the profession to apply two standards under PCAOB standards. We also believe that the definitions found in US GAAS make it clear that an auditor’s employed specialist is a part of the engagement team. Further, we encourage the staff to consider the requirements of AU-C Section 620 as we believe it adequately guides the auditor through applying procedures when using the work of employed and engaged specialists.

We foresee considerable operational issues with extending AS 10 to an auditor’s engaged specialist and believe the concerns cited by the staff on page 29 of the Consultation Paper outweigh any potential benefit of this alternative. Therefore, we do not support this approach. Alternatively, we would be supportive of enhanced guidance to auditors, such as suggested inquiries to prompt more consistent assessments of the specialist’s competence and objectivity. See additional comments regarding assessing objectivity of engaged specialists below.

Potential amendments

Overall, we are supportive of enhancing the requirements for using the work of auditor’s specialists and providing auditors enhanced guidance that could result in addressing the quality

issues noted in the Consultation Paper. We reiterate the need to focus on areas that are specific to enhancing quality in addressing the key areas that address financial statement misstatement risks. We also reiterate the need for any amendments to allow (and direct) the auditor to apply judgment as to the extent of work necessary in evaluating a specialist's knowledge or skill based on risk assessment and other audit procedures performed.

With regard to the potential changes in communications with the specialist, we agree that greater clarity in the standard could promote better communication between the audit team and its specialists. We do note, however, that certain aspects of the proposal, such as the need to document the nature and timing of communications (page 38 of the Consultation Paper), is overly prescriptive and may hinder rather than help the communication process. We suggest that perhaps revising the context for certain of those communications could result in enhancing the auditor's understanding of the specialist's conclusions. For example, including guidance related to the need for the auditor to discuss potential negative evidence noted by the specialist and how the specialist assessed the potential impact of that negative evidence could enhance the quality of the auditor's consideration of that evidence.

Furthermore, we note that the Consultation Paper suggests that the agreement between the auditor and the auditor's specialist would have to be evidenced in writing, and the corresponding footnote 74 on page 38 clarifies that the evidence could be in the form of "planning memoranda, separate memoranda, audit programs, or other related workpapers." We believe this is important application guidance since auditors could infer that the potential requirement would call for a formal engagement letter between the auditor and auditor's specialist, which we don't believe is the staff's intention. We encourage the staff to specifically include the footnote clarification in the potential requirement.

We note the potential requirement to evaluate whether the methods used by the specialist are in conformity with the applicable financial reporting framework. We acknowledge the auditor's responsibility to have adequate knowledge, but accounting principles generally accepted in the United States do not consistently provide the specificity necessary to make this requirement operational for many circumstances. We believe it can be a relevant factor in evaluating assumptions but only if the applicable financial reporting framework contains precise requirements. Therefore, it could be more operational if the procedure remained principle-based and details such as this were provided as application guidance for the auditor to consider, when applicable.

Objectivity

We believe the current requirements related to assessing a specialist's objectivity are appropriate. Thus, it is difficult to make a clear connection to the issue the staff is trying to address through possible revisions to these requirements. We foresee operational issues with the alternative regulatory approaches proposed in the Consultation Paper. Currently, there is no regulatory framework to require a specialist's independence or monitoring such as that found in the audit profession, and such an endeavor would require extensive collaboration with other standard-setters and regulators.

We expect that if implemented, these proposed changes would impact the availability of qualified specialists to be used by auditors as the specialists may deem the requirements too cumbersome and costly and therefore focus their practices on assisting companies directly. We also believe that the concerns cited by the staff in the Consultation Paper for both alternatives are significant, and we encourage the staff to continue to carefully consider these as this project continues.

Definitions

We are supportive of the proposed definitions of specialists found on page 34 of the Consultation Paper. We believe it is important to continue to distinguish between “employed” and “engaged” auditor’s specialists, based on the issues discussed above. While we agree with the initial views as to excluding income tax and information technology professionals from the definition of specialists, we note that for some firms, including ours, those professionals are incorporated into the audit similarly to valuation professionals. In that regard, we support further evaluation by the staff as to whether it would be appropriate to treat any of those professionals as specialist in circumstances where they are engaged, versus employed, by the auditor.

We do not believe individuals with regulatory compliance skill and knowledge should be considered specialists. Rather, they assist management in interpreting laws or regulations so that management may make the appropriate accounting determination.

We also support scoping out certain activities of third-party pricing sources from the definition of specialists as this is consistent with our recommendations in our comment letter regarding the staff’s consultation paper on auditing estimates and fair value measurements. Furthermore, we note that the proposed definition may need to be refined to address the need for the auditor to consider the nature of certain commercial information that is available for a fee. We believe this phrase could be widely interpreted and have an unintended consequence of reducing audit effort in areas of higher audit risk. We believe that there are aspects of the information provided by pricing sources that may still require an audit approach similar to that used in evaluating the work of a specialist (for example prices provided on more complex instruments). We also ask the staff to consider clarifying that this exclusion would include sources that may provide pricing or other financial information for free, such as foreign exchange prices available on certain commonly used websites.

We would be pleased to discuss our comments with you. If you have any questions, please contact Trent Gazzaway, National Managing Partner of Professional Standards, at (704) 632-6834 or Trent.Gazzaway@us.gt.com.

Sincerely,





July 20, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803
Via E-mail: comments@pcaobus.org

Re: Request for Public Comment – Staff Consultation Paper No. 2015-01, *The Auditor’s Use of the Work of Specialists* (May 28, 2015)

Dear Office of the Secretary:

Thank you for the opportunity to comment on the PCAOB’s Staff Consultation Paper 2015-01, *The Auditor’s Use of the Work of Specialists*. As an independent securities valuation specialist with over twenty years’ experience in financial reporting, securities valuation, and the use and application of fair value measurement, Harvest Investments, Ltd. welcomes the Board’s attention to the work of specialists and concurs with its general assessment that the requirements now governing the work of specialists are in need of revision. Through its activities and publications, the PCAOB has already helped foster an environment favorable to the extension of better practices throughout the finance and audit communities. We have also noticed that many of our audit clients have made great strides in their oversight of valuation issues and processes – a development that attests to the importance of those factors within current financial reporting and fair-value accounting, and also signals a general preparedness for additional guidance.

In what follows, we offer our comments on several of the specific questions posed by the Board, numbered sequentially below. Again, we agree with the Board’s decision to revise the standards that have governed the work of both employed (*AU 10*) and engaged specialists (*AU 336*). Our comments are premised upon our extensive experience with the regulatory and contextual challenges of fair-valuation, and also on our resulting assessment of the strengths and weaknesses of the current regulatory and professional environment. We hope the Board will find them helpful to its deliberations.

Question #4 – On Accounting Firms’ Use of an Auditor’s Employed Specialists:

We have observed that concerns about confirmatory bias and auditor deference to management have surfaced during the Board’s Standing Advisory Group meetings.¹ In our estimation, these concerns are both reasonable and appropriate, since an employed specialist has a stake in the audit, whereas an engaged specialist does not. The Board has also rightly stressed the analytical importance of maintaining skepticism and independence within the audit and valuation processes in order to ensure adequate transparency and objectivity, as well as to avoid risk. Because the literature shows that confirmatory bias can function both intentionally and unintentionally, we think that it would be very difficult (if not impossible) to avoid it within a system in which valuation and audit take place under the same aegis, even if functionally separated. Our general review of the scholarly literature on the topic has confirmed what our professional experience had already indicated: namely, that confirmatory bias is hard to circumvent through better policing of auditors and their employed specialists. At the same time, however, we acknowledge that working with an engaged specialist also presents challenges, since overall audit Q&A may be diminished. Nevertheless, we think that the risks associated with persistent findings of confirmatory bias and related managerial pressure are more substantial, given the possibilities for pressure to confirm a client’s values.

Question #5 – On Accounting Firms’ Use of an Auditor’s Engaged Specialists

With respect to engaged specialists, the guidance set by AU sec. 336 has not been substantially updated since 1994; since that time, as the Board notes (p. 3), both the use and importance of specialists have increased. This same period witnessed a significant expansion in investment complexities and therefore also in the range of methods, inputs, and documentation used by specialists. Disclosure requirements have not always kept pace with these developments, making it difficult at times for an auditor or client to obtain an adequate assessment of a specialist’s knowledge, skill, or reasoning. Because of these shifts, there has been a “learning curve” for many in the use, supervision and evaluation of a specialist’s work.

In acknowledgment of these factors, Harvest applies a consistent, documented approach, so that all inputs as well as the reasoning behind all inputs are clearly available for each price, ensuring the consistent independence and transparency of our findings and evidential matter. In accordance with AU sec. 336, our qualifications and deliverables are clear. Further, we offer voluntary annual due-diligence reviews on-site as an optional service to our clients, which aids in planning and also in coming to agreement on the work delivered. Our standard report includes Harvest prices, models, and levels, as well as links to the various methodologies used. We make all inputs available to our clients so that they are able to collect and review them; in this way, our methods and results constitute an open rather than proprietary book, in which one can find clear documentation of and rationale for each input. As an engaged specialist, we have found that such measures, which ensure a high degree of transparency within our valuation processes, are also helpful in variance resolution and in guarding against possible management biases and material misstatements.

¹ Cf. Helen Munter’s comments at the 2 October 2014 PCAOB SAG meeting, pp. 22ff, http://pcaobus.org/Standards/SAG/Documents/10022014_SAG_Transcript.pdf

Question #7 – On Whether Standards Need Improvement

The Board asks whether there are additional issues that should be considered in connection with the need to improve current standards (*Section IV, Question 7*). We applaud the Board’s attention to the significance of understanding both the qualifications of specialists and the methodologies (including inputs) that are used in order to assess fair value processes appropriately and to limit the risks of material misstatement. We have observed a marked improvement among our audit clients when it comes to their review of our work, and this is very encouraging. We do, however, think that scrutiny of inputs and approaches should be consistent across all of the various types of specialists and/or pricing services in the industry. Additionally, we would like to highlight two areas that could be addressed in order to limit risk in fair value practices and avert another financial crisis:

- First, misconceptions remain that certain types of investment holdings are “low risk” or “easy to value.” Such holdings are often passed over entirely or sampled inappropriately. For example, alternative investments can be mistaken for mutual funds because deciphering their features can be difficult, leaving them untested in audits. Similarly, some bond portfolios are not appropriately tested, because of the perception that there is little or no valuation risk. Testing and samples should both be based on a vigorous assessment of structural features; otherwise, the financial reporting industry is left yet again at risk of material misstatement. Harvest’s valuation and sampling methods involve a review of 200 data-points in order to understand an item, define its risk, and determine an appropriate approach to its valuation. We do this specifically because the only bonds that are truly “easy-to-value” are high-grade, fixed rate bullets. We underscore this point about valuation because it bears on the conditions under which a financial crisis can (and did) develop and spread: mistaken values are highly correlated to general instability. To underscore the importance of adequate testing and sampling, we offer the following specific observations:
 - a. Harvest sees unreasonable variances in the fair values of many bonds each year. For example, we frequently see mispricings of the agency mortgage pools we review; these are a core investment for banks, the foundation of our financial system. Further, we see variances in auction rate bonds 45% of the time, in lower grade non-agency CMOs 37% of the time, and in newly issued non-agency CMOs 23% of the time.
 - b. Testing within the parameters of an extended low-rate/tight-spread environment will simply not give an adequate picture of what could happen were that environment to change. For example: between May and October of 2007, we saw spreads on “low risk,” “easy to price” high grade corporate bonds increase by 40-60%, while more complex products lost large percentages of their overall values. Our prolonged low interest rate environment has encouraged “common” issuers to add complexities to their bond structures through the use of multiple calls, variable coupons, and other options in order to make the issuances profitable. These features cannot be identified without digging into the

asset's structure, and sudden market movements cause large price variances in such structures that could result in material misstatements, as we experienced in the financial crisis.

- Second, the ASC 820 (formerly FAS 157) level hierarchy already exists to address and highlight how observable an item's valuation inputs and resultant values are in the marketplace, in order to assess the risk of potential misstatements and call investors' attentions to such risk. Even so, we believe that the leveling hierarchy is in need of further clarification. As the present guidance clearly stipulates, "[t]he level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability."² Yet even though the standards clearly state that appropriate designation of levels depends on the lowest level input used in a valuation, some within the financial reporting community will default to a level 2 designation on a significantly wide range of instruments simply based on issuer sector or pricing source, rather than on the basis of the relevant inputs. Level designations have been and remain an area in need of improvement, not least because an investor would want to know about any exposures to level 3 investments. Again, ASC 820 was formulated to highlight and document such risks and exposures. When it comes to actual practice, however, we remain concerned that the levels of each input are frequently not being calculated at all, or that they are not being calculated correctly. For these reasons, we suggest more clarification in this area.

Question #8 – Understanding Specialists' methods

The above remarks on the importance of understanding a security's structural features as well as the inputs used to value such structures are also relevant to the Board's queries concerning the degree to which a specialist's methods are, or need to be, understood (*Section IV, Question 8*). On the one hand, there is a "factual" question of whether or not something is understood – for example, whether inputs and methods are adequately grasped. On the other hand, there is a "situational" question about how context affects what is understood, as the problem of confirmatory bias clearly illustrates. The accelerating use of specialists underscores some important features of our present audit and accounting system – that it is complex, increasingly diversified, and also highly collaborative. Both factual and situational matters are at stake, and we applaud the Board's efforts to integrate both features under the new regulations.

In connection with its concern for situational risks of material misstatement, the Board notes that 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" (p. 22). Harvest concurs, and would also suggest that an auditor's employed specialist is subject to the same, if not greater, influence due to client pressure to confirm client data rather than to question or dispute it.

² FASB *Statement of Financial Accounting Standards No. 157*, p. 12 (www.fasb.org)

Additionally, we advise that an over-emphasis on models may distract from other equally important aspects of valuation. To underscore a point made earlier, we strongly recommend that the focus be on inputs as well as the clear documentation of the basis for and reasoning behind each input. In our experience, 99% of all meaningful variances we discover are due to inappropriate inputs. Further, we think that valuation experts should be obliged to assess both the documentation and the reasoning behind each input, since doing so is essential for accurate valuation and proper placement within the fair-value hierarchy.

Question #10 – Auditor’s Procedures re: Engaged and Employed Specialists

With regard to the question of whether an auditor’s oversight procedures should differ when dealing with an employed versus an engaged specialist (*Section V, Question 10*), we agree that they should be held to similar standards and would like to raise the following concerns about the range of approaches, capabilities, and methods presently gathered under the rubric of the term “specialist.” We recommend that the Board carefully consider the qualifications of both the engaged and employed specialists involved in the fair value process. All engaged specialists should have appropriate backgrounds and experience, and be aware of the relevant financial reporting requirements; employed specialists should have similar qualifications. While many internally employed valuation teams and pricing desks are excellent, some rely heavily on the work of inexperienced interns. In addition, some pricing desks rely on third-party pricing vendors without fully understanding their methods, documentation, or inputs. The use of pricing sources without a grasp of the underlying methodologies used to generate prices is worrisome: if the methodologies are not understood, then neither are the inherent valuation risks. The role of an auditor is to provide an objective, independent assessment of that which is being audited; similarly, the word “accountability” underscores the general social value of the obligation to be answerable for the accuracy of one’s information.

Question #19 – Appropriateness of Specialist Definitions

In its Staff Consultation Paper, the Board defines an “auditor’s specialist” as “a specialist who performs work to assist the auditor in obtaining sufficient appropriate audit evidence” (p. 34). Regarding its query about the appropriateness of this definition (*Section V, Question 19*), we respectfully recommend that the Board consider the following:

- 1) There are substantial, significant differences among the types of specialists that this general definition would accommodate. Any general definition of an auditor’s specialist would need to address the differences among sources, procedures, and practices directly.
- 2) If the definition of an auditor’s specialist were to exclude pricing services and vendors that provide “information that is routinely and commercially available for a fee,” the following issues should be of paramount concern and attention:

- a. *Independence*: If pricing services that provide “information that is routinely and commercially available for a fee” are not included within the definition of a specialist, it will be essential for the audit review to include a secondary, independent source. Given that the vast majority of all client prices that Harvest sees come from the same pricing service, testing through an independent source will be critical when it comes to identifying errors and material misstatements; otherwise, little will have been accomplished in the reporting of fair value since the financial crisis.
 - b. *Mispricing*: Harvest sees errors in the prices and values we test across all financial sectors, many of which are held by our financial institutions, money market and mutual funds. This means that vulnerabilities exist in the very places where middle-class Americans invest for college savings and retirement.
 - c. *Transparency*: If pricing services providing “information that is routinely and commercially available for a fee” are not treated as specialists, those services must be able to disclose valuation inputs and the documentation behind those inputs. In addition, as we stated earlier, we remain concerned that testing within an extended low-rate/tight-spread environment cannot give an adequate picture of what could happen were that environment to change. If the methods, inputs and documentation are not readily available, the progress made over the last eight years with respect to transparency will be jeopardized.
 - d. *Flawed Inputs*: The complex algorithms used by automated pricing services break down, given changes in rates, curves, and/or market conditions. The inappropriate methodologies and inputs of 2007 (stale ratings, etc.) resulted in inflated prices of mortgage securities, asset-backed securities, and pooled trust preferreds. The profoundly distressing economic results of that valuation system must not be forgotten.
- 3) Any new definitions should be formulated in line with the lessons learned from the financial crisis, to help ensure the integrity of future practices. Those in place prior to 2007 did not prevent reliance on single valuation sources and non-transparent methods, a situation that did not work out well for investors. In order to attain the degree of skepticism, transparency and independence that the Board is clearly seeking with its proposals, we strongly recommend that the Board address our concerns about the inclusivity of its definitions with regard to pricing.

Again, because the differences among specialists and pricing sources are considerable, and because those differences relate to larger issues of transparency, accuracy, and risk of material misstatements, we recommend that the Board take these considerations into account when finalizing these key definitions.

Question #24 – Obstacles to Documentation and Compliance

The Board raises the question of whether there are any obstacles to documentation and compliance regarding its potential requirements (*Section VI, Question 24*), and also provides a series of proposed requirements (pp. 37-8, points a-g) with respect to the kind of written agreement that should obtain

between an auditor and an auditor's specialist. We respond to them in sequence, below, drawing upon our experience working with auditors as well as our current practices and policies:

- a) *On the responsibilities of an auditor's specialist and the clear statement of objectives, nature/timing/extent of the work, and potential issues of control or other matters that could affect the work:* we agree that these matters should be directly addressed. Compliance would not be burdensome, and could be addressed via due diligence and/or an additional page in every Harvest report.
- b) *On accounting estimates and fair value:* we note that testing a specialist's independent inputs and methods has become increasingly expensive. Market data and tools, along with licensing fees (e.g. for CUSIP) have all risen in cost.
- c) *On company-provided or third-party information and the review of a client's work:* Harvest does not generally engage in such activity; rather, we manufacture all of our prices and values independently.
- d) *On the inclusion of relevant financial reporting requirements:* we agree that this is essential. A specialist qualified for financial reporting should always be aware of and comply with guidance, and should be able to provide this information clearly and up-front.
- e) *On the clarity and availability of information:* Harvest agrees that the nature and extent of audit information provided by an auditor's specialist should always be clear and available to the auditor. For example, the inputs and documentation in our IPR-SEC and PVAR reports are provided in great detail so that methods can be tested and variance resolution can be addressed.
- f) *On issues of timing and the possibility of changes or adjustment to the work undertaken by a specialist working with an Engagement Team or Partner:* we agree that all of these matters should be very clearly communicated. It is both appropriate and necessary for all parties to be aware of possible pitfalls or reasons for delay.
- g) *On professional skepticism:* Harvest agrees with the Board in emphasizing professional skepticism, a questioning mind and the critical assessment of evidence. Price and level variances can both raise issues that are difficult for an auditor simply to "resolve," especially in the face of client pressure. In our opinion, documentation is key, and in case of variance and/or contradiction, the most rigorously documented information should be used.

Question #26 – On what Information a Specialist should Provide

With regard to the Board's query about the information provided by an auditor's specialist to the auditor (*Section VI, Question 26*), it is our view that a specialist should make available all valuation inputs as well as the basis and documentation for each input. This is already Harvest's policy, independently of a specific auditor's request; however, not all specialists and pricing sources do this, nor do all auditors necessarily request this amount of information. Our reason for providing it to auditors is based on the principles of transparency, objectivity and intelligibility that we think are essential to an accurate and meaningful valuation process. Our clients have responded favorably to this level of disclosure, using our information to get a better understanding of our methods and assumptions and also to address variance resolution.

Question #27 – Proposed Requirements and Auditor Review of Independent Estimates

With respect to auditor responsibility regarding a specialist’s independent estimate (*Section VI, Question 27*), we think that the potential requirements look very reasonable. Our IPR-SEC report, for example, was created especially to satisfy the existing requirements. We would also like to applaud the Board for addressing the “basis for selecting the methods and assumptions used” in developing an estimate (p. 41, b.3), because we believe that doing so will help to ensure enhanced transparency and accuracy. In current practice, observable documentation for inputs is simply missing from many pricing vendors.

Question #29 – Auditor Evaluation of Specialists’ Work

Over the past few years, Harvest has seen great progress in client review of our work: clients are now focusing on our methods and assumptions in order to understand the methodologies and rationales behind our inputs, especially when it comes to more complex items. They have also become increasingly engaged with in-depth input review in order to assess and resolve variances, which helps to identify risk areas within the fair value of each portfolio. All of this is very encouraging: in firms ranging from large to small, we see much more engagement with hard market data, as well as an increasingly robust sense of professional skepticism and a clear commitment to understanding argumentation and evidence. Even so, we caution that we still observe frequent mispricings, even of generic items. We therefore encourage the Board to focus on structural nuances with regard to testing and sampling as well as the use of ASC 820 levels as indicators for risk in fair value.

Question #31 – On the Appropriateness of Potential Requirements

Harvest thinks that the type of review proposed is generally appropriate for all audits.

Question #32 – On Auditor Evaluations of Relationships between Engaged Specialists and Clients

In our experience as engaged specialists, some auditors and clients will request background investigations and/or annual disclosures regarding contributions and gifts. We provide these as requested.

Questions #33, 35, 39 – On Whether a Reasonable Investor Test is Feasible for a Specialist

Harvest both understands and appreciates the Board’s concerns about disclosure and maintaining objectivity. Already, we ensure that our company does no work for a direct client unless our audit client permits. We would be willing to consider instituting an Employee Background Investigation Policy that would disclose relevant financial, employment and/or business relationships or other significant information to address the Board’s concerns.

Question #34 – On Engaged Specialists and Independence

Some of the provisions contained in 17 CFR 210.2-01 (Qualifications of accountants)³ are already consistent with Harvest’s approach regarding the importance of independence. For example:

- At no time does a single person have control over any full portfolio review
- Controls and checks are carried out by multiple analysts or managers so that consistently high quality is maintained
- Individual analysts only address certain sectors, not the portfolio as a whole

We have no objections to additional measures or procedures for safeguarding independence and objectivity, and averting conflicts of interest.

* * *

By way of a general response to the Board’s questions about the economic impact of its proposed regulations (*Section VIII*, pp. 52-4), we offer the following comments, underscoring a concern expressed in our response to *Question 24b*, above. In relation to the Board’s desire that its recommendations “be scalable and result in the same requirements for evaluating the work of employed and engaged specialists, which would create consistency in practice among accounting firms of all sizes” (*Section V, Question 11*, p. 29), Harvest notes that economies of scale pertain within the audit and valuation fields, which means that smaller firms may easily incur additional costs because they cannot obtain the same audit evidence. Data and access to data have become very expensive, and explicit acknowledgement of and attention to that fact is warranted. In our experience, smaller audit clients in particular have difficulty in confirming all data, simply because doing so can require either expensive systems and/or a high level of financial knowledge. Such clients usually do not have much trouble tracing some spreads and yields; however, independent confirmation of all appropriate inputs (i.e., pre-payment and default/loss assumptions on a whole loan CMO, for example) remains more difficult. This state of affairs is in no small part due to costs.

* * *

In closing, we thank the Board for the opportunity to comment on this Staff Consultation Paper, and for its time in reviewing our arguments and concerns. If the Board would be interested in discussing any of our views in more detail, we are at its disposal: please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.

³ <https://www.law.cornell.edu/cfr/text/17/210.2-01>



July 31, 2015

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society (“Committee”) is pleased to comment on the PCAOB’s Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*, dated May 28, 2015. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

We agree with the Staff’s observations in the Consultation Paper that the use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions.¹ We believe any enhancements to existing auditing requirements and guidance should promote audit quality, be adaptable to changes in the evolving capital markets, and continue to recognize the auditor’s need to use the work of a specialist when situations arise that require specialized knowledge and subject matter expertise not possessed by the auditor.

In this letter, we provide for the Board and Staff’s considerations, our thoughts regarding the topics outlined in the Consultation Paper, including the Staff’s suggested amendments to the related auditing standards. Our letter is organized in the following order:

1. General Thoughts on the Staff’s Consultation Paper
2. Using the Work of an Auditor’s Specialist
3. Using the Work of a Company’s Specialist

The Committee believes that the potential changes in these areas could present challenges that should be considered carefully.

1. General Thoughts on the Staff’s Consultation Paper

The Consultation Paper discusses certain operational challenges related to the auditor’s use of the work of specialists, describes the Staff’s preliminary views concerning the potential need for improvement, and presents potential amendments to PCAOB auditing standards that govern the auditor’s use of the work of specialists in response to the perceived need for improvement. These potential amendments could affect certain aspects (or all) of AU sec. 336, *Using the Work of a Specialist* (AU sec. 336) and certain aspects of Auditing Standard No. 10, *Supervision of the Audit Engagement* (AS10). Although we support the Staff’s consideration of amendments to existing auditing standards, we believe any such amendments related to the auditor’s use of the work of specialists should align with the Board’s risk assessment standards and generally keep the concepts in AU sec. 336 with respect to the work of the specialist, including considering his or her professional qualifications and relationship to the client, and the auditor’s responsibilities when using the findings of the specialist, with certain clarifications and enhancements.

a. Importance of Retaining the Objectives of AU sec. 336

¹ Page 3, the Consultation Paper.



The Consultation Paper presents observations from Board oversight activities that may indicate a potential need for guidance or changes to the auditing standards.² Although we support the consideration of potential changes, we believe such changes would be better accomplished through enhancing, as opposed to rescinding, AU sec. 336. In particular, the Committee believes the essential principle of AU sec. 336 provides the auditor with a fundamental basis for evaluating the work of a specialist, and when applied appropriately, promotes audit quality.³ The auditor's ability to utilize the framework under AU sec. 336 should be maintained and strengthened by certain clarifying enhancements, discussed in detail below.

b. Possible Unintended Consequences of the Potential Amendments

The Staff is seeking comment on two alternative regulatory approaches for how the auditor evaluates the relationship between an auditor's specialist and the company. The two approaches are⁴:

1. Applying the requirements of the Independence Rule in PCAOB standards to engaged specialists; and
2. Applying an approach for an auditor's engaged specialist that would incorporate some but not all elements of the Independence Rule.

We believe that these potential approaches could result in unintended consequences regarding the ability of public accounting firms [of all sizes] to continue to engage specialists, and that the Staff should carefully consider these potential consequences as it evaluates potential amendments to the existing standards. As it relates to the approach to require an auditor-engaged specialist to comply with the requirements of Rule 2-01 of Regulation S-X ("Rule 2-01"), the Committee believes that there are significant unintended consequences to this approach, including that engaged specialists may be unable to comply with the quality control processes and procedures necessary for the evaluation of relationships that might impair that specialist's independence. Also, the availability of auditor-engaged specialists could be reduced and possibly force accounting firms to employ specialists, if they can afford to do so. This will be cost-prohibitive for many public accounting firms, which could eliminate smaller firms from auditing public companies and shift audit market concentration even more unfavorably.

We have concerns about the combined effects of the approaches described above and the potential requirement to evaluate the information provided by the company's specialist in the same manner as information produced by others in the company. Typically, firms other than the largest global accounting firms do not employ specialists, and therefore, rely on engaging specialists to assist in their audit procedures (when engaging an auditor's specialist is considered necessary). Audit quality will likely suffer if the potential amendments, coupled with existing limitations on auditor access to its engaged specialists' proprietary models and methodologies, result in effectively eliminating the opportunity for the auditor to engage a specialist. Accounting firms that engage specialists to support the audit could determine that they are unable to comply with these potential requirements, which could potentially force firms to decide not to engage a specialist and instead direct the engagement team to perform the work, which could have a detrimental effect on audit quality. This also could limit a firm's ability to continue to audit public companies altogether.

2. Using the Work of an Auditor's Specialist

² As noted on Page 23, the Consultation Paper.

³ Paragraph 12, AU sec. 336, "The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist [...]."

⁴ As noted on Page 46, the Consultation Paper.



ILLINOIS CPA SOCIETY.

When to use the work of an auditor's specialist in the audit is driven by the auditor's risk assessment process including the complexity of the estimate or fair value measurement, its significance to the audit, and the knowledge, skill, and ability, of the engagement team members.

When an auditor's specialist is employed by the accounting firm, we believe the specialist should continue to be considered a member of the engagement team and be subject to the same supervision and review requirements as any other engagement team member in accordance with AS10. However, we believe the approach to treat an engaged specialist as a member of the engagement team under AS10 may limit an auditor's ability to use the work of an engaged specialist; particularly, the requirement in AS10 for the engagement partner to supervise engagement team members' compliance with PCAOB standards (e.g., Quality Control, Ethics and Independence standards) would be difficult, if not impossible, to apply to an engaged specialist.

a. Evaluating the Knowledge and Skill of an Auditor's Specialist

An auditor's employed specialist is required to follow the firm's system of quality control. This includes a rigorous evaluation of an employee's independence, integrity and objectivity, among other things. This system of quality control requires employed specialists to adhere to a high level of reviews of their knowledge and skills and provides engagement teams deciding to use the work of an employed specialist with the appropriate basis to determine a specialist's objectivity.

When an engaged specialist is utilized, the auditor would need to evaluate the engaged specialist's competency, capabilities, and objectivity. We recommend that this evaluation include consideration of the following (either by inquiry or through other procedures):⁵

- Consider whether the auditor's engaged specialist's work is subject to technical performance standards or other professional or industry requirements (for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation);
- Inquire of the entity and the auditor's engaged specialist about any known interests or relationships that the entity has with the auditor's engaged specialist that may affect that specialist's objectivity;
- Gain an understanding of the auditor's engaged specialist's knowledge and experience of the entity's industry;
- Consider the relevance of the auditor's engaged specialist's competence to the matter for which the specialist's work will be used, including any areas of specialty within the specialist's field; and
- Evaluate the competence of the engaged auditor's specialist with respect to relevant accounting and auditing requirements.

We agree with the Consultation Paper that information regarding the engaged specialist's knowledge and skill can be obtained from a variety of sources, including:⁶

- Experience based on previous work of the specialist;
- Knowledge of the specialist's qualifications, membership requirements of a professional body or industry association, certifications/license or other forms of external recognition;
- Published papers or books written by the specialist; and
- Discussions with the specialist and others who are familiar with the specialist's work.

⁵ The procedures listed are consistent with many included in AU-C 620, paragraphs A16-A21.

⁶ Page 36, the Consultation Paper.



ILLINOIS CPA SOCIETY.

b. Evaluating the Work of an Auditor's Specialist

We continue to believe that AU sec. 336 provides the auditor with the appropriate basis to evaluate the work of a specialist, whether employed or engaged, and generally support the direction of the potential amendments within the Consultation Paper. However, we are concerned with the potential requirement to evaluate the work of an auditor's specialist differently depending on the testing approach used by the specialist. We believe that when the specialist tests the methods and significant assumptions used by the company, it is appropriate for the auditor to evaluate the specialist's conclusions.⁷ However, we are concerned that the potential requirements for when the auditor's specialist develops an independent estimate would result in the auditor essentially being required to re-perform the work of the specialist.⁸ The potential change will impose a requirement on the auditor that he/she is not qualified to complete. The auditor may not have the background or experience necessary to evaluate whether the methods used by the specialist are appropriate as the specialist was engaged because the auditor wants to involve someone with skills outside of his or her own. We believe the requirements for the auditor in both situations should require only an evaluation of the specialist's conclusions about the items outlined in the potential amendments.

In situations where the audit team believes that the findings of the specialist are unreasonable, the auditor should expand his or her audit procedures to gain additional audit evidence to support the conclusion such as detailed recalculations of the specialist's model, shadow calculations, or sensitivity analyses; alternatively, the auditor should obtain the opinion of another specialist.

c. Evaluating the Objectivity of an Auditor's Specialist

Evaluating the objectivity of an auditor's specialist is an integral part of determining the nature, timing and extent of procedures performed by the specialist and the reliability of the work provided by the specialist as audit evidence.⁹ However, there could be possible limitations on the ability of an auditor to engage a specialist that could arise from the potential amendments regarding the evaluation of the objectivity of an auditor's engaged specialist. Rather than indirectly imposing such restrictions on specialists, we believe that the existing requirements in AU sec. 336 could be enhanced to provide additional specificity around how the auditor evaluates the objectivity of a specialist, as well as how that evaluation affects the auditor's assessment of the reliability of the evidence obtained from the specialist, discussed in detail below.

Rule 2-01 of Regulation S-X

We have significant concerns with the Staff's potential requirement for the auditor's engaged specialist to adhere to this rule. The Consultation Paper recognizes that Rule 2-01 was written primarily for accounting firms and not for organizations, such as specialist entities or individual specialists, who may have considerable challenges in complying with this rule.¹⁰

We believe requiring an auditor's engaged specialist to adhere to the full requirements of Rule 2-01 could impose major limitations on an auditor's ability to engage a specialist willing to implement the appropriate processes and procedures necessary to comply with Rule 2-01. Therefore, the potential amendment could result in specialists not accepting

⁷ As outlined in item b. on Page 40, the Consultation Paper.

⁸ As outlined in item a. on Page 40, the Consultation Paper.

⁹ Paragraph 11, AU sec. 336, states that if the auditor believes 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.

¹⁰ As noted on page 47 of the Consultation Paper.



ILLINOIS CPA SOCIETY.

engagements as the rigors of complying with the SEC independence rule may outweigh the benefits. Further, accounting firms could find it difficult to engage a specialist, which could drive many accounting firms out of the business of auditing public companies. For the largest firms, this might not be a consequence as many of these firms employ specialists.

Enhanced Objectivity Approach

We are in favor of the identification of certain business relationships, financial relationships, or employment relationships that impair a specialist's objectivity. However, we do not think the auditor should obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's request for information.¹¹

The requirements under this approach, while not as extensive as discussed above under Rule 2-01, are more than the current requirements under AU sec. 336. The "reasonable investor test" still represents a challenge to assessing the objectivity of a specialist, mainly with respect to the auditor's ability to verify the information required under the enhanced objectivity approach. For example, under this framework, the auditor would be required to obtain and evaluate the processes and procedures used by the specialist to formulate responses to the auditor's request for information. If the specialist's employer does not have processes and procedures in place, it would present challenges for an accounting firm to obtain reasonable assurance about the objectivity of an engaged specialist, including the specialist's employer.¹² ISA 620 could be used as a guide to develop those requirements for the auditor to obtain information as to a specialist's relationships with the client.

3. Using the Work of a Company's Specialist

We believe that the current guidance contained within AU sec. 336 is sufficient to evaluate the work of company employed or engaged specialists and should be retained.¹³ Given the PCAOB's oversight observations, further guidance or clarification may be helpful regarding what steps are considered necessary to obtain sufficient, appropriate audit evidence under the existing standards, rather than concluding that the standard itself is not sufficiently rigorous. One principal comment regarding the Consultation Paper is that it is heavily, if not wholly, focused on considerations related to the use of specialists with respect to accounting estimates such as fair value measurements and forms of valuation. Over the past decade these are the areas in which auditors have vastly improved their knowledge and experience; other areas of specialization (e.g., real estate, cyber issues, environmental concerns) are where auditors lack more depth of knowledge. There are other situations of varying complexity when a specialist may be used. We suggest that the key "specified procedures" related to the auditor's use of the work of company specialists under the existing framework of AU sec.336 be retained, with potential revisions or additional clarification concerning the area of accounting estimates, rather than attempting to apply a "one size fits all" approach to all company specialists.¹⁴

For example, one key area absent from Figure I on page 7 of the Consultation Paper in which accounting firms commonly seek to rely on the work of the company's specialists is in the area of internal investigations, specifically the auditor's evaluation of management's response and the potential impact on the financial statements of matters discussed in AU sec. 317, Illegal Acts by Clients. It is not uncommon for larger, public companies to engage outside counsel, or outside counsel along with forensic accounting specialists engaged by the company through outside counsel, to conduct independent investigations of such matters that come to the attention of management. The auditor's concerns in these matters are more typically in the area of internal controls, management integrity, or disclosure considerations, rather than an evaluation of the assumptions used in a specific model to value an asset or liability.

¹¹ As noted on page 50 of the Consultation Paper.

¹² As noted on page 48 of the Consultation Paper.

¹³ AU sec 336, ¶18 - 12.

¹⁴ As noted on pages 4, 12, and 21-22 of the Consultation Paper.



ILLINOIS CPA SOCIETY.

The use of company engaged specialists is a best practice in the area of internal investigations. The Consultation Paper suggests that revisions be made that would require the auditor to evaluate the information supplied by the company's specialist in the same manner as the auditor evaluates information produced by others in the company, rather than utilize the "specified procedures" currently included in AU sec. 336.¹⁵ One potential unintended result of revising the level of auditor evaluation of the independent investigators' work, including the requirement to "test information provided by the specialist as if it were produced by the company" may be that companies are discouraged from seeking outside expertise in this important area (or in other key areas beyond valuation where specialists are engaged).¹⁶ The cost of these outside professionals can become quite high but provides significant value to the investor along with a greater assurance of reliability to the auditor, as contemplated by AU sec. 336. Alternatively, should outside specialists continue to be retained, unnecessary duplication of efforts by the auditor of work performed by seasoned, independent professionals may occur which would not provide additional value to the investor. In current practice, we consider the audit firm's evaluation of the specialists work in these matters under paragraphs 8 through 12 of AU sec. 336 to be sufficiently rigorous to ensure a complete investigation has been conducted and to assess the reasonability of the findings.

Companies may also utilize in house counsel and/or human resources personnel to assist with certain investigative type matters, *i.e.*, company employed specialists. In these cases the auditor places heightened emphasis on the current objectivity considerations set forth in AU sec. 336 paragraphs 10 and 11. If the auditor believes the specialist's objectivity might be impaired, the auditor may either suggest to the investigative team additional procedures which could be performed or may consider additional audit procedures be completed by the audit team itself. Requiring the auditor to evaluate the work of company engaged specialists as if it were produced by the company appears to be inconsistent not only with those current objectivity considerations but also with the additional or revised independence considerations set forth in the Consultation Paper.

We agree that under any potential revision, the auditor should continue to be required to evaluate the knowledge, skill, and objectivity of the company's specialist. That evaluation should retain the objectivity considerations currently set forth in AU sec. 336 paragraph 11. However, we believe that: 1) the audit firm's evaluation of the company specialists' work under paragraphs 8 through 12 of AU sec. 336 is sufficiently rigorous to assess the reasonability of the specialist's findings; and 2) the appropriateness and reasonableness of methods and assumptions used should remain the responsibility of the specialist.

The Committee is supportive of the Staff's consideration of developing potential revisions related to the auditor's use of the work of specialists, and commends the Board and its Staff for advancements made in this important area.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

Elizabeth J. Sloan, CPA
Chair, Audit and Assurance Services Committee

James R. Javorcic, CPA
Vice Chair, Audit and Assurance Services Committee

¹⁵ Ibid.

¹⁶ As noted on page 24 of the Consultation paper.



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APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2015 – 2016

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:**National:**

Scott Cosentine, CPA	Ashland Partners & Company LLP
Eileen M. Felson, CPA	PricewaterhouseCoopers LLP
James J. Gerace, CPA	BDO USA, LLP
Michael Hartley, CPA	Crowe Horwath LLP
James R. Javorcic, CPA	Mayer Hoffman McCann P.C.
John Offenbacher, CPA	Ernst & Young LLP
Matthew Rotta, CPA	McGladrey LLP
Elizabeth J. Sloan, CPA	Grant Thornton LLP
Kevin V. Wydra, CPA	Crowe Horwath LLP

Regional:

Jennifer E. Deloy, CPA	Frost, Rittenberg & Rothblatt, P.C.
Barbara F. Dennison, CPA	Selden Fox, Ltd.
Genevra D. Knight, CPA	Porte Brown LLC
Andrea L. Krueger, CPA	CDH, P.C.

Local:

Matthew D. Cekander, CPA	Doehring, Winders & Co. LLP
Lorena C. Johnson, CPA	CJBS LLC
Mary Laidman, CPA	DiGiovine, Hnilo, Jordan & Johnson, Ltd.
Carmen F. Mugnolo, CPA	Trimarco Radencich, LLC
Jodi Seelye, CPA	Mueller & Company LLP
Joseph Skibinski, CPA	Trimarco Radencich, LLC
Richard D. Spiegel, CPA	Steinberg Advisors, Ltd.

Industry:

Matthew King, CPA	Baxter International Inc.
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Educators:

David H. Sinason, CPA	Northern Illinois University
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Staff Representative:

Ryan S. Murnick, CPA	Illinois CPA Society
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31 July 2015

PCAOB
Mr. Martin F. Baumann
Office of the Secretary
1666 K Street, N.W.
Washington DC 20006-2803
USA

by email to: comments@pcaobus.org

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Dear Mr. Baumann,

**Re.: Staff Consultation Paper No. 2015-01:
The Auditor's Use of the Work of Specialists – May 28, 2015**

The IDW would like to thank you for the opportunity to comment on the above mentioned Staff Consultation Paper: The Auditor's Use of the Work of Specialists, released May 28, 2015 (hereinafter referred to as the "paper").

The IDW agrees that there is a need to reconsider the appropriateness of the PCAOB's interim standards with regard to the auditor's use of the work of specialists because the need for expertise beyond auditing and accounting matters as well as the extent to which auditors rely on specialists has changed since those standards were developed. Alignment to the PCAOB's newer risk based standards is also needed, especially in the context of the audit of accounting estimates and fair value measurements.

As we have previously commented to the PCAOB, we welcome the updating of the PCAOB's interim standards, and particularly alignment with the relevant ISAs as a measure towards the international convergence of auditing standards needed for international capital markets. We refer to our previous letters to the PCAOB in which we addressed this issue more fully, as we have chosen not to

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA



page 2/8 to the PCAOB dated 31 July 2015

repeat our detailed comments in this letter. We nevertheless confirm our previously stated views.

In this letter, we comment on those aspects of the paper with which we have concerns or upon which we hold firm views and have chosen not to respond to individual questions.

The Potential Need for Standard Setting

In addition to the issues discussed in the paper, the nature of action on the part of the PCAOB also ought to depend on the reasons behind any perceived lack of stringency within audits in this area. We note many instances where the paper explains that the Board has encountered non-compliance with the extant standard(s). In such cases, it would be useful for the Board to ascertain whether the underlying reason is a) a failure to satisfactorily document work that had actually been performed, b) an insufficient or erroneous understanding or interpretation of the requirements, or c) willful non-compliance on the part of the auditor. Enhanced clarification of the relevant requirements within the PCAOB's standards may be the most appropriate course of action in the first two cases. The deterrent impact of the Board's investigations program over time should already serve to address the last case.

Hence, although we support the Staff consultation as a means of gaining information as to current practice, we also believe that a thorough root cause analysis of the PCAOB's inspection findings is needed to inform the Board as to the possible need to enhance application guidance within its standards.

Staff Consideration of Alternative Approaches

General Approach

In terms of investor protection, action to prevent weaknesses occurring in the conduct of the audit is preferable to retrospective identification of weaknesses that have already occurred. Therefore, the IDW supports the Staff's view that the Board should focus on its standard setting activities rather than devoting additional resources to inspections and enforcement of existing standards. However, not all issues are susceptible to resolution through standards setting and therefore the PCAOB should ensure that standards setting activities are directed towards those issues that can be dealt with through standards.



page 3/8 to the PCAOB dated 31 July 2015

We comment on the alternatives discussed in the paper regarding the auditor's and company's specialists separately:

Auditor's Specialist

We support the development of a separate standard for using the work of an auditor's specialist "similar to the approach used by the IAASB in ISA 620" (alternative no. 1 on page 27). We particularly agree with Staff as to the benefits of a scalable approach that takes account of the practical differences resulting from the auditor's engagement as opposed to employment of a specialist.

In respect of the concern that this approach could "create the misconception that an auditor's employed specialist is not a member of the engagement team" (page 28), we note that the IAASB includes a definition of the term "auditor's expert" that specifically clarifies this particular issue. We are not aware that this distinction has proven problematical in practice amongst auditors applying the ISAs and would encourage the PCAOB to expand the definition proposed on page 34 to specifically clarify this difference.

In our opinion, extending the supervision requirement in A-S 10 to an auditor's engaged specialist (alternative no. 2 on page 28) would likely be impracticable, since various factors, including access, may preclude an appropriate degree of supervision. Additional significant differences in this context include the fact that an engaged specialist may not be subject to the firm's training and quality control system. Furthermore, as we discuss in more detail below, a proposal similar to that explored on page 28 i.e., to "integrate the engaged specialists into the engagement team" would potentially decrease the availability of specialists in some fields or jurisdictions to the detriment of audit quality.

Company's Specialist

Of the two alternatives discussed in the paper, we would have a slight preference for the Board rescinding AU sec 336 as far as it relates to company specialists. In our view, the concern highlighted in the paper that this would result in less specific direction for auditors could be relatively easily overcome by guidance pointing auditors to the relevant PCAOB standards.



page 4/8 to the PCAOB dated 31 July 2015

Key Aspects of a Potential New Standard and Related Potential Requirements

In general, we are concerned that some potential requirements discussed in the paper include requirements in relation to procedures that mirror application material as opposed to requirements of the ISAs. Such procedures may be appropriate in certain circumstances; they may however be excessive in some other circumstances. Thus explanatory material as to how the auditor may fulfil requirements that are applicable in all cases would be appropriate. For example, ISA 620.8 and A10 recognize that the nature, timing and extent of the auditor's procedures with respect to specific procedures will depend on a variety of matters. To the extent that the PCAOB deems further requirements beyond those of ISA 620 necessary in the context of SEC issuers, they should either be conditional requirements or be applicable only to specific circumstances.

We also suggest that the material in ISA 620.A5, which points out the potential reduction in risk assessment when the company uses a specialist, in combination with internal controls in this regard should also be reflected in the PCAOB's approach.

Bearing this position in mind, we would like to make the following comments regarding auditor's and company's specialists separately:

Auditor's Specialist

We agree that any revisions to the PCAOB's standards should require the auditor to a) evaluate the knowledge, skill and objectivity of an auditor's specialist; b) inform the specialist of his or her responsibilities; and c) evaluate the specialist's work and conclusions (pages 28 and 35). However, ultimately the auditor will need to scale his or her own work as necessary using his or her professional judgement having assessed a number of factors (see ISA 620.08). We comment on the three aforementioned aspects in turn:

a) Evaluation of the knowledge, skill and objectivity of an auditor's specialist

Clearly the manner in which the auditor can evaluate whether the specialist has the prerequisite levels of knowledge, skill and objectivity will depend on the specialist's status vis-à-vis the firm (employed or engaged). In general, employed specialists are likely more prevalent in larger audit firms, whereas engaged specialists are likely more commonly used by smaller firms. For example, a term similar to that used in ISA 620 (necessary competence, capabilities and objectivity for the auditor's purpose) is appropriate, since it acknowledges the relevance of these attributes to the specific circumstances.



page 5/8 to the PCAOB dated 31 July 2015

Some aspects of the potential requirement in the box on page 36 may be excessive and impracticable. A requirement to evaluate the specialist's "reputation and standing in the views of peers and others familiar with the capability or performance of the auditor's specialist" (item c.) could be excessive when the auditor is already satisfied as to the professional qualifications and experience of the specialist. In any case, it may be impossible to fulfil, if there are few such specialists in a jurisdiction or if there is reluctance in the area of specialty to "grade" competitors. Thus this evaluation should not be required in every case.

We comment on the issue of objectivity, and specifically on the two alternatives upon which views are sought in a separate section of this letter.

b) Informing the specialist of his or her responsibilities (pages 37 and 38)

We are concerned as to the practical connotations of a requirement for "reaching agreement regarding ... the importance of professional skepticism in an audit and the need to consider contradictory information". The auditor cannot delegate the exercise of professional skepticism to the specialist, nor will the specialist likely have the required training to fully appreciate what this means and entails in practice. The instructions need to be very clear on these aspects and may need to be rephrased as to require the specialist to inform the auditor of all information that is contradictory to, or deviates (by a specific amount determined by the auditor), from the specialist's findings or conclusions.

We also believe that an agreement also needs to recognize that the auditor may have encountered additional information in this context during the audit to which the specialist is not privy, and that the auditor may pass this on to the specialist in a timely manner to the extent permitted under confidentiality requirements. Matters such as adherence to confidentiality requirements or, where applicable, the need to notify the auditor of changes in circumstances pertaining to the specialists' objectivity should also be reflected in specific agreements with the auditor's specialist.

c) Evaluation of the specialist's work and conclusions

In our view, the potential requirements for evaluating the work of an auditor's specialist as depicted in the boxes on pages 40 - 41 are generally reasonable but there is a need for the PCAOB to explain the possible manner(s) in which the auditor may fulfil these requirements.

We note the observation on page 41 that the auditor's understanding of the specialist's subject matter may vary depending on the particular area of expertise. ISA 620 contains useful guidance material as to how an auditor may



page 6/8 to the PCAOB dated 31 July 2015

obtain an understanding of the field of expertise sufficient to enable the auditor to determine the nature, scope and objectives of the work to be performed by the expert and to evaluate the adequacy of that work for the auditor's purposes (as required by ISA 620.10). Because it is the sufficiency of this understanding that may be the key issue in practice, we believe that it would be appropriate for the PCAOB to include similar guidance.

We agree that professional skepticism is a key issue and that it is appropriate for the PCAOB to address issues related to the failure of the auditor to consider contradictory evidence or to resolve discrepancies, differences or other concerns that the specialist identified.

Company's Specialist

We concur with Staff's view that the objectivity and competence of the specialist in combination with other factors in the auditor's risk assessment should be key factors in the auditor's consideration of the extent to which he or she may use that work, if at all, and generally support the Staff's deliberations in the second paragraph of section D on page 30. This broadly mirrors the approach taken in ISA 500.

The auditor's decision to employ or engage an auditor's specialist needs to be dependent on various factors, including the auditor's own knowledge and experience of the area of specialization, and needs to follow a risk based approach. The IDW therefore believes a principles-based approach similar to that of ISA 500 is needed.

Whilst we understand the concerns raised on pages 30 and 31 in relation to extant text concerning the role of the specialist and the auditor's acceptance of specialists' work, we are concerned that the Staff proposal to revise the extant wording of AU sec 336 – and, in particular, the elimination of text that currently permits the auditor to use the specialist's work without further examination – may have unintended consequences. For example, the elimination of text could be interpreted as a de facto preclusion of using a company's specialist in all cases; whereas a change in the wording to acknowledge this as a possibility in cases not involving significant risks, or involves low risks of material misstatements, and where the auditor exercises professional skepticism and does not have indications that contradict the specialist's work might be a better alternative.



page 7/8 to the PCAOB dated 31 July 2015

Additional Specific Issues

Delineation between Auditor and Specialist

The delineation between auditing and accounting and other areas of expertise is generally clear to those in the auditing profession. We agree that the potential definition of the term "Specialist" benefits from the proposed clarification in foot note 2, but suggest the following wording: "Because income provisions and information technology used in accounting systems are specialized areas of accounting and auditing, this definition does not apply to a person with specialized knowledge or skill in those areas." However it might also be helpful to expand on this to explain that e.g., an individual who specializes in complex taxation law would be providing legal expertise and so would constitute a legal specialist, or that at expertise in IT beyond the basic accounting system would be an IT specialist. In this context we refer to ISA 620.A2.

Objectivity of an Auditor's Specialist

During its so-called clarity project, the IAASB debated at some length whether an auditor's engaged specialist should be considered as a member of the engagement team and thus be required to adhere to the audit firm's independence rules. This proposal was, however, rejected by the IAASB on the grounds that such a requirement could deny the auditor access to appropriate specialists. Therefore, we do not believe that alternative no 1 (i.e., to apply the requirements of Rule 2-01 of Regulation S-X to engaged auditor's specialists) would be in the interests of investors.

In some jurisdictions and in some fields of expertise, there may be a limited number of specialists and so the balance between inconsequential threats to independence and that specialist's professionalism which may mitigate any perceived threat needs to be weighed against the desire to permit the auditor recourse to the best possible expertise.

We therefore believe that the Board should adopt a principles-based "enhanced objectivity approach" along the lines described in the paper. However, we note that the potential requirements set forth in the paper are far more prescriptive than the requirements of ISA 620, and in many cases mirror the application material in that standard. To the extent that the PCAOB intends to follow its risk based approach these are potentially excessive. For example, if the auditor obtains detailed information from the company as to the threats to objectivity of the auditor's engaged specialist it seems excessive to require the specialist to



page 8/8 to the PCAOB dated 31 July 2015

duplicate this in "a written description regarding (i) any business, employment or financial relationships and the process used by the specialist to formulate the responses to (i)". The PCAOB does not set requirements for external specialists and requiring the auditor to enforce such requirements in his or her negotiations pertaining to the engagement of a suitably qualified specialist could have the similar impact as described above in regard to requiring specialists adhere to stringent independence rules. In our view, it may be equally appropriate to consider whether the objective of ensuring objectivity could be fulfilled by alternative means, e.g. explicit confirmation in an engagement letter as well as obtaining a letter of representation from the specialist.

If you have any further questions about our comments, we would be pleased to discuss our comments with you.

Yours very truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Head of International Affairs

541/584



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.



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.

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 objectivity, 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,

A handwritten signature in blue ink that reads "N. Schroeder".

Nancy J. Schroeder, CPA
Chair, Financial Reporting Committee
Institute of Management Accountants
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July 31, 2015

Mr. James R. Doty, Chairman
US Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006 USA

By email: comments@pcaobus.org

Dear Chairman Doty,

RE: Staff Consultation Paper 2015-1, *The Auditor's Use of the Work of Specialists*

We follow with interest the PCAOB's initiative to explore ways to strengthen and modernize the PCAOB's interim standards addressing the auditor's use of the work of specialists. As indicated in the Staff Consultation Paper (the Paper), the IAASB's standards that address this topic are ISA 620, *Using the Work of an Auditor's Expert*, and ISA 500, *Audit Evidence*.

As you may know, the IAASB has commenced work this year on the topic of [Special Considerations in the Audit of Financial Institutions](#). As part of its work, the IAASB will consider issues that have been highlighted relating to auditing accounting estimates, including fair value measurements, and whether such issues are more broadly applicable to entities other than financial institutions. Although considerations are only at an early stage, it is anticipated that the topic of the auditor's use of the work of specialists (referred to as "experts" in the ISAs) will feature prominently as part of the IAASB's deliberations, including as it relates to specialists engaged or employed by companies and auditor's specialists. For example, discussion may be in relation to the implications of IFRS 9, *Financial Instruments*, and the need for expertise to evaluate credit risk, the use of third-party pricing sources, or, more generally, on related matters when auditing fair value accounting estimates. Similarly, the IAASB's new work on [Quality Control](#) will include deliberation on the topics of direction, supervision, performance and review, including the appropriate involvement of individuals with specialized skills or knowledge, auditor's specialists, and the resultant implications on audit quality.

Accordingly, even though the IAASB does not have in its [Work Plan for 2015–2016](#) a separate project to revise ISA 620 or ISA 500, we believe there may be opportunities for the IAASB to benefit from the PCAOB's work on this important project. Similarly, we believe that the PCAOB may also benefit from the IAASB's experiences. We believe that interactions between the IAASB and PCAOB at both Board and staff levels on Auditor Reporting have been mutually beneficial; we would be pleased to continue similar constructive dialogue with the PCAOB Board Members and Staff to share relevant perspectives on common issues.

The PCAOB Staff Consultation Paper 2015-1 (the Paper) includes discussion on a number of areas the IAASB also had to consider when it revised and redrafted ISAs 620 and 500. We believe therefore that the PCAOB Staff may find the information contained in the IAASB Staff-prepared [Basis for Conclusions](#)

useful in understanding why the IAASB took particular decisions in response to feedback from its public consultations on ISA 620, including, among others, in relation to:

- The importance of flexibility and “scalability”, in light of the wide range of circumstances in which specialists are used and recognizing that the nature, timing and extent of audit procedures are expected to vary depending on such matters as the nature of, and risks of material misstatement in, the matters to which the specialist’s work relates, and the significance of the specialist’s work in the context of the audit.
- The implications of having auditor’s engaged specialists (referred to as “auditor’s external experts” in the ISAs) subject to all the quality control policies and procedures the firm applies to its partners and staff and all the independence requirements of the IESBA’s¹ *Code of Ethics for Professional Accountants*.
- Other definitional matters.

If you have any questions regarding the above, please do not hesitate to contact me at KathleenHealy@iaasb.org or (212) 471-8713.

Yours sincerely,



Kathleen K. Healy
Technical Director, IAASB

CC: Martin F. Baumann, Chief Auditor and Director of Professional Standards, PCAOB
Prof. Arnold Schilder, IAASB Chairman
James Gunn, Managing Director, Professional Standards

¹ International Ethics Standards Board for Accountants



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July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Staff Consultation Paper
The Auditor's Use of the Work of Specialists

Dear Madam Secretary:

KPMG LLP is pleased to submit its comments about the Public Company Accounting Oversight Board's (PCAOB or the Board) Staff Consultation Paper entitled *The Auditor's Use of the Work of Specialists* (the Paper). We welcome the opportunity to work with the Board, PCAOB staff (the Staff), and other stakeholders to improve audit quality through enhanced auditing standards.

As members of the Center for Audit Quality (CAQ), we participated in the development of the CAQ's views on the Paper as expressed in its comment letter dated July 31, 2015. We are generally supportive of the views expressed in that letter, particularly regarding the importance of retaining the principles of AU sec. 336, *Using the Work of a Specialist*. Specifically, we are supportive of the principle that 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. We are concerned that replacement or modification of current auditing requirements with requirements for the auditor to effectively re-perform the procedures undertaken by the specialist will challenge the underlying principles of AU sec. 336 and present operational difficulties resulting in potentially unintended consequences.

Our additional comments are based on the fact that we primarily use auditor employed specialists and use auditor engaged specialists only on an infrequent basis and that our audit methodology takes into consideration the standards of the PCAOB, the Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB).

Use of Company's Specialists

We agree with the overall view expressed in the Paper that the extant auditing literature no longer adequately addresses the variety of circumstances in which a company may use specialists, whether engaged or employed. In considering questions 14 -16 of the Paper, we believe that there should be different requirements for a company's specialist than for an auditor's specialist, irrespective of the similarity of the work performed. Because objectivity of a company's specialist may not be the same as that of an auditor's specialist, the persuasiveness of the evidence is not the same. We believe that the approach adopted by the ASB and the IAASB to

consider a company's specialist using the same criteria as other audit evidence is both practical and scalable.¹

We suggest the Staff consider whether use of the work of a company's specialist is analogous to how the auditor considers the use of the work of internal audit or others. When evaluating whether to use the work of internal audit or others, an auditor considers competence and objectivity, including reporting lines, when assessing the reliability of the audit evidence. We believe a similar evaluation should be performed when using the work of a company's specialist and take into consideration the significance of assumptions and methods being used, and any resulting analysis, to the financial statements. Such an approach would be consistent with the requirements of AU-C 500, *Audit Evidence*, and International Standards on Auditing 500, *Audit Evidence*.

In our response to the Staff Consultation Paper entitled *Auditing Accounting Estimates and Fair Value Measurements*,² we agreed with the Staff that in a potential new standard it should be clear that management is responsible for all assumptions, including those used by specialists, because the existing fair value framework includes a requirement for the auditor to understand the methods and assumptions used and to make appropriate tests of data provided to the specialist, taking into account the assessment of control risk among other requirements. The assessment of control risk is appropriately directed toward management's oversight of specialists and selection of assumptions, regardless of whether the specialists are employed or engaged.

Further, in the same response, we stated that a requirement for an auditor to test information developed by management's specialist as if it were produced by the company would effectively obviate any benefit management obtains by engaging such a specialist, and we did not agree with the expansion of such a requirement. After careful consideration of the background information in the Paper³ and listening to the Standing Advisory Group meeting held on June 18, 2015, we continue to believe that such a broad requirement, stated as "in the same manner as the auditor evaluates information produced by others in the company" may be difficult to operationalize.

Other Matters – Terminology

We are concerned that the proposed wording used in a potential requirement to evaluate the work of the auditor's specialist may be difficult to apply. Specifically,

- "*in conformity with the applicable financial reporting framework*"⁴ would not appear to be appropriate terminology, as financial reporting frameworks do not consistently specify a method and the specialist may not be as well versed in the financial reporting framework as auditors.
- "*generally accepted within the specialist's field of expertise*"⁵ may be difficult to achieve, as both acknowledged by the Staff and our own observations, since many specialist disciplines do not have industry standards.

¹ See AU-C 500, *Audit Evidence*, and International Standards on Auditing 500, *Audit Evidence*.

² See KPMG comment letter dated November 3, 2014

³ Page 40 of the Paper.

⁴ Page 40 of the Paper.

⁵ Ibid.

We support the Staff's continued efforts to seek input on audit concepts that impact new auditing standards and appreciate the Board's and Staff's consideration of our comments. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann (212-909-5770 or gherrmann@kpmg.com) or Ilene Kassman (212-909-5667 or ikassman@kpmg.com).

Very truly yours,

KPMG LLP

cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor

SEC

Mary Jo White, Chair
Luis A. Aguilar, Commissioner
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Kara M. Stein, Commissioner
James Schnurr, Chief Accountant
Wesley R. Bricker, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie Erhardt, Deputy Chief Accountant

From: [Ken Lining](#)
To: [Comments](#)
Subject: Staff Consultation Paper No. 2015-01, The Auditor's Use of the Work of Specialists
Date: Tuesday, July 21, 2015 5:43:39 PM

Dear Members of the PCAOB:

Thank you for inviting me to participate as a panelist in the June 18th SAG meeting.

I want to re-iterate my responses to the requested questions from the Staff Consultation Paper that were provided on the last page of my submitted remarks.

Q-6b: Does Figure 1 in Section II.A accurately describe the activities for which an auditor uses the work of a company specialist?

Yes, agree that a qualified actuary should calculate the pension & OPEB obligations

Q-8a: If auditor has access to specialist's methods (or models), is the access sufficiently detailed for auditor to obtain sufficient evidence?

Actuaries generally utilize proprietary valuation systems; however, they may provide illustrative models to auditors in some instances

Q-8b: If auditor does not have such access, how does auditor obtain sufficient appropriate audit evidence...?

More typical situation so the auditors will generally review selected items, e.g., data counts, asset statements, year-to-year reconciliations of benefit obligations & assets, variances in actual vs. expected benefits paid, present value of projected cashflows

Q-14: Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist...?

Yes, and note that actuaries frequently are requested to certify to this information

Q-15: How do auditors obtain understanding of assumptions & methods used by a company specialist?

Company specialist actuaries typically invest time helping auditors understand the material effects of various assumptions/methods & sensitivities to changes

Many of the large auditing firms employ in-house actuaries

Also, to expand somewhat on my remarks to Q-15 (above), I would like for the PCAOB to consider the following additional comments (some of which I made during the follow-up Q&A), which emphasize how the auditors often employ their own specialists in reviewing the work of actuaries:

- As noted on page 30 of the staff consultation paper, "[i]n cases when the auditor does not possess the specialized knowledge or skill to perform those more rigorous procedures, the auditor might need to employ or engage his or her own specialist." This would generally be the case in a review of a company's obligations for pensions and other postretirement

benefit plans. Many of the large auditing firms employ in-house actuary specialists or engage actuary specialists. These auditor's specialists generally review the methods, assumptions, data, etc. used by the company's actuary specialist to ensure that they are reasonable and appropriately documented. They also provide the audit engagement team with a detailed report summarizing their review and conclusions. The staff consultation paper does not appear to specifically address this situation where both the company and the auditor use their own specialists, but it is a very common situation when auditors review companies' obligations for pensions and other postretirement benefit plans. The use of auditor's specialists may be less common among smaller auditing firms. Auditing firms that do not currently employ or engage actuary specialists might need to do so under revised standards.

- In determining what level of testing the auditor should perform on information provided by the company's specialist, it is important to establish appropriate limits on the amount of testing required so that the testing is not unduly burdensome. For example, in reviewing a company's obligations for pensions and other postretirement benefit plans, it would be excessive to require the auditor to fully reproduce the work of the company's specialist. In addition, the auditor would generally not possess the necessary expertise to do so. Instead, it would be more appropriate to require the auditor (or their specialist) to evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist.
- In a situation where the auditor's specialist is reviewing information provided by the company's specialist, the auditor's specialist should perform testing sufficient to confirm whether the methods, assumptions, and results are reasonable. This can be accomplished by reviewing appropriately documented actuarial communications provided by the company's specialist, testing census data and assumptions, etc. and should not require the auditor's specialist to fully reproduce the company's specialist's work.

Thank you again for this opportunity to provide comments into this important process. Please let me know if you have any questions.

Regards,

Ken

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July 30, 2015

Office of the Secretary
Public Company Accounting Oversight Board
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Washington, D.C. 20006-2803

Re: PCAOB Staff Consultation Paper No. 2015-01

McGladrey LLP appreciates the opportunity to offer our comments on PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We are pleased the PCAOB staff has conducted outreach as it considers ways to improve the standards that apply to the auditor's use of the work of specialists. The increasing complexity of information needed to account for transactions in today's business environment has caused our firm and our clients across many industries to use the work of specialists more often than in prior years. Because an auditor does not have the expertise of a person trained for another profession or occupation, it is imperative that auditors continue to be able to use the work of a specialist effectively and efficiently for complex or subjective matters that are potentially material to the financial statements and that require special skill or knowledge to obtain sufficient appropriate evidence.

We believe the proper use of the work of a specialist enhances audit quality in situations requiring specialized knowledge and subject matter expertise the auditor does not possess (i.e., subject matter other than audit and accounting). Furthermore, the audit deficiencies identified in the staff's consultation paper were failures to comply with the existing standard. We therefore believe the foundational elements of AU 336, *Using the Work of a Specialist*, should be retained. Clarifying and enhancing the auditor's responsibilities with respect to the work of specialists will be beneficial for auditors, registrants and investors. We support the staff's objective of improving the standards that apply to the auditor's use of the work of a specialist. However, we believe some of the alternatives proposed in the Staff Consultation Paper may have unintended consequences for non-Big Four firms and the clients they serve.

Our letter explains the use of the work of specialists in our current practice, our views on the potential need for improvement of the standards to address certain operational challenges related to the auditor's use of the work of specialists, and our conclusions regarding possible alternatives discussed in the Staff Consultation Paper.

The use of the work of specialists in our current practice

We use the work of specialists in approximately 80 percent of our audits conducted in accordance with PCAOB standards. Activities for which we most commonly use the work of specialists include the following:

- Valuation specialists for fair value of reporting units in analyzing goodwill impairment
- Valuation specialists for valuation of securities and other complex financial instruments
- Valuation specialists for assets acquired and liabilities assumed in business combinations
- Valuation specialists for intangible asset impairment
- Actuaries for pension and other post-employment obligations

Office of the Secretary
Public Company Accounting Oversight Board
July 30, 2015
Page 2

When auditing accounting estimates, auditor's specialists may be used to assist in testing the company's estimation process or in developing an independent estimate. Factors that impact our engagement partners' decisions as to how to use the work of an auditor's specialist in the auditing of an accounting estimate most effectively (i.e., in testing the company's estimation process or developing an independent estimate) include the following, among others:

- The nature of the account for which the estimate is developed.
- The complexity of the estimate. For less complex estimates, it may be efficient and effective to develop an independent expectation of the estimate. For more complex estimates, the development of an independent expectation might be cost prohibitive.
- Whether management has employed or engaged a specialist.
- The level of estimation uncertainty involved in the estimate. Specifically, when there is high estimation uncertainty, the auditor is more likely to test the company's estimation process.
- The depth of knowledge and experience of the engagement team with respect to the estimate.

When we engage a specialist, we usually are not told the number of hours the specialist worked on the audit engagement. However, for audits in which the work of an auditor's engaged specialist is used, we estimate the specialist's hours comprise, on average, less than five percent of the total engagement hours. For audits in which the work of an auditor-employed specialist is used, we estimate the specialist's hours comprise, on average, approximately five percent of the total engagement hours.

Potential need for improvement and alternatives discussed in the Staff Consultation Paper

Evaluating the work of the company's specialist

We believe the core principle of AU 336, when appropriately applied, provides the auditor with a fundamental basis for evaluating the work of a company's specialist. Although certain clarifying enhancements could be made to AU 336 as discussed below, we believe the basic framework of AU 336 should be maintained because it provides the appropriate basis for evaluation of the work of a company's specialist.

Per page 22 of the Staff Consultation Paper, "...the staff is exploring whether the auditor should evaluate the work of a company's specialist in the same manner as other information produced by the company is evaluated." This potential revision would require the auditor to evaluate the appropriateness of the methods and models, test the data used and evaluate the reasonableness of significant assumptions as if the information was produced by the company. Such a requirement would not be practical, and may not even be possible, for the following reasons, among others:

- Because the company's specialist would possess special skills or knowledge in a field other than accounting or auditing, it is probable that the auditor would not have the necessary expertise, and therefore would need to use the work of another specialist to evaluate the work of the company's specialist. This duplication of efforts would result in audit inefficiencies and increased costs to the issuer. Such increased costs could discourage issuers from using specialists, which could have a detrimental effect on the quality of the financial statements.
- In an audit of internal control over financial reporting that is integrated with an audit of financial statements, the auditor would be required to evaluate and test the design effectiveness and operating effectiveness of the internal controls of the company's specialist, the cost of which we believe would outweigh any potential benefit to investors.

Office of the Secretary
Public Company Accounting Oversight Board
July 30, 2015
Page 3

When making enhancements to AU 336 for evaluating the work of a company's specialist, consideration should be given to International Standard on Auditing (ISA) 500, *Audit Evidence*, and AU-C 500, *Audit Evidence*, which provide application guidance that is incremental to AU 336 and are sufficient when evaluating the work of the company's specialist. For example, paragraph 8(c) of ISA 500 requires the auditor, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, to evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion. This is supplemented by application guidance in paragraph A48, which states:

"Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data."

Developing a separate standard for using the work of an auditor's specialist

To avoid confusion, we agree that it makes sense for the PCAOB to develop a standard for using the work of an auditor's specialist that is separate from the standard for using the work of a company's specialist. The International Auditing and Assurance Standards Board and the Auditing Standards Board both already have developed separate standards:

- ISA 620, *Using the Work of an Auditor's Expert*, and AU-C 620, *Using the Work of an Auditor's Specialist*, which apply to the use of the work of an auditor's employed or engaged specialist
- ISA 500 and AU-C 500, which apply to the evaluation of the sufficiency and appropriateness of evidence prepared using the work of a company's specialist

Requirements in a separate standard for the use of the work of an auditor's specialist should apply to a specialist employed or engaged by the auditor, similar to the approach used in ISA 620 and AU-C 620. The requirements in ISA 620 and AU-620 provide more detailed guidance than those of AU 336 and therefore should be included in a new separate standard. Also, that guidance is already familiar to auditors who perform audits under International Standards on Auditing and U.S. generally accepted auditing standards.

We believe there should continue to be a distinction between an auditor's engaged specialist and an auditor's employed specialist in that an auditor's engaged specialist should not be considered a member of the engagement team. The supervision requirements in PCAOB Auditing Standard (AS) No. 10, *Supervision of the Audit Engagement*, should not be extended to an auditor's engaged specialist because the specialist or the specialist's firm is responsible for their own system of quality control, including supervision and review and it would not be practicable, other than by using an auditor-employed specialist, for the auditor to supervise and review the work of the engaged specialist.

Office of the Secretary
Public Company Accounting Oversight Board
July 30, 2015
Page 4

Applying the requirements of SEC Regulation S-X Rule 2-01 to an auditor's engaged specialist

PCAOB Rule 3520, *Auditor Independence*, requires an auditor's employed specialist to be independent of the company. Under PCAOB standards, an accounting firm is required to have quality control policies and procedures to provide reasonable assurance that personnel maintain independence in all required circumstances, perform all professional responsibilities with integrity and maintain objectivity in discharging professional responsibilities.

The staff has included a potential requirement to subject an auditor's engaged specialist to the requirements and restrictions that apply to covered persons in the accounting firm under Rule 2-01 of SEC Regulation S-X. We do not believe this requirement would be practicable because the vast majority of specialists do not have the quality control systems needed to monitor compliance with Rule 2-01 and thus would likely be unable to comply. Such a requirement could reduce the number of specialists who are willing to be engaged by auditors because they may not be willing to implement the required processes and procedures, nor make the necessary disclosure of their personal financial information, to demonstrate compliance with Rule 2-01. This problem would be especially challenging for non-Big Four firms who do not employ the majority of the specialists they use and may not be able to continue to engage specialists due to the lack of availability of specialists and/or the increased cost of engaging the specialists.

Although an auditor's engaged specialist currently is not required to be independent of the company, AU 336.10 already requires the auditor to evaluate the relationship between an auditor's engaged specialist and the company, including circumstances that might impair the specialist's objectivity. We believe an enhanced objectivity alternative should be developed to provide additional specificity about how the auditor would be required to evaluate whether the auditor's engaged specialist has the necessary objectivity for the auditor's purposes. We believe such an evaluation of objectivity should be similar to that in ISA 620 and AU-C 620 and should include:

- Inquiry of the company and the auditor's engaged specialist regarding any known interests or relationships the company has with the auditor's engaged specialist that may create a threat to the objectivity of the auditor's engaged specialist
- Discussion with the auditor's engaged specialist of any applicable safeguards, including any professional requirements applying to that specialist, and evaluate whether the safeguards are adequate to reduce threats to an acceptable level
- A determination, based on the evaluation of that information, whether the objectivity of the auditor's engaged specialist is impaired

Such procedures should be limited to inquiry and other knowledge gained in the audit, and should not extend to procedures to corroborate the inquiries. Also, the auditor's inquiries of the specialist should be sufficient to obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's inquiries. Further, interests and relationships that may be relevant should include business, employment and financial relationships between the auditor's engaged specialist and the company. Because the auditor's engaged specialist most likely will not have the necessary quality control policies and procedures in place, financial interests considered only should include the financial interests of the individual specialist(s) who is serving on the audit engagement and those who could influence the outcome of the specialist's work. Consideration should not extend to the financial interests of others in the specialist's firm.

Office of the Secretary
Public Company Accounting Oversight Board
July 30, 2015
Page 5

Supervising the auditor's employed specialist

When we use the work of an auditor's employed specialist, such as a valuation specialist, we find that overall there is enough guidance in AS 10 regarding supervising the work of the employed specialist. However, as the specialized skills and knowledge of the auditor's employed specialist become further removed from the fields of accounting and auditing, such as geology and engineering, it becomes more difficult to fully apply the requirements of AS 10. For example, it would be difficult for the engagement partner and, as applicable, other engagement team members performing supervisory activities, to inform such specialists of their responsibilities, including, among others, the nature, timing and extent of procedures they are to perform as required by paragraph 5.a. of AS 10. Also, it would be difficult for the engagement partner and other engagement team members performing supervisory activities to review the work of such a specialist to evaluate whether the objectives of the procedures were achieved as required by paragraph 5.c.2. of AS 10. Therefore, we recommend that interpretive guidance to clarify the supervisory activities related to the use of an auditor's employed specialist be specified in AS 10 and then referenced to the new standard for using the work of an auditor's specialist.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to Sara Lord, National Director of Assurance Services, at 612.376.9572.

Sincerely,

A handwritten signature in cursive script that reads "McGladrey LLP".

McGladrey LLP

July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via e-mail: comments@pcaobus.org

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

Dear Office of the Secretary:

We appreciate the opportunity to share our views on Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (the "Paper"), developed by the staff of the Office of the Chief Auditor (the "Staff") of the Public Company Accounting Oversight Board (the "PCAOB").

Moss Adams LLP is one of the 15 largest accounting and consulting firms in the United States. Our staff of more than 2,000 includes approximately 260 partners. Founded in 1913, Moss Adams LLP serves as the independent registered public accounting firm for approximately 90 public companies in a variety of industries.

We are supportive of the Staff's objective of obtaining stakeholder feedback in their review of the auditing standards surrounding the use of specialists in an audit. When taken together with the Staff's previous Consultation Paper *Auditing Accounting Estimates and Fair Value Measurements*, these standards are highly impactful to auditing public companies. We agree with the Staff's observations that the use of specialists has increased since the standards were originally issued, driven by the increased use of fair value in financial reporting and an increasingly complex business environment. We also agree that the auditing profession may benefit from enhancements to certain elements of the extant auditing standards subject to the Staff's consultation papers. However, in undertaking any potential standard-setting, we urge the Staff and the Board to appropriately consider the scalability of any proposed guidance to smaller firms, which we believe includes:

- Retaining the model in AU 336 *Using the Work of a Specialist* ("AU 336"); and
- Proposing supervision standards (or specified procedures) for engaged specialists that are operational.

We consider these items to be critical to our firm's ability to continue to perform public company audits. As further discussed below, a number of the potential alternatives discussed in the Paper may have the unintended consequence of curtailing the types of public companies for which we could perform an audit in accordance with PCAOB standards. Our understanding is that many firms other than the largest national firms would be in a similar position. We believe that potential proposed standards that would diminish smaller firms' ability to audit public companies is a consequence with negative public policy implications that should be avoided.

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Office of the Secretary
Public Company Accounting Oversight Board
July 31, 2015
Page 2

Our more detailed comments on these points are as follows:

Scalability

The Staff observes in the Paper that smaller firms predominantly engage a specialist when an auditor's specialist is required, whereas the auditors' specialists used by the largest accounting firms are substantially all employed by the firm. Our firm employs a number of specialists, primarily related to the field of business valuation; however, we also engage specialists as needed. We also apply extant AU 336 to a variety of company-engaged specialists, including actuaries, appraisers, and attorneys, among others, and rely on the audit evidence obtained. Rarely does our firm rely on the work of a company-employed specialist as audit evidence because small and middle market public companies typically do not employ specialists.

As further discussed below, we believe that retaining the AU 336 model is an important step in maintaining an appropriate level of scalability. It is not economically feasible for our firm to employ all of the specialists that may be necessary to conduct public company audits in any given year, and we rely on the work of engaged specialists to provide sufficient appropriate audit evidence. Given the integral nature of an engaged specialist's work as audit evidence, the supervision standards that apply to auditor- and company- engaged specialists must be operational. Our observations on an operable supervision standard are also included below.

Retention of the AU 336 Model

Retaining the core principles of the extant AU 336 standard, which acknowledges that an auditor may use the work of individuals outside the engagement team with specialized knowledge, is important to scalability. As noted above, it is not practicable for our firm to employ all of the specialists that may be necessary. Further, appropriate application of the procedures in extant AU 336 to the work of company-engaged specialists frequently provides sufficient appropriate audit evidence. Elimination of the ability to use a company-engaged specialist's work as audit evidence would require the use of an auditor's specialist, which will frequently be an auditor-engaged specialist for firms other than the largest national firms. We do not believe that the incremental audit costs associated with using an auditor's specialist would outweigh the benefits to audit quality, as the additional cost would be significant in many circumstances.

We are supportive of considering both the results of a risk assessment performed in accordance with Auditing Standard No. 12 *Identifying and Assessing Risks of Material Misstatement* ("AS 12") and the procedures in AU 336 in considering the use of the work of a company-engaged specialist. As a result of these procedures, we believe an auditor should apply judgment to conclude whether the company-engaged specialist's work alone will provide sufficient audit evidence. Such an approach, which holistically considers both the overall audit risk assessment and specific procedures under extant AU 336, would form an appropriate basis for a proposed future standard. We observe that the Paper's proposed alternatives would eliminate such an approach.

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Office of the Secretary
Public Company Accounting Oversight Board
July 31, 2015
Page 3

For company-employed specialists, we acknowledge that clarifying, and potentially amending, the auditor's procedures and perceived responsibility may be appropriate. However, both of the alternatives proposed in the Paper (amending or rescinding AU 336) do not differentiate between a company-engaged and a company-employed specialist. Particularly with respect to company-engaged specialists, both of the Paper's alternatives would result in significant additional audit work to use an auditor's specialist to evaluate the information provided by the specialist, without, in our view, a correspondent increase in audit quality. We believe that an auditor should, after considering the results of their risk assessment procedures and the procedures in extant AU 336, be able to apply judgment in considering whether:

- A company-engaged specialist's work provides sufficient audit evidence;
- The use of an auditor's specialist is necessary;
- Additional procedures are necessary to obtain sufficient appropriate audit evidence.

Supervision

The Paper identifies two potential alternatives with respect to supervising an auditor's specialist, one of which is to extend the supervision requirements in Auditing Standard No. 10 *Supervision of the Audit Engagement* ("AS 10") to an auditor's engaged specialist. We do not believe this would be sufficiently scalable or operational for smaller firms engaging an auditor's specialist. In addition to the concerns noted in the Paper (which we agree are valid concerns), our experience is that an auditor's engaged specialist is unwilling to provide the same level of access to proprietary models or assumptions as would be available to an auditor's employed specialist. While the Paper states that a benefit of this alternative would "... result in the same requirements for evaluating the work of employed and engaged specialists..." we do not believe that an auditor would have the level of access necessary to an engaged specialist's model and assumptions to meet a comparable standard between employed and engaged specialist. This is similar to our concern in the previous section with respect to company-engaged specialists.

In addition, the Paper considers the expansion of the AS 10 supervision requirements to an auditor-engaged specialist and further amendments to paragraph 5.c to provide specific requirements for the engagement partner's supervision of all auditors' specialists. The proposed alternatives outlined in the Paper would require the auditor to apply a more rigorous "evaluate" standard to the work and conclusions of specialists, and the potential amendments to paragraph 5.c would provide specific procedures on completing the evaluation. We are concerned that, notwithstanding the definition of a specialist, the PCAOB expects the engagement partner to have a de facto knowledge of the specialist subject matter that is similar to the knowledge of the specialist themselves. For example, the proposed paragraph 5.c. amendments would require the engagement partner to consider whether the specialist used appropriate methods and reasonable assumptions. If the engagement partner had sufficient knowledge of the specialized subject matter to perform these procedures, the use of an auditor's specialist would have been unnecessary to begin with. Accordingly, we believe these provisions are not operable, and would result in needing to have two specialists involved and/or for the engagement partner to undertake additional specialized training in any area where an auditor's specialist is used.

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Office of the Secretary
Public Company Accounting Oversight Board
July 31, 2015
Page 4

Finally, the Paper considers whether the independence requirements of the Securities and Exchange Commission's Rule 2-01 of Regulation S-X should be applied to an auditor's engaged specialist and the specialist's firm, if applicable. We do not believe that an auditor-engaged specialist firm would have the quality control infrastructure in place to comply with Rule 2-01 in the same manner as an auditing firm. Further, these specialists' primary business is practicing in their line of specialty, which is generally not being an auditor's specialist, and may result in a reluctance to develop the necessary quality control infrastructure to comply with Rule 2-01. Therefore, we do not believe such a standard would be operable, and may have the consequence of limiting the population of specialists an auditor could engage or requiring an audit firm to employ all of the necessary specialists.

The alternative identified in the Paper is to apply an enhanced objectivity framework. While we are supportive of enhancing an auditor's consideration of the objectivity of engaged specialists, the framework proposed in the Paper is unclear as to how the procedures performed by the auditor link to the conclusions reached, and whether the analysis is a "principles-based" or "rules-based" analysis and the intended application of any principles. For example, the Paper proposes that the objectivity of the specialist is impaired if the company can influence the specialist, but it is unclear how the auditor would conclude as to whether such influence exists, and if the existence of any influence would impair the specialist's objectivity, or if judgment could be applied in assessing the level of potential impairment of objectivity in assessing whether the auditor could use the engaged specialist's work. We believe any enhancements to the extant objectivity assessment in AU 336 should provide auditors with a clear understanding of the procedures to be performed and what constitutes an impairment of a specialist's objectivity.

We appreciate the effort and time the Staff has devoted to the Paper and we appreciate the opportunity to comment on the Paper. Please direct any questions to Fred Frank or John Donohue in our Professional Practice Group at 206-302-6800.

Very truly yours,

Moss Adams LLP

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 3, 2015

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Delivered Electronically

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

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to the Staff Consultation Paper, *The Auditor's Use of the Work of Specialists* (the Staff Paper).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 224 companies representing an equity market capitalization of \$890 billion at June 30, 2015. Of these companies, 183 were Equity REITs representing 93.5% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to \$832 billion)¹. The remainder, as of June 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of \$58 billion.

¹ <https://www.reit.com/sites/default/files/reitwatch/RW1507.pdf> at page 21.



Ms. Phoebe W. Brown
August 3, 2015
Page 2

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. However, NAREIT has significant concerns with the Staff Paper as drafted. NAREIT's comments are primarily focused on the areas that would impact NAREIT member companies (*i.e.*, use of specialists in valuing investment properties, equity and mortgage-backed securities, and derivative positions.)

Why is a change to the existing audit framework for the auditor's use of specialists warranted?

NAREIT is not persuaded that a change to the audit framework for the auditor's use of specialists is necessary. In NAREIT's view, the expansion of audit requirements for the work of specialists is an unnecessary change given the amount of work performed by auditors today. NAREIT's member companies observe that external auditors currently perform a significant amount of audit work surrounding estimates prepared by specialists pursuant to existing audit standards. For example, multiple member companies have indicated that the audit fees for auditing fair value estimates of real estate and auditing purchase price allocations in business acquisitions *exceed* the fees paid to the third party valuation companies that develop the estimates. In NAREIT's view, the suggestions in the Staff Paper would not pass a cost benefit test. The suggestions in the Staff Paper would only expand the work that auditors perform today, with no increase in the reliability or credibility of the audited financial statements. Further, as discussed below, there is no evidence that the existing auditing standards related to the auditor's use of the work of specialists fail to detect significant errors in financial statements. In short, NAREIT sees no basis to conclude that increased audit work (and thus audit fees) would provide any measurable benefit.

What is the underlying problem that the Staff Paper is trying to solve?

NAREIT does not believe that the Staff Paper articulates a pervasive problem that would be solved by a change in auditing standards. The Staff Paper seems to be justifying a significant increase in audit work (and cost) based on academic research papers and limited circumstances where *existing* audit guidance was not followed by the auditor. Further, NAREIT is not aware of any significant audit failures (with "audit failures" defined as restatements of financial statements) driven by the inappropriate reliance on work performed by a specialist in recent history that would necessitate standard setting by the PCAOB.

Why should external third parties be considered an extension of management?

NAREIT strongly objects to the alternative of expanding the scope of audit work in the evaluation of processes and controls when management uses a third party specialist or pricing services. NAREIT continues to believe that the auditor's evaluation of the objectivity of the specialist and the accuracy of information provided to the third party are appropriate. Additionally, NAREIT considers the existing requirements for both management and auditors to evaluate the information provided by third parties to be sufficient in accordance with current audit literature.

The idea that either management (in its assessment of the adequacy of the company's internal controls over financial reporting) or the external auditor (in its evaluation of management's



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Ms. Phoebe W. Brown
August 3, 2015
Page 3

assessment) could evaluate third parties' processes and controls is simply not operational. NAREIT notes that existing audit guidance in AU 342.04 *Auditing Accounting Estimates* acknowledges that "[a]s estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them."² Finally, third party specialists and pricing services are separate entities from the companies that engage them. To assume otherwise is not factual.

By suggesting that the auditor treat third party specialists as part of the entity that they are auditing, the Staff Paper seems to be requiring management to understand and evaluate the operating effectiveness and sufficiency of controls at third party vendors. There are two clear business reasons why companies engage third parties to assist in the development of estimates: (i) the company does not have the requisite expertise or time to perform the work in-house; and (ii) the company's management believes that the use of third parties enhances the objectivity and reliability of its estimates. Requiring management and the auditor to evaluate the third parties' processes and controls as if they were part of the company itself would exacerbate the company's resource constraints in the first scenario and potentially discourage the company's efforts to utilize outside specialists in the second scenario. NAREIT cautions the PCAOB of the potential for the unintended consequence of management deciding not to use outside expertise in order to avoid incremental audit fees.

Summary

NAREIT appreciates the PCAOB's staff efforts in their endeavor to further audit quality. However, NAREIT does not believe that the PCAOB has identified the root cause that would necessitate further amendments to auditing standards. While the PCAOB cites academic research papers and limited examples of where the auditor failed to follow existing auditing standards, NAREIT fails to see the impetus for a change in auditing standards. In the event that the PCAOB decides to move forward with some change to existing auditing standards, NAREIT recommends that the PCAOB use a targeted approach that address the root cause of problems that are identified.

* * *

We thank the PCAOB for the opportunity to comment on the Staff Paper. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

² <http://pcaobus.org/standards/auditing/pages/au342.aspx>

Ms. Phoebe W. Brown
August 3, 2015
Page 4

Respectfully submitted,

A handwritten signature in black ink that reads "George L. Yungmann" followed by a horizontal line.

George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

A handwritten signature in black ink that reads "Christopher T. Drula".

Christopher T. Drula
Vice President, Financial Standards
NAREIT





National Association of State Boards of Accountancy

◆ 150 Fourth Avenue, North ◆ Suite 700 ◆ Nashville, TN 37219-2417 ◆ Tel 615.880-4201 ◆ Fax 615.880.4291 ◆ www.nasba.org ◆

July 28, 2015

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

comments@pcaobus.org

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

The National Association of State Boards of Accountancy (NASBA) appreciates the opportunity to comment on Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (the "Concept Paper"). NASBA's mission is to enhance the effectiveness and advance the common interests of the Boards of Accountancy that regulate all certified public accountants and their firms in the United States and its territories. In furtherance of that objective, we offer the following in response to the questions posed in the Concept Paper.

OVERALL COMMENTS

We agree with the Board's efforts to consider the need for requiring auditors to have (i) similar responsibilities for overseeing an auditor's employed or engaged specialist, (ii) greater responsibility for evaluating the methods and assumptions used by an auditor's specialist, and (iii) responsibility for evaluating the reasonableness of methods and assumptions used by a company's specialist.

We also agree with the PCAOB's considering these proposed changes to the specialist standards with the topic of auditing management estimates, since many auditors and companies use specialists in the review of significant estimates. We would also encourage the PCAOB to issue any proposed revisions to guidance in these areas at the same time, so that commenters could consider the impact of those changes concurrently. Likewise, we would encourage the effective dates of any proposed changes to these standards be effective at the same time.

The PCAOB and other audit regulators continue to disclose a number of audit deficiencies related to an auditor's use of specialists. The Concept Paper indicates that one way to improve audit quality would be through additional resources being devoted to inspections and enforcement of existing standards. However, we do not believe that would solve the underlying issues identified in the Concept Paper, and therefore we support the issuance of new guidance in this area.

Practice Monitoring of the Future
American Institute of Certified Public Accountants
July 28, 2015
Page 2 of 3

We agree that an auditor's specialist should be independent and objective. However, we believe that the cost would significantly outweigh the benefits of changing the requirements of SEC Regulation S-X Rule 2-01 as this would have a huge impact on smaller firms and specialist entities. Therefore we support the "enhanced objectivity approach" outlined in the Concept Paper.

SPECIFIC COMMENTS

Potential amendments- definitions:

In response to Question 20, we do not believe that changes should be made to the standards regarding the use of specialists with respect to income taxes or information technology. These individuals are considered part of the engagement team and the lead audit partner is responsible for the supervision and review of the engagement team. In situations where a smaller firm may need to engage a third party IT or income tax specialist, they should apply existing professional standards in the oversight of that specialist.

Question 21 asks should the staff provide clarification about what constitutes a specialized area of accounting and auditing? The Concept Paper discusses that not all third parties may be "specialists." We suggest that the PCAOB specifically address this in the definition, or a footnote, and clarify the difference between a third party information provider and a specialist. For example, a third party that provides readily available fair value investment information to a company or an auditor through the use of a subscription service should be not be considered a specialist.

Evaluating the objectivity of an auditors' specialist:

The Concept Paper discusses two alternatives that would result in significantly changing the objectivity requirements relating to engaged auditor's specialists.

The first alternative would apply the independence requirements of Rule 2-01 of Regulation S-X to engaged specialists. We understand that large firms have spent significant time and resources in developing, monitoring and maintaining systems to assist their professionals, including engaged specialists, in complying with these requirements. It appears that in evaluating independence of engaged specialists under this alternative, auditors would be required to verify the processes and controls at the specialist entity are effective in meeting independence requirements. If this alternative were made a requirement, auditors would need additional guidance on expectations regarding the verification of an engaged specialist's independence, including whether a similar evaluation of the engaged specialist's system of quality control would be necessary.

The second alternative would apply an enhanced approach to incorporating the reasonable investor test as an overarching principle and, similar to Rule 2-01, would require the auditor to obtain and evaluate information regarding relationships or interests an auditor's engaged specialist has with the company

Practice Monitoring of the Future
American Institute of Certified Public Accountants
July 28, 2015
Page 3 of 3

that might impair the specialist's objectivity. This too would require significant changes in practice by specialist entities.

The PCAOB should carefully consider the potential economic impact of either of these alternatives as it may not be practicable for specialist entities to continue to provide services to auditors as a result of these alternatives.

Evaluating the work of specialists:

We agree with the PCAOB staff that an auditor who reviews the work of an auditor's engaged specialist or management specialist should focus on the risks associated with the assumptions and models used in the specialist's work. The auditor should also have knowledge of the industry, subject matter and applicable reporting framework. However, the proposed standard should recognize that an auditor is likely not a specialist in many of the areas where specialists are used. There are likely limitations in the nature and extent of the review that auditors can perform over specialists, particularly auditor's engaged specialists or management specialists.

* * *

We appreciate the strong relationship between the PCAOB, NASBA and the State Boards of Accountancy, and we look forward to being able to continue to provide transparent, relevant financial information to the users of our financial statements. Thank you for the opportunity to share our comments on Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*. Please contact us if you have questions or need clarification regarding our comments.

Sincerely,



Walter C. Davenport, CPA
NASBA Chair



Ken L. Bishop
NASBA President and CEO



October 29, 2015

VIA Email

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803
comments@pcaobus.org

RE: Staff Consultation Paper, *Auditors' Use of the Work of Specialists*

INTRODUCTION

The National Venture Capital Association ("NVCA") represents the vast majority of American venture capital under management.¹ This letter is intended to both comment on the Staff Consultation Paper ("SCP") noted above and to supplement the comment letter NVCA submitted on the 2014 SCP, *Auditing Estimates Including Fair Values*. This letter updates our comments regarding audits of fair values of venture capital funds ("VCFs") and adds our perspective to the staff's more recent consideration of the link between auditors' use of the work of specialists and the audits of fair values. We hope this additional and updated information will be useful and that it will receive the staff's full consideration even though we are submitting it after the close of the official comment period.

We have reviewed the SCP on *Auditors' Use of the Work of Specialists* and we agree with the Chief Auditor's staff's conclusions that there is significant overlap

¹ Venture capitalists are committed to funding America's most innovative entrepreneurs, working with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. As the voice of the U.S. venture capital community, the National Venture Capital Association empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community's preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its nearly 300 members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

between issues arising from audits of estimates and auditors' use of specialists. Indeed, many of the concerns that prompted us to file a comment letter on the 2014 SCP, *Auditing Estimates Including Fair Values* involve the impact of valuation specialists. The Introduction section of NVCA's 2014 letter adequately frames the points I hope to convey in this letter. Since that letter is available in the PCOAB comment file,² I will dispense with repeating them here.

NVCA's members have largely completed the 2014 audit season. Through our CFO Task Force³ we have received sufficient information to conclude that fair value audits remain a serious concern in the venture capital industry.

NVCA members recognize the importance and the difficulty of the auditors' role in auditing the valuation of assets that are inherently difficult to value. The task of arriving at a single-point fair value for VCF assets confronts the inherent subjectivity in valuing early stage (often pre-revenue) companies where established industry benchmarks and valuation metrics are often non-existent. This difficulty prompts auditors to use valuation specialists who are technically proficient in the theoretical principles of valuation, where many models and concepts have been developed to explain why market participants reach their conclusions as to valuation. However, valuation of VCF assets requires an understanding of venture investing and the innovative types of companies in which most funds invest. Therefore, many valuation specialists actually compound the auditors' challenge because they lack the venture-specific background needed to appropriately value venture fund assets.

As noted in our November letter, most securities held by a typical venture capital fund are "Level 3 assets" and must be reported to investors at fair value on a quarterly basis. The absence of solid information about the market for most VCF-held securities creates difficulties anticipated in Topic 820. As we noted in our November letter:

Topic 820 recognizes that, with the exception of Level 1, fair value cannot be determined with precision. While the accounting standard requires that the fund account for its Level 3 investments using a point estimate, the standard recognizes that there is a range of possible values for a specific investment. This simply reflects reality. In practice, investing professionals read Level 3 fair value estimates with the understanding that a point estimate for fair value implies a level of precision that is illusory.⁴

Nonetheless these fair values need to be audited to the specifications of top accounting firms, which naturally reflect PCAOB standards. Because of the difficulty

² http://pcaobus.org/Standards/Staff_Consultation_Comments/017_National_Venture_Capital_Association.pdf.

³ NVCA's CFO Task Force is made up of the Chief Financial Officers and Administrative Partners of more than 100 of our member firms.

⁴ *Supra*, Note 2, page 4.

of auditing uncertain values of VCF assets, auditors have increasingly relied on quantitative inputs and the judgment of valuation specialists.

In many cases, valuation specialists provide independent expertise and analysis needed to meet the audit standard. Valuation specialists can also help to document what are usually highly subjective conclusions as to value. Increased use of valuation specialists as part of the audit process has helped auditors to better understand valuation models and the tools and terminology employed by valuation specialists in documenting fair value estimates.

While this is a positive development, it seems that many audit firms have relied too much on the judgments of their internal valuation specialists. This is unfortunate given the fact that many valuation specialists lack a complete understanding of Topic 820 and its emphasis on the assumptions that market participants use in valuation. In general, the models and methods specialists employ are often not among the tools or methods that market participants employ, especially for VCFs. The conclusions of audit firm valuation specialists are no more accurate than those of VCF professionals or their advisers who apply Topic 820 to VCFs on a regular basis.⁵ Still it is not uncommon for an auditor to favor the specialists' valuation procedures over those of the reporting fund.

As a result, in some cases, the involvement of valuation specialists has inhibited rather than enhanced the audit process involving fair value determination. Undue reliance on internal specialists brings complexity, confusion, and delay into the audit process through unnecessary and sometimes even counterproductive procedures.

Many valuation problems arise, in our view, from an incorrect reading of the FASB standard, Topic 820. Examples include:

- the unquestioned use of "price times quantity" as the sole input when the security being valued is not actively traded;
- the use of option pricing models ("OPMs") when such models do not reflect market participant assumptions or the specific facts and circumstances associated with the investment being valued. Auditors sometimes refuse to accept valuations for venture capital portfolios unless an OPM is applied to each company in the portfolio, notwithstanding the fact that market participant funds have not used an OPM.⁶

⁵ The technical authorities for determining fair value under GAAP can differ significantly depending upon the type of transaction being accounted for. A fair value determination for income tax purposes would be based upon still another set of rules or principles.

⁶ This practice in particular became more widespread in 2012 when the AICPA published its initial draft of its Practice Guide entitled "Valuation of Privately-Held-Company Equity Securities Issued as Compensation" (commonly known as the "Cheap Stock Guide"). Although expressly "off-label" for use in applying Topic 820 to fund investments, this document became attractive to auditors as a means of making quantitative assessments of inherently subjective valuation approaches.

- A focus on precision in mathematical inputs to a model rather than far more subjective inputs even when the subjective inputs are far more material to the valuation.

In general, it seems that audits have become biased in favor of anchoring valuations to quantitative observable metrics -- perhaps to ensure that nothing in the audit work papers can be proven wrong -- whether those inputs would have a material impact on valuation or not.⁷ In other cases, audit firms have insisted on the use of models so that the valuations used for financial reporting conform to the results of the model, independent of whether the results from the model actually represent Topic 820 "fair value," i.e., the amount that would be received in an orderly transaction based on market participant assumptions.

On the other hand, sometimes models are "massaged" so that the results of the model approximate the fair value estimate that resulted from using market participant assumptions. In these cases it seems that the use of the models is solely about the documentation. Clearly requiring this type of documentation to be prepared by fund personnel or the use of fund resources for outside valuation specialists does not improve the quality or reliability of the financial statements.

Therefore, we believe that both the quality and the efficiency of audits can be improved through PCAOB guidance that emphasizes limits to the role of specialists in the audits of VCF assets and the importance of subjective judgment and auditor discretion regarding hard-to-value assets, in general.

Appendix A is a compilation of three short examples, and Appendix B consists of two more in-depth case studies submitted by our task force members. We believe that the basic problems identified in our 2014 letter on auditing fair value are illustrated by these examples and case studies.

- Topic 820 requires that fair value be measured based on "the assumptions that market participants would use in pricing the asset...,"⁸ not methods that valuation specialists prefer.
- Often the most crucial assumptions that venture capital market participants use in either assigning a value or making an investment are based on the venture professionals' judgment regarding intangibles – quality and track record of the management team, size of a perceived future market, momentum in a market sector, etc.

⁷ When the AICPA "Cheap Stock Guide" raised awareness of these models the audit professions' increasing reliance on them coincided with anecdotes of additional scrutiny by the PCAOB of fair values estimates and the documentation thereof. This practice, analogous to a physician's practice of defensive medicine, merely imposes additional compliance costs as the price of getting a clean audit opinion.

⁸ ASC Topic 820-10-35-9.

- VCFs use a variety of quantitative and qualitative tools⁹ to assess a fair price and almost always assess the asset in terms of a range of values, not a point estimate.
- The fact that valuation models depend upon user-selected assumptions undermines the seeming objectivity and precision implied by their quantitative nature.

Recommendations

1. Relating to Auditors' use of valuation specialists, we urge the PCAOB to:
 - a. Make it clear to auditors that valuation specialist, whether a third party or auditor-affiliated, should enhance not restrict the auditor's exercise of independent judgment in assuring that valuations are in keeping with the nuances of Topic 820 regarding hard-to-value assets. Auditors should look to valuation specialists and their tools as inputs to be considered in the audit process rather than outputs that can override the auditor's independent judgment or the fund manager's expertise in determining and documenting the fair value estimate in the first place.
 - b. Consider studying the accuracy of valuation specialists' conclusions on Level 3 fair values, e.g., back-test their findings to see to what extent a valuation specialist's conclusions resulted in fair value estimate that came closer to the valuations at which real transactions occurred within a 6- to 9-month period following the determination, relative to similar situations in which no valuation specialist was employed.
2. In addition we would like to reiterate and augment the recommendations in our November 3, 2014 letter as relevant to this SCP as well. We recommend that the PCAOB:
 - a. Publicly acknowledge the role of judgment and support the auditing profession in situations where there are factors that are inherently subjective. Emphasis should be on the audit process and assessment of all qualitative and quantitative factors, rather than a more narrow focus on specific mechanical models;
 - b. Consider a "safe harbor" for auditors who are able to establish ranges for estimated values. (For example, to the extent that the audit client's reporting

⁹ These tools include, but are not limited to options pricing models, probability-weighted estimates, Monte Carlo simulations, and discounted cash flow, where any cash flow exists. When a portfolio company reaches a more advanced stage, market comparable data may be available.

- is within the range and has provided reasonable explanation for how they determined their point estimate, audit requirements are met);
- c. Actively engage with accounting and valuation trade organizations to encourage the development of training programs and materials that educate relevant professionals. Training and materials should approach fair value determinations with a focus on market participant assumptions. They should encourage specialists to base their analysis on a better understanding of the market participant's perspective and acknowledge that some determinations are inherently subjective; and
 - d. Create a private sector advisory group of preparers and auditors with specialists in the technical areas and industries where fair value determinations and other estimates are regularly involved to advise the Board.

Conclusion

NVCA appreciates the opportunity to participate in the PCAOB's consultation process. We stand ready to work with the staff on this and other important matters. We would be pleased to arrange a meeting or conference call with some of the NVCA CFO Task Force members and PCAOB staff so that we can further explain examples of situations they have experienced in dealing with their auditor's interpretation of audit requirements and accounting rules.

Please feel free to contact me at 202 864 5925 or bfranklin@nvca.org or John Taylor, NVCA Head of Research at 646 571 8185 or jstaylor@nvca.org.

Sincerely yours,



Bobby Franklin
President & CEO

Appendix A – Examples
Appendix B – Case Studies

Auditors' Use of the Work of Specialists
National Venture Capital Association

Appendix A – EXAMPLES

The observations and cases set out here and in Appendix B were collected from NVCA CFO Task Force members¹ and advisers to venture funds and other investment funds, with whom we work. These are examples, not a comprehensive compilation. As some of our member firms have broader mandates than just early stage venture capital some of these examples relate to later stage companies, some of which may have publicly listed securities. However, all of them involve auditing fair value and some involve an auditor's use of a valuation specialist. We believe these examples illustrate situations in which the additional effort and cost by the preparer and the added work done by the audit firm did not enhance the quality of financial reporting or utility of the financials to VCF investors.

1. Fund invested in a portfolio company using a combination of equity/warrants and debt. The portfolio company was reported as a Level 3 holding by the Fund. As part of its initial reporting of the investment, the Fund allocated the purchase price based upon its estimate of the relative fair value of debt and equity. In connection with this initial allocation, the Fund manager sought input from both the Fund auditor and portfolio company management and the allocation methodology was agreed to and the approach was determined to be thorough and sound.

Almost a year later, the portfolio company's auditor – from the same firm as the Fund's auditor -- decided they didn't like the analysis upon which the Fund and the portfolio company allocation was based. The portfolio company auditor questioned the approach that affected at most 1% of value being allocated to equity over debt. In other words, the maximum impact to the value of the Fund's equity could have been \$10 million on a \$1.5 billion enterprise value.

The portfolio company auditor required the portfolio company to engage an outside valuation expert to use a number of academic models including a Monte Carlo simulation. The portfolio company had concluded that the academic approach would require material extra effort (including significant external valuation support) and would have minimal impact on the results.

Weeks of discussion ensued among the portfolio company auditor, the portfolio company and the Fund with significant support provided by the Fund and its advisers to the portfolio company and its auditor. Effectively, the portfolio company auditor was uncomfortable with the arms-length nature of the original allocation agreement and determined that the original documentation for the allocation did not have sufficient support in academic literature. As a result, a massive "make-work" exercise had to be undertaken, which at the end of the day resulted in no change to the initial allocation. It is situations like this, where the audit firm is the primary beneficiary (through added audit fees) of the additional work they mandate that allow cynics to view the documentation requests as being particularly self-serving.

¹The NVCA CFO Task Force is a working policy group made up of the CFOs of NVCA's venture firm members. About 100 of NVCA member firms participate in the Task Force.

2. Fund invested \$ 8 million in a convertible preferred security in September, at which time the underlying actively traded common stock was trading at \$ 4 per share. The Fund made the investment knowing that the underlying common shares were “thinly traded” and based their investment decision on the current and expected performance of the company, not on the “thinly traded” share price. Fund reported this investment as based on Level 3 inputs.

At December 31, Fund valued the investment at \$ 7.9 million given slight changes in expected cash flows and the interest rate environment. Auditor decided to trifurcate the value of the investment as the principle component, the coupon, and the conversion feature. At December 31, the underlying common was trading at \$ 1.50 because of announced degradation in performance (which was anticipated by the Fund based on their due diligence).

The auditor’s internal valuation specialists preliminarily concluded that the security should be valued at \$ 6 million due to the decrease in value of the option component of the security (using an option model with the \$ 1.50 share price). After the Fund manager had discussions with the auditor, and the auditor’s national office, auditor was able to realize that the security being valued was not actively traded and therefore should not be blindly valued using the “actively traded input”, but should be valued using market participant assumptions.

Using the inputs to the Fund’s valuation process and calibrating to the initial transaction, the Fund’s auditor ultimately concluded that the Fund’s estimation of the fair value at \$7.90 million had understated the value. The Fund therefore adjusted its fair value estimate to report the security as being valued at \$ 7.95 million.

3. In making its initial investment decision for its investment in portfolio company A, a Fund valued its investment using a scenario analysis—weighting various expected outcomes, i.e., level 3 inputs. The Fund had determined that the most likely acquirer of its position at that time would be another venture capital fund and the scenario based analysis is a common approach used by venture capital funds. As a result, the Fund Manager determined that continuing to use the same approach as at initial investment or “entry” was appropriate. Therefore, at its first reporting date, the Fund used a similar scenario analysis taking into account calibration at entry and changes in expected outcomes. Notwithstanding the fact that the Fund’s methodology was consistent with market participant assumptions in the exit market, the Fund’s auditor initially insisted that investment be valued solely using an option model. Only after extensive discussion with the auditor and the auditor’s national office that it was concluded that the fund’s approach used market participant assumptions and was an acceptable approach to value the investment.

Auditors' Use of the Work of Specialists
National Venture Capital Association

Appendix B – CASE STUDIES

CASE STUDY 1

BACKGROUND:

The Company used in this example had been performing very well and actually had a number of outside investors willing to finance the Company at an uptick from the prior round of financing. The prior round, Series B, had a “post-money” valuation of approximately \$50M. Additionally, the Company closed on a Series C financing on December 18, 2013, or approximately two weeks before the valuation measurement date. Even though this information was communicated to the auditors working on the engagement, the auditors insisted that we run a series of OPM calculations on the Company to try to determine the appropriate valuation. The data table below provides further information regarding the wide array of values that were calculated using the OPM.

VALUATION SUPPORT:

Summary of Share Price by Valuation Technique

Actual Series C Price Paid \$ 1.127

Share Class	OPM Back Solve	OPM @Current FD	CASCADE	Original Issue Price
C	\$ 1.127	\$ 1.670	\$ 1.346	\$ 1.127
B	\$ 0.605	\$ 1.428	\$ 1.219	\$ 1.000
A	\$ 0.312	\$ 1.212	\$ 1.219	\$ 1.000
Common/Other	\$ 0.078	\$ 0.551	\$ 0.219	

Based on the instruction of our auditors, we ran an OPM Back Solve calculation to determine the implied equity value based on the price (\$1.127/share for the Series C) of the most recent financing. In this instance, the OPM Back Solve method implied that the equity value of the Company would be \$34M, a value that was 55% below the current fully diluted post money valuation of \$75M. This valuation level would have resulted in a write down of our holdings to approximately 30% below our current cost basis. Given that the recent round was led by a new outside investor, and additional new investors were eager to invest at an uptick, we felt strongly that this calculation was not indicative of the correct value of the Company as of the measurement date.

Additionally, we also ran an OPM based on the current fully diluted post money valuation. Due to downside preferences in place to protect the new investor, the OPM calculation in this instance would actually have resulted in a write up to the current round of financing that closed just prior to the valuation date. This OPM calculation was again deemed to be inappropriate as the outside investor priced the round independently within weeks of the valuation date and therefore was deemed to pay a fair price for the shares.

CONCLUSION:

After performing numerous OPM calculations on approximately fifteen portfolio companies, including the example discussed above, it was determined that it was not appropriate to use this model to value companies held within our portfolio. The example above is a good illustration of the wide level of variations that are produced when using an OPM based valuation technique. In using the OPM valuation technique for this specific company, we observed valuations that were both well above and well below the current price paid for shares of the Company within weeks of the valuation measurement date. After a significant amount of time working on OPM calculations and discussing them

with valuation specialists at the auditing firm, the auditors agreed with our original thesis that the investment should have been held at the Series C value.

In general, it is very difficult to determine the correct level of volatility for OPMs of early stage companies like most venture capital investments. With this major input difficult to determine, it is hard to say that the results of the OPM are reliable in the determination of valuations for these types of companies. We communicated to the auditors on numerous occasions that venture capital companies are valued by investors on a fully diluted basis, which therefore makes the output of the OPM calculations difficult to use in measuring the fair value of a company. We were still asked to perform OPM calculations on fifteen portfolio companies even though at the end of the audit not one OPM valuation was used as support for the fair market value of any of our portfolio companies.

CASE STUDY 2

On 11/1/2012, PortCo held the first closing of its \$25M Series D financing round at \$275M post-money valuation [# common stock equivalents on a fully diluted basis times \$4.4009 per share, or +139% of prior round price]. The price (or pre-money value of \$250M) was set by a new institutional investor that had no previous investment in PortCo. The Series D Preferred Stock had a 1x senior preference to the other classes of outstanding preferred stock, and converted to common 1:1. The financing was oversubscribed. The company was performing very well (and better than it had at the time of its Series C financing priced at 1.843 per share). This PortCo had made substantial business progress since the closing of its Series C financing round. Venture Fund participated in the financing at its full *pro rata* share. The term sheet for the deal was agreed to and signed on 10/12/2012. The Price from the term sheet is copied below:

Price:

The "Original Purchase Price" will represent a fully-diluted pre-money valuation of \$250 million (including an unissued reserved employee pool representing 5.0% of the fully-diluted post-money capitalization) and a fully-diluted post money valuation of \$275 million. A capitalization table showing the Company's capital structure immediately following the Closing is attached.

The judgment of the Venture Fund's GP was that this very recent outside-led financing round was clearly the best market data in existence to support the Venture Fund's 12/31/12 valuation of PortCo.

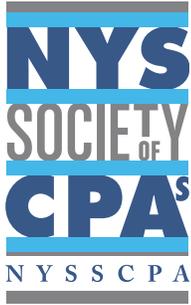
However, because PortCo's valuation was approximately 5% of the Venture Fund's total NAV -- not an unusual situation in VCFs -- our audit firm required us to create a mathematical model to support our valuation. They asked us to prepare an OPM backsolve, even though the OPM backsolve is not the method used by any venture investor to price this or any other financing round.

We ran the model, which concluded with an Implied Total Equity value of \$136M, a number substantially lower than the \$250M pre-money value of the recently closed financing. Obviously this was a problem, because the judgment of the Venture Fund's GP was that the investment was now more valuable than it had been at the time of its prior year Series C financing round priced at \$1.843 per share.

We ran the model, which concluded with an Implied Total Equity value of \$136M, a number substantially lower than the \$250M pre-money value of the recently closed financing, and only slightly higher than the \$100M post-money value of the prior round. Obviously this was a problem, because the judgment of the Venture Fund's GP was that the investment was now significantly more valuable than it had been at the time of its prior Series C financing round priced at \$1.843 per share (approximately \$100m total). Indeed the fund GP placed the value at the more recent Series D \$250 pre-money valuation.

PortCo's current operating metrics projected 2013-2014 forward revenue much higher than the company's 2010 revenue. Also, as noted, the Series D round was led by an independent institutional investor.

Since our audit firm required a mathematical model to substantiate our 12/31/12 valuation, they then asked us to prepare a PWERM to support our GP's judgment that the investment should be valued at the price recently paid for its Series D preferred shares. We complied with their request and created a PWERM analysis. We were able to find assumptions that could be supported by market data (M&A and IPO comparables) and our GP was able to support his probabilities for each scenario of the PWERM analysis. In the end the valuation of securities that we calculated using the PWERM was within an acceptable range of our original proposed valuation which was based on the recent Series D financing round, and the Valuation Group at our auditor signed off on our audit report. This process took a significant amount time from both the Venture Fund CFO and Fund GP. It also took over two weeks for the audit firm to further question the analysis and review the model's assumptions. All of this substantially delayed the issuance of our audit report.



July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

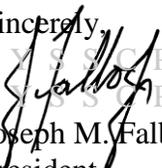
By e-mail: comments@pcaobus.org

Re: Staff Consultation Paper 2015-01, The Auditor's Use of the Work of Specialists

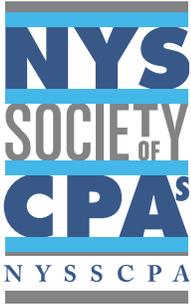
Dear Madame Secretary:

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 28,000 CPAs in public practice, business, government and education, welcomes the opportunity to comment on the above captioned consultation paper.

The NYSSCPA's SEC and International Accounting and Auditing Committees deliberated the consultation paper and prepared the attached comments. If you would like additional discussion with us, please contact Charles Abraham, Chair of the SEC Committee at (516) 620-8526, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Joseph M. Falbo, Jr.
President

Attachment



**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON
STAFF CONSULTATION PAPER 2015-01, *THE AUDITOR'S USE OF THE WORK
OF SPECIALISTS***

July 31, 2015

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Anthony S. Chan
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From the International Accounting and Auditing Committee:

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New York State Society of Certified Public Accountants

Comments on

Consultation Paper 2015-01, *The Auditor's Use of the Work of Specialists*

The New York State Society of Certified Public Accountants appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*, May 28, 2015 ("Consultation Paper").

As a state society, we do not represent one auditing firm or company. Our response represents the views of our membership based on the feedback from members and our general sense of our members' experiences. Accordingly our response is built upon varied observations, grounded in our technical knowledge and based on extensive experiences in public and private industry.

General Comments

Overall, we support those elements of the Consultation Paper that propose clarification of the existing standards and provide guidance for the work to be performed by the auditor and that will better protect investors through enhanced consistency in practice. We believe that any changes to PCAOB auditing standards should narrow the expectation gap between the accounting profession and users of financial statements and focus on objective criteria.

While we generally support improvements to AU sec. 336, *Using the Work of a Specialist*, (similar to the requirements under AU-C Section 500, *The Fourth Standard of Reporting*; ISA 500, *Audit Evidence*; AU-C Section 620, *Using the Work of an Auditor's Specialist*; and ISA 620, *Using the Work of an Auditor's Expert*) and how auditors should approach the use of specialists, we do not believe that it is necessary to rescind AU sec. 336. We believe that the audit procedures performed by the engagement team should create the same level of reliability on the financial statements whether the specialists are employed or are engaged either directly by the company or by the auditor. We also believe that the auditors should obtain an understanding of the methods and assumptions utilized, irrespective of the affiliation of the specialist.

While we understand that the PCAOB wants to enhance the standards and align with the IAASB and ASB, there also seem to be concerns about compliance with current standards (based on the results of PCAOB inspections). We note the responses of the IAASB¹ and FEE (Federation of European Accountants)² on the PCAOB consultation paper regarding *Auditing Accounting Estimates and Fair Value Measurements*, August 19, 2014. We believe that the opinions expressed therein apply here as well, in that alignment and a cohesive standard is

¹ PCAOB website, Response No 39, Prof. Arnold Schilder, Chairman, IAASB, Nov 21, 2014

² PCAOB website, Response No.4, Andre Killesse, President, Olivier Boutellis-Taft, Chief Executive, FEE.

desired, but that above all we believe that standards should remain on a high principles-based approach to allow practitioners to use a level of judgment. We are concerned equally that standards may become over-engineered in that public expectations may become unrealistic. For this reason, we support having non-mandatory application material and practice notes to allow for judgment instead of check-the-box lists.

We believe that it is necessary to maintain professional skepticism which includes challenging management's assumptions and an identification of significant risks of material misstatement.

Our view is that continued use of auditor's judgment is paramount and is a driving principle behind high-quality audits that are responsive to the risks of material misstatement.

Our responses to the specific questions posed in the Consultation Paper's request for comments are set out below and are consistent with these overarching concepts. We did not respond to questions 3, 4, 24 – 26, 32, 39, 40 and 42 – 48.

Responses to Selected Questions

1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?

We agree that, in general, the practice, as described, characterizes current practice. Section III of the staff consultation paper also stated that based on inspected audits; smaller audit firms are more likely to utilize company specialists. Smaller audit firms might be more likely to utilize auditor-engaged specialists in circumstances in which their smaller clients might not have engaged/employed a specialist at all.

2. Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?

The challenges associated with current practice appear to be more associated with the ability to supervise the work of a specialist directly. It may also be more difficult to understand the procedures used by specialists hired by the company as company staff may interface between the specialist and the auditors. It would be natural for auditors not to fully "re-create" the work of a specialist and to place reliance on the work done as experts. It can be argued that the use of a specialist, at its basic level, indicates that the audit engagement team does not have the expertise to do it itself.

The challenges associated with meeting the requirements of the ASB or IAASB should be fairly consistent with the challenges of meeting PCAOB requirements as ASB and IAASB standards are fairly similar although enhanced. For example, paragraph 6 of ISA 620 requires the auditor when using a specialist to obtain knowledge about the nature, scope, and objectives of the

specialist's work including relevance and reasonableness of specialist conclusions, assumptions and methods and relevance, completeness and accuracy of source data.

Further, ISA 500, *Audit Evidence*, paragraph 4, requires the auditor to determine the significance of the work performed by the specialist, evaluate competence, capabilities and objectivity, and appropriateness of the work as audit evidence.

Despite the 2013 findings of the IAASB (Clarified International Standards on Auditing – Findings from the Post-Implementation Review 44-45 (July 2013), of ISA 620), which found inconsistency in the current procedures and insufficient testing and follow-up; the standards themselves appear to be adequate. It is the execution and compliance with the standards that appear to be the concern. We believe that these findings can be addressed with additional non-authoritative guidance and examples (*i.e.* Staff Practice Alerts) to clarify expectations and enhance the documentation of the procedures and evaluations performed.

5. For accounting firms that use the work of an auditor's engaged specialist:

a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?

Prior to utilizing an auditor-engaged specialist, the audit firm reviews the experience of the specialist's firm in similar circumstances (this includes a consideration of both the depth of expertise and how recent the experiences). This requires a detailed discussion regarding the type of assignment, the scope of the work to be performed, and the risks associated with the assignment. In addition, the firm will evaluate the credentials of the specialists that are expected to be assigned to the engagement. The firm might request a sample report to ensure that there is sufficient detail in order to perform the procedures prescribed by AU sec. 336. A firm will conduct online research including a review of the website of the specialist to ensure that the firm has an understanding of the specialist's reputation. In addition, if the auditor has significant experience in the industry and has worked with other clients in the company's line of business, the reputation of the specialist might be well-known.

b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (*e.g.*, performs procedures similar to those in Auditing Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?

No, we have not observed such circumstances. In our experience, the auditor-engaged specialist has been vetted prior to the engagement, and there is a very low probability that additional procedures beyond AU sec. 336 would be required.

c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?

The firm generally applies the guidance in AS No. 8, *Audit Risk*, through AS No. 15, *Audit Evidence*, to assess the risks associated with the particular financial statement line item, prior to

the application of AU sec. 336. In the planning process, the firm determines which areas have risks of material misstatements and designs procedures to be responsive to those risks. For example, in the jewelry business, a firm considers risk assessment including understanding the entity, fraud risks, existence and valuation of inventory. This risk assessment would lead to a conclusion regarding the need for a specialist. If the fact pattern or circumstances change, the risk assessment is revisited to ensure that the procedures performed are still responsive to the risks identified. In general, we have observed that the use of an auditor-engaged specialist is determined during the planning phase.

d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?

Generally, if the firm required access to the models of the specialist, that would be discussed and agreed upon prior to the engagement. There are instances in which the models utilized by the specialist are proprietary or the models utilized would require the installation of proprietary software to which the auditor is not provided access. Generally, firms have not required access to all models utilized by the specialist; however the specialist's report is specific and detailed as to a description of the models and assumptions utilized which allows an auditor to obtain an understanding of the methods and assumptions utilized by the specialist.

6. For accounting firms that use the work of a company's specialist:

a. What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.

In most cases, the firm will use the work of a company's specialist when it is satisfied with the specialist's professional qualifications and has not taken any exception to the nature and quality of the work performed by the specialist. The related audit procedures performed are similar to those listed in our response to question 5a (with additional consideration given to the relationship between the specialist and the company as discussed in AU sec. 336.10 and 336.11).

There are circumstances where the auditor might perform procedures in addition to those prescribed in AU sec. 336. Examples of such circumstances would be (a) scenarios in which there is a relationship between the specialist and the client that "might" impair independence, (b) the risks involved in the audit area are so significant that the auditor believes additional procedures are warranted to reduce the risks of material misstatement, (c) the specialist's assumptions or findings are deemed unreasonable, *etc.*

b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist?

Yes, Figure 1 in Section II.A accurately describes examples of the activities for which the auditor uses the work of a company's specialist.

Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?

No, but it should be noted that there is an evolving development of sustainability statements under the Sustainability Accounting Standards Board (SASB). However, it is premature to include these types of activities in the scope of this project.

c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?

During the course of the audit, the auditor may come across evidential matter (such as unreasonable methodologies, improbable assumptions developed by the specialist, *etc.*) that brings into question the findings of the company's specialist. Under such circumstances, the auditor will not place any reliance, or will place less reliance, on the work performed by the company's specialist, and will have to determine an alternative to reduce the risk of material misstatement. Depending on the significance of the risks of material misstatement, alternatives might include requesting that the specialist re-work his or her analysis utilizing different assumptions/methodologies, the auditor utilizing his or her own specialist to develop an independent estimate, or requiring management to engage another specialist.

d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?

Our response would be similar to our response to question 5c. Also, as noted in our response to question 6a, additional consideration is given to the relationship between the specialist and the company during the risk assessment process.

7. This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?

We agree that there is a need to improve the AU sec. 336 auditing standard on using the work of a specialist. A fundamental issue is the requirement that the auditor evaluate the work of the specialist. The specialist possesses the skills and qualifications that the auditor admittedly does not usually possess; so, additional, clearer guidance is needed on how an auditor can conclude if he or she is qualified to "evaluate" in such circumstances.

AU sec. 336 should be improved by (a) better alignment with the risk assessment standards, and (b) by adding additional guidance related to the considerations an auditor must make in connection with the engagement of an auditor's specialist. However, we do not believe that an auditor-engaged or company engaged/employed specialist needs to have a level of supervision

that is similar to AS No. 10, *Supervision of the Audit Engagement*. In addition, we would not be opposed to adding specificity in AS No. 10 regarding the use of specialists, as long as the revisions continue to be in a principles-based approach that retains auditor judgment and scalability.

We do not believe that the information provided by the company's employed specialist should be treated as if it were information coming from the company itself in all cases (for example there are scenarios in which the company-employed specialist works as part of a team of specialists with a mandate to provide such analyses on a regular basis, is not directly involved in the financial reporting process, *etc.*). It is not necessary to mandate such a requirement, but perhaps the language as stated in AU sec. 336.11, "if the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures...", can be strengthened to account for the PCAOB staff's concerns.

8. When an auditor obtains an understanding of the methods used by the company's specialist:

a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?

It has been our experience that most specialist reports contain sufficient detail to allow the auditor to obtain sufficient appropriate audit evidence.

b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

The company should locate a specialist who will provide sufficient detailed access, or the auditor should perform additional procedures utilizing professional judgment (including considering whether an auditor-employed or engaged specialist is necessary) in order to obtain sufficient appropriate audit evidence. Typically, these factors are identified and resolved prior to the commencement of the audit engagement.

9. Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

Targeted revisions to the current PCAOB standards in a principles-based approach are the most appropriate way to address the issues as discussed; supplemented (as needed) with PCAOB staff guidance and examples. We believe that the most appropriate method to accomplish the Board's goal is to revise AU sec. 336, instead of developing a separate auditing standard, extending the requirements of AS No. 10, or rescinding AU sec. 336.

10. Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

No. The auditor should modify procedures when the auditor's specialist has been engaged and is not the auditor's employee. Different procedures would be required because the engaged specialist would not be familiar with some basic concepts of auditing and firm quality control procedures that would be relevant (such as the extent of sufficient appropriate audit evidence). The extent to which an auditor's employed specialist is familiar with these matters also needs to be considered. Illustrations of modified procedures should be provided.

Auditors should at all times be aware of the credentials of the person involved as a specialist, whether engaged or employed. Documentation should be provided as to why a particular person or group is selected to assist in a specific engagement. To the extent that the firm has employed specialists, baseline credentials should be established, as well as an understanding of the basic firm procedures and the requirements of the engagement.

When an outside specialist is engaged, the procedures that the specialist uses should be indicated in the scope of services, reviewed for consistency with the general firm approach and/or tailored as needed to the specific engagement. The baseline requirements of care should be met as the engagement of an outside specialist may indicate a need beyond the internal expertise of the firm.

11. Are there other considerations related to the alternatives presented that the staff should be aware of?

No. We are not aware of any other considerations related to the alternatives presented.

12. Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.

No. There do not appear to be any other practical alternatives.

13. Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

No. We do not believe there are limitations on treating the work of an engaged specialist the same way as the work of an employed specialist as appropriate audit evidence. However, we do believe that there are limitations in the ability to supervise an engaged specialist versus an employed specialist. Any revisions to the current standards should consider and reflect this limitation.

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

We believe it is appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist. If the company employs a competent and objective specialist, the auditor should be able to utilize the rules for the use of an outside expert. It is our belief that if the auditor will rely on the expert's work, it is imperative that the skills, knowledge and objectivity of the expert be challenged and documented by the auditor. Should the auditor be dissatisfied, additional procedures should be performed based on the auditor's judgment to reduce the risk of material misstatement to a level acceptable to the auditor.

We believe that retaining the procedures in AU sec. 336 in the first alternative is preferable for this area. The auditor's prior knowledge and familiarity with this standard will make any transition less cumbersome and not require significantly more audit work. We do not believe that the proposed eliminations of certain language would be of any significant benefit. We agree that the auditor should be required to evaluate the reasonableness of significant assumptions and methods because this could have a material effect on the financial statements.

In alternative two, we do not believe that rescinding AU sec. 336 is a reasonable alternative. Specific guidance related to the use of a company's specialist is necessary and positively impacts audit quality. Without AU sec. 336, we believe that there will be more inconsistency in practice as practitioners will have less guidance regarding using the work of specialists.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

We believe that generally, auditors have discussions with the specialist in order to gain an initial understanding of the methodology and the source of the assumptions. They also review the assumptions and methods used for reasonableness. We have noted instances in which the auditor will consult with his or her firm expert or an expert he or she has worked with before outside the firm to see if the assumptions and methods used are reasonable under the circumstances. This can be more easily accomplished for more common valuations such as intangible assets in business acquisitions and purchase price allocations. This becomes more difficult when related to areas that can be significantly more subjective such as the valuation of derivatives. The auditor, in addition to the steps previously mentioned, may try to find similar items in other public filings to get some comfort as to the assumptions, methods and results. The auditor might also hire his or her own outside expert to assist.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

We do not believe that the work of a company's specialist should be treated as company-provided audit evidence in all cases. If the audit firm has satisfied itself as to qualifications, objectivity, abilities, and reasonableness of the specialist and his or her work, this should serve as acceptable evidence. If the auditor were required to treat the company specialist's work as

information provided by the company, it would probably lead to the auditor increasingly needing to employ or engage specialists to perform work to assist with testing the work of a company's specialist. We do not believe this would be a cost-effective and practical requirement that would be of significant benefit.

18. Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

As we stated as part of our response to question 14, we do not believe that rescinding AU sec. 336 is a reasonable alternative. Specific guidance related to the use of specialists is necessary and positively impacts audit quality. Without AU sec. 336, we believe that there will be more inconsistency in practice as practitioners will have less guidance regarding using the work of company specialists.

19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

The potential definitions are appropriate except that there should be additional clarity as to how the Board defines "specialized knowledge in a field of expertise other than accounting or auditing" as that would lead to more consistency in practice.

20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

While income taxes and IT have become more complex, it is part of the risks identified in the audit planning process, and the audit procedures performed are designed to address those risks. Income taxes are an integral part of the financial reporting process of a company, and part of the audit (if deemed to be a significant or fraud risk). In the same regard, IT continues to be an integral part of the financial reporting infrastructure (and has gained additional focus in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control—Integrated Framework*, May 2013). The definition should continue to exclude those with specialized knowledge or skill in income taxes or IT who are covered under AS No. 10.

21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

We believe that it would be beneficial to have additional clarity regarding what constitutes a specialized area of accounting and auditing.

In the example provided above, we would not deem persons with specialized knowledge or skill in regulatory compliance to be persons deemed to be specialists in the AU sec. 336 context. We believe that an auditor requires specialized knowledge in regulatory compliance in order to perform the audits of brokers and dealers for example, and it should be excluded from the definition of a specialist. However, if a law firm were providing services related to interpreting a provision in The Investment Company Act of 1940, we would consider that law firm to be a specialist (as implied by AU sec. 336.02).

We believe that the discussion in the Consultation Paper appropriately describes when third parties may be in the scope of the definition of an auditor's specialist. We agree with the thought process that a third party pricing service would not be deemed to be a specialist.

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

Guidance is needed on how to deal with very technical aspects of a specialist's work that an auditor may be incapable of evaluating. All of the inquiry and analysis of a specialist's experience, objectivity, competence *etc.* is not going to enable an evaluation of a highly specialized conclusion or calculation that is beyond the auditor's capabilities and experience or expertise. We have also observed that specialists in certain fields do not have any professional certifications as there might not be a certification or industry license required/applicable in that particular field. In these cases, the experience of the specialist in the type of work under consideration is weighed heavily in the evaluation.

23. Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

Yes, the matters described appear to be sufficient and appropriate.

27. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Yes. The potential requirements reflect the auditor's responsibilities when an auditor's specialist develops an independent estimate; however we believe that the guidance should not be mandatory (*i.e.* utilizing the word "should"). These revisions should be subject to the auditor's

considerations of risks, rather than being mandatory. For example, it would be difficult to determine what is generally accepted in the specialist's field of expertise in all scenarios without having to consult a second set of experts to confirm general practice or additional research or procedures. There are similarities between the potential requirements in the Consultation Paper to the appendices of AU-C Section 620 (paragraphs A35 to A42), that offer the auditor interpretations rather than mandatory requirements.

28. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Yes. Our response regarding when the auditor's specialist tests the company's methods and significant assumptions is similar to our response to question 27.

29. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Yes. The potential requirements reflect the auditor's responsibilities when the auditor evaluates the results and conclusions of the work of an auditor's specialist. We don't think this should differ from current practice (or practice in accordance with ISA 620 or AU-C Section 620), in that the conclusions should "reasonableness-check", support the relevant financial statement assertions and be consistent with evidence from other audit procedures performed. It is possible that the focus of current practice does not link adequately or document these assumptions sufficiently and, upon review, enhancements would be required. Also refer to our response to question 27.

30. Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?

We believe that more interpretive guidance is needed on the auditor's consideration of such limitations, restrictions, and caveats in the report of an auditor's specialist, and on the possible effect on the auditor's report.

31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

A potential problem which currently exists and could continue to exist is whether the auditor can evaluate the specialist's methods, assumptions and conclusions fully given that the auditor is an auditor and not a specialist. It is unfeasible for an auditor to possess sufficient knowledge to fully evaluate the appropriateness of methods (and whether they are generally accepted) in fields in which an auditor is not an expert.

33. Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?

We are in agreement for the need for guidance related to evaluating the objectivity of the auditor's engaged specialist. However, certain aspects of the potential requirements might be challenging for a specialist to provide. For example, the potential requirement to obtain a written description regarding financial relationships appears to be a simple matter; however there are some specialist firms that do not have systems in place to provide accurate information regarding the ownership of securities by its employees, prior employment history, *etc.* In our experience, such financial relationships are generally not tracked by specialists, yet other factors such as "business relationships" are easily available.

34. Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

We believe that an auditor's engaged specialist (and his or her employer) should be independent and objective. However, we do not believe that he or she should be required to meet the independence criteria of Rule 2-01. Rule 2-01 is designed to ensure that the auditor is qualified and independent. Specialists might not be able to provide information regarding any investments in the audit clients, loans/debtor-creditor relationships, credit cards, *etc.* easily. As stated in our response to question 33, we are generally supportive of an enhanced objectivity evaluation approach; however, Rule 2-01 was not intended to evaluate the independence of engaged specialists. In practice, it would be difficult to do such an evaluation.

35. Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor's specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist's firm?

Please refer to our responses to questions 33 and 34. In addition, we would like to comment on page 51 of the Consultation Paper which states that if "a specialist is employed by a financial institution that is involved in selling or structuring financial instruments issued by the company" in the Staff's view it would impair objectivity. However, we believe that certain financial institutions have put in place information barriers (*i.e.* between their research and underwriting departments), that could lead an auditor to believe that the specialist can be objective.

36. Are the potential requirements for the auditor to evaluate the objectivity of an auditor's specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account "threats" to objectivity and "safeguards" to reduce the threats, as provided in ISA 620?

Please refer to our responses to questions 33 and 34. It is appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity. If the potential requirements took into account some of the pertinent concepts from ISA 620, it would be appropriate.

37. Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor's engaged specialist will not be influenced by business, employment, or financial relationships?

The enhanced objectivity approach is a reasonable approach that should enable the auditor to conclude that the specialist would be objective. However, we note that there are certain concerns depicted in our response to question 33 that should also be considered.

38. Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?

We believe that additional clarity is required regarding what information is necessary and what will be deemed appropriate regarding the process used by the auditor's engaged specialist to formulate responses to the auditor's questions related to relationships and interests. In some instances in which the specialist might not have systems in place to track such information, the process may be limited to inquiry alone. With the varied types of specialists and sizes of their companies, it is difficult to assess what "process" would be acceptable to an auditor. In addition, it will be challenging for an auditor to dictate the type of process that a specialist needs to have in place.

41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?

Our general belief is that the economic impacts, both benefits and costs, cannot be reasonably determined. In our experience, expanded procedures generally result in increased costs. In addition, as we discussed in the general comments, we believe that when auditing standards become too prescriptive, the profession runs the risk of deteriorating audit quality. Mandatory requirements impede the risk-based design of audit procedures and unintentionally promote a "checklist" mentality.

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October 5, 2015

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

Having recently become aware of your Staff Consultation Paper No. 2015-01, The Auditor's Use of the Work of Specialists, I would like to call your attention to an area of auditing that may otherwise be overlooked. I am sorry that my comments are beyond the due date of July 31 (as noted in the August 2015 issue of Journal of Accountancy). Being a retired CPA, I am not always current with reading professional journals. Anyway, I think my comments may be of interest to your staff.

The Defense Contract Audit Agency (DCAA), a component of the Department of Defense (DoD), performs audits of financial statements prepared by public companies to support pricing proposals and claims submitted to the government. These audits are held out as being in accordance with generally accepted auditing standards. The agency functions much like a large CPA firm within the government, doing audits for other federal agencies and billing by the hour like a CPA firm. Many, if not most, of their auditors are CPAs.

The DCAA audit reports usually indicate either reliance upon the work of technical specialists or include qualifying statements regarding the lack of technical assistance needed to form a complete opinion on the financial statements. An example of technical assistance used or needed would be the need for a qualified engineering analysis of estimates of hours to perform specific functions in the manufacture of a proposed weapon system. Helpful technical assistance would identify the relationship of proposed tasks with tasks of prior systems manufactured. This would enable the auditor to draw upon cost data of the prior tasks in evaluating the fairness of the company's estimate of costs for the new system.

I recommend that your staff include the audits of DCAA in assessing their use of specialists in forming audit opinions on financial statements.

I would be pleased to discuss this subject or provide additional comments upon request.

Sincerely,

A handwritten signature in cursive script, appearing to read "Fred J. Newton".



July 28, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., Washington, D.C. 20006-2803

Transmitted by e-mail to: comments@pcaobus.org

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

We appreciate the opportunity to respond to the Staff Consultation Paper No. 2015-01, "The Auditor's Use of the Work of Specialists," (the "SCP") issued May 28, 2015, by Office of the Chief Auditor (the "staff") the Public Company Accounting Oversight Board (the "PCAOB" or the "Board").

Part 1 – Overriding Concerns

It is our firm belief that, in general, auditing standards should be principles-based rather than rules-based and should guide but not eliminate, or even substantially reduce, the need for auditors' professional judgment. Therefore, we are not in favor of prescriptive, "one-size-fits-all" standards that mandate procedures without regard to auditors' scope judgments when appropriately made based on facts and circumstances, most significantly, their assessments regarding the materiality of the subject matter, the inherent risk of material misstatement and the nature and extent of other evidence to be relied upon in support of the related assertion(s). We are extremely concerned that an evolving pattern of more prescriptive standards will ultimately result in a future generation of non-thinking, checklist-driven auditors capable only of a robotic approach to auditing. Accordingly, when developing new standards, we believe the Board should give greater recognition to this principle than the present apparent leaning of the language in the SCP, and should minimize the prescription of both unconditionally and presumptively mandatory procedures, as they are defined in Rule 3101.

Consistent with our comments made hereinbelow and in our previous letters to the PCAOB, we believe the essence of risk-based auditing (which the Board has embraced in theory) is to determine audit scope judgmentally after thoughtful analysis of the significant assertions, materiality, risk of material misstatement, and the nature and extent of other evidence rather than based on a cookbook of mandated audit procedures. In fact, we believe that the establishment of cookbook standards results in unnecessary costs without benefits and is, in fact, an overreach of the PCAOB's statutory charge in Section 101(a) of the Sarbanes-Oxley Act of 2002 for the "establishment and enforcement of *appropriate* auditing standards [emphasis added]."

In addition, if the so-called "potential requirements" set forth in the SCF were to be adopted in the standards, it would place additional burdens on smaller firms that are unable economically to employ personnel with the requisite knowledge or skills to perform these additional procedures, such as large firms typically do. Accordingly, in many circumstances, such firms might be compelled to or engage its own specialists.

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 2 of 10

That said, we recognize and concur with the SCP that today's complex business environment has resulted in a need for auditors to rely to a greater extent than in the past on the work of specialists; however, we question whether such circumstances warrant any significant strengthening of the extant standards or alternatively, whether they merely warrant additional guidance (which may be nonauthoritative), and training for audit firms that do not provide it adequately internally. According to the second full paragraph on p. 4 (Section I), the staff asserts that the SCP "has been informed by, among other things, current accounting firm practices, findings from the Board's oversight activities, discussions with the Board's inspections and enforcement staff and the Board's advisory groups, and comment letters submitted to the Board on other matters." Intuitively, we suspect that observations from inspection activities weighed heavily in informing the consultation paper and will likely do so in the development of any future standards or amendments.

The foregoing notwithstanding, p. 6 in Section I of the SCP describes the size of the so-called "sample" of audits identified in connection with PCAOB inspections of engagements conducted by large firms and the number of audits conducted by small firms that were analyzed (as to which the term "sample" is not used). According to the last sentence in the cited paragraph, "The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and ... may not represent the use of the work of specialists across a broader population of companies." Accordingly, we seriously doubt whether the number of engagements analyzed in either category can constitute statistically valid samples from which reasonably reliable conclusions about the actual extent of deficiencies related to the use of specialists' work may be drawn. We hope this fact is given due consideration by the staff and the Board in determining the need for and proposing more robust standards to address such observations.

In the first paragraph in Section IV.B (p. 23) of the SCP, the staff summarizes observations from the Board's oversight activities (which we read as inspections and enforcement actions) that "have informed the staff's views about current practice and the potential need for guidance or changes to the standards." These observations are characterized in the next sentence in that paragraph as indicating that auditors, at times, "may not have fulfilled their responsibilities under existing standards" when using the work of a specialist, whether an auditor's or a company's specialist. However, neither that language nor the specific audit deficiencies cited appear to suggest significant weaknesses in the extant standards that need to be addressed but rather appear primarily to be criticisms of auditors' judgments, training or competency or merely their compliance levels.

For example, as stated by the staff in the third bullet on p. 4 (Section I) of the SCP, we recognize and appreciate that the extant standard, Auditing Standard ("AS") No. 10, does not provide any specific requirements for how to supervise the work of an auditor employed specialist, but we believe detailed supplemental guidance in that regard might best be provided in another form, rather than in a standard, *e.g.*, as a Staff Audit Practice Alert, as is suggested in Section V.A, footnote 60 (p. 26) of the SCP. As noted in our response to Question 9 in Part 2 of this response, we view this approach as a far more viable alternative to standard-setting. In our opinion, it would also better serve the public interest (as a protective device that would better assure and enable a higher level and frequency of compliance) than the other suggestion contained in Section V.A, *i.e.*, stepping up the Board's inspection and enforcement activity to serve more effectively as a deterrent to noncompliance because the latter approach (like closing the barn door after the horse is out) would necessarily come only after observed instances of noncompliance.

The foregoing notwithstanding, we believe that only minor modifications to the extant standards are warranted, *e.g.*, for clarifying and emphasizing that AS No. 10 applies to all auditor's employed specialists.¹

¹ Section IV.A.1 of the SCF states that AS No.10 "requires the auditor to, among other things: (i) inform the specialist of his or her responsibilities, including the objectives of the procedures he or she is to perform and the nature, timing, and extent of those procedures; (ii) direct the specialist to bring issues to the attention of the auditor so the auditor can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards; and (iii) review the specialist's work to evaluate whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 3 of 10

Part 2 – Answers to Specific Questions Presented in the SCP

Primarily because of (a) the extensive length, depth and breadth, overall, of the SCP and the large volume of questions presented therein by the staff and the vast diversity of possible responses necessary to adequately address the wide variety of facts and circumstances likely to be encountered in practice (depending on the subject matter to be addressed by the work of a specialist), (b) our limited resources, and (c) the short period of time allowed for submitting comments, we have limited our responses to certain selected questions where we believe our responses are most likely to be useful to the staff. The selected questions are numbered below to correspond with their numbers as presented in the SCP.

1. *Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?*

Subject to the following clarification, we believe the information presented in Section III, most particularly Section III.C, is generally correct. We agree with the information captioned “**Auditor's Specialist**” beginning on p. 15 (primarily because of the use of non-absolute terms describing widely varying practices like “many” and “may.” We also believe that except to the extent driven by differences in firms’ internal practice guidance, such widely diverse practices are more likely to be found among individual engagement partners and engagements within a given firm than among firms and that many such variations are most likely attributable primarily to judgmental differences in perceived risks and other attendant circumstances (which should clearly be encouraged rather than prohibited by any future standard).

We disagree with the unqualified statement in the short paragraph captioned “**Company's Specialist**” on p. 16, which reads “...smaller firms were more likely to use the work of a company's specialist,” but would agree if words like “if any” were added. This is because the smaller clients of smaller firms are less likely to employ their own specialists, and if one were to be engaged for the audit, we believe it is most likely that the auditor would engage one.

We believe that observed differences in practice described under the caption, “**Standards Issued by Other Standard Setters**,” likely result from differences in levels of familiarity with the cited alternative standards, a desire to comply with what are seen by engagement personnel as “best practices,” or an overriding firm policy that is commonly built into the firm’s practice aids effectively requiring compliance with the most robust requirements derived from among such alternative standards.

7. *This section [Section IV] provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?*

As we have stated in Part 1 of this response, we agree that auditors would likely benefit from more specific guidance (preferably outside the standard) about how to supervise an auditor's specialist than is currently provided in AS No. 10. However, we do not agree that the principles-based character of the operative standard or any supplemental guidance to be provided (or any other standard for that matter) should be abandoned as is suggested by the staff on p. 21 of the SCP. In general, we believe in principles-based auditing standards because we believe (a) that there is no substitute for sound auditor judgment and (b) that the primary role of the PCAOB should be to

work support the conclusions reached.” However, these responsibilities are not mentioned in AS No. 10 (which is very brief) of with any specific reference, nor is there is no any indication in that standard that it is intended to apply in any way, to an auditor-employed specialist. In fact, the only references in AS 10 to a specialist direct the reader to AU sec. 336. Moreover, with the exception of income tax and information technology specialists, which are singled out in footnote 1 to AU sec. 336.01. Also, there is no clear language in AU sec. 336 that either (a) excludes auditor-employed specialists from its applicability or (b) indicates the applicability of AS No. 10 thereto instead. Although we see this as a serious flaw in the extant standards, it is, nevertheless, easily (and should be) fixed.

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 4 of 10

help guide that judgment and not to substitute pre-judgments of the standard-setters for those of the auditor who has the ability to assess the relevant facts and circumstances firsthand. In this particular case, we believe the potential variations in relevant circumstances are too great to allow such pre-judgments as would be necessary for a “one-size-fits-all” standard to be either effective or efficient.

In the first paragraph on p. 21 of the SCP, the staff asserts that “a less rigorous level of oversight of specialists whom the auditor engages” is imposed by AU sec. 336, as compared to that imposed by AS No. 10 for an auditor’s employed specialist. We concur with this assessment only, as the term “oversight” is defined in footnote 46 on p. 20 of the SCP (*i.e.*, to direct the work of the specialist). We point out, however, that the requirements of AU sec. 336 are necessarily more rigorous than those of AS No. 10 in the sense that auditors must perform procedures under AU sec. 336 to assess the competency and objectivity of engaged specialists.

Subject to our comments in footnote 1 to Part 1 of this response (about the lack of clarity as to the applicability of the requirements of AS No. 10 specifically to use of the work of an auditor’s employed specialist other than a tax or information technology specialist), we see this so-called “less rigorous level of oversight” as limited to a lack of any articulated requirement in AU sec. 336 to (a) obtain and understanding with the specialist as to the responsibilities to be assumed and the objectives, nature, timing, and extent of the procedures to be performed, (b) to direct the specialist to bring certain issues of potential significance to the audit objectives, if encountered, to the auditor’s attention for evaluation and resolution, and (c) review the specialist’s work to evaluate whether it was performed as agreed and adequately documented, the objectives of the procedures were achieved, and the results of the work support the specialist’s conclusions.

We agree with those who believe that AU sec. 336 should be made more rigorous so as to include the additional requirements described in the preceding paragraph so long as it is made clear in the amended or new standard that such requirements are intended to be sufficiently scalable such that the extent of procedures necessary to comply remains commensurate with the auditor’s judgments about materiality, risk and the degree of reliance being placed on the specialist’s work in relation to other evidence. Nevertheless, we believe it is appropriate for the level of oversight of engaged specialists (once again, as the term “oversight” is defined in footnote 46 on p. 20 of the SCP), to be less than that of auditor’s employed specialists. In addition, the auditor should be expected to apply a broader type of oversight to auditor’s employed specialists in connection with the firm’s quality control system, *e.g.*, by exercising discretion over the nature and extent of training to be received by the specialist and by setting goals and periodically evaluating performance, and by monitoring the objectivity, of the specialist.

It is mentioned in Section IV.C on p. 24 of the SCP, that it is the view of many PCAOB Standing Advisory Group members that auditors’ responsibilities under AU sec. 336.12 should be expanded to require evaluating the reasonableness, rather than merely obtaining an understanding, of methods and assumptions used by an auditor’s specialist or a company’s specialist (whether engaged or employed). However, we see this a dangerous ground that might likely lead to unrealistic expectations and actions by adversaries who attempt to hold auditors responsible to have knowledge and skills that far exceed reasonable levels of competency based on typical auditors’ education, training, experience and skill sets. Auditors cannot reasonably be expected to have more than a fundamental knowledge of other disciplines for which the use of specialists is deemed appropriate and is commonplace. It would be analogous to attempting to hold auditors responsible as handwriting experts to identify forged signatures on documents, a limitation that has long been generally accepted.

We also agree with the views of some that are cited in Section IV.D on pp. 24-25 of the SCP that support retaining the requirement in AU sec. 336.12 for testing information provided by a company’s employed specialist as if it were developed by company management primarily because of the substantial inherent risk that such information was obtained by the specialist from, or influenced by, management and, therefore, is biased. The same may be true, but most likely to a lesser extent, for a company’s engaged specialist, depending on the company’s relationship with the specialist.

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 5 of 10

We believe it is important that any future revisions to the relevant standards make it clear that, like other procedures to be performed, the extent of work necessary in connection with the auditor's evaluation of both the objectivity and the competency of any specialist other than auditor's employed (who must be independent of the issuer under all the rules applicable to the auditor and who is subject to the audit firm's training, resources, and other elements of its QC system) should be commensurate with the auditor's materiality judgment, assessment of the risk of material misstatement and the relative degree of reliance to be placed on the specialist's work with regard to the related assertion(s). The standards should make it clear that there is an increasing inherent risk of impaired objectivity, and a commensurate need for auditors to exercise professional skepticism when (once judged to be competent), a specialist is, respectively, either (a) employed by the auditor, (b) engaged by the auditor, (c) engaged by the company, or (d) employed by the company. Further, it should be made clear that the nature of procedures to be applied in each of these circumstances relative to any given audit objective (all other considerations being equal) may likely be the same, but the extent thereof (e.g., the testing of data submitted to the specialist) should vary directly with the objectivity risk assessment.

We have the following views regarding the staff's consideration of whether the requirement in AU sec. 336 to evaluate the risk of possible impairment of objectivity, specifically with respect to an auditor- engaged specialist, should be strengthened. As set forth in the previous paragraph, we believe the risk of impairment of objectivity in such cases typically to be relatively low except when it is readily apparent that the issuer engages the specialist for a significant amount of services from time-to-time. AU sec. 336.10 lists several other, less common circumstances (described in Section VII.B.1 of the SCP) that might impair the specialist's objectivity. We think auditors should be able to use that limited guidance effectively to develop the appropriate procedures to make that assessment, in view of the limited risk, without any strengthening of the standard in this regard. In the event, however, that supplemental guidance were to be issued, such as in a Staff Audit Practice Alert, we would be in favor of including some suggested but not mandatory, audit procedures for consideration by auditors.

9. Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

As we have noted above, we believe that although certain minimal revisions to AS No. 10 and AU sec. 336 are warranted at this time, we believe the standards are generally appropriate as is. Nevertheless, we believe many auditors would likely benefit primarily from adopting the alternative of providing additional, nonmandatory guidance, such as would best be provided in a Staff Practice Alert, with regard to the use of either an auditor's or a company's specialist, whether engaged or employed.

We do not favor the alternative (presented in Section V.B.1 on p. 27 of the SCP) of developing a separate standard presented in that would apply to an auditor's specialist, whether employed or engaged, while retaining the general applicability of the supervision standard (AS No. 10). We hold this view merely because, in practice, we think the probability of auditor understanding and compliance is greater when all applicable requirements are found in one place. However, this will likely become a moot question once the codification of auditing standards is operational.

As we indicated in our response to Question 7 (second paragraph), we are in favor of extending some of the requirements of AS No. 10 to what is now AU sec. 336, *i.e.*, those that would require to (a) obtain and understanding with an auditor's engaged specialists as to the responsibilities to be assumed and the objectives, nature, timing, and extent of the procedures to be performed, (b) to direct the specialist to bring certain issues of potential significance to the audit objectives, if encountered, to the auditor's attention for evaluation and resolution, and (c) review the specialist's work to evaluate whether it was performed as agreed and adequately documented, the objectives of the procedures were achieved, and the results of the work support the specialist's conclusions. However, because we believe it is unreasonable to expect any auditor to have the skill set necessary to supervise a professional qualified in another discipline effectively to an extent (as presented as an alternative approach in Section V.B.2 on p. 28 of the SCP) that "would integrate the engaged specialists

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 6 of 10

into the engagement team, and would provide requirements for evaluating the work of an auditor's engaged specialist that are the same as the auditor's responsibilities for supervising the work of employed specialists," we do not believe, it is either practical or appropriate to extend the auditor's responsibility to such an extent. Further, we believe that any auditing standard that would establish such an unreachable expectation for auditors would likely have serious adverse effects on auditors in litigation or other adversarial proceedings.

We believe the operative supervision standard should place greater emphasis on the notion that the nature and extent of supervision to be provided to a specialist, whether engaged or employed by the auditor, should be in direct proportion to the auditor's familiarity with and judgmental evaluation of the specialist's level of knowledge, skill and relevant experience, which is a concept touched upon rather subtly and briefly in paragraph 6(d) of AS No. 10 but which, in our opinion, should be made more prominent (*i.e.*, in a separate paragraph) and expanded upon.

10. Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

See the sixth paragraph of our response to Question 7 and the last paragraph of our response to Question 9.

11. Are there other considerations related to the alternatives presented that the staff should be aware of?

See the last sentence of our response to Question 9.

12. Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.

We believe Question 12 is addressed by the sixth paragraph of our response to Question 7 and the last paragraph of our response to Question 9. We have no alternatives to suggest at this time.

13. Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

Yes. We believe Question 13 is also addressed by the sixth paragraph of our response to Question 7 and the last paragraph of our response to Question 9.

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? [Second part of Question 14 has been omitted.]

Yes; depending, of course, on the auditor's judgments about materiality, risk and the degree of planned reliance to be placed on the specialist's work, it is essential for an auditor to take reasonable steps to assess the knowledge, skill, and objectivity of a company's specialist and to respond appropriately in developing the scope of other procedures to any perceived deficiencies in such attributes, *e.g.*, by seeking to obtain other evidence to corroborate (or correct) the specialist's conclusions, which may include engaging an auditor's specialist.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

We see the first part of Question 16 as related to objectivity. Once again, depending, of course, on the auditor's judgments about materiality, risk and the degree of planned reliance to be placed on the specialist's work, we believe that the work of a company's employed specialist should be viewed with a higher degree of professional skepticism, probably requiring additional corroborative evidence, primarily because of the

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 7 of 10

substantial inherent risk of bias because information was obtained from, or results influenced by, company management. We believe the same would be true for a company's engaged specialist, depending on the results of the auditor's assessment of the specialist's objectivity, but most likely to a lesser extent.

See our response to Question 14, which we believe addresses the second part of Question 16.

17. Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?

We have no alternatives to suggest at this time.

19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

We have no issues with the proposed definitions.

20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

We do not believe the operative definition of a specialist in any new or amended standard should be expanded from its current version to include persons with specialized knowledge or skill in accounting and auditing.

21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

We believe persons with specialized knowledge or skill in regulatory compliance that are engaged in the practice of accounting and auditing (e.g., related to audits of brokers and dealers) should be considered to be persons with specialized knowledge or skill in accounting and auditing. Based on our view as state in our response to Question 20, we do not believe such persons should be treated as specialists within the meaning of the subject standards. However, other third parties with specialized knowledge or skill in regulatory compliance that are not engaged in the practice of accounting and auditing, such as an attorney, may need to be viewed as specialists if engaged to perform work to assist the auditor in obtaining sufficient appropriate audit evidence, as opposed to providing specialized information or expert (i.e., not necessarily in the legal sense) opinions based on technical research or knowledge but not on work performed for the auditor such as relative to a value estimate. Although it may be challenging or difficult to articulate, we believe the standard (or any supplemental guidance to be issued) that would apply to auditor's engaged specialists should clearly exclude consultations with individuals with specialized knowledge or skills but that do not constitute performing such work.

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

Except that we believe the word "determine" should not be used (because it implies a degree of responsibility that is absolute and, therefore, unreasonable), and a term such as "evaluate" or "assess" should be substitutes, we believe the language presented in the grey shaded box in Section VII.A.1 on p. 36 of the SCP is appropriate for an auditor's engaged specialist.

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 8 of 10

However, we believe the knowledge and skill of an auditor's employed specialist should be evaluated in the same manner, to the same extent and subject to the same auditing (and documentation) standards, as other members of the assigned audit staff. This would generally mean that auditor's employed specialists would be subject to the same hiring and periodic performance evaluation and advancement policies and procedures that the firm's QC system applies to audit staff.

23. Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

In our opinion, a written agreement between the auditor and an auditor's engaged specialist, such as a letter of engagement, is appropriate and should be required by the applicable standard. However, the content of such an agreement should be based on the auditor's judgment (about materiality, risk and the degree of planned reliance to be placed on the specialist's work and other circumstances) as to what is necessary and appropriate in the circumstances, and that all of such content should rarely be necessary. Such judgment should be guided by a list similar to that illustrated in the grey shaded box in Section VII.A.2 on pp. 37-38 of the SCP, which list should not be part of the standard but rather should be incorporated in supplemental guidance (such as a Staff Practice Alert) that clearly indicates that is to be used only a source of ideas from which relevant and significant items should be selected.

As suggested in footnote 74 on p. 38 of the SCP, we believe the understanding between the auditor and the specialist could be in the planning memoranda, separate memoranda, audit programs, or other related audit documentation but only for an auditor's employed specialist, who can be expected to have access to such materials. We also believe such documentation need not be as extensive as an agreement with an auditor's engaged specialist should be. We do not believe this form of documentation, if used for an auditor's employed specialist, should be referred to in the operative standard as an "agreement," but we do believe that such documentation should be acknowledged by a signature of the employed specialist thereon.

24. Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?

As states in our response to Question 23, we believe that reaching an agreement and documenting all of the categories of information described in the potential requirements set forth in Section VII.A.2 on pp. 37-38 of the SCP should rarely be necessary, and that the extent to which it is should be is a matter of auditor's judgment (about materiality, risk and the degree of planned reliance to be placed on the specialist's work and other circumstances).

25. Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?

Question 25 seems to relate primarily to the risk that because the company is judged to be exercising employer-like control over the specialist, an auditor's engaged specialist might lose independent contractor status and be classified as an employee by the IRS. This would result in employer tax consequences to the company. The IRS publishes extensive, complex guidance for evaluating whether an individual should be classified as an employee or and independent contractors based on three categories of factors, behavioral, financial and relationship. However, in our experience, except in extreme situations unrelated to compliance with the operative auditing standard, there is little or no risk of a professional in another discipline, who provides specialist services to an auditor on an as needed basis, being deemed an employee of the auditor is extremely minimal in almost all cases. Similarly, we see little or no risk of an unintended consequence

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 9 of 10

relative to the specialist qualification to receive employee benefits. We see nothing in the suggested enhancements to the operative auditing standard that would alter this conclusion.

27. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate?* [Second part of Question 27 has been omitted.]

Once again, while we believe the “potential requirements” set forth in the grey shaded areas of pp. 40-41 of the SCP, we believe such material should be provided not as requirements but rather only as guidance, preferably outside the standards, to be considered and applied to the extent deemed appropriate for the circumstances in the auditor’s professional judgment, *i.e.*, based on materiality, risk and the degree of planned reliance to be placed on the specialist’s work. Accordingly, such guidance, wherever presented, should not be characterized as “requirements” nor should it begin with language (*e.g.*, “should include” such as appears on p.40) that would cause it to be viewed as presumptively mandatory under Rule 3101.

28. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions?* [Second part of Question 28 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

29. *Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist?* [Second part of Question 29 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

30. *Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?*

Our response with regard to requirements vs. guidance would be similar to our response to Question 27.

31. *Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)?* [Second part of Question 31 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

33. *Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?*

Our response with regard to requirements vs. guidance would be similar to our response to Question 27.

34. *Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?*

Although independence is the bedrock of the attest function and, therefore, the audit process and profession, it is beyond objectivity and is neither relevant nor well understood by those practicing in other professions. Specialists who may be engaged by auditors are not in the attestation business of lending credibility to the assertions of others; they are merely engaged to provide audit evidence by determining and reporting a conclusion objectively based on their own special expertise. Other third party sources of of audit evidence,

Office of the Secretary
Public Company Accounting Oversight Board

July 28, 2015
Page 10 of 10

such as those from whom external confirmations are typically requested and relied upon, are not expected to be independent as are other auditors performing part of the audit work.

35. *Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor's specialist (including his or her employer) and the company appropriate?* [Second part of Question 29 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

36. *Are the potential requirements for the auditor to evaluate the objectivity of an auditor's specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity?* [Second part of Question 29 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

37. *Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor's engaged specialist will not be influenced by business, employment, or financial relationships?*

Yes.

38. *Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear?* [Second part of Question 29 has been omitted.]

Our response with regard to providing requirements vs. guidance would be similar to our response to Question 27.

* * * * *

The limited time allowed for comments did not permit us to respond individually and in detail to questions (nos. 40-47) related to economic impacts and implications that are presented in Section VIII of the SCP. However, in general, we believe it should be evident that (a) unnecessary costs will be added to audits in direct proportion to the extent any new or amended standards that result from this process contain procedures that are universally or presumptively mandatory under Rule 3101 and that, therefore, effectively preclude auditors from exercising selective judgment based on the wide variety of circumstances that may present themselves, and (b) those additional costs may be substantial and without benefit in the form of added audit quality.

Thank you for this opportunity to comment on this SCP. We hope the Board finds our comments useful in its deliberations on this important matter. Please contact the undersigned at hlevy@pbtk.com or 702/384-1120 if there are any questions about these comments.

Very truly yours,

Piercy Bowler Taylor & Kern, Certified Public Accountants



Howard B. Levy, Principal and
Director of Technical Services

August 11, 2015

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803

Via e-mail – comments@pcaobus.org

Re: Staff Consultation Paper 2015-01 – *The Auditor's Use of the Work of Specialists*

Plante & Moran PLLC (Plante Moran) is the 13th largest public accounting firm in the United States and serves a wide range of public and non-public entities in multiple industries. Plante Moran supports the PCAOB's efforts to improve standards by seeking feedback and appreciates the opportunity to provide comments on the Staff Consultation Paper ("consultation paper") referenced above. In addition, as requested in the consultation paper, we have provided a summary of the most common specialists that are employed by us, engaged by us, or engaged by the issuers we audit.

Nature of Plante Moran's Primary Connections with Specialists

Plante Moran employs or engages a variety of specialists. Where we have evaluated that a business case exists for Plante Moran to directly invest in specialists, we have done so. Currently, we have specialists on staff in the following areas and these staff members participate in our audit engagements for both issuers and non-issuers as needed:

- Assets acquired and liabilities assumed in business combinations – Valuation specialist
- Goodwill impairment – Valuation specialist
- Long-lived asset and intangible asset impairments – Valuation specialist
- Real estate assets – Appraiser
- Stock options – Valuation specialist
- Complex financial instruments – Valuation specialist

Where we have not been able to support a business case for an employed specialist, we may engage a specialist to assist our assurance teams in audit engagements for both issuers and non-issuers. The most common specialists that we engage are as follows:

- Insurance loss reserves - Actuary
- Complex financial instruments – Valuation specialist

Issuers and non-issuers we audit have also engaged specialists, when they deem necessary, in the following specialty areas:

- Insurance loss reserves – Actuary
- Defined benefit plan actuarial liabilities - Actuary
- Complex financial instruments – Valuation specialists
- Long-lived asset and intangible asset impairments – Valuation specialists
- Real estate assets – Appraiser
- Assets acquired and liabilities assumed in business combinations – Valuation specialist
- Goodwill impairment – Valuation specialist
- Stock options – Valuation specialist

Plante Moran Commentary on the Staff Consultation Paper

Revision or Removal of AU section 336, *Using the Work of a Specialist*

Generally, we believe the core principles in AU section 336 should be maintained. When applied properly, we believe the concepts in AU 336 are effective audit guidance for auditors addressing complex calculations and nuances in specialty areas in which the auditor may not be well versed, while still placing appropriate responsibility on the auditor to evaluate the specialist's work. We also recommend the issuance of a practice alert on this topic to highlight key areas where failures to properly apply AU section 336 have been noted in order to improve how auditors currently conduct audits under the existing guidance and to improve overall consistency and effectiveness. In the absence of, or in addition to, a practice alert, we believe that clarifying and, in some cases enhancing, the requirements within existing AU section 336 guidance would assist in providing greater consistency and effectiveness in its application.

Our suggestions related to improving consistency in application include providing guidance, either by enhancing the existing standard or in a practice alert, on the following:

- Identifying responsibilities of the auditor and the specialist
- Evaluating objectivity and credentials of specialists
- Evaluating methods and assumptions used by specialists and linking risk assessment to proper audit procedures for risks identified
- Using auditor judgment/scalability
- Evaluating differences that arise during this process
- Documenting results and conclusions

We believe that eliminating AU section 336 would create unnecessary confusion related to the appropriate standards to apply and would result in additional divergence in practice based on the application of such alternative guidance.

Factors to be Considered When Using the Work of Any Specialist

We believe, consistent with the risk-based audit approach, that the use of a standard approach for all types of specialists may not be the proper approach. We believe that the use of any type of specialist requires a significant amount of auditor judgment and depends on many factors such as materiality and risk of material misstatement, sensitivity and complexity of the accounting estimates under audit, the knowledge and expertise of the auditor with respect to those estimates and the methods and practices customarily used by specialists in developing those estimates, as well as the qualifications, expertise and credentials of the specialist being utilized.

Underlying credentials of specialists

An important aspect of the credentials of the specialist is the quality of the membership or other requirements underlying those credentials. These requirements would include technical and other requirements for membership, and ongoing requirements for compliance with a code of professional conduct and professional standards, continuing education, and discipline. Where a particular specialty lacks significant membership requirements underlying the credentials, particularly with respect to maintaining those credentials, we perceive there is a higher risk associated with the results of a specialist's services.

In addition, credentials can change over time, as credential source organizations evolve in response to marketplace demands. For instance, the available credentials for valuation professionals have improved in recent years in response to the growing demand for fair value measurements. There are also multiple sources of credentials for appraisal and valuation engagements and, in our view, auditors need to evaluate the relative quality of those credentials in order to properly apply the guidance.

We recommend that the Board provide additional guidance in the standards to assist auditors in understanding their responsibilities with regards to (1) the nature and quality of specialists' credentials based upon the underlying membership requirements; (2) the need to regularly reassess the quality and relevance of the credentials as they change over time and (3) properly differentiating among existing credentials within a specialty when evaluating the quality of a specialist's credentials.

Testing approach

The consultation paper suggests a potential shift in relative responsibility for accounting estimates, from a non-auditor employed specialist to the auditor, whereby the auditor would be responsible for the detailed assumptions and models utilized by the specialist at the same level as the specialist, rather than vesting the specialist with the principal responsibility for determining the appropriateness and reasonableness of the methods and assumptions used, with the auditor responsible for an overall judgment with respect to the reasonableness of those matters in the circumstances. In our view, the use of specialists emanates from the auditor needing specific

expertise to properly evaluate an accounting estimate. As a result, we have a couple of specific concerns associated with this proposed revision:

- Potential duplicative efforts and costs of hiring an auditor-engaged specialist to audit the work of the specialist that has been employed or engaged by the issuer when there is an insignificant reduction in risk of material misstatement in the financial statements from performing these procedures. For instance, if an issuer insurance company has engaged an actuary to opine on its loss reserves, and if the auditor appropriately follows the existing PCAOB standards for specialists in the course of the audit, the auditor may not need to always engage its own actuary to assist in the audit. There are, of course, some circumstances where engaging the actuary by the auditor may have some significant benefit to the quality of the audit. The auditor should be able to exercise appropriate judgment in response to different circumstances.
- Issues related to the resolution of the differences in estimates developed by multiple credible specialists that will inevitably exist due to the nature of the work being performed by the specialists. We believe the Board should consider providing guidance related to resolution of these differences when a range of acceptable results exists, especially in instances whereby differences between those results would be material to the financial statements.

We believe that the approaches to auditing the work of the specialist vary depending on the risk associated with the factors discussed above and that one standard audit approach should not be mandated for all types of specialists. Auditors should be able to exercise their judgment to determine additional audit procedures to be applied, if deemed necessary.

Auditor-employed and Auditor-engaged Specialists

We believe that when using both auditor-employed specialists and auditor-engaged specialists, auditors should continue to evaluate the appropriate skill level of the specialist based on proper credentials, experience and reputation and should continue to clearly outline responsibilities of the specialist in accordance with existing PCAOB standards. In addition, we support the continued use of auditor judgment in determining the extent to which the work of these specialists can be relied upon when evaluating the work performed related to the audit. We believe it is important to retain the flexibility to evaluate and review the reasonableness of the work performed by the specialist and determine if and when additional audit procedures may be necessary under the current standard.

With respect to additional supervision requirements associated with auditor-engaged specialists specifically, although we recognize the importance of continuing to identify specific relationships that may have an impact on objectivity, we would caution that mandating compliance with similar quality control standards that currently exist under AS10 related to auditor-employed specialists (such as independence) may not be practical or possible to implement for auditor-engaged specialists and may not result in additional objectivity or improve overall audit quality. In fact, we believe the implementation of such a broad based standard may have the opposite effect resulting in a decreased number of qualified specialists willing to be engaged by auditors. Furthermore, we then have concerns that firms unable to economically justify the employment of a variety of

specialists may not be able to engage qualified specialists willing to abide by AS 10, therefore resulting in a practical inability to comply with these new requirements.

Issuer-employed and Issuer-engaged Specialists

We believe there is a spectrum of acceptable evidence that can be obtained from different specialists that could be considered reasonable and appropriate depending on the circumstances. On one end of the spectrum, we view evidence obtained from auditor employed or engaged specialists (as discussed above) to have the highest level of evidence quality, moving next to issuer-engaged specialists and then to issuer-employed specialists on the other end of the spectrum. The evaluation of evidence quality, in our view, also evolves during the audit as the credentials and reputation of the preparer are determined and assumptions, models and conclusions are subjected to auditor scrutiny.

We find that our assessment of the evidence provided by specialists varies and can result in application of additional audit procedures in order to substantiate the reasonableness of the specialists' methods, assumptions and conclusions. There may be instances where an auditor should engage a specialist to provide an additional level of evidence on a material, sensitive estimate. However, auditors should be able to continue to apply judgment with regard to the nature and scope of audit procedures, including the work of specialists combined with other procedures, to appropriately audit these significant estimates.

We believe the existing guidance in AU section 336, when applied appropriately, allows for the flexibility to audit the work of specialists employed in developing estimates in response to differing circumstances. We believe the standard, if enhanced, should retain this flexibility, while providing additional clarification regarding the documentation requirements associated with properly complying with the standard.

Other Potential Specialists

We believe that experts used related to information technology and taxes should continue to be excluded from the definition of "specialists". While these areas have increased in complexity over the years, we believe these are aspects of the accounting and auditing discipline and the expertise of auditors, and that, generally, auditors of issuers should maintain the internal expertise required to effectively audit these areas.

Independence

We believe that specialists engaged by the auditor should not be required to be independent under SEC rules as it would be impractical to require the auditor to establish and enforce this level of independence with an engaged specialist. The SEC independence rules are complex and we expect that specialists are not well versed enough in this area to determine their applicability and ultimately make this representation to the auditors. We are concerned that a requirement that causes the specialist to create a quality control system to track SEC independence compliance may be a cost and effort that the specialist is unwilling to undertake, with a possible result being a decreased number of otherwise qualified specialists being available to the auditor. In addition, smaller firms cannot generally make a business case for employing

numerous specialists to cover all the specialty areas that may be applicable to its issuer audit engagements. The end result might be to discourage qualified smaller firms from continuing their SEC practices, which is not in the best interest of investors.

Also, some specialists do confirm certain aspects of objectivity that are required in the underlying membership requirements of their specialty in their reports that can assist the auditor in evaluating the specialist's objectivity. We do not believe that an auditor-engaged specialist needs to be SEC independent in the sense of auditor independence in order to be qualified. We believe a specialist's compliance with its own underlying membership requirements will generally be sufficient, if those requirements have been deemed sufficient in the auditor's judgment.

In summary, we believe the existing standard, when applied appropriately, remains relevant and useful in providing guidance to auditors when specialists are relied upon during an audit. We believe the majority of the issues arising in practice with respect to the use of specialists relate to improper application of existing standards that we believe could be best addressed in a practice alert specific to this topic. In the absence of, or in addition to, a specific practice alert being issued, we support enhancements to the current standard to provide this additional clarity.

Thank you again for the opportunity to comment on this consultation paper. We would be pleased to respond to any questions the PCAOB or its staff may have about these comments. Please direct any questions to John Klisch at john.klisch@plantemoran.com or 312-980-3336 or Joan Waggoner at joan.waggoner@plantemoran.com or 312-980-2945.

Very truly yours,

PLANTE & MORAN, PLLC



Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

July 31, 2015

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

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Staff Consultation Paper No. 2015-01: The Auditor's Use of the Work of Specialists* (the "Staff Consultation Paper"). Similar to PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*, we commend the Board and its staff for its use of a staff consultation paper, as we believe it can be an effective mechanism for obtaining feedback from stakeholders early in the standard-setting process. We further commend the Board and its staff for continued outreach, including the Standing Advisory Group ("SAG") public meeting held on June 18, 2015.

Overview

We are supportive of the overall project and agree the auditing standards related to the auditor's use of the work of specialists could be enhanced. In general, the information presented in Sections II¹ and III² of the Staff Consultation Paper accurately characterize current practice and the ways in which auditors use the work of specialists. Our observations and recommendations in this letter are informed by our firm's current use of specialists in audits of financial statements. In general, as it relates to an auditor's specialist, our engagement teams primarily use specialists employed by our firm. These employed specialists are subject to our internal continuing professional education requirements related to accounting and auditing; therefore, our employed specialists attend some of the same internal training courses that are attended by our engagement teams, including courses that emphasize the importance of professional skepticism. As discussed in the Staff Consultation Paper, our engagement teams may use an auditor's employed specialist to either develop an independent estimate and/or to test the methods and significant assumptions used by the company.³ An engagement team's determination of the appropriate use of a specialist is driven by its risk assessment process and the engagement team's professional judgment of the most effective manner of obtaining sufficient appropriate audit evidence.

¹ See *Staff Consultation Paper*, page 5.

² See *Staff Consultation Paper*, page 11.

³ See *Staff Consultation Paper*, page 40.

The Staff Consultation Paper primarily discusses potential changes to the auditor’s use of an auditor’s employed or engaged specialist. As a result, this letter includes various suggestions primarily related to the specific requirements described in the Staff Consultation Paper related to an auditor’s specialist. Specific to an auditor’s use of a company’s engaged specialist, our concerns with the Staff Consultation Paper’s consideration of rescinding AU 336, *Using the Work of a Specialist* (“AU 336”), would, among other matters, create a requirement that the auditor “test the information provided by the [company’s engaged] specialist as if it were produced by the company.”⁴ In our letter responding to the PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*, we expressed our concerns with such a requirement, and we supplement that discussion with additional recommendations in this letter.

We believe AU 336 appropriately acknowledges 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.”⁵ The principles in AU 336 today allow an auditor to use the work of a specialist to obtain appropriate evidential matter in areas outside of accounting and auditing in which the auditor would not be expected to have the expertise or qualifications of a specialist.

As a result, we believe any changes to existing standards should enhance audit quality and be operational and adaptable to changes in the evolving capital markets. We believe improvements to audit quality would be better accomplished not through rescinding AU 336, but through strengthening certain of its core principles, including certain areas as outlined in the Staff Consultation Paper. We believe this can be accomplished, in part, by implementing the model of “evaluating the specialist’s conclusions” outlined below.

The consideration of changes should include feedback from all key stakeholders, including specialists, as any changes to the standards will impact specialists and companies. We have organized our observations and recommendations into the following topical areas:

- Use of an auditor’s specialist
- Rescissions of, or amendments to, AU 336
- Other matters

Use of an auditor’s specialist

As noted in the Staff Consultation Paper, the staff is exploring whether to include more specific requirements when an auditor uses the work of an auditor’s specialist. Among other matters, these specific requirements would include enhanced requirements for (1) evaluating the knowledge, skill and objectivity of an auditor’s specialist, (2) informing an auditor’s specialist of his or her responsibilities, and (3) evaluating the work of an auditor’s specialist.⁶

Evaluating the knowledge, skill and objectivity of an auditor’s specialist

The staff is considering, among other matters, requiring auditors to evaluate an auditor’s specialist’s professional qualifications, experience in the type of work under consideration, and reputation and standing in the views of peers.⁷ We generally agree with the potential requirements identified. We appreciate that evaluating the professional qualifications includes evaluating whether the auditor’s specialist is subject to technical performance standards or other professional or industry requirements, as we believe this allows for greater consistency and higher quality of work performed by the specialist. As a result, as we said in our response to the PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*, we believe a specialist’s professional standards framework could be

⁴ See PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*, page 38.

⁵ See AU 336.06.

⁶ See *Staff Consultation Paper*, page 35.

⁷ See *Staff Consultation Paper*, page 36.

considered when the auditor determines the extent of the procedures to be performed in order to rely on the specialist's work.

We agree with the staff that this evaluation should occur for both auditors' employed and auditors' engaged specialists.⁸ We also agree that the manner in which the auditor obtains the information for this evaluation may differ depending on whether it is an employed or engaged auditor specialist. We question, however, what the staff intends when they describe that, for an auditor's employed specialist, "*the auditor may take into account information available from the accounting firm* (e.g., information contained in the firm's QC system, results of internal and external inspections, and results of the firm's performance reviews) to assist him or her in making that evaluation."⁹

Today, when our engagement teams determine they will use the work of an auditor's employed specialist, the specialist is assigned based on, among other matters, relevant subject matter expertise and consideration of our quality control standards. The Firm, through its system of quality controls, is responsible for determining that the professional qualifications and experience in the work under consideration is appropriate. When describing that "*the auditor may take into account information available from the accounting firm*," it is unclear to us if the staff is considering changing this practice by having each individual engagement team obtain this information. If so, in order to demonstrate the engagement complied with the standards of the PCAOB, this sensitive information, including the results of performance reviews, would be required to be part of the audit documentation,¹⁰ which would then be accessible to all engagement team members and non-regulator third-parties who may be reviewing the audit workpapers.

We also believe it is necessary to acknowledge that individual engagement teams often do not have visibility into resource and other allocation decisions related to auditor employed specialists, as the individuals responsible for assigning the employed specialists will typically have more information about the availability of the specialists and be more familiar with their experiences, as they work with the specialists on a day-to-day basis. This is not to suggest the engagement leader does not have a say in the assignment, but considering whether the employed specialist is the appropriate specialist should be based, in part, on discussions with those responsible for assigning the employed specialists, who are subject to the firm's quality control standards, instead of a separate evaluation by each engagement team. As a result, we believe the best approach is the practice today, in that those in leadership positions who have access to this information are making appropriate decisions based on the firm's quality control standards in collaboration with the engagement partner.

A similar concept applies in the Staff Consultation Paper when determining if the employed auditor specialist is independent by "basing it on information contained in the firm's quality control system."¹¹ Similar to the discussion related to the knowledge and skill, it is unclear whether the intent is to change current practice, which is to rely on individual confirmations and the quality control standards of the firm to monitor independence. We believe current practice is the best approach and would recommend changes not be made in this area.

Informing an auditor's specialist of his or her responsibilities

The staff is considering requiring auditors to reach an agreement with the auditor's specialist in writing regarding, among other matters, the responsibilities of the auditor's specialist and the work to be done.¹² We are supportive of the proposed requirements as it could enhance consistency in execution. Our experience is that clarifying the roles and responsibilities in writing facilitates the development of a mutual understanding of responsibilities between the engagement team and the auditor's specialist and

⁸ We also agree, as discussed on page 30 of the Staff Consultation Paper, the evaluation requirements should also apply when an auditor is using management's specialists, and that the requirements should include consideration of technical performance standards or other professional or industry requirements as part of the auditor's determination of the extent of the procedures to be performed in order to rely on the specialist's work.

⁹ See *Staff Consultation Paper*, page 36. (Emphasis added)

¹⁰ See AS 3.05.

¹¹ See *Staff Consultation Paper*, page 49.

¹² See *Staff Consultation Paper*, page 37.

an understanding of the form and content of documentation that is expected to be included in the audit workpapers.

Evaluating the work of an auditor's specialist

The Staff Consultation Paper appropriately acknowledges an auditor's specialist may perform work related to evaluating accounting estimates by (1) developing an independent estimate or (2) testing the methods and significant assumptions used by the company. When an auditor's specialist develops an independent estimate, the staff is considering potential requirements for the auditor to determine whether the methods used by the specialist are appropriate and whether the significant assumptions used by the specialist are reasonable. When an auditor's specialist tests the methods and significant assumptions used by the company, the staff is considering potential requirements to evaluate the specialist's conclusions about the appropriateness of the company's methods and the reasonableness of the company's significant assumptions.¹³

Evaluating the work of an auditor's specialist when the auditor's specialist tests the methods and significant assumptions used by the company

We generally agree with the potential requirements to evaluate the auditor's specialist's conclusions described in the Staff Consultation Paper when the auditor's specialist tests the methods and significant assumptions used by the company¹⁴ (a model we refer to in this letter as "evaluating the specialist's conclusions"). We note, however, that "conformity with the applicable financial reporting framework" may not be applicable for all methods since the methods being used are in a field other than accounting and auditing; therefore, we recommend the staff add "if applicable" after this potential requirement.

We would also support additional considerations not currently contemplated by the Staff Consultation Paper, including evaluating the auditor's specialist's conclusions about whether the company's significant assumptions are reasonable by taking into account whether the significant assumptions are consistent with:

- Existing market information, if available;
- Market participant assumptions or management's plans, including what management expects will be the outcome of specific objectives and strategies;
- Assumptions made in prior periods, if appropriate;
- Actual experience related to the estimate to the extent currently applicable; and
- Other matters relating to the financial statements, for example, assumptions used by management in other accounting estimates in the financial statements.

Evaluating the work of an auditor's specialist when the auditor's specialist develops an independent estimate

Unlike the potential requirements to evaluate the auditor's specialist's conclusions described above, the potential requirements to determine the appropriateness of the methods and reasonableness of significant assumptions used by an auditor's specialist when developing an independent estimate is not limited in the Staff Consultation Paper to evaluating the conclusions. It is unclear what is expected of the auditor by the differences in wording of the requirements, but these differences could be read to indicate the auditor would be responsible for "testing the specialist's process." While we agree with the staff's observation that "it is important for an auditor who reviews the work of an auditor's specialist to focus on the risks associated with assumptions and methods,"¹⁵ we are concerned the potential requirements in the Staff Consultation Paper unnecessarily go beyond the model to "evaluate the specialist's conclusions" described above, and contradict the discussion in AU 336.06 that "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."¹⁶ For

¹³ See *Staff Consultation Paper*, page 40.

¹⁴ See *Staff Consultation Paper*, page 40.

¹⁵ See *Staff Consultation Paper*, page 39.

¹⁶ See AU 336.06.

example, if an auditor is using a gemologist to assist in performing audit procedures related to the authenticity of gemstones, it would be impractical to expect the auditor would have the expertise to evaluate whether the process in determining the methods are appropriate. Also, as discussed in AU 336.06, the auditor uses the auditor's specialist to obtain appropriate evidential matter in areas related to the specialist's special skill or knowledge.

We do, however, agree that the current standard could be enhanced. We believe that using the model of "evaluating the specialist's conclusions" as outlined in the Staff Consultation Paper (and supplemented by our recommendations outlined above) would help achieve the staff's objectives.

Independence under Rule 2-01 of Regulation S-X

The staff is considering two alternative approaches for how the auditor should evaluate the relationship between an auditor's engaged specialist and the company. The approaches are to either (1) apply the full requirements of Rule 2-01 of Regulation S-X ("Rule 2-01"), or (2) apply an approach that would incorporate only certain elements of Rule 2-01.¹⁷ Under the first approach, the auditor's engaged specialist would be subject to all the requirements and restrictions that apply to "covered persons" in an accounting firm under Rule 2-01. The second approach would require the auditor to evaluate whether the engaged specialist has the necessary objectivity by:

- Obtaining information regarding business, employment, and financial relationships between the auditor's specialist and the company;
- Evaluating that information; and
- Determining whether the objectivity of the auditor's specialist is impaired.

Given the extensive prohibitions in Rule 2-01, it appears likely some specialists, otherwise available to the auditor, would either be unable or unwilling to comply with the proposed requirement to be subject to Rule 2-01 in its entirety, and therefore could not be engaged. For example, if engaged specialists were required to comply with Rule 2-01, a direct financial interest in an audit client (or its affiliates) would be considered a violation regardless of materiality and it would apply to all covered persons (and their immediate family members), including those in the "chain of command" at the specialist's organization. Accordingly, it is likely the pool of external specialists available to auditors would be reduced, perhaps significantly, which could have a negative impact on audit quality. The impact on smaller independent public accounting firms will be greater as they use engaged specialists more frequently than larger firms, but it will also impact larger firms that use engaged specialists for certain unique audit areas requiring specialized skills and knowledge.

Additionally, we are concerned about the practical limitations of being able to apply rules intended for auditors to engaged specialists. As the staff notes, if there is no quality control system at the specialist's employer to monitor compliance with Rule 2-01, it would present considerable challenges for an accounting firm to obtain reasonable assurance that engaged specialists, including the specialist's employer, has implemented and complied with the detailed independence requirements.¹⁸ We question whether the potential requirements could be effectively monitored and enforced for entities and individuals that are not otherwise subject to the SEC's independence rules. In addition, some specialists who today serve as an auditor's engaged specialist may not want to invest in implementing the quality control systems needed and may decide to not serve as an auditor's engaged specialist.

The "Enhanced Objectivity Approach" described in the Staff Consultation Paper is more practical than applying the full requirements of Rule 2-01 to an auditor's engaged specialist. However, the intent of the assessment to be performed under the enhanced objectivity approach is to use, at least to some extent, the requirements of Rule 2-01 as a framework for evaluating impairments of objectivity. The staff has developed potential requirements for evaluating whether an auditor's engaged specialist has the necessary objectivity regarding the company being audited, and these potential requirements are based on the

¹⁷ See *Staff Consultation Paper*, pages 45 and 46.

¹⁸ See *Staff Consultation Paper*, page 47.

principles in Rule 2-01. For example, the problematic relationships listed on page 51 of the Staff Consultation Paper that would, in the staff's view, impair the specialist's objectivity are relationships prohibited under Rule 2-01. As a result, it is unclear how the enhanced objectivity approach differs, in any substantive way, from directly applying the "covered person" requirements of Rule 2-01 to auditor engaged specialists.

We support the identification of certain business, financial, and employment relationships that may impair an auditor's engaged specialist's objectivity. However, we do not believe the auditor should be required to "obtain a written description from the specialist regarding the process used by the specialist to formulate responses to the auditor's request for information."¹⁹ By requiring this information be obtained by the auditor, there is an implication the auditor would need to evaluate the specialist's process in order to determine its reliability. This would be difficult for the auditor to evaluate because the auditor would not have a basis for determining if the process is appropriate for an entity. For example, the auditor will not have knowledge of how the entity is organized; therefore, what is appropriate for one entity may not be appropriate for another, such as, the process related to a decentralized entity compared to a centralized entity may be completely different but appropriate in each situation. In addition, there is no mechanism with which to enforce the consistency of documentation related to the process, which will also drive inconsistency in what information is provided to the auditor to evaluate.

We agree with the staff's premise in question 36²⁰ requiring auditors to apply the "reasonable investor test" in conjunction with performing a threats and safeguards evaluation, presuming the benchmark for determining whether a relationship with an audit client impairs the auditor engaged specialist's objectivity is not Rule 2-01. A more substantive distinction between the staff's two proposed approaches could be to allow, under the Enhanced Objectivity Approach, consideration of materiality, as is the case in all accounting and auditing judgments. Hence, for example, a de minimis financial interest or business relationship that would otherwise be prohibited under Rule 2-01 could be deemed permissible for the engaged specialist under a less onerous threats and safeguards approach.

Impaired objectivity

Under the approaches described above, if the auditor's specialist's objectivity is impaired, the auditor would not be permitted to use the work of that specialist.²¹ This would be a change from AU 336 which, in addition to acknowledging the auditor is not expected to have the expertise of a specialist, states the auditor should perform additional procedures if he believes the specialist's objectivity might be impaired.²² Objectivity should be viewed as a continuum that affects the extent of audit procedures performed. Rather than eliminating this continuum, we suggest the "testing" to be performed be consistent with our supplemental recommendations to the model of "evaluating the specialist's conclusions" described later in this letter, and believe it would add clarity to the procedures expected to be performed and would appropriately overcome concerns about objectivity of the specialist.

Rescissions of, or amendments to, AU 336

The Staff Consultation Paper discusses the potential to either (1) amend AU 336 to remove certain provisions that may be considered to limit the auditor's responsibilities to evaluate the work of a company's specialist, or (2) rescinding AU 336 without issuing new requirements.²³

¹⁹ See *Staff Consultation Paper*, page 50.

²⁰ See *Staff Consultation Paper*, page 52.

²¹ See *Staff Consultation Paper*, pages 47 and 48.

²² See AU 336.11.

²³ See *Staff Consultation Paper*, page 30.

Potential rescission of AU 336

We do not support rescinding AU 336, which would require auditors to look to other applicable PCAOB standards when the work of a company’s specialist is used,²⁴ as we think this would be a significant change in practice and not be consistent with the core principles of AU 336. We acknowledge the Staff Consultation Paper discusses that, under this method, the auditor would evaluate the knowledge, skill, and objectivity of a company’s engaged specialist, and the results of this evaluation may affect the auditor’s assessment of the risks of material misstatement and the nature, timing, and extent of the auditor’s procedures.²⁵

Rescinding AU 336 would, among other matters, create a requirement that the auditor “test the information provided by the [company’s engaged] specialist as if it were produced by the company,”²⁶ as the Staff Consultation Paper discusses the auditor would evaluate the evidence similarly to any other evidence provided by the company to the auditor.²⁷ As a result of the language in the Staff Consultation Paper, it is unclear how the auditor would alter the nature, timing, and extent of their procedures. Therefore, our concerns about such a requirement are the same as those discussed in our letter responding to the PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*. Those concerns included such a requirement would appear to be different from the principles in AS 15, *Audit Evidence*, to consider the relevance and reliability of the audit evidence and, due to practical issues, could in certain situations eliminate the ability of the auditor to test the process used by management to develop an estimate as the auditor could not use the work of a company engaged specialist, which may reduce audit quality.

We note the staff is considering a number of alternatives to this approach, including auditors (1) testing specialist-developed assumptions as if they were developed by management, (2) testing the information provided by a company’s specialist as if it were produced by the company only when a significant risk is identified, or (3) testing information provided by management to the specialist and considering management’s ability to influence the results of the specialist.²⁸ If the staff were to pursue a requirement to test specialist-developed assumptions as if they were developed by management, we would suggest this be clarified to mean significant assumptions, as that term is described in AU 328.33. We would also suggest the “testing” to be performed be consistent with our supplemental recommendations to the model of “evaluating the specialist’s conclusions” described earlier in this letter as the same concerns around “testing the specialists” process as discussed above would apply. If the requirement applies to a significant risk, it would not alleviate the concerns outlined in our letter responding to the PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*.

We do, however, agree with a potential requirement to test information provided by management to the specialist and to consider management’s ability to influence the results of the specialist. We believe this could be incorporated into the objectivity analysis.

Amending AU 336

Among other matters, the staff is considering clarifying the current responsibility to “obtain an understanding of the methods and assumptions” used by a company’s specialist because, in the staff’s view, that requirement is less rigorous than standards that apply when the company does not use a specialist.²⁹ We believe the requirements of AU 336.12 appropriately reflect the fact that specialists engaged by the company are typically more objective, bring a wider range of experience, and may operate within a set of professional standards.

²⁴ See *Staff Consultation Paper*, page 32.

²⁵ See *Staff Consultation Paper*, page 30.

²⁶ See PCAOB *Staff Consultation Paper: Auditing Accounting Estimates and Fair Value Measurements*, page 38.

²⁷ See *Staff Consultation Paper*, page 32.

²⁸ See http://pcaobus.org/News/Events/Documents/06182015_SAGMeeting/Accounting_Estimates_and_Fair_Value.pdf

²⁹ See *Staff Consultation Paper*, page 31.

We understand the staff's concern that the general nature of the AU 336 requirement may result in a variety of practices and inconsistent application but, instead of the elimination of certain language that the staff believes limits the auditor's responsibilities, we recommend the staff consider including the model described earlier in this letter ("evaluating the specialist's conclusions"). As noted earlier, we believe this model would improve audit quality by clarifying the responsibilities of the auditor when using the work of any specialist, and would also drive consistency when the auditor is using the work of any specialist, either that of the company or of the auditor.

The Staff Consultation Paper suggests some of the provisions of AU 336 may be considered to limit the auditor's responsibilities to evaluate the work of a company's specialist, and suggests removing these provisions from AU 336. Examples of the provisions in AU 336 the staff believes limits the auditor's responsibilities to evaluate the work of a company specialist, and suggests removing these provisions from AU 336 include:

- "The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist,
- Ordinarily the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances, and
- [I]f the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained."³⁰

We do not believe the language and provisions being considered for removal have the effect of limiting the auditor's responsibilities but that, as stated earlier, the language and provisions are important to continue to recognize that the auditor is not expected to have the same expertise of the specialist. We do, however, understand the language in AU 336.12 that the auditor ordinarily would use the work of the specialist unless the auditor believes the findings are "unreasonable" may lead to diversity in practice. We believe it may not be appropriate to remove this language or the other provisions in their entirety, but modifications could be considered in concert with the recommendation of incorporating the model of "evaluating the specialist's conclusions" discussed above.

In addition, the staff should consider modifying AU 336.12 to also describe that, if the procedures performed to evaluate the specialist's conclusion, in combination with other audit evidence, do not result in sufficient appropriate audit evidence, the auditor should apply additional procedures. The example of additional procedures could be expanded from obtaining the opinion of another specialist to also include:

- Obtaining independent market information that corroborates or contradicts the specialist's assumptions or methods,
- Considering the actual results of historical estimates,
- Creating an independent estimate, or
- Considering subsequent events.

We believe this addition may enhance audit quality as auditors would be required to evaluate whether sufficient appropriate audit evidence was obtained in performing the procedures related to evaluating the specialist's conclusion model discussed above.

Other matters

Other example of attorney specialist

AU 336.02 appropriately describes attorneys as specialists in situations other than to provide services to a client concerning litigation, claims, or assessments, to which AU Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, applies. AU 336.02 also uses an example where attorneys may be specialists when interpreting the provisions of a contractual agreement. To promote consistency in practice, we recommend an additional example be included when attorneys are used to

³⁰ See *Staff Consultation Paper*, pages 30 and 31.

assist audit committees or management in conducting investigations related to financial reporting, as some external counsel do not believe the scope of AU 336 applies.

Interpretation of AU 336

The Staff Consultation Paper is silent on what the staff is considering related to the interpretation of AU Section 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*, (“AU 9336”) especially if AU 336 is rescinded. Similar to our recommendation not to rescind AU 336, we would also recommend the Board not rescind AU 9336, as that interpretation currently serves as the sole source of authoritative guidance to assist auditors in evaluating the sufficiency of legal opinions obtained to support the assertion that transferred financial assets meet the legal isolation criterion in ASC 860, *Transfers and Servicing*. We also recommend the Board consider updating AU 9336 to reflect current practice and the updated accounting standards.

Conclusion

We are supportive of the project, including many of the recommendations discussed in the Staff Consultation Paper. We are concerned that the direction of some of the recommendations would remove some of the fundamental principles in AU 336, which we believe are still applicable today and, with the continued complexity of business transactions, will most likely continue to be relevant. As an alternative, we recommend that AU 336 be supplemented with the model of “evaluating the specialist’s conclusions” as outlined in the Staff Consultation paper (and supplemented by our recommendations), which could be used when the auditor uses the work an auditor’s specialist or a company’s engaged specialist.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Marc A. Panucci (973-236-4885) or Neil A. Weingarten (973-236-5862) regarding our submission.

Sincerely,

A handwritten signature in cursive script that reads "PricewaterhouseCoopers LLP". The signature is written in dark ink and is positioned below the "Sincerely," text.

Thomas I. Selling PhD, CPA

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Phoenix, AZ 85018
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July 30, 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:

In October 2014, the PCAOB convened a special meeting of its Standing Advisory Group (SAG) for a series of panel discussions based on the August 2014 SCP, *Auditing Accounting Estimates and Fair Value Measurements*. I was on the panel discussing investor perspectives.

The issues addressed in SCP 2015-01 on the work of specialists overlaps significantly with the August 2014 SCP, since specialists are typically engaged to produce estimates. I will provide specific comments related to the use of specialists, beginning with general comments and recommendations that apply equally to both SCPs. I respectfully request that the Board consider my comments when deliberating both SCPs.

My comments are organized as follows: I begin with evidence to support the view that fundamental reform is called for with regard to producing and auditing estimates. After describing the fundamental reform I have in mind for producing and auditing estimates, I provide specific recommendations concerning the use of specialists.

The Critical Role of Management’s Estimates in Financial Reporting

Estimates are pervasive throughout financial statements. They are in the economic lives of buildings and machinery, the loan loss allowances of banks on their loans to Greece, and practically everything else in between. Yet, these estimates are fundamentally flawed for three reasons:

1. A basic deficiency in financial reporting is that every estimate is produced by management, or specialists who are (usually) not independent from management. Although management will not always undertake to produce biased estimates, it is generally conceded that incentives often exist for management to personally benefit by producing biased estimates.

2. Existing PCAOB standards on auditing estimates produced by management or non-independent specialists do not require auditors to fully correct management bias. They are only expected to provide reasonable assurance that the estimates are within a “reasonable” range.
3. Too many estimates are unauditable for too many reasons. For example: they are based on management intent, which auditors have little incentive or basis to question; or circumstances have changed to the point where recent trends are not predictive of the future.

The purposes of the following examples is to show how pervasive and ingrained the problem of management estimates has become in financial reporting:

- Jack Welch, former CEO of General Electric Co. (GE) and an iconic management thought leader, included the following vignette in his memoirs:

“The response of our business leaders to the [earnings] crisis was typical of the GE *culture*. Even though the books had closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra \$10 million, \$20 million, and even \$30 million from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I had been hearing from the Kidder people.”¹ [emphasis added]

Mr. Welch has stunningly revealed, without any apparent sense of impropriety, that financial statement manipulation was an honorable management activity at one of the iconic U.S. public corporations. He evidently required his subordinates to fill their own accounting “cookie jars” with accounting reserves, and as team players they were expected to share them. It is also worth noting that GE has retained the same audit firm for the last 105 years. One could speculate as to how forcefully the current partner-in-charge of the GE account would push back against the current CEO’s accounting estimates in a similar scenario — and risk losing GE as a client for the firm.

- If only to confirm that Mr. Welch is not alone in his view of financial reporting, Walter Schuetze, former SEC’s chief accountant and a charter member of the FASB, provided this characterization of his experiences as an auditor:

“I’ve got scars on my back from when I ... told my clients that they could not manage their earnings. My clients went to the Board of Directors of the firm and said, ‘get Walter off my account—just get him off.’

¹ Welch, Jack (2003), *Straight from the Gut*, Warner Books, p. 225.

Earnings management was rampant ... It was like dirt; it was everywhere and *I think it's still everywhere because the accounting standards that we have today still allow management to have control of the numbers ... and the auditors don't have any foothold to go to management and say no, that number is wrong.*"² [emphasis supplied]

- The New York Times columnist on economic policy matters, Nobel laureate Paul Krugman, rarely writes on financial reporting matters, but in one he writes with unconcealed frustration following the Financial Crisis of 2008:

"So here's what Mr. Summers [Secretary of the Treasury] — and, to be fair, just about everyone in a policy-making position at the time — believed in 1999: America has honest corporate accounting; this lets investors make good decisions, and also forces management to behave responsibly; and the result is a stable, well-functioning financial system.

What percentage of all this turned out to be true? **Zero.**" [emphasis supplied]

- In October 2010, the European Commission asked how, given the large losses recently recognized, auditors could have justified clean opinions on the reports of numerous banks from 2007 to 2009. It is far from clear that any of the long-delayed proposals for additional management estimates, or enhanced auditing standards can make significant improvements. Yet, if anything, unchecked management bias is becoming more prevalent in critical areas such as loan loss allowances by large financial institutions.
- In April 2014, the International Forum of Independent Audit Regulators expressed grave concern for the numerous deficiencies involving the examination of estimates.
- In October 2014, the PCAOB reported that of 23 audits inspected for a major international auditing firm, 65% were completed without obtaining sufficient information to support its opinion.
- The comment letter on this SCP from the Institute of Management Accountants, which purports to express a "corporate point of view," states as follows:

"There is too much of an implication [in the SCP] that management will always try to bias its financial reporting so that auditors have to be extra sensitive to this 'bias.'" (p. 3)

Notwithstanding, a 2015 survey, conducted by the Institute of Internal Auditors Research Foundation, of 500 North American audit executives found that

² SEC Historical Society Interview with Walter Schuetze, available at: <http://tinyurl.com/oa5ls9w>

incidences of management exerting undue influence on financial reporting is pervasive. Specifically, 55% of the survey participants had been directed to change or ignore results of their investigations. Many had been threatened either physically or with being fired, while others suffered cuts in internal audit staff and budgets as part of concerted efforts to neutralize them. In addition, 49% of those surveyed reported their managers or executives directed them to avoid high-risk areas of the business.³

- In a recent speech, SEC Commissioner Kara Stein opined that financial reporting had not “...worked ideally in the financial crisis, and neither [US GAAP or IFRS] may service investors well in today’s post-financial crisis.”⁴
- Profit and loss for the largest and most systemically important financial institutions can depend almost entirely on managements’ estimates of loan loss allowances and their valuations of non-traded derivative financial institutions. Throughout history, many have expressed concern that the financial disclosures of large financial institutions opaque, misleading and contribute to the frequency and severity of economic crises. For recent and prominent examples, I encourage you to read *The Bankers’ New Clothes: What’s Wrong With Banking and What to Do About It* (Anat Admati and Martin Helwig).
- Former Enron CFO and convicted fraudster, Andy Fastow, recently stated at a conference of the Association of Certified Fraud Examiners:

“I wasn’t the chief finance officer at Enron, I was the chief loophole officer ... [I]n my opinion, the problem today is *10 times worse* than when Enron had its implosion ... The things that Enron did, and that I did, are being done today, and in many cases they’re being done in such a manner that makes me blush — and I was the CFO of Enron.” [emphasis supplied]

He cited the continuing widespread use of off-balance-sheet vehicles, as well as inflated financial assumptions embedded in corporate pension plans.⁵

The Basic Deficiency in PCAOB Standards

The longstanding basis for the relationship between management estimates and the audit engagement is currently set forth in AU § 342.03 of the PCAOB’s interim standards (AU 328 contains similar language concerning auditing fair values), which states, in relevant part, as follows:

³ WSJ blog available at <http://blogs.wsj.com/cfo/2015/03/11/internal-auditors-face-pressure-over-results-survey-says/>

⁴ Available at <http://www.sec.gov/news/speech/2015-spch032615kms.html>.

⁵ As reported by Fortune.com, available at <http://fortune.com/2013/07/01/the-confessions-of-andy-fastow/>.

“Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.”

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole....” [emphasis supplied]

This longstanding rule of auditing, which vests the right to determine financial statement values — subject to a vague constraint of “reasonableness” — has no direct basis in the securities laws. And, what management chooses to consider when forming its judgments is a matter of management judgment itself. *The PCAOB inherited this language from the AICPA, and the PCAOB should change it.*

Even under ideal circumstances, assessing the “reasonableness” of management’s estimates, or seriously contesting management’s stated intent to take future actions, poses formidable challenges to audit quality. Indeed, history has repeatedly demonstrated that when facts and circumstances indicate to any extent that the past is not predictive of the future, no auditor — not matter how technically qualified or independent — could competently assess the “reasonableness” of management’s (or a specialist’s) estimates.

A Proposal for Fundamental Change

In essence, an audit can be seen to compromise two distinct services: (1) verification of *facts*, and (2) providing assurance that the *subjective* estimates made by management are “reasonable.” Perhaps the greatest regulatory success story post-Enron is how the PCAOB, and regulators in other jurisdictions following its lead, have used inspections to document the recurrence of alarmingly high rates of audit deficiencies from *failure to adequately examine management’s estimates*. And, by the absence of cases, the inspections have provided a strong indication that auditors are satisfactorily performing their duties as verifiers of fact.

Decades of experience should have taught us that merely incremental change to the language of AU Sections 328, 336 or 342 will not have an appreciable effect on audit quality, and recent evidence supports fundamental change toward verification focused audits. A promising point of departure toward would be to change the way that the fair values of financial instruments of Systemically Important Financial Institutions (i.e., those subject to supervision by the Federal Reserve Board and to prudential standards under the Dodd-Frank Act) are measured and audited. For the financial instruments where fair values are *not* derived from quoted prices in active markets for identical financial instruments (so-called “Level I” fair values per

U.S. GAAP), management should be required to engage independent appraisal specialists to estimate the fair values. Consistent with a verification focus, the auditor would be called upon to verify key facts, such as the following:

- The factual information provided by management to the appraiser is accurate and complete.
- The appraiser possesses the necessary professional qualifications.
- The appraiser meets specific independence standards.
- The appraiser’s measurements comply with U.S. GAAP and their engagement letter with the issuer.
- The appraiser’s calculations are free from error.

Even if only the incremental step of focusing on fair value estimates by SIFIs were implemented, that would be substantial progress, indeed! But looking further ahead, more pervasive use of independent estimates would diminish issuer preferences for judgment-based accounting — since they would no longer be able to control how those judgments are made. Appraisal specialists will, as always, prefer to make their inferences from arm’s-length transactions, and from there it is not difficult to envision that resistance from issuers to the use of market prices for measuring assets will steadily diminish.

Following my presentation at the SAG meeting, much of the ensuing discussion was devoted to concerns with the reliability of independent appraisals. For this reason, Bo Nordlund and I reviewed existing research on this and related questions. Our forthcoming paper is attached.⁶

In brief, we found that:

- Independent appraisals would not be a radical change from current practice when auditing fair value estimates. The larger audit firms have teams of specialists that are capable of performing the independent appraisal function. Perhaps, even, an appropriately isolated group within the audit firm could perform appraisal work that would ultimately become the numbers in the financial statements of the audit client.
- While challenges to appraiser independence can exist, they are similar to auditor independence. Like auditors, the ethical standards of the appraisal profession require the appraiser to inoculate itself from improper client involvement in its work. Individual state regulatory agencies are responsible for licensing appraisers, investigating complaints and taking appropriate disciplinary action.

⁶ Thomas I. Selling and Bo Nordlund, “The Problem of Management Bias in Accounting Estimates: An Investor Perspective on Root Causes and Solutions,” *Business Horizons*, forthcoming.

- Estimation uncertainty in measuring current values does not differ dramatically from other types of estimates. Researchers have estimated uncertainty in property valuations, and the overall findings are not out of range of the perceived overall uncertainty in financial reporting.

Specific Comments on SCP 2015-01

The principles I describe on the use of appraisal specialists for producing estimates of fair values extends naturally to the general use of specialists employed by either management or the auditor.

SCP 2015-01 states, “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.” (p. 22) Accordingly, the auditor’s responsibilities to test estimates should be limited *only* if a specialist is independent of management. Consistent with the logical basis for independence and the evident intent of the securities laws, any other relationship between management and a specialist should not alter the responsibilities of either the auditor or management.

But, if a specialist is independent from management, then management need not be held responsible for the estimates produced by the specialist. The auditor’s responsibilities would be limited to the verification functions that I outlined earlier:

- To verify that the specialist possesses the qualifications to perform the engagement, and complies with rules of independence set forth either by the PCAOB or the SEC.
- To verify, on a test basis, inputs that are capable of verification and to test that calculations are free from error.

With respect to the independence standards used for specialists, I believe that either the PCAOB or SEC should promulgate independence requirements for specialists using the existing standards for auditors (Article 2 of Reg. S-X) as a starting point.

* * * * *

U.S. GAAP is becoming more complex, and in the process it is becoming even more susceptible to estimation bias by management, who are given strong economic incentives to manifest their biases.

Even in stable times, management bias produces unjustified and embarrassing wealth transfers from investors to management. There is also still strong justification for the view that inadequate financial reporting regulations will be a significant contributor to a next financial crisis. At minimum, the PCAOB’s own inspection evidence suggests that existing PCAOB standards governing auditing of

management estimates contributes to perceptions that auditors lack independence from their clients and/or fail to exercise due professional care.

If the responsibility for financial statement judgments were transferred to independent appraisers and specialists, auditing could become solely a verification service. Auditors would benefit, and financial statements would better serve investors and the public interest in a stable economy.

Sincerely,

A handwritten signature in cursive script, appearing to read "Thomas L. Hellwig".



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

ICAEW welcomes the opportunity to comment on the *PCAOB Staff Consultation Paper: The Auditor's Use of the Work of Specialists* published by PCAOB on 28 May 2015, a copy of which is available from this [link](#).

This response of 31 July 2015 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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MAJOR POINTS

Management and auditors need to be more involved in the work of specialists.

1. This Staff Consultation Paper (the Paper) is welcome. The use of specialists is of increasing significance as audit becomes more of a multi-disciplinary process. Companies and the auditing profession are on a steep learning curve as financial statements become technically more complex, but this is not the first time this has happened. The development of the auditing profession from its beginnings in the 19th Century has been characterised by increasing expectations regarding the skills auditors should master, and the extent to which they should ask questions, probe and apply professional scepticism.
2. The profession has not always welcomed pressure to do more but history shows auditors benefitting every time it meets the challenge and develops new skills. This is one reason why the profession has not just survived, but continues to flourish. The idea that auditors' responsibilities are limited to ensuring that invoices have been posted to the correct accounts in the correct accounting period, and that there is no need for them to question inventory levels, inspect properties or kick tyres, is long gone. Working with specialists is just a continuation of this theme and neither management nor auditors should attempt to reduce their respective responsibilities in this area by passing responsibility to each other, or to the specialists involved. If all that can be reasonably expected is that auditors read the letters on file from specialists confirming a valuation, and limit their enquiries to any obvious errors, omissions or inconsistencies, auditing will come to be seen as a low-value post-room management exercise.
3. Management and auditors have to raise their game by actively challenging specialists' assertions, and particularly the assumptions they have made. If, for example, assumptions used by specialists in a valuation model are different to observable market data, or if a data set used as a basis for projections covers a very short period, investors can reasonably expect management and auditors to ask why. If they fail to do so, investors will rightly ask why they did not, and both will lose credibility. Auditors will pay a price if they seek to portray themselves as highly-qualified project managers, supervising the work of others, but remaining largely uninvolved in the detail.
4. No-one should be afraid of complex valuation models. If auditors do not understand them, they must ensure that they have an appropriately qualified specialist available, preferably an audit-literate one, with whom they are willing and able to communicate. Most importantly, auditors must be prepared to ask simple and direct questions, to demand answers that they understand, and to ask for changes to be made when the answers do not seem right.

The Staff Consultation Paper would benefit from strategic direction from the Board, more focus on substance and less on process.

5. The Paper does make some reference to these strategic issues and in particular to the need for auditors to improve the nature and extent of their communications with specialists, which we applaud. However, the Paper, and its next iteration in the project, would benefit from more high-level focus and strategic direction from the Board. The 48 questions are detailed and repetitive, and mainly lacking in any genuine sense of enquiry. This is one reason we have not attempted to answer all of them. It is also the reason for the number of instances in which we have cross-referred one answer to another in our response.
6. It is hard to avoid the impression that Staff have already have answers to the questions they have asked. Staff have presumably consulted extensively with firms and appear to be seeking confirmation of what they already know. More importantly, it is equally hard to avoid the impression that Staff have already decided on likely outcomes, and are not really interested in alternative approaches. This is consultation the wrong way round. It would be better to ask a relatively small number of questions in an attempt to gauge high levels views among different

stakeholder groups, and then develop the detail. Such an approach might have avoided the need for some recent re-proposals.

7. We believe that this project needs a substantially different focus if changes to standards are to be effective. The current focus is on process at the expense of substance - on the formal relationships, the categorisation of specialists and on the need for auditor specialists to check what management specialists have done. Very little directly addresses the problem of auditors failing to challenge the substance of the assumptions or methods used by specialists.

The PCAOB should acknowledge the scale of the task facing auditors, the costs involved and operational issues that cannot be dealt with by auditing standards alone.

8. US guidance currently permits auditors to avoid responsibility for assumptions and methods used by some specialists, which is no longer acceptable, and is not in accordance with ISAs. However, any paper purporting to improve audit quality by introducing new requirements for auditors to take more responsibility for the valuations specialists produce, needs to reflect and address a number of operational issues that are not standards-related.
9. Operational challenges regarding the use of the work of specialists that cannot be fixed by amending auditing standards include:
 - a shortage of certain specialists leading to independence and objectivity issues; and
 - the fact that specialists, regardless of whether they work for companies or auditors, and regardless of whether they are employed or engaged, do not speak the same language as auditors.
10. Specialists who do not understand what they are being asked for, or why, and who are reluctant to communicate with auditors in terms other than their own, are a widespread problem. This issue warrants more recognition than the Paper gives it.
11. The PCAOB should not underestimate the scale of the task or the costs involved. Additional requirements will lead to increased costs. Provided the benefits in terms of improved audit quality are commensurate, that is acceptable, but we fear that they may not be.

Treating information produced by management specialists as if it is produced by the company and requiring auditors to employ other specialists to review it, is likely to have perverse consequences.

12. The proposals to require auditors to treat information prepared by company specialists as if it is prepared by the company will increase costs, and discourage companies from using specialists.
13. Companies, particularly smaller companies, may cease engaging or employing their own specialists, and instead challenge auditors to prove management calculations wrong, or effectively rely on the numbers the auditor's specialist produces. The idea that legal counsel can be provided to a company and that auditors would then need to get another opinion on a routine basis is absurd. It defeats the point of management employing or engaging a specialist and would have the perverse effect of discouraging the use of specialists by companies, and encouraging directors to perform their own valuations and leave it to the auditors to employ a proper valuation expert to make sure that it is right. This has auditors dangerously close to taking responsibility for the valuation. If the PCAOB does go down this route (and we do not believe that it should) the alternative suggested – requiring auditors to employ another specialist only where information is produced by a company's *employed* specialist – would be preferable to a blanket requirement applying to *all* specialists employed or engaged by the company.

The PCAOB should future-proof auditing standards and make sure that they work now in jurisdictions in which IT and tax specialists are not part of the audit team.

14. There are inconsistencies in the definitions of specialists. Firms have differing practices. IAASB standards scope out accounting and auditing experts, but tax practitioners dealing with complex or unusual issues are scoped in. The proposed PCAOB definition is the same on the face of it but IT and income tax specialists are scoped out.
15. The situation is changing. In future, it is likely that many more specialists will be integrated within audit teams. This is a good example of a situation in which a principles-based approach is much more likely to have the desired effect on auditor behaviour than any attempt at defining who is caught and who is not in any given situation. The PCAOB's standards are applied world-wide and there will be many jurisdictions in which it would be wholly inappropriate to scope out IT and tax specialists because the profession and firms are structured very differently to the way they are in the USA.
16. The important point is that auditors should be more careful than they are now in supervising *all* individuals involved in the audit who are not trained auditors, or do not regularly provide audit support, and may not have a good understanding of audit methodologies. This would not change the position with respect to many income tax and IT specialists, but it would serve to scope out other specialists, such as valuation specialists who are now regularly involved in purchase price allocations, and others who in the future become more integrated with the main audit practice. More importantly, it would not inappropriately scope out tax and IT specialists in situations in which they really do need close supervision.
17. If the standard must scope out tax specialists, the focus should be not on the nature of the tax (income tax) but on its unusual or complex nature, as in the ISAs.

Distinguishing between specialists employed and engaged by firms and companies respectively is unnecessary.

18. Distinguishing between those specialists employed and engaged by firms and companies respectively over-complicates the issue. Distinguishing between independence and objectivity at this high level is and always has been difficult. No-one being paid to do a job can ever be absolutely independent, regardless of whether they are employed or engaged and there are in practice degrees of objectivity and independence that are not recognised in auditing or ethical standards. The most important distinction is between those employed and engaged by the auditor, and those employed or engaged by the company. The softer distinction between employment and engagement *can* be recognised and dealt with as part of the risk assessment on individual audits, and by scaling the response accordingly. Other risks that should be acknowledged include the risks involved where management influences the methods and assumptions used.

The PCAOB should acknowledge that the education of auditors and enforcement are relevant.

19. We agree that extant PCAOB standards do not adequately address a number of issues but we do think that the education of auditors and enforcement are important. If enforcement of existing standards is not resulting in compliance with those standards, in which the requirements are significantly less onerous than those proposed, absent any attempt to address the reasons for non-compliance in terms of education and enforcement, it seems likely that enforcement of new standards will be even more of an issue. Are auditors any more likely to comply with new standards if they cannot be persuaded to apply the existing ones properly?

Scoping auditor work on assumptions and methods is critical.

20. Standards need to better address the nature and extent of auditor work on methods and assumptions used by specialists, and auditors should be encouraged to challenge specialists when considering the reasonableness of assumptions and methods used. But we caution

against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.

21. We should all be mindful of instances in which professional bodies, standard-setters and regulators have been rightly admonished for failing to address egregious weaknesses in assumptions and methods in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date. However, *individual auditors* cannot reasonably be expected to critique established professional practice outside their own professional expertise. They do not have the locus or the skills to question or choose between established methods or standardised assumptions, not least because those methods and assumptions are intended for use by specialists. Even when there are alternative methods from which choices can be made, auditors are unlikely to be in a position to make an effective judgement about whether an appropriate choice has been made.
22. However, *a distinction might be made between auditor work on variable assumptions, and auditor work on methods and standardised assumptions*. Methods are generally fixed and some assumptions are standardised, used by convention or mandated by professional bodies or regulation. Auditors are less likely to be able to critique these effectively than they are the more variable assumptions that are not standardised.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?

Q2: Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?

23. The information presented in Section III broadly characterises current practice but it glosses over some important higher-level issues that standards may not be able to address fully. These issues should be recognised and taken into account as new standards and guidance are developed.
24. Common day-to-day logistical difficulties in communicating with specialists arise from the fact that specialists are often unfamiliar with the specialised language used by auditors and vice versa. Auditors have difficulties explaining to specialists the requirements of auditing standards regarding the design and implementation of controls and control deficiencies, for example. More emphasis on the need for auditors to properly communicate the nature and extent of adequate audit documentation in these areas to specialists would be helpful, but auditing standards are not the right place for detailed guidance. The PCAOB might consider encouraging or facilitating liaison between professional bodies representing auditors and the larger bodies representing valuations and pensions experts, for example.
25. More is needed on high-level, up-front communications between auditors and specialists, as well as on the specifics of what is to be communicated, and output. The proposals provide considerable detail on the content of agreements between auditors and specialists, but more emphasis is needed on a high-level review of who does what to ensure that nothing falls between the cracks.
26. On balance, we believe that the four 'buckets' on page 8, distinguishing between those employed and engaged by firms and companies respectively, over-complicates the issue. Distinguishing between independence and objectivity at this high level is and always has been difficult. No-one being paid to do a job can ever be absolutely independent, regardless of

whether they are employed or engaged and there are in practice degrees of objectivity and independence that are not really dealt with in auditing or ethical standards. Treating them as if they are hard distinctions is not helpful.

Q3: For accounting firms that use the work of an auditor's specialist:

- a. Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit.
- b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?
- c. What type of work do the specialists perform? Does the type of work vary depending on whether the firm employs or engages the specialist? Does the type of work vary depending on the specialist's field of expertise?
- d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate? Why?

Q4: For accounting firms that use the work of an auditor's employed specialist:

- a. Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?
- b. How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?
- c. Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?
- d. How would the evaluation change if the firm engaged the specialist?
- e. What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist? How does that assistance affect the auditor's supervision of the work of the employed specialist?

Q5: For accounting firms that use the work of an auditor's engaged specialist:

- a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?
 - b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?
 - c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?
 - d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?
27. The employment or engagement of a specialist is determined by demand for expertise both generally and within the firm, and its availability in the market-place. Larger firms seek to employ specialists whose skills are required on an on-going basis.

28. Auditor specialists are more likely to test the company's process than to develop an independent estimate.
29. There are situations in which firms do not have access to all the methods and models of engaged specialists and when access to proprietary methods or models is restricted by the specialist or the specialist's employer. We do not think this difficult situation can be resolved by imposing ever more demanding requirements in auditing standards. When the amounts involved are not material, there is often little that can be done. Please see our answer to question 8 for further observations on this issue.

Q6: For accounting firms that use the work of a company's specialist:

- a. What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.
- b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?
- c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?
- d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?
- e. Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?
30. It is rare for a firm not to at least attempt to use the work of a company's specialist and it would be perverse to do otherwise. We are not aware that firms conclude that the findings of a company's specialist are unreasonable and perform additional procedures on a regular basis.

Q7: This section provides the staff's views about the need to improve the standards based on issues related to the standards, inspections observations, and the views of the SAG. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?

31. On balance, we believe that some refinement of existing standards is needed. However, it is important to recognise, as the Paper does, that changes to standards will not necessarily change auditor behaviour. We are puzzled by the apparent assertion in the last sentence of the first paragraph on page 24, to the effect that auditing standards need to be made more robust because auditors are not complying with existing standards. If that is the case, as inspection findings show and as seems likely, it is surely *education and enforcement* that need to be addressed. How are new standards likely be more effective if auditors are not applying the existing standards properly?
32. The alternatives to standard-setting discussed on page 26, such as the development of additional guidance or the devotion of additional resources to inspection and enforcement, have been too easily dismissed by Staff. Education and enforcement are equally, if not more, likely than standard-setting to change auditor behaviour.
33. We do not agree that more specificity about how to supervise auditors' specialists will necessarily benefit auditors or, more importantly, investors. We re-emphasise our long-held belief that principles-based standards are, in the long run, better tools for both auditors and regulators. They are surely harder to develop than rules-based standards but rules-based standards do not permit regulators to challenge auditors effectively and they encourage both

auditors and regulators to hide behind the rules. Principles-based standards only work where regulators have the confidence to apply them and principles-based regulation requires regulators to use their judgement. The PCAOB and its Staff need to consider these issues and to think again about the sustainability and value of a rule book that grows ever longer.

Q8: When an auditor obtains an understanding of the methods used by the company's specialist:

a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?

b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

34. There is a general problem with the auditability of proprietary methods and models and data, the detail of which is not publicly available. An unpalatable fact not yet widely acknowledged is that this type of situation is becoming more common. Auditors often struggle to obtain sufficient, appropriate audit evidence, but because the amounts involved are not material, there is often little that can be done. The issue is not one that can be resolved simply by ever more demanding auditing standards.

35. It is unrealistic to believe that requiring auditors to obtain more information in these circumstances will be effective. No amount of pressure from auditors or others in the financial reporting supply chain will persuade the owners of these proprietary methods, models and data to release the necessary information in the absence of an obligation to do so. Requiring auditors to avail themselves of the specialist expertise needed to develop independent models when that expertise is effectively unobtainable is likely to be similarly ineffective.

36. The issue is partly one of accounting standards which require the fair valuation of many assets, particularly opaque financial instruments and intangible assets in business combinations. The issue is also partly one for those who regulate the markets in which opaque financial instruments are traded, and we encourage the PCAOB, as we have other regulators, to liaise more closely with these stakeholders to address this issue.

Q9: Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

37. Please see our answer to question 7.

Q10: Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

Q11: Are there other considerations related to the alternatives presented that the staff should be aware of?

Q12: Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.

Q13: Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

38. Distinguishing between those employed and engaged by auditors and companies respectively over-complicates the issue. The distinction between independence and objectivity is not absolute because no-one being paid can ever be wholly independent, regardless of the contractual arrangements. In practice there are degrees of objectivity and independence.

39. The most important distinction is between those employed and engaged by auditors, and those employed or engaged by companies.
40. The softer distinction between employment and engagement can be recognised and dealt with as part of the risk assessment and by scaling the response accordingly. Other risks that should be acknowledged include the risks involved where management influences the methods and assumptions used.
41. A better question would be, 'should auditors be required to assess and evaluate the work of auditors' engaged and employed specialists in the same way, applying the same criteria?' The answer would be 'yes'. The procedures are less important than the evaluation of the independence, objectivity, knowledge and skills of the auditor's specialist, the quality control, ethical and technical standards to which they are subject and which they are required apply, and the quality of the work that that they have performed.
42. Generally speaking, someone employed by a firm is less of a risk because they are subject to the firm's quality control requirements and can be more closely supervised than someone engaged by a firm. This will not always be the case though, where an employed individual has a senior role within the firm, for example, or where an engaged individual performs a great deal of work for the firm and works to detailed firm requirements. This is a judgement and plenty of guidance can be provided in auditing standards to support that judgement, but trying to take the judgement out of it altogether may well lead to dysfunctional behaviour, inefficient auditing and poorer quality audit evidence.
43. The development of a separate standard for using the work of auditor specialists would keep PCOAB requirements in line with the ISAs.

Q14: Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

44. It is appropriate for auditors to consider the knowledge, skill and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist. However, attempts to change company behaviour by changing auditing standards and putting pressure on auditors to put pressure on management are fraught with difficulties.
45. It is important to avoid situations in which information produced by company specialists is treated as if it is produced by the company, and requiring auditors to employ other specialists to review it. This is likely to have perverse consequences, including at the same time discouraging the use of specialists by companies, and encouraging reliance on specialists employed or engaged by auditors, with the attendant threats to independence and objectivity. It cannot be right that companies effectively leave valuations to auditors' specialists. If the intention is to persuade companies to use external specialists, it would be a great deal better to mandate external valuations under accounting regulations. We therefore believe that amending the AU sec. 336 requirements by removing the limitations on auditor responsibilities regarding the evaluation of company specialists is preferable to rescinding AU sec. 336.
46. If the PCAOB does go down this route (and we do not believe that it should) the alternative suggested – requiring auditors to employ another specialist only where information is produced by an company's *employed* specialist – would be preferable to a blanket requirement covering all specialists employed or engaged by the company.

Q15: How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

47. We agree that extant PCAOB standards do not adequately address the nature and extent of auditor work on methods and assumptions used by company specialists, and that auditors should be encouraged to challenge specialists and apply professional scepticism when considering the reasonableness of assumptions and methods used.
48. Auditors must not be afraid of complex valuation models. If they do not understand them, they must ensure that they have an appropriately qualified specialist available, preferably an audit-literate one, with whom they are willing and able to communicate. Most importantly, auditors must be prepared to ask simple and direct questions, to demand answers that they understand, and to ask for changes to be made when the answers do not seem right.
49. However, we caution against creating expectations, explicit or implicit, that individual auditors are in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.
50. We should all be mindful of instances in which professional bodies, standard-setters and regulators have been rightly admonished for failing to address egregious weaknesses in methods and assumptions in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date. However, *individual auditors* cannot reasonably be expected to critique established professional practice outside their own professional expertise. They do not have the locus or the skills to question or choose between established methods or standardised assumptions, not least because those methods and assumptions are intended for use by specialists. Even when there are alternative methods from which choices can be made, auditors are rarely in a position to make an effective judgement about whether an appropriate choice has been made.
51. However, *a distinction might be made between auditor work on variable assumptions, and auditor work on methods and standardised assumptions*. Methods are generally fixed and some assumptions are standardised, used by convention or mandated by professional bodies or regulation. Auditors are less likely to be able to critique these effectively than they are the more variable assumptions that are not standardised.
52. The approach to obtaining an understanding of assumptions and methods should be determined less by whose assumptions and methods are being considered, and more by reference to the specific risks associated with the specialist concerned, their competence and experience. Once again, the focus on the categorisation of the specialist misses the point somewhat.

Q16: Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

Q17: Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?

Q18: Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

53. Please see our answer to question 14 regarding treating information produced by company specialists as if it is produced by the company, and our answer to question 13 regarding the

distinction between those employed and engaged by auditors, and those employed or engaged by companies.

Q19: Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

Q20: Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

Q21: Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

54. There are inconsistencies between the definitions of specialists in practice and auditing standards. IAASB standards scope out accounting and auditing experts, but tax practitioners dealing with complex or unusual issues are scoped in. The proposed PCAOB definition is the same on the face of it but IT and income tax specialists are scoped out. Recognising these inconsistencies is important but more important is the recognition that many firms are still not doing enough on the relevant financial statements assertion *regardless* of whether the individuals concerned are categorised as specialists. Focussing on the identity and qualifications of the specialist rather than on the audit evidence required may not be the most efficient approach.
55. The PCAOB's standards are applied world-wide and there will be many jurisdictions in which it would be wholly inappropriate to scope out IT and tax specialists. Auditors should be more careful than they are now in supervising *all* individuals involved in the audit who are not trained auditors or do not regularly provide audit support, and may not have a good understanding of audit methodologies. This will not change the position with respect to many income tax and IT specialists. However, it would serve to scope out other specialists, such as valuation specialists who are now regularly involved in purchase price allocations, and others who in the future become more integrated with the main audit practice. More importantly, it would not inappropriately scope out tax and IT specialists in situations in which they really do need close supervision.
56. We urge the PCAOB to consider the merits of the IAASB approach. If the standard must scope out tax specialists, the focus should be not on the nature of the tax (income tax) but on its unusual or complex nature, as in the ISAs. We do not think that either approach requires much clarification. We do not believe that IT specialists should be scoped out of the proposals because firms continue to struggle to recruit an appropriate level of resource into audit practices and to assume that such individuals are all sufficiently audit-literate for these purposes is a step too far at this stage.

Q22: Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

57. We find nothing objectionable in the box on page 36 although it does not address all of the issues identified on page 23.

Q23: Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other

matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

Q24: Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?

58. Reaching an agreement and documenting the list of issues in the box on page 37 may not be appropriate when dealing with the auditors' employed specialists as it may effectively amount to one person in a firm asking another (the employed specialist) about the firm's own methodology. Restricting the list of matters to be covered to the higher-level list in paragraph 11 of ISA 620 might avoid an unnecessary and pointless compliance exercise in such cases. Requiring the documentation of the relevant communications might be less burdensome than requiring a written agreement in all cases.

Q25: Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?

Q26: How do accounting firms determine what information an auditor's specialist should provide to the auditor? Are there circumstances in which auditors may not retain all audit evidence obtained from the specialist?

59. The information to be provided by specialists to auditors is determined in all cases by the need to provide audit evidence to support the audit opinion.

60. We are not aware of situations in which auditor engaged specialists with access to proprietary models permitting auditors to review the models or data sets but without making any sort of record or taking notes, as sometimes happens in group audit situations.

Q27: Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Q28: Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Q29: Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Q30: Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?

Q31: Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

61. Please see our answer to question 15. .

Q32: How does the auditor evaluate relationships between an auditor's engaged specialist and a company under AU sec. 336?

Q33: Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?

Q34: Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

62. Specialist firms are unlikely to have the systems in place, nor be willing to invest in them, in order to be able to confirm their compliance under Reg. S-X Rule 2-01.

Q35: Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor's specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist's firm?

Q36: Are the potential requirements for the auditor to evaluate the objectivity of an auditor's specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist's objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account "threats" to objectivity and 'safeguards' to reduce the threats, as provided in ISA 620?

Q37: Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor's engaged specialist will not be influenced by business, employment, or financial relationships?

Q38: Is the potential requirement that the auditor obtain information about the process used by the auditor's engaged specialist to formulate the responses to the auditor's request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?

Q39: Does the specialist (or his or her employer) typically have a system in place capable of tracking the information to respond to the auditor's request? If not, could a system feasibly be created?

Q40: For accounting firms that use the work of an auditor's or a company's specialist for public company audits:

a. In how many (e.g., what percentage) of those audits is the work of specialists used? Provide details within the following categories:

- (i) Auditor's employed specialists;**
- (ii) Auditor's engaged specialists;**
- (iii) Company's employed specialists; and**
- (iv) Company's engaged specialists.**

b. For the auditor's specialists described in a.(i) and a.(ii), what is the ratio of specialist hours to total audit hours?

c. How are the auditor's engaged specialists compensated?

Q41: What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?

Q42: To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies, and fraud?

Q43: Would any of the potential alternatives lead to increased cost? If so, what are the estimated (i) number of audits affected and impact on audit hours and cost and (ii) effects on companies' costs?

Q44: Do the incremental costs associated with any of the potential alternatives decline as an accounting firm uses specialists more frequently?

Q45: Are the costs of the potential alternatives likely to be reduced in years after the year of initial implementation?

Q46: Are the economic impacts of the potential alternatives likely to be different for audits involving (i) emerging growth companies, (ii) brokers and dealers, (iii) companies in specialized industries, (iv) companies in certain stages of their life cycles (e.g., development stage), and (v) the use of the work of specialists in specific fields of expertise? If so, provide relevant details.

Q47: Are the economic impacts of the potential alternatives likely to affect accounting firms of different sizes differently? If so, provide relevant details. Are there other alternatives that might address the need for improvement noted in this staff consultation paper at lower cost or greater efficiency?

Q48: As part of considering the need for change, the staff is analyzing academic literature that relates to the auditor's use of the work of a specialist.¹⁰⁴ Is there ongoing research or other information, other than that identified in this staff consultation paper, that the staff should consider in evaluating the economic aspects of changes in standards for the auditor's use of the work of a specialist?

63. The PCAOB should not underestimate the costs involved in the alternatives suggested by Staff. Additional requirements will surely lead to increased costs. Provided that the benefits in terms of improved audit quality are commensurate, that is acceptable. However, we fear that the proposals to require auditors to treat information prepared by company specialists as if it is prepared by the company may increase costs disproportionately, particularly for smaller companies.



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July 31, 2015

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Dear Sir or Madam:

This letter documents the comments of Towers Watson on the Staff Consultation Paper No 2015-01 ("SCP"), The Auditor's Use of the Work of Specialists, as requested in the release of May 28, 2015.

Towers Watson is a global human capital and financial management consulting firm specializing in employee benefits, human capital strategies, and technology solutions. Towers Watson employs approximately 16,000 associates on a worldwide basis, over 1,100 of whom are members of U.S. actuarial bodies. The undersigned have prepared our company's response with input from others in the company.

We appreciate the opportunity to comment. Note that our comments relate solely to the situation where the specialist involved is a credentialed actuary who is operating as a "specialist engaged by the company" as described in the SCP.

Summary

We respect the role of the auditor and understand the need for guidance on the auditor's use of the work of a specialist. However, we do not believe that the auditor should need to replicate the work of a credentialed actuary to confirm that the result is reasonable and not materially misstated. The examination and continued education requirements of the U.S. based actuarial organizations¹, the actuarial standards of practice and Code of Conduct set forth by the U.S. actuarial profession and the professional excellence standards of actuarial firms should provide sufficient evidence to the auditor to confirm the qualifications and objectivity of the actuary, to understand the nature of the work, the assumptions and methods used in the work, and to evaluate the findings of the work.

Current Practice

With respect to the audit of company or benefit plan financial statements, Towers Watson is typically a specialist engaged by the company (i.e., Specialist #3 in Figure 2 of the SCP), most often in the areas of valuations of pension, postretirement and postemployment plans.

Under current practice, the work of our actuaries is typically reviewed by the "specialist employed by the auditor" (i.e., Specialist #1 in Figure 2), generally through responses to audit questionnaires and data

¹ The American Academy of Actuaries (Academy), the American Society of Pension Professionals and Actuaries, the Casualty Actuarial Society, the Conference of Consulting Actuaries, and the Society of Actuaries.

questions, but also through open dialogue with the auditor or the auditor's specialist. In recent years, we have seen auditors' reviews become significantly more detailed, including more granular review and testing of data and actuarial assumptions to evaluate the reasonableness of the measures produced by the actuary.

Auditor Requirements under AU 336

As described in the SCP, under the current standard (AU 336), when using the work of a company's engaged specialist, the auditor is required to

- Evaluate the professional qualifications of the specialist
- Understand the nature of the specialist's work
- Evaluate the relationship of the specialist to the client, including circumstances that might impair the objectivity of the specialist
- Understand the methods and assumptions used
- Test the data provided
- Evaluate whether the specialist's findings support the financial statement assertions

As described below, we believe the existing qualification and continuing education requirements, and standards of practice of the actuarial profession, should provide the auditor the information and evidence needed to evaluate the work the actuary does for the company. In addition, the quality procedures of the actuary and his or her employer should be taken into consideration in determining the appropriate level of testing needed to support the auditor's evaluation.

Professional Standards

The U.S. based actuarial organizations provide a robust framework for the ongoing qualification of their members. This begins with a rigorous multi-year examination process and supervised experience period leading to professional designations, and continues with ongoing continuing professional education requirements necessary to sign actuarial communications. Both the actuarial organizations and many actuarial firms, including ours, provide significant opportunities to meet these continuing education requirements with sessions that are relevant to the work actuaries do every day.

Adherence to these qualification standards is monitored by the profession, and information about an actuary's attestation to meeting these requirements is publicly available. The profession also audits a percentage of the attestations each year to confirm compliance with the continuing professional education requirements. The standards of the actuarial profession, as well as the standards of actuarial firms like ours, require that an actuary only perform work that he or she is qualified by education and experience to perform.

Objectivity

While our firm is engaged by the company, the expectation and intent of both the company and our firm is that the actuary be an objective specialist, leveraging our knowledge and expertise to provide the services the company needs. In addition, our professional standards and firm standards, as well as reputational risk, ensure our objectivity. The risk of losing credentials by not meeting the actuarial profession's standards, or damaging our reputation in the marketplace by having our work not stand up to scrutiny, is more significant than the relationship risk we may face if an individual client does not agree with our work. In addition, our firm's standards significantly limit individual financial investments in our clients.

Our firm's professional excellence standards also ensure our objectivity. Our internal processes require that all work be reviewed by at least two qualified individuals and, in many instances, additional reviews are performed, including review by an experienced actuary with deep expertise in that area but who was not involved in the preparation of the work. We expect other actuarial firms have similar internal standards and protocols in place and would expect the auditor to evaluate those as noted above.



Nature of the Work

The actuarial standards of practice regarding communications require disclosure of the purpose of the work we have performed as well as any reliances and limitations the user of the work should be aware of. This information is integral to the deliverable provided to the client as well as the information provided to the auditor.

Understanding Assumptions and Methods

Actuarial standards of practice require us to disclose the assumptions and methods used in our work, their sources, and the rationale for any significant assumptions selected by the company, which may or may not be recommended by the actuary based on analysis of data and his or her expertise. In addition, the actuary must make an explicit disclosure if he or she believes that an assumption selected by the company significantly conflicts with what the actuary believes would be reasonable with respect to that individual assumption.

In addition, the actuarial standards of practice regarding communications, which have recently been revised, require significant additional disclosures, including any biases in techniques used, reliance on other parties, and material deviations from the actuarial standards of practice. In addition to the work product, additional information is typically provided as part of the auditor questionnaire. There may also be discussions regarding the assumptions and methods amongst the auditor, the auditor's specialist, the company, and the company's specialist to facilitate the auditor's understanding of the assumptions and methods.

Expanding the Requirements

We believe that the proposals in the SCP would result in significant additional cost with no perceptible improvement in the audit evaluation of the work performed by an actuary engaged by the company. The proposed changes seem to require duplication of the work of actuaries and/or significant evaluation of the work of actuaries by non-actuaries. They also would entail audit time spent reviewing complex proprietary valuation systems that require years of development and internal testing by the actuarial firm, and which are generally well beyond the technical expertise of an auditor. Further, some specialists may be unwilling to provide requested detail on proprietary models for business reasons. This could slow down the audit process and deprive companies of specialist services they need – all for no clear benefit.

Our observations regarding the Alternatives for Revising Standards – Company's Specialist are as follows:

We agree that the assumptions used in measuring amounts reported in the company's financial statements are selected by and are the responsibility of the company, not the specialist. As such, we agree with revising AU sec. 336 to eliminate the statement that "the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist". We would also observe that actuarial standards of practice require disclosure if the assumptions selected by the client significantly conflict with what the actuary considers to be reasonable for the purpose of the measurement.

We also agree that auditors should evaluate the reasonableness of significant assumptions and appropriateness of methods used by a company's specialist in the same manner as the auditor evaluates information produced by others in the company, and would note that with respect to actuarial valuations, that is already current practice.

However, we are concerned with the proposal to eliminate the provisions that enable the auditor to use the work of the company-engaged specialist if the findings are reasonable. Requiring auditors (or, more likely their employed specialists) to redo and confirm an actuarial valuation performed by an independent actuary (the specialist) is costly and unnecessary given the "reasonableness" checks currently performed by auditors or their specialist actuaries, the rigorous education and qualification standards to become an actuary, and the actuarial standards of practice to which members of U.S. based actuarial organizations



Office of the Secretary of the PCAOB
July 31, 2015

are subject. We also believe the auditor's understanding of the internal quality procedures followed by the actuary should be considered in determining the amount of testing that is appropriate.

We are also concerned about the inference in Question 8 that in order to obtain an understanding of the methods used by the company's specialist, the auditor should have access to the specialist's methods or models at a sufficiently detailed level. While we do not disagree the auditor should have a general understanding of the valuation system, the comment fails to recognize the complexity of actuarial valuation systems, the level of sophistication of the systems development, and the extensive testing performed by technical experts when the system is developed or modified. Importantly, in our firm and presumably other actuarial firms, those developing, testing and using the actuarial valuation system have a detailed understanding of both how the models should operate (i.e., the actuarial science and accounting requirements) and how they are structured. It is unrealistic and an unnecessary duplication of effort for others (whether auditors or their employed or engaged actuaries) to have sufficiently detailed access to those models to "check the work", given the level of both general actuarial and model-specific knowledge needed to do so. In addition, the proprietary nature of models may cause specialists to refuse to provide needed services rather than share what they view to be valuable intellectual property.

We believe that instead the auditor should consider the knowledge, skill, and objectivity of a company's specialist, as well as the quality procedures of the actuary and his or her employer, when evaluating the reliability of information provided by that specialist. In fields for which there are accrediting bodies, standards of practice and continuing education requirements, we believe an auditor should be able to rely on the confirmed competence and objectivity of the specialist, with reasonableness reviews of assumptions, methods and results, but without detailed confirmation or replication of the underlying calculations.

Thank you for this opportunity to comment on the SCP. If you have any questions concerning our comments, please contact us directly.

Sincerely,

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Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Staff Consultation Paper No. 2015-01 on *The Auditor's Use of the Work of Specialists* (May 28, 2015)

Dear Ms. Brown:

The U.S. Chamber of Commerce (the “Chamber”) is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation.

The CCMC supports efforts to improve audit effectiveness and appreciates the opportunity to comment on the Public Company Accounting Oversight Board (“PCAOB”) Staff Consultation Paper on *The Auditor's Use of the Work of Specialists* (“Consultation Paper”). The CCMC applauds the PCAOB for using staff consultation papers to educate and inform the Board and staff before proceeding with a standard-setting initiative. Given the potential implications for both auditors and companies, this is especially important before deciding whether to propose that any current PCAOB auditing standard(s) should be rescinded, replaced, or otherwise modified on the auditor’s use of the work of specialists.

Ms. Phoebe W. Brown
July 31, 2015
Page 2

The Consultation Paper was discussed at the PCAOB's Standing Advisory Group ("SAG") meeting on June 18, 2015. The SAG discussion revealed that the PCAOB has much work to do in order to understand current practice. The CCMC strongly encourages the PCAOB to complete this work before reaching any decision on whether or how to proceed. As it stands the Consultation Paper gives the impression that academic research (based on a limited number of studies), rather than practice, has had more influence on the PCAOB's thinking to date in regards to the issues.

In addition, the CCMC has comments on the use of judgment, economic analysis, field-testing, and pre-implementation reviews, and using inspections to inform audit standard-setting in regards to the Consultation Paper. The CCMC also believes that a better understanding of current rules and an improved application should be considered as an option as well.

Use of Judgment

The CCMC has encouraged the PCAOB to appreciate the importance of auditor judgment and put in place policies to promote judgment.¹ The CCMC supports a principles-based approach to auditing standards that empowers auditor judgment. Such an approach is preferable to prescriptive auditing standards that can result in a "check-list" approach to and "one-size fits all" auditing.

In regards to the Consultation Paper, SAG members likewise encouraged the PCAOB to avoid making any revisions in auditing standards in the area of using the work of specialists with a "one-size-fits-all" mindset. Similarly, the CCMC is particularly concerned with statements in the Consultation Paper indicating the PCAOB sees that current auditing standards need to be more rigorous. For example, the Consultation Paper states:

¹ As an example, *see* the October 9, 2013 letter from the CCMC to SEC Chair Mary Jo White on modernizing financial reporting policies. The letter is attached hereto and we request that it be made a part of the record for the Consultation Paper comment file.

Ms. Phoebe W. Brown
July 31, 2015
Page 3

*Although the staff considers Auditing Standard No. 10 to be a more rigorous standard for the oversight of the work of an auditor's specialist than AU sec. 336, it is exploring whether **additional specificity** is needed to the principles-based requirements in Auditing Standard No. 10 (p. 21).*

and

*In the staff's view, the specified procedures of AU sec. 336 may **not be rigorous enough** to address the risks of material misstatement associated with many accounting estimates, given the increased importance of specialists as discussed earlier (p. 22).*

In discussing various alternatives, the Consultation Paper often uses the term “scalable”—for example, that any ensuing guidance under the described alternative, albeit more rigorous, would be scalable. However, it is not clear how the PCAOB intends that more rigorous and prescriptive guidance would likewise be scalable—as the concepts appear incompatible and certainly are not reconciled in the Consultation Paper.

Economic Analysis

Indeed, scalability should be an issue to be deliberated if the consideration of these issues moves from the consultation to the standard setting stage. An important consideration during the standard setting process is that the benefits outweigh the cost. Similarly, the costs and burdens must be scalable so that the standard is not regressive in nature and can provide a benefit for users of the audit for smaller businesses. The Chamber believes that the PCAOB has moved forward with economic analysis in a beneficial manner to improve the standard setting process. We would hope the PCAOB continues this as it considers these issues further and request that an economic analysis be published and subject to comment if a standard is proposed for comment.

Field Testing and Pre-Implementation Reviews

The CCMC has strongly encouraged the PCAOB to engage in field testing and similar-type measures *before* implementing any changes in auditing standards. Doing so is especially important in this area. The consequences of any proposed changes

Ms. Phoebe W. Brown
July 31, 2015
Page 4

need to be thoroughly considered prior to finalizing any revisions in extant auditing standards related to the auditor’s use of the work of specialists—as there are many moving parts here.

The CCMC is particularly concerned about the consequences for companies of any changes in PCAOB auditing standards in this area. For example, SAG members cautioned the PCAOB not to rescind the current auditing standard on “Using the Work of a Specialist” (AU 336), in part, because doing so would require companies to do more work.

Using Inspections to Inform Audit Standard-Setting

The Consultation Paper does contain a section on observations from the Board’s oversight activities including inspections. However, the observations are only described at a general level and in terms of “instances” rather than systematic evidence. The CCMC has some concerns about these observations, including the following:

- A few audit engagements where auditing standards were not adhered to related to the use of the work of specialists do not support the need for any wholesale changes in auditing standards. More systematic evidence is necessary.
- In this regard, the Consultation Paper contains no quantitative or qualitative analysis of inspection findings on the use of the work of specialists. This analysis should include a mapping from inspection findings to how standards could be revised to facilitate audit practice and improve audit effectiveness.
 - As just one example, the PCAOB observations in Consultation Paper do not specifically indicate any concerns about the objectivity or independence of specialists. Yet, the Consultation Paper has an extensive discussion on whether the PCAOB should amend the requirements for evaluating the objectivity of an auditor’s specialist.

Ms. Phoebe W. Brown
July 31, 2015
Page 5

- The PCAOB has been encouraged to consider “best practices” during its inspection process. Doing so would seem especially helpful in this area as various SAG members during the June meeting suggested that audit practice has moved beyond current standards.

Conclusion

Once again, the CCMC appreciates the opportunity to comment on the Consultation Paper.

We believe that the PCAOB has taken the appropriate steps to issue this Consultation Paper, but believe that a factual, evidentiary based decision process is needed to weigh a potential movement toward standard setting. As we have discussed in this letter, various tools, such as field testing, pre-implementation reviews and economic analysis, should be used to gather the information for a well-informed decision making process. The CCMC also believes that one of the factors that should be weighed is if the enforcement of existing rules is a preferable option in lieu of writing a new standard.

Thank you for your consideration and the CCMC stands ready to assist in these efforts.

Sincerely,

A handwritten signature in black ink, appearing to read 'TK' followed by a long horizontal flourish.

Tom Quadman



CENTER FOR CAPITAL MARKETS
C O M P E T I T I V E N E S S

TOM QUAADMAN
VICE PRESIDENT

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October 9, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chair White:

The U.S. Chamber of Commerce (the “Chamber”) is the world’s largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness (“CCMC”) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. To achieve these goals, the CCMC has supported the development of robust financial reporting systems and strong internal controls to promote efficient capital markets and capital formation.

We have read with interest recent reports that the Securities and Exchange Commission (“SEC”) will step up its enforcement efforts, particularly focusing on potential accounting fraud and financial disclosure irregularities. The CCMC applauds the efforts of SEC to drive bad actors from the market place and create a level playing field for participants who operate in good faith and abide by the law. As SEC uses accounting fraud and financial reporting irregularities as a means to achieve this goal, we also believe that it is incumbent for SEC to modernize financial reporting policies to facilitate the release of relevant disclosures, reduce complexity, and achieve more efficient capital formation and competition. Accordingly, we would also respectfully request an update on the status of SEC’s implementation of the recommendations of the Advisory Committee on Improvements to Financial Reporting (“CIFiR”).

Modernization of financial reporting policies is well overdue.

In the wake of the Enron and WorldCom scandals and the subsequent passage of the Sarbanes-Oxley Act (“SOX”), financial reporting has undergone significant changes and transitions. Policy makers realized that financial reporting must keep pace with those changes. Consequently, then SEC Chairman Chris Cox formed CIFiR, which released its report and recommendations to improve financial reporting in August 2008. Unfortunately, the demands of the financial crisis diverted the time and attention of the agency from its ongoing agenda of

The Honorable Mary Jo White
October 9, 2013
Page 2

modernizing financial reporting. We believe that the implementation of these recommendations remains an urgent item on SEC's agenda.

Adding to the urgency of these recommendations is the pace of change in financial reporting that has taken place since the financial crisis. Among the many new legislative, regulatory, and standard-setting requirements that have influenced financial reporting in the last few years is the Jumpstart Our Business Startups Act ("JOBS Act"). This law exempts emerging growth companies ("EGCs") from new rules of the Public Company Accounting Oversight Board ("PCAOB"), unless SEC determines that those rules are necessary and in the public interest¹, and allows EGCs to comply with any new or revised Financial Accounting Standards Board ("FASB") standards in the same timeframe as companies that are not issuers. Similarly, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has profoundly impacted and exacerbated many of the issues identified in the CIFIr report.

For these reasons, it is important for SEC to adopt a comprehensive approach to modernizing financial reporting policies that includes, in addition to stepped-up enforcement, increased communication and cooperation among regulators, standard setters and stakeholders. This will reinforce SEC's efforts to drive bad actors out of the marketplace, by eliminating the complexity and ambiguity on which they thrive. In fact, the CIFIr report found that financial reporting complexity is a key driver in the disconnection between current financial reporting and the information necessary to make sound investment decisions. Since keeping a clear focus on SEC's mission to ensure that investors receive relevant decision-useful information and to promote capital formation will maximize the agency's chances of success in stamping out accounting fraud and financial disclosure irregularities, we view this as a win-win for SEC and its stakeholders.

Listed below are some of the issues and suggested solutions to improve financial reporting.

Issues and Proposed Solutions

Issue 1: Provide Investors with Information Needed for Sound Decision Making

Problem: Inconsistent definitions of materiality.

Solution: The SEC should supplement existing guidance and coordinate in such a way to ensure that SEC, FASB and PCAOB use a common definition of materiality.

¹ See letter from the Chamber to the SEC (October 5, 2012) that Section 104 of the JOBS Act requires an analysis and finding that new PCAOB standards and revisions must promote efficiency, competition and capital formation in order to apply to EGCs.

The Honorable Mary Jo White
October 9, 2013
Page 3

Background: FASB has defined materiality for U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) differently than the securities laws, while the PCAOB is using the definition from the federal securities laws.

PCAOB Auditing Standard No. 11 states in part:

In interpreting the federal securities laws, the Supreme Court of the United States has held that a fact is material if there is ‘a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.’ As the Supreme Court has noted, determinations of materiality require ‘delicate assessments’ of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him ...

FASB Concept Statement No. 8 uses the following definition: “Information is material if omitting it or misstating it *could* influence decisions that users make on the basis of the financial information of a specific reporting entity.”²

Additionally, FASB’s Invitation to Comment on Disclosure Framework (File Reference 2012-220), states that reporting entities would assess the relevance of each disclosure using the basic criterion that “information should be disclosed if it has the potential to make a difference in users’ decisions about providing resources to the reporting entity.”^{3 4}

CIFiR recommended that the FASB or SEC, as appropriate, should supplement existing guidance to reinforce that:

*Those who evaluate the materiality of an error should make the decision based upon the perspective of a reasonable investor; and, materiality should be judged based on how an error affects the total mix of information available to a reasonable investor, including through a consideration of qualitative and quantitative factors.*⁵

² Par. QC11, Chapter 3

³ FASB Invitation to Comment on Disclosure Framework, paragraph 4.5 (page 45).

⁴ For additional insights on the issues, see “What is Materiality? SEC & PCAOB v. FASB & ASB” by Samuel P. Gunther in *Bloomberg BNA* (May 7, 2012).

⁵ Recommendation 3.1, page 80, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

The Honorable Mary Jo White
 October 9, 2013
 Page 4

It should also be noted that the International Integrated Reporting Council (“IIRC”) and the Sustainability Accounting Standards Board (“SASB”) are creating their own concepts of materiality in attempting to develop voluntary standards of non-financial reporting and disclosure – with the SASB’s disclosures intended to be included within Management Discussion and Analysis (“MD&A”) in Form 10-K and 10-Q filings with SEC. The Chamber has written to both organizations expressing concerns that the development of these standards needs to be done with SEC and that any work in this area must conform to the definitions, usage, and enforcement of materiality as defined in the Securities Acts and their progeny.⁶ Similarly, in testimony before the U.S. Senate Subcommittee on Securities, Insurance, and Investment the Chamber stated:

The SEC, FASB, and PCAOB should develop standards of materiality for investors, as well as the scope of outreach to the investor community. This will provide perspective on various accounting and auditing issues such as the need for restatements on the one end, while framing the picture for input on the front end of standard setting.⁷

Problem: Information overload from multiple overlapping and sometimes contradictory reporting and disclosure requirements and standards.

Solution: Develop a Disclosure Framework.

Background: CIFIIR recommended that SEC and FASB work together to develop a disclosure framework to, among other things:

Integrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards.⁸

A disclosure framework would also address issues of placement of information within audited U.S. GAAP financial statements versus MD&A which is unaudited, has safe harbors and provides forward looking information.⁹

⁶ See letters from the Chamber to IIRC (July 15, 2013) and SASB (July 26, 2013).

⁷ See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

⁸ Recommendation 1.2, page 8, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

⁹ FASB currently has a disclosure framework project in progress and the SEC Chief Accountant announced in February, 2013 that a SEC Staff Paper on disclosure is expected to be released with roundtables planned to follow.

The Honorable Mary Jo White
October 9, 2013
Page 5

Problem: The accounting standards setters continue down the path of including the recognition, measurement, and disclosure of more fair values and accounting estimates that require judgment and, therefore, investors and others cannot expect there to be a single “right answer” in accounting and auditing matters.

Solution: Issue a policy statement articulating how SEC evaluates the reasonableness of accounting judgments.

Background: CIFIIR recommended that:

The SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The statement of policy applicable to accounting-related judgments should address the choice and application of accounting principles, as well as estimates and evidence related to the application of an accounting principle. ... We believe that it would be useful if the SEC also set forth in the statement of policy factors that it looks to when evaluating the reasonableness of preparers' accounting judgments.¹⁰

Solution: The PCAOB should issue a policy statement on how it evaluates the reasonableness of audit judgments.¹¹

Background: CIFIIR recommended that:

[T]he PCAOB develop and articulate guidance related to how the PCAOB, including its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. The PCAOB's statement of policy should acknowledge that the PCAOB would look to SEC's statement of policy to the extent that the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.¹²

¹⁰ Recommendation 3.5, pages 13-14, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

¹¹ See various CCMC comment letters including to the PCAOB on Request for Public Comment on Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards and Notice of Roundtable (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34).

¹² Recommendation 3.5, page 14, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

The Honorable Mary Jo White
 October 9, 2013
 Page 6

Solution: The SEC work with the FASB and PCAOB to consider the auditability of GAAP when developing accounting standards and disclosure requirements.

Background: Again in testimony before the U.S. Senate Subcommittee on Securities, Insurance, and Investment the Chamber stated:

A formal, ongoing, and transparent dialogue should be created to consider the auditability of accounting standards. This would allow for the auditing of accounting standards to work in conjunction with standard development. It would also provide for the identification and resolution of issues that arise in practice. A similar process should be created to ensure that regulators have an understanding of standards and that different entities are not working at cross purposes. The era of “not my problem” needs to end.¹³

Solution: Conduct formal pre and post-implementation reviews.

Background: CIFIIR recommended that the Financial Accounting Foundation (“FAF”), FASB, and other participants in the financial reporting system:

Enhance the consistency and transparency of key aspects of FASB’s field work, including cost-benefit analyses, field visits, and field tests.

Formalize post-adoption reviews of each significant new standard to address interpretive questions and reduce the diversity of practice in applying the standard, if needed.

Formalize periodic assessments of existing accounting and related disclosure standards to keep them current.¹⁴

The Chamber reinforced this notion by stating that standards should be field tested and put through a rigorous process to identify unintended consequences before implementation and after implementation.¹⁵

¹³ See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

¹⁴ Included in recommendation 2.3, page 11, Final Report of the SEC Advisory Committee on Improvements to Financial Reporting, August 1, 2008.

¹⁵ See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance, and Investment (April 6, 2011).

The Honorable Mary Jo White
 October 9, 2013
 Page 7

The Chamber appreciates that the FAF and FASB are moving in the direction of this recommendation and we suggest that the PCAOB should do likewise and that SEC should ensure that the FASB and PCAOB are coordinated in these efforts.

Issue 2: Increase Communication and Coordination amongst Regulator and Standard Setters

Problem: Lack of transparent communication and coordination among regulators, standard setters and market participants.

Solution: Establish a Financial Reporting Forum (“FRF”).

Background: CIFI¹⁶ recommended the creation of a FRF, made up of the SEC, FASB, PCAOB, financial regulators, investors (broadly defined), and businesses, with a mission to identify and propose solutions to problems before they reach the crisis stage. A FRF will also provide a mechanism to allow for appropriate coordination amongst regulators and input from investors and businesses.¹⁶ It should also be noted that in the 111th Congress, the House of Representatives passed a version of H.R. 4173, the precursor bill of the Dodd-Frank Act, which contained an amendment by Rep. Gary Miller to create an FRF.

Problem: Potential expectation gap created by the PCAOB’s recent definition of an audit failure.

Solution: Through the exercise of SEC’s oversight authority over the PCAOB reestablish the long-standing definition of an audit failure.

Background: Several years ago and without explanation, the PCAOB began describing Part I deficiencies as audit failures in inspection reports for annually inspected firms (although the PCAOB does not use these terms in inspection reports for tri-annually inspected firms). This change in definition contradicted the long-standing and widely used definition of an audit failure as used by the Government Accountability Office (“GAO”). GAO defined audit failures as:

[A]udits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was not conducted in accordance with generally accepted auditing standards, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that

¹⁶ See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance, and Investment (April 6, 2011).

The Honorable Mary Jo White
 October 9, 2013
 Page 8

*appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.*¹⁷

In other words, for example, differences of opinion in the exercise of judgment on audit procedures or other audit deficiencies – which do not occur in conjunction with any material misstatement of the financial statements – could not be considered an audit failure.

You will also find with this letter, as an attachment, a letter sent by the Chamber to PCAOB Chairman James Doty that contains a more robust discussion of our concerns on the failure to properly define audit failure, the communication, and portrayal of inspections findings and how it may undermine public confidence in financial reporting.

Issue 3: Reduce Fraudulent Financial Reporting

Problem: Lack of a comprehensive and holistic approach to understanding fraudulent financial reporting, diagnosing its root causes and detecting fraud through the application of useful and appropriate methodologies and technologies.

Solution: Establish a Fraud Center.

Background: The Advisory Committee on the Audit Profession (“ACAP”) recommended:

*SEC and Congress, as appropriate, provide for the creation by the PCAOB of a national center to facilitate auditing firms' and other market participants' sharing of fraud prevention and detection methodologies and technologies, and commission research and other fact-finding regarding fraud prevention and detection, and further, the development of best practices regarding fraud prevention and detection.*¹⁸

Financial reporting frauds undermine investor confidence in the capital markets. In October 2010, the Center for Audit Quality (CAQ) formally joined forces to form an Anti-Fraud Collaboration with Financial Executives International, The Institute of Internal Auditors, and the

¹⁷ See GAO 04-217 Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation (2003) page 6.

¹⁸ ACAP Final Report (October 6, 2008), page VII:1

The Honorable Mary Jo White
 October 9, 2013
 Page 9

National Association of Corporate Directors to develop thought leadership, awareness programs, educational opportunities, and other related resources specifically targeted to the unique roles and responsibilities of the primary participants in the financial reporting supply chain. The projects and activities under this Anti-Fraud Collaboration are designed to enhance awareness and understanding of factors that contribute to financial reporting fraud, as well as strengthen the abilities of all applicable parties' efforts to deter and/or detect financial reporting fraud. These types of private sector initiatives can lead to long term progress in combating threats to investor confidence in the U.S. capital markets.

Since fraud can never be completely prevented, efforts to combat fraud must be continuous. All key participants in the financial reporting supply chain – preparers, audit committee members, auditors, *and regulators* – have important roles to play with regard to deterring and detecting financial reporting fraud. We believe the PCAOB can and should do more with the information it has accumulated through its various programs to identify trends, best practices, and specific actions that could be shared with auditors and preparers to assist in the deterrence or detection of financial statement fraud.

Issue 4: Increase Transparency and Accountability of FASB and PCAOB

Problem: Neither the FASB nor the PCAOB are formally subject to the traditional regulatory provisions for accountability and transparency.

Solution: Both the FASB and PCAOB and their attendant advisory groups should abide by the same rules of procedures as required of regulatory agencies by the Administrative Procedures Act and Federal Advisory Committee Act, including any advisory groups should be balanced in presentation and open in process.¹⁹

Solution: The PCAOB should form a Business Advisory Group to understand the role of companies as investors, their use of investments, and the potential impact of standard setting on businesses. The PCAOB should also establish an Audit Advisory Group to more substantively bring the expertise of practicing auditors to inform the PCAOB's activities and initiatives.²⁰

Background: For example, a Business Advisory Group would provide the PCAOB another means of input and broader understanding of issues that need to be addressed in the development of standards and other means of resolving important issues related to audited

¹⁹ See testimony of the U.S. Chamber of Commerce on The Role of the Accounting and Auditing Profession in Preventing Another Financial Crisis at the hearings of the U.S. Senate Subcommittee on Securities, Insurance and Investment (April 6, 2011).

²⁰ Ibid.

The Honorable Mary Jo White
October 9, 2013
Page 10

financial statements. This dialogue could help the PCAOB better appreciate business operations and the unintended consequences that may impact businesses through the development and implementation of accounting and auditing standards. The avoidance of adverse outcomes for businesses is critical to protect the investors who invest in them.²¹

Issue 5: Addressing the needs of Private Company financial statement users

Problem: Private company financial statement users have differing needs and find public company U.S. GAAP to be too complex and burdensome.

Solution: Preserve U.S. GAAP as the accounting language, while empowering the Private Company Council to address the needs of private company users.

Background: Any modernization of financial reporting policies requires that the differing needs of users of the financial statements be considered and addressed. In particular, privately held users do not require the same information as users those entities that are owned by the public. It is imperative that any changes made to standards do not have the unintended consequence of requiring privately held entities to follow standards which may provide information critically important to users of publically held entity financial statements but which is not relevant to their users. While CIFIIR did not address these issues, following extensive study and research, the Blue Ribbon Panel on Standard Setting for Private Companies (“Blue Ribbon Panel”) made several recommendations which eventually led to the creation of the Private Company Council under the auspices of the FAF. Additionally, Congress, in passing the JOBS Act, made the public policy decision that users of financial reports are not monolithic and different business structures (ie. public company, emerging growth companies) will dictate the needs of financial statement users. Accordingly, we believe the SEC, FRF, and FAF should closely monitor the activities of the PCC to ensure the needs of private company users are met and that the Congressional intent of the JOBS Act is fulfilled.

This is not an exhaustive list of reforms or issues that should be addressed. Rather, we view this as a starting point of discussion and would respectfully request to meet with you to discuss these ideas and proposals in greater depth and detail. While we know and appreciate the workload of SEC, it is our belief that the many changes in financial reporting over the past decade require a response to prevent disharmony in financial reporting that can adversely impact the capital markets, businesses and the investors who provide them with the resources to grow and operate on a daily basis.

²¹ See CCMC letter to Martin F. Baumann (May 10, 2013).

The Honorable Mary Jo White
October 9, 2013
Page 11

Thank you for your consideration of these views, and we look forward to further discussion with you and SEC staff as well as an update on the implementation of the CIFiR recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read 'TK' with a long horizontal flourish extending to the right.

Tom Quaadman

cc: The Honorable Luis A. Aguilar, U.S. Securities and Exchange Commission
The Honorable Daniel Gallagher, U.S. Securities and Exchange Commission
The Honorable Kara Stein, U.S. Securities and Exchange Commission
The Honorable Michael Piwowar, U.S. Securities and Exchange Commission
Mr. Paul Beswick, U.S. Securities and Exchange Commission
Mr. Russell Golden, Financial Accounting Standards Board
Mr. James Doty, Public Company Accounting Oversight Board
The Honorable Tim Johnson, U.S. Senate
The Honorable Michael Crapo, U.S. Senate
The Honorable Jeb Hensarling, U.S. House of Representatives
The Honorable Maxine Waters, U.S. House of Representatives
The Honorable Scott Garrett, U.S. House of Representatives
The Honorable Carolyn Maloney, U.S. House of Representatives



U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.
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July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015)

This letter provides the GAO's comments on the Public Company Accounting Oversight Board's (PCAOB) referenced staff consultation paper.

We support the PCAOB's efforts to improve the quality of financial reporting and increase the confidence users have in the audit of financial statements. We encourage the PCAOB to work closely with other standard setters, such as the International Auditing and Assurance Standards Board and the Auditing Standards Board, to promote robust auditing standards and consistency of practice by continuously improving and harmonizing standards.

We concur with the PCAOB's view, discussed in detail in Section IV of the staff consultation paper, concerning the need for improvements to PCAOB standards related to use of specialists. In addition, we generally concur with the potential amendments presented in the staff consultation paper. We believe such changes would significantly improve the PCAOB standards.

The PCAOB staff consultation paper seeks comment on 48 specific questions. We have provided comment on most of those questions in an enclosure to this letter.

We thank you for considering our comments on these important issues as the PCAOB continues its effort to enhance its auditing standards.

A handwritten signature in black ink, appearing to read 'James R. Dalkin', written over a white background.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Enclosure

Comments on Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*

Following are our comments on the questions included in Sections III through VIII of the consultation paper.

III. Current Requirements and Current Practice

1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice—at larger and smaller accounting firms—relevant to the staff's consideration of potential standard setting in this area?

GAO audits are conducted in accordance with generally accepted government auditing standards (GAGAS). GAGAS incorporate by reference the American Institute of Certified Public Accountants' (AICPA) Statements on Auditing Standards. Accordingly, PCAOB standards do not apply to GAO. Nevertheless, the information presented in Section III appears to reasonably characterize our understanding of current practice.

2. Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAASB or of the ASB into their audit methodologies?

We have not encountered significant challenges associated with implementing AU-C sec. 620.

3. For accounting firms that use the work of an auditor's specialist:

- a. Does the firm employ or engage those specialists? How does the firm decide to employ versus engage a specialist? For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists? If the firm employs and engages specialists, describe the relevant ways in which each may be used in an audit.
- b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?
- c. What type of work do the specialists perform? Does the type of work vary depending on whether the firm employs or engages the specialist? Does the type of work vary depending on the specialist's field of expertise?
- d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate? Why?

GAO employs and engages auditor specialists. Generally, our employed specialist is a stakeholder for the audit engagement. Generally, our determination to engage a specialist is based on the need for additional resources to perform detailed evaluations or detail testing.

Figure 1 in Section II.A appears to reasonably describe the activities for which firms use specialists.

We use specialists to assist in evaluating internal control relating to information systems. In addition, we use specialists to assist in evaluating certain significant estimates. Significant estimates include pension liabilities, health care liabilities, environmental and disposal liabilities, insurance and guarantee liabilities, and asset valuations. In addition, we use specialists to assist in evaluating certain projections, such as those included in the U.S. Government's Statements of Social Insurance. Also, the component auditors for our audit of the U.S. Government's consolidated financial statements use a variety of specialists.

While the work of our specialists includes both testing models and assumptions and developing independent estimates, the work is more process testing oriented. A considerable amount of work is related to information systems controls. In addition, for a variety of unique estimates, the more efficient method of testing is deemed to be through testing management's process, especially since we generally perform an evaluation of internal control.

4. For accounting firms that use the work of an auditor's employed specialist:

- a. **Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?**
- b. **How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?**
- c. **Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?**
- d. **How would the evaluation change if the firm engaged the specialist?**
- e. **What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist? How does that assistance affect the auditor's supervision of the work of the employed specialist?**

GAO audit engagements generally include the participation of the corresponding GAO specialists.

We evaluate the work of our employed specialists in accordance with AU-C sec. 620. Specifically, we evaluate the adequacy our specialists' work by evaluating the relevance and reasonableness of the specialists' findings and conclusions and their consistency with other audit evidence. For work that involves the use of significant assumptions and methods, we obtain an understanding of the specialists' assumptions and methods and evaluate the relevance and reasonableness of the assumptions and methods in the circumstances. We consider the rationale and support the specialist provides and how these relate to our other findings and conclusions. In addition, to the extent applicable, we evaluate the relevance, completeness, and accuracy of source data used by the specialists.

When we engage a specialist, in addition to the steps indicated above, GAO's employed specialist generally reviews in detail the work of the GAO-engaged specialist.

5. For accounting firms that use the work of an auditor's engaged specialist:

- a. **What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?**
- b. **Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Auditing Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do**

senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?

- c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?**
- d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist, or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?**

As part of engaging a specialist, we generally issue a request for proposal that details, among other things, the required knowledge and skills of the specialist. The proposals are evaluated by senior members of the audit engagement team and, as appropriate, GAO specialists. Assessing a specialist's knowledge, skills, experience, and independence is critical to engaging a specialist.

We evaluate the work of an engaged specialist consistent with AU-C sec. 620. See our answer to question 4 for procedures performed relating to the work of our auditor specialists.

We generally provide our engaged specialist our risk assessment. In addition, as applicable, the specialist will test or assist in testing key controls.

Generally, our approach has been to test the agency's methods or models. Either our employed specialist, or our engaged specialist, tests the methods used and evaluates the reasonableness of the assumptions. In cases where GAO uses an engaged specialist, a GAO specialist reviews the engaged specialist's work for reasonableness, in addition to the reviews performed by the auditors.

6. For accounting firms that use the work of a company's specialist:

- a. What are the circumstances in which the firm uses the work of a company's specialist? If so, describe the related audit procedures performed in connection with the specialist's work. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.**
- b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?**
- c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?**
- d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?**
- e. Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?**

Consistent with AU-C sec. 500, *Audit Evidence*, we consider the work of a company's specialist as audit evidence provided by management, and accordingly, we subject such information to audit procedures that may include having GAO-employed specialists or GAO-engaged specialists review the methods and assumptions.

IV. Potential Need for Improvement

7. Do commenters agree with the staff's analysis of the need to improve standards? Are there other issues the staff should consider with respect to this need?

We concur with the staff's analysis for the need to improve PCAOB standards related to using the work of specialists.

As suggested in the staff consultation paper, the work of a company-employed or company-engaged specialist should be considered information provided by management, and thus requires sufficient audit procedures to assess its adequacy to ensure that the specialist's work is reasonable for the auditor's purposes.

8. When an auditor obtains an understanding of the methods used by the company's specialist:

- a. **If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient, appropriate audit evidence?**
- b. **If the auditor does not have such access, how does the auditor obtain sufficient, appropriate audit evidence regarding the relevant assertion?**

We generally obtain the access to the agency's specialists' methods (or models) at a very detailed level that allows our specialists (either GAO-employed or GAO-engaged) to obtain sufficient, appropriate audit evidence.

V. Alternative Regulatory Approaches

9. Are revisions to PCAOB standards the most appropriate way to address the issues as discussed in this staff consultation paper? Are there other alternatives that should be considered?

Revisions to PCAOB standards appear to be the most appropriate way to address the issues discussed in the staff consultation paper. In addition, the PCAOB's concurrent efforts relating to auditing accounting estimates and fair value measurements, as discussed in its *Estimates and Fair Value Consultation Paper*, should help address some of the issues discussed in the staff consultation paper.

10. Should the auditor perform the same procedures when using the work of an auditor's engaged specialist as those required for an auditor's employed specialist?

As in essence the auditor's engaged specialist and the auditor's employed specialist are performing identical tasks, the audit requirements should be similar. However, it does not appear unreasonable to have different requirements for an employed specialist to the extent that the employed specialist's work is subject to PCAOB Auditing Standard No. 10.

11. Are there other considerations related to the alternatives presented that the staff should be aware of?

We do not offer a response to this question.

12. Are there other alternatives related to the auditor's use of the work of an auditor's specialist that would result in the consistent treatment of the work of an auditor's employed and engaged specialist? If so, explain the other alternatives.

We do not offer a response to this question.

13. Are there any limitations on an auditor's ability to treat the work of an engaged specialist the same way as that of an employed specialist?

We do not offer a response to this question.

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist? If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?

It is appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist. Nevertheless, it is our view that for assertions with higher risk of material misstatement, to the extent applicable, the auditor should be required to use the services of an auditor-engaged independent specialist or an auditor-employed specialist.

The evaluation of the knowledge, skill, and objectivity of a company's specialist may have a bearing on the auditor's risk assessment and may affect the extent of the auditor's specialist's review of the work performed by the company's specialist.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

Please see answer to question 4.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

As suggested in the staff consultation paper, we believe that the work of the company's specialist should be considered as audit evidence and should be subject to audit procedures similar to other audit evidence obtained from the company.

17. Are there other alternatives that would be a more appropriate response to the risks of material misstatement in areas where companies use the work of specialists? If so, what are those alternatives?

The PCAOB may consider an approach similar to AU-C sec. 500.08 (and its application guidance AU-C sec. 500.A35-49) for areas of lower risk. This would allow the auditor to use the work of a company's specialist after performing certain audit procedures, including evaluating the relevance and reasonableness of the assumptions and methods used. However, for assertions with higher risk of material misstatement, we believe the approach suggested in the staff consultation paper—in essence, the auditor using the auditor-employed or auditor-engaged specialist—is warranted.

18. Are there any practical concerns with rescinding AU sec. 336? The staff is especially interested in the views of auditors, companies that typically use the work of specialists, and specialists, including those in specialized industries (such as oil and gas and environmental engineering). Are there other challenges associated with testing the work of a company's specialist?

We do not offer a response to this question.

VI. Potential Amendments – Definitions

19. Are the potential definitions of an auditor's specialist and a company's specialist appropriate? If not, what would be alternative definitions for those terms?

In general, we concur with the potential definitions provided. However, as indicated in footnote 2 in the staff consultation paper, the definitions exclude persons with specialized knowledge in income taxes and information technology. Distinguishing the role of an auditor with expertise in accounting and auditing from that of an expert in another field may require professional judgment. For example, a non-certified public accountant (CPA) who is an expert in tax issues related to transfer pricing, or a non-CPA who is an expert in cybersecurity, perhaps should be considered as a specialist in a field other than accounting and auditing, but would not be considered a specialist under the potential definition in the staff consultation paper. We believe that persons with highly specialized skills in taxes or information systems should be evaluated to determine whether they should be considered specialists for the purposes of AU sec. 336. To the extent that such persons do not possess the skill and knowledge to perform financial statement audits, the PCAOB may consider whether such persons should be considered specialists.

20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

Please see answer to question 19.

21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?

Please see answer to question 19.

VII. Potential Amendments – Auditor's Employed or Engaged Specialist

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

While the requirements appear adequate, we suggest that the introductory wording be reevaluated. The auditor generally does not "determine the knowledge and skill" of a specialist. Rather, the auditor evaluates information to determine whether the specialist possesses the necessary skill and knowledge to assist the auditor in obtaining sufficient, appropriate audit evidence.

23. Are the matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

The matters described in the potential requirements on which the auditor and an auditor's specialist should reach an agreement appear to be sufficient and appropriate. The PCAOB may consider also requiring that the auditor communicate with the specialist the relationship of the audit's risk assessment to the work the specialist is performing. Clear communication of such audit risks will likely augment the effectiveness of the specialist's work.

24. Are there any obstacles to reaching an agreement and documenting all of the categories of information described in the potential requirements? Would it be difficult to comply with some of the potential requirements? Are there other alternatives to accomplish the objectives?

We do not envision any significant obstacles.

25. Could the potential requirements for informing the auditor's engaged specialist of his or her responsibilities and reviewing the specialist's work and conclusions result in unintended consequences (e.g., tax or employee benefit consequences)?

We do not offer a response to this question.

26. How do accounting firms determine what information an auditor’s specialist should provide to the auditor? Are there circumstances in which auditors may not retain all audit evidence obtained from the specialist?

Generally, a GAO-employed or GAO-engaged specialist provides a copy of the entire set of audit documentation that is reviewed and incorporated into our audit documentation. Consistent with the agreement with our specialist, generally such documentation includes detailed audit plans, documentation of procedures performed, and a report on findings and conclusions based on the procedures performed.

27. Do the potential requirements appropriately reflect what the auditor’s responsibilities should be when an auditor’s specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

The potential requirements appear to reasonably reflect what the auditor’s responsibilities should be when an auditor’s specialist develops an independent estimate.

PCAOB may consider clarifying that the auditor needs to evaluate the sufficiency of the work that the specialist performed. As worded, it appears that the auditor defines the “nature, timing and extent of the work the specialist is to perform” and the auditor evaluates the “conclusions of the specialist.” It may not be clear that the auditor needs to also evaluate the sufficiency of the work performed as a basis for the conclusions reached.

We also suggest that the PCAOB consider clarifying that the auditor should evaluate the auditor’s specialist’s consideration of alternative methods and assumptions available, and the auditor’s specialist’s rationale for selecting the specific methods and assumptions used in developing an independent estimate. While the rationale may be implicit within the “information presented in the report or documentation of the specialist,” we suggest clarification as the specialist’s rationale for selecting certain methods and assumptions over other available alternatives may have a significant bearing on a financial statement audit. In addition, the auditor’s specialist, in evaluating the work of a company’s specialist, should also explain why he or she believes (or does not believe) that the specific methods and assumptions are reasonable in the particular circumstances.

28. Do the potential requirements appropriately reflect what the auditor’s responsibilities should be when an auditor’s specialist tests the company’s methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Please see answer to question 27.

29. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?

Please see answer to question 27.

30. Do the potential requirements provide appropriate direction for the auditor's consideration of any limitations, restrictions, and caveats in the report of an auditor's specialist?

The PCAOB may consider providing additional guidance on steps that the auditor should consider in evaluating the work of an auditor's specialist. For example, AU-C sec. 620.A36-37 provides application guidance on various steps the auditor may perform in evaluating an auditor's specialist's findings and conclusions.

31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?

Please see answers to questions 27 and 30.

32. How does the auditor evaluate relationships between an auditor's engaged specialist and a company under AU sec. 336?

Please see answer to question 5.

33. Are the potential requirements under the enhanced objectivity approach for the auditor's use of the work of an engaged specialist appropriate and feasible?

The potential requirements appear appropriate and feasible.

34. Should the auditor's engaged specialist (and his or her employer) be required to meet the independence criteria of Rule 2-01? Are there certain types of specialists that would not be able to satisfy these criteria? Could these criteria affect the availability of specialists?

The auditor's engaged specialist should meet the independence criteria.

35. Are the potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor’s specialist (including his or her employer) and the company appropriate? If not, should other relevant factors be added to the potential enhanced objectivity requirements? For example, should the potential requirements take into account information barriers or other controls to address conflicts of interest at a specialist’s firm?

The potential requirements for the auditor to obtain information regarding business, employment, and financial relationships between the auditor’s specialist (including his or her employer) and the audited company appear appropriate.

36. Are the potential requirements for the auditor to evaluate the objectivity of an auditor’s specialist appropriate? Is it appropriate to apply the reasonable investor test as an overarching principle in assessing the specialist’s objectivity? If not, are there other relevant factors that would be helpful to add to the potential requirements? For example, should the potential requirements take into account “threats” to objectivity and “safeguards” to reduce the threats, as provided in ISA 620?

The potential requirements for the auditor to evaluate the objectivity of an auditor’s specialist appear appropriate.

37. Does the enhanced objectivity approach provide sufficient assurance that the work of an auditor’s engaged specialist will not be influenced by business, employment, or financial relationships?

The enhanced objectivity approach appears to provide sufficient assurance.

38. Is the potential requirement that the auditor obtain information about the process used by the auditor’s engaged specialist to formulate the responses to the auditor’s request for information appropriate and sufficiently clear? If not, are there other relevant factors that would be helpful to add to the potential requirement?

We suggest that PCAOB consider further clarifying the purposes of obtaining “information about the process used by the auditor’s engaged specialist to formulate responses to the auditor’s request for information.” Also the PCAOB may consider clarifying what constitutes an adequate process. Such clarification would improve the quality and consistency of the work performed.

39. Does the specialist (or his or her employer) typically have a system in place capable of tracking the information to respond to the auditor’s request? If not, could a system feasibly be created?

We do not offer a response to this question.

VIII. Questions Related to Economic Impacts and Implications

40. For accounting firms that use the work of an auditor's or a company's specialist for public company audits:

- a. In how many (e.g., what percentage) of those audits is the work of specialists used? Provide details within the following categories:
 - i. Auditor's employed specialists;
 - ii. Auditor's engaged specialists;
 - iii. Company's employed specialists; and
 - iv. Company's engaged specialists.
- b. For the auditor's specialists described in a.(i) and a.(ii), what is the ratio of specialist hours to total audit hours?
- c. How are the auditor's engaged specialists compensated?

Not applicable. GAO does not perform public company audits.

41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?

We do not offer a response to this question.

42. To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies, and fraud?

The potential alternatives should significantly improve audit quality.

43. Would any of the potential alternatives lead to increased cost? If so, what are the estimated (i) number of audits affected and impact on audit hours and cost and (ii) effects on companies' costs?

We do not offer a response to this question.

44. Do the incremental costs associated with any of the potential alternatives decline as an accounting firm uses specialists more frequently?

We do not offer a response to this question.

45. Are the costs of the potential alternatives likely to be reduced in years after the year of initial implementation?

We do not offer a response to this question.

46. Are the economic impacts of the potential alternatives likely to be different for audits involving (i) emerging growth companies, (ii) brokers and dealers, (iii) companies in specialized industries, (iv) companies in certain stages of their life cycles (e.g., development stage), and (v) the use of the work of specialists in specific fields of expertise? If so, provide relevant details.

We do not offer a response to this question.

47. Are the economic impacts of the potential alternatives likely to affect accounting firms of different sizes differently? If so, provide relevant details. Are there other alternatives that might address the need for improvement noted in this staff consultation paper at lower cost or greater efficiency?

We do not offer a response to this question.

48. As part of considering the need for change, the staff is analyzing academic literature that relates to the auditor's use of the work of a specialist. Is there ongoing research or other information, other than that identified in this staff consultation paper, that the staff should consider in evaluating the economic aspects of changes in standards for the auditor's use of the work of a specialist?

We do not offer a response to this question.



July 30, 2015

VIA E-MAIL comments@pcaobus.org

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington DC 20006-2803

Re: PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* ("Staff Consultation Paper")

Dear Office of the Secretary:

WeiserMazars LLP ("WeiserMazars") welcomes the opportunity to comment to the staff of the Chief Auditor (the "Staff") of the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Staff Consultation Paper. WeiserMazars appreciates the PCAOB's efforts to improve AU 336, *Using the Work of a Specialist* ("AU 336"), in order to provide auditors with greater clarity and guidance about their responsibilities when using the work of a specialist; either employed or engaged by the company or by the audit firm. From our perspective, adding enhancements to AU 336 and related application guidance through the use of an appendix will serve to improve audit quality.

WeiserMazars is a firm with over 100 partners and 700 professionals in nine offices across the United States ("U.S."), an independent member firm of the Mazars Group, an organization with over 15,000 professionals in more than 70 countries around the world, and a member of Praxity, a global alliance of independent firms. Because we are a U.S. registered public accounting firm, and a member of an international network, our perspectives may differ from those our international counterparts due to variations in the client population and in the regulatory and litigation environments.

Our responses to the Staff Consultation Paper are driven primarily by our position in the U.S. marketplace as a medium-sized public accounting firm servicing mostly small business issuers and broker-dealers. Therefore, our primary focus is to address our concerns and challenges as they relate to companies with similar characteristics to our issuer and broker-dealer client base.

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Overall Views

We concur with the Staff's observations that AU 336 in the current audit environment needs improvement in certain areas. Our vision for improved performance in auditing in areas where specialists are used includes alignment with the PCAOB's other relevant auditing standards as well as with other standard-setters, and clarification of the definition of a "specialist" and the auditor's responsibilities when using specialists. Issuance of a revised AU 336 would maintain the ability for auditors to exercise appropriate professional judgment of when and how to use the work of a specialist during the execution of their audits.

We offer our insights to certain questions raised by the Staff as follows:

- 1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of potential standard setting in this area?**

Overall, we believe that the information presented in Section III accurately characterizes current practice.

Whether a larger firm uses its own specialist or a smaller firm engages an outside specialist, the requirements of reaching an agreement with the specialist on the work to be performed, adequate evaluation of the specialist's work, and resolution of any differences for purposes of an audit are the same. In addition, engagement teams from any public accounting firm acknowledges the requirements of AU 336 in avoiding any appearance of actual or perceived "hand-off" of responsibility.

There are differences in practice in the execution of AU 336 between larger and smaller accounting firms when auditing the work of a specialist. We understand that larger accounting firms generally have employed in-house specialists. Smaller-sized accounting firms, at times, may engage an outside specialist when necessary, in their judgment, to effectively apply AU 336. The application of the principles of AU 336 (and related standards) is consistent regardless of the size of firm.

- 2. Are there any challenges associated with current practice, especially for those accounting firms that have incorporated the standards of the IAAS or of the ASB into their audit methodologies?**

We do not believe that there are any significant challenges associated with the current practice of incorporating the IAAS or the ASB requirements and guidance into an international accounting firm's audit methodology.



3. For accounting firms that use the work of an auditor's specialist:

a. Does the firm employ or engage those specialists?

We both employ specialists and engage specialists.

How does the firm decide to employ versus engage a specialist?

Engagement teams determine in planning whether a specialist is required on a particular engagement. If the expertise needed exists within the firm, we follow the requirements of AS No. 10, *Supervision of the Audit Engagement* (AS 10). If specific expertise is not employed, we would determine whether we should engage an outside specialist. Whether we employ or engage a particular specialist is a decision based both on risk and on a cost-benefit analysis and the need for particular expertise. Cost, however, will not override the need to comply with the current requirements of professional standards and the auditor's risk assessment.

For larger firms that employ specialists, are there circumstances when the firm uses engaged specialists?

Yes, we believe that all firms will engage a specialist if such expertise is required and is not available within the firm (i.e. oil and gas reserves, valuation of precious metals, artwork, etc.).

b. Does Figure 1 in Section II.A accurately describe the activities for which the firm uses the work of a specialist? What other specialized knowledge and skill do specialists have and in what areas of the audit is their work commonly used?

Figure 1 in Section II.A, while not an all-inclusive list, does represent the majority of the activities for which we would use a specialist and apply the principles of AU 336.

c. What type of work do the specialists perform?

The activities of employed or engaged specialists most frequently used by our firm include: valuation of financial instruments, business combinations, goodwill impairment analysis, real estate valuations, share-based compensation, post-employment obligations, and insurance loss reserves.



Does the type of work vary depending on whether the firm employs or engages the specialist?

The type of work performed generally does not differ regardless of whether the firm employs or engages the specialist. However, the use of an employed specialist will require supervision of his or her work in accordance with AS 10.

Does the type of work vary depending on the specialist's field of expertise?

The specialist's field of expertise does not drive the type of work performed or compliance with the requirements of AS 10 or AU 336. The underlying assumptions and methodologies may vary based on financial statement assertions and related disclosures being audited.

d. Is the auditor's specialist more likely to assist in testing the company's process or developing an independent estimate?

The auditor's specialist is more likely to assist in testing the company's process. The nature and extent of testing conducted or the need to develop an independent estimate is driven by facts and circumstances and the auditor's risk assessment.

4. For accounting firms that use the work of an auditor's employed specialist:

a. Does supervising the work of employed specialists in accordance with Auditing Standard No. 10 present any challenges?

No, we do not see any challenges in the application of AS 10 with regard to the supervision of an employed specialist.

b. How does the firm evaluate whether the work was performed and whether the results of the employed specialist's work support the conclusions reached?

The engagement team evaluates the work performed by the employed specialist by obtaining an understanding of the assumptions and methodologies used and procedures performed. In addition, the auditor evaluates the underlying data used by the employed specialist, in accordance with AS No. 15, *Audit Evidence* ("AS 15"), as to whether such information is sufficient and appropriate for the purposes of the audit engagement team.

c. Does this evaluation vary by the nature of the specialization and degree of the auditor's familiarity with that particular specialization?



We do not believe that the evaluation process in accordance with relevant auditing standards would vary by the nature of the specialization. However, more complex or unfamiliar areas may require more time to be incurred by an engagement team, and potentially additional support from another employed or even an auditor engaged specialist to evaluate a specialist's findings.

d. How would the evaluation change if the firm engaged the specialist?

We do not believe that the evaluation of an engaged specialist's work would change as compared to that of an employed specialist. However, the auditor would need to initially evaluate the credentials, objectivity, and independence of an engaged specialist which would not be required for an employed specialist.

e. What is the process for determining whether more senior specialists in the firm, such as partners or principals, should assist the auditor in supervising the work of the specialist?

We believe that the industry, level of complexity, years of experience of an employed specialist, and any other factors, as identified during the planning process of an audit engagement, should determine whether a more senior specialist should assist in the supervision of an employed specialist. This decision is a matter of the engagement team's professional judgment during the planning and execution of the engagement.

How does that assistance affect the auditor's supervision of the work of the employed specialist?

Assistance from an employed senior specialist generally would not change the engagement team's supervision of an employed specialist.

5. For accounting firms that use the work of an auditor's engaged specialist:

a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?

The process used to assess the knowledge and skill of a specialist before engaging the specialist includes the auditor's determination and understanding of:

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



The performance of these procedures may include direct communication with the specialist and his or her firm and use of external sources and references.

- b. Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist (e.g., performs procedures similar to those in Auditing Standard No. 10)? If so, describe those circumstances and the reasons for using that approach. Do senior specialists in the firm (if any), such as managers and partners, assist in evaluating the engaged specialist's work?**

We do not routinely go beyond AU 336 for auditor engaged and company specialists. In our experience, the work of the auditor engaged specialist is evaluated in accordance with AU 336. However, in the circumstance that auditor's procedures lead him or her to believe that the engaged specialist's findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist, also in accordance with AU 336.12.

- c. How does the firm apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of an engaged specialist?**

The firm performs the engagement using the guidance contained in AS 8 through AS 15 to assess the risks associated with particular financial statement assertion(s) prior to the application of AU 336. During the planning phase of the audit, the firm determines which areas have risks of material misstatements and designs procedures to be responsive to those risks. If circumstances change, the risk assessment is revisited to ensure that the procedures performed are still responsive to the risks identified. In almost all cases, the use of an auditor engaged specialist is determined during the planning phase, and the risks associated with the use of an engaged specialist are factored into particular financial statement assertions. The specialist's work is then audited using the guidance in AU 336.

- d. In using the work of an engaged specialist, does the firm have access to all the methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?**

If the firm requires access to the models of the specialist, that would be discussed and agreed upon prior to engagement. There are instances where the models utilized by the specialist are proprietary, or the models utilized would require the installation of proprietary software, to which the auditor is not provided access. We have not been restrained in applying AU 336 in the circumstance where we have had limited access to the methods and models of the specialist.



6. For accounting firms that use the work of a company's specialist:

a. What are the circumstances in which the firm uses the work of a company's specialist?

The firm will use the work of a company's specialist and rely upon it when the guidance in AU 336 can be applied to the specialist and the firm is satisfied that the specialist's work can be audited in accordance with AU 336. Such specializations include:

- Valuation of financial instruments (Level 2 and Level 3 assets/liabilities)
- Assets and liabilities acquired/assumed in a business combination
- Goodwill impairment
- Stock options (ASC Topic 718)
- Equity instruments provided to non-employees (ASC Topic 505)
- Real estate
- Post-employment obligations (defined benefit plan, deferred compensation, etc.)
- Contingent and environmental liabilities
- Insurance loss reserves
- Property, plant, and equipment (salvage value)
- Inventory stockpiles
- Valuation of precious metals, stones, etc.
- Art work
- Oil and gas reserves

If so, describe the related audit procedures performed in connection with the specialist's work.

If a firm is to rely on the findings of a company's specialist, the related audit procedures performed in connection with the specialist's work are to obtain an understanding of:

- The objectives and scope of the specialist's work
- The specialist's relationship to the client
- The methods or assumptions used by the specialist
- A comparison of the methods or assumptions used with those used in the preceding period
- The appropriateness of using the specialist's work for the intended purpose
- The form and content of the specialist's findings that will enable the auditor to make the evaluation described in AU 336.12



Are there circumstances when the auditor performs procedures in addition to those specified in AU sec. 336 to evaluate the work of the specialist? If so, describe those circumstances and the reasons for using that approach.

We do not perform procedures beyond AU 336 unless the results of our work indicate the results of the specialist's work are unreasonable (AU 336.12). See our discussion in 6.c below.

- b. Does Figure 1 in Section II.A accurately describe the activities for which the auditor uses the work of a company's specialist? Are there other activities in which the auditor uses the work of a company's specialist that should be considered within the scope of this project?**

Figure 1 in Section II.A, while not an all-inclusive list, does represent the majority of the activities for which we would use a specialist and apply the principles of AU 336.

- c. In what circumstances has the firm concluded that the findings of the company's specialist were unreasonable and therefore performed additional procedures, as required by AU sec. 336? In those circumstances, what procedures did the auditor perform?**

If we determine that the results of the specialist's work are deemed unreasonable under the circumstances, we will perform additional procedures, which include conducting extensive discussions with the specialist to gain a better understanding of his or her thought process, assumptions, and methodologies used. If we still cannot use the work of the specialist, we may utilize an employed or an engaged specialist to (a) utilize another model to recalculate, (b) utilize assumptions from different sources, or (c) perform sensitivity analyses on the assumptions utilized, in order to assess whether the company's conclusions are within a reasonable range.

- d. How does the firm currently apply the requirements of AU sec. 336, in conjunction with the risk assessment standards, to the use of the work of a company's specialist?**

During the planning phase of an engagement, the firm determines which areas have risks of material misstatements and designs procedures to be responsive to those risks. If the fact pattern or circumstances change, the risk assessments are revisited to ensure that the procedures performed are still responsive to the risks identified. In almost all cases, the use of an auditor engaged specialist is determined during the planning phase, and the risks associated with the use of a company's specialist are factored into particular financial statement line items as well as overall risk assessments of the engagement. The company specialist's work is then audited using the guidance in AU 336.



e. Are there any differences between how the firm uses the work of a company's employed specialist and a company's engaged specialist?

Our audit response to company employed versus engaged specialist is facts and circumstances driven. If the results of our risk assessment procedures coupled with the results of our AU 336 inquiries indicate the specialist may lack objectivity, we will perform additional procedures to satisfy ourselves that the financial statement assertions are supported. See 6.c. above for types of additional procedures.

8. When an auditor obtains an understanding of the methods used by the company's specialist:

a. If the auditor has access to the specialist's methods (or models), is that access at a sufficiently detailed level (as opposed to a general level, such as a website description) to allow the auditor to obtain sufficient appropriate audit evidence?

We have not been deterred by limitations on access to proprietary models. In addition, the company specialist's reports are usually issued with sufficient detail to allow for audit procedures to be either performed in accordance with AU 336 or we are able to further satisfy ourselves through inquiry related to assumptions and methods used. If we are not satisfied, we perform additional procedures (AU 336.12 and discussed above in 6.c. & e).

b. If the auditor does not have such access, how does the auditor obtain sufficient appropriate audit evidence regarding the relevant assertion?

See 8.a. above.

14. Is it appropriate for an auditor to consider the knowledge, skill, and objectivity of a company's specialist when evaluating the reliability of information provided by that specialist?

It is essential for an auditor to consider the knowledge, skill, and objectivity of a company's specialist, as he or she would for an auditor engaged specialist when evaluating the reliability of the information provided by the company specialist. As auditors, we must always maintain a healthy level of professional skepticism when evaluating the reliability of information as audit evidence.

If so, how might the company's use of the work of a competent and objective specialist under the potential alternatives affect the nature, timing, and extent of the auditor's procedures?



We do not agree with the elimination of the responsibilities of the company's specialist for the appropriateness and reasonableness of their methods and assumptions used. We recommend retaining and enhancing AU 336 to provide additional guidance to the auditor which would assist the auditor with the evaluation of methods and assumptions used by the company specialist.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

In order to obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336, we:

- Obtain and read a copy of the specialist's report.
- Review the methodology and underlying assumptions for applicability, and reasonableness, including how they relate to the financial statement line items being addressed by the specialist. Compare assumptions/methods used in the current year specialist's report to the prior year's specialist report for consistency or proper changes therein.
- Query the specialist to gain a better understanding of the assumptions and methods used on the client's data.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company?

No. We believe that AU 336 should be retained.

Are there concerns associated with more rigorous testing of the work of a company's specialist that may result from this approach? For example, would auditors increasingly need to employ or engage specialists to perform work to assist the auditor with such testing?

We do not believe that the elimination of AU 336 would improve audit quality. We do, however, support enhancements to AU 336 to improve auditor performance.

20. Is it appropriate to retain the definition of a specialist from AU sec. 336 or is there a need to update the definition to reflect the increased use of the work of persons with specialized knowledge or skill in accounting and auditing? For example, should that definition also include those with specialized knowledge or skill in income taxes or IT?

It is appropriate to retain the definition of a specialist from AU 336. We do agree income taxes and IT have become more complex, but the definition of a specialist should continue to exclude those with specialized knowledge or skill in income taxes or IT, as they are covered



under AS 10 and should remain under AU 336 as included in the field of accounting or auditing.

- 21. Is it clear what constitutes a specialized area of accounting and auditing? For example, are persons with specialized knowledge or skill in regulatory compliance (e.g., related to audits of brokers and dealers) considered to be persons with specialized knowledge or skill in accounting and auditing? Should the staff provide clarification about what constitutes a specialized area of accounting and auditing? Does the discussion in this staff consultation paper appropriately describe when third parties may be inside or outside the scope of the potential definition of an auditor's specialist?**

It would be beneficial to have additional clarity regarding what constitutes a specialized area of accounting and auditing.

We believe that, generally, it is clear what constitutes a specialized area in accounting and auditing, and that such specialization does not qualify the auditor as a specialist in accordance with AU 336. It would be helpful, however, for the staff to provide additional clarity about what constitutes a specialized area of accounting and auditing as compared to that of a specialist as noted in Figure 1 in the Staff Consultation Paper.

We believe that the Staff Consultation Paper describes, appropriately, when third parties are deemed to be auditor's specialists.

- 27. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist develops an independent estimate? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?**

We do not believe that all of the potential requirements reflect, appropriately, the auditor's responsibilities. The potential requirements state, among others, that the auditor should evaluate whether the methods (which may include models) used by the specialist are generally accepted within the specialist's field of expertise, and are applied consistently, including whether consistency is appropriate considering changes in the environment or circumstances affecting the company. Both of these evaluations by the auditor are outside of the scope of the auditor's normal skillset and would require either the use of another auditor's specialist or specialized auditor training to evaluate the work of the auditor's specialist when he or she develops an independent estimate. Such evaluations are discussed but are not mandatory within the scope of AU-C 620.



- 28. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when an auditor's specialist tests the company's methods and significant assumptions? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?**

Our response regarding when the auditor's specialist tests the company's methods and significant assumptions is similar to our response to question 27.

- 29. Do the potential requirements appropriately reflect what the auditor's responsibilities should be when the auditor evaluates the results and conclusions of the work of an auditor's specialist? How would these potential requirements differ from current practice (e.g., for audits performed in accordance with ISA 620 or AU-C Section 620)?**

We believe that the potential requirements reflect, appropriately, the auditor's responsibilities. The potential requirements as noted in the shaded box on page 41 of the Staff Consultation paper relating to the evaluation of results and conclusions of the specialist's work are within the scope of AU 336 and AU-C Section 620. In addition, such potential requirements do not require additional areas of expertise for the auditor.

- 31. Are the potential requirements for evaluating the work of an auditor's specialist appropriate for all types of specialists used in audits (e.g., valuation specialist, actuary, geologist, lawyer, or engineer)? If not, how should the potential requirements be tailored?**

We do not believe that the potential requirements for evaluating the work of an auditor's specialist is appropriate for all types of specialists used in audits. We believe, however, that general requirements for evaluating the work of an auditor's specialist, as in AU 336, are necessary with added appendices, such as in the format of AS 18 Appendix A, that would provide special discussions and guidance for specific types of specialists such as those noted in Figure 1 in the Staff Consultation paper. We also believe that current requirements in AU 336 can be revised to provide additional guidance that results in increased consistency in application without adding significant cost of implementation of meeting performance requirements.



In Summary

We applaud the Staff for its extensive analysis of possible alternatives to improve audit quality in connection with the use of specialists. We support a revised AU 336, inclusive of an appendix that would provide auditors with greater clarity and guidance about their responsibilities relating to an auditor's use of the work of a specialist. We do not support the elimination of AU 336 or the creation of less subjective audit requirements as methods to improve audit quality. We remain committed to participating in future discussions with the Board and its Staff about how to best implement appropriate recommendations generated by the Staff Consultation Paper that would enhance audit quality and improve transparency with respect to audits of issuers and broker-dealer audits where specialists are used.

We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Wendy B. Stevens, Partner-in-Charge, Quality Assurance, at (212) 375-6699 (wendy.stevens@weisermazars.com) or David Bender, Director, Quality Assurance, at (516) 620-8497 (david.bender@weisermazars.com).

Very truly yours,

A handwritten signature in cursive script that reads 'WeiserMazars LLP'.

WeiserMazars LLP



July 30, 2015

Office of the Secretary, PCAOB
1666 K Street
Washington, D.C. 20006-2803

REGARDING: The Auditor's Use of the Work of Specialists

Wilary Winn thanks the PCAOB for the opportunity to respond to *Staff Consultation Paper No. 2015-01 – The Auditor's Use of the Work of Specialists – May 28, 2015*.

Wilary Winn LLC and Wilary Winn Risk Management LLC provide objective fee-based advice to financial institutions located across the country. We work as “engaged specialist” for the external auditors and for companies directly. We have performed work for half of the accounting firms ranked from 5 through 25 and currently have 43 bank clients which are publicly traded. We are a highly specialized firm with a relatively narrow set of valuation services. The services we provide which we believe are relevant to the PCAOB include valuation of:

- Non-Agency (private label) mortgage-backed securities
- Pooled trust preferred collateralized debt obligations (TruPS)
- Servicing rights, including residential and commercial
- Mortgage banking derivatives
- Assets acquired and liabilities assumed in business combinations
- Goodwill impairments
- Intangible assets

We believe the Staff Consultation Paper rightly recognizes the increasing complexity of financial reporting standards, especially fair value, and the increased use of specialists. We caution the PCAOB that the alternatives identified in the paper risk the loss of specific expertise in order to build perceived improved objectivity. We believe the keys to ensuring quality audit results involving the use of specialists are to ensure:

1. The specialist provides non-contingent fee-based advice regardless of whether it performs work directly for the audit firm or the company.

2. The specialist limits its advice to areas where it has a deep understanding of the issues.
3. The specialist's work is transparent with valuation methodologies clearly laid out and input assumptions described in such specificity that they can be independently corroborated when possible.
4. The specialist has a good understanding of the accounting and regulatory issues related to the valuation in addition to the financial and economic factors.

Following are our specific responses to selected staff questions:

1. Does the information presented in Section III accurately characterize current practice? Are other aspects of current practice – at larger and smaller accounting firms – relevant to the staff's consideration of standard setting in this area?

In our experience, the staff has accurately characterized current practice with regard to the use of specialists. Over the course of the past several years, we have had numerous opportunities to discuss our valuation findings with the external auditors and banking regulators. These interactions include discussions with the very large firms' employed specialists.

We have not worked as an engaged specialist for one of the "big four" firms directly, but we have performed valuation work for companies audited by them. We have generally found that the auditing firms which have engaged us directly, or referred us to their clients, did so when faced with complex valuation issues. We also believe in certain cases that we have a deeper understanding of the complex financial instruments we value than did the audit firms' employed specialists. We found this to be especially true in the case of the TruPS and non-Agency MBS. We believe this is because the employed specialists are expected to have an understanding of a wide variety of financial instruments, while we have focused and developed deep expertise on a very narrow set of securities.

5. For accounting firms that use the work of an auditor's engaged specialist:

a. What process does the firm use to assess the knowledge and skill of a specialist before engaging the specialist?

We provide a 14 page SAS 73 questionnaire response to each of the audit firms for which we provide valuation services. The response addresses:

- Professional qualifications
- Independence and potential conflicts of interest

- Engagements we will undertake and, perhaps more importantly, engagements we will not undertake
- Reputation and standing on the views of peers and others familiar with our work
- Understanding the nature of the work of the expert
- Valuation methodologies, including the development of input assumptions

Attached to the questionnaire we include samples of our valuation work, bios of our senior team, copies of white papers and presentations, as well as a list of our references.

We note that we have licensed CPAs on staff and are fully aware of the need for objectivity and healthy skepticism.

d. In using the work of an engaged specialist, does the firm have access to all methods and models of that specialist or are there instances when access to proprietary methods or models is restricted by the specialist or the specialist's employer?

We believe the issues here center on the transparency of a specialist's work. We do not allow our employees to send our proprietary cash flow engines outside of the office and we are generally not permitted to directly share our vendors' valuation models with others. We note that our vendors include Intex and Bloomberg. However, we routinely provide "pdf" copies of our proprietary model cash flow results. In addition, we provide cash flow results from our vendor supplied models upon request after obtaining permission from our providers. We welcome clients (auditors and companies) to visit our offices where we are willing to walk through our models in detail.

6. For accounting firms that use of the work of a company's specialist.

a. What are the circumstances in which the firm uses the work of a company's specialist?

Accounting firms across the country recommend our firm to their clients. This includes public and private companies. In our experience, an accounting firm will recommend that a company engage us if it believes the company does not have the internal wherewithal to perform the work on its own. This includes instances in which the external auditors are skeptical or uncomfortable with the company's valuation results. In general, we have already been vetted by an accounting firm before they refer work to us. If our firm is new to the external auditor that refers the work, we forward our SAS 73 documentation to them as a matter of course.

11. Are there other considerations related to the alternatives that staff should be aware of?

We caution against the unintended consequences of making a change to the existing rule. We believe a benefit of the existing standards is that we are able to share our expertise with multiple accounting firms directly as an engaged specialist, and indirectly as an engaged specialist of their clients. We

caution against integrating engaged specialists into the engagement team and providing requirements for evaluating the work of an auditor's engaged specialist that are the same as the auditor's responsibilities for supervising the work of employed specialists. We believe this could lead to acquisitions of independent specialist firms by the larger accounting firms in order to gain an economic advantage. We believe this could have two adverse consequences. First, smaller firms would be deprived of needed objective expert advice. We note that we have informed smaller firms about the details of complex securities accounting – OTTI for example – using information provided to us by the national experts in the larger firms. We believe the result is a stronger external auditing industry.

Second, we believe that, like us, many independent valuation firms depend on referrals from multiple accounting firms. If an independent valuation firm were to be acquired by a large accounting firm, we believe it would lose clients as other accounting firms would be hesitant to continue providing referrals to a firm owned by one of their competitors. We believe this could in turn lead to diminished expertise because the valuation firm would not be able to spread its costs over as many valuation clients. For example, we have approximately 25 clients for which we value TruPS. This allows us to spread our costs and develop deep expertise in the area. We further believe that in order to replace the revenues lost, an independent valuation firm would feel pressure to accept internal engagements for which it did not have as deep an expertise. As an independent valuation firm serving nearly 400 clients located across the country, we can afford to offer niche valuation products that we understand extremely well. We can also afford to offer new valuation services only after we have developed extensive expertise, recognizing that we can again offer them widely. The depth of our client base also allows us to decline engagements when we are not comfortable with the potential client or when we believe we do not have sufficient expertise to meet our internal quality standards.

We thus caution against a rule change believing it could lead to diminished expertise.

15. How do auditors currently obtain an understanding of the assumptions and methods used by a specialist under AU sec. 336?

We have experienced differing levels of due diligence among the auditing firms with which we work. At the one extreme, we have spent hours and hours reviewing our cash flow results and input assumptions with firms that had not previously engaged us before. Others largely rely on the fact that we have been engaged by their peers to perform valuation work and spend less time understanding our models and assumptions. As we indicated earlier, we believe the key here is transparency. We believe a specialist should be willing to detail its model methodologies and walk its clients through the process and not treat the model as a “black box”. We further believe that specialists should be willing to share their specific input assumptions, detail how they were developed, and provide corroboration for their use, including the results of back-testing.

16. Should the work of a company's specialist be treated as audit evidence the same way as other information provided by the company? Are there concerns associated with more rigorous testing of the

work of a company's specialist that may result from this approach? For example, would auditors increasing need to employ or engage specialists to perform work to assist the auditor with such testing?

We believe a concern here is that the external audit firm may not have sufficient internal expertise to thoroughly understand a company's engaged specialist's results. This would require the audit firm to engage its own specialist. We believe many companies would not want to pay for the same work twice and would disengage their specialist, relying instead on the auditor's engaged specialist. We believe this would deprive the company of the benefit of having a specialist with which it can develop an ongoing relationship. We believe this in turn could deprive the company of the opportunity to discuss and better understand financial issues which are not directly related to audit results. For example, our clients routinely ask us for our opinion about matters not directly related to their valuations.

22. Are the potential requirements to evaluate the knowledge and skill of an auditor's specialist clear and appropriate? Are there other alternatives to accomplish the objectives? Are there other factors that the auditor should consider?

We were surprised to learn that the smaller firms used the work of a company's specialist only 14 percent of the time and an engaged specialist just 5 percent of the time. We believe the PCAOB should consider providing additional guidance as to the circumstances in which a specialist should be used.

We have been engaged after the fact to assess and correct the work performed by an accounting firm's employed specialist. We believe the PCAOB should consider providing guidance as to the circumstances in which an accounting firm must consider engaging an outside specialist as opposed to using an employed specialist.

23. Are the matters described in the potential requirements on which the auditor and auditor's specialist should reach an agreement sufficient and appropriate? If not, what other matters should be required to be specified in the agreement before the auditor's specialist performs work to assist the auditor?

In our work, we always lay out our objectives and procedures, including their nature, timing and extent in the form of an engagement letter before we commence work. In addition, we have found that the external auditors generally provide context for the engagement when we work directly for them. We have found this to be particularly true when the engagement involved sensitive or high-risk issues and/or when the audit firm's client is in a difficult situation.

Much of our work is related to fair value. Our engagement letter sets forth our approach to estimating fair value, while our reports detail our methods and assumptions, including our information sources. We have provided hundreds of valuations under the fair value rules and are not aware of a single incidence when our valuation was considered to be unreasonable.

41. What are the likely economic impacts, including benefits and costs, of the potential alternatives discussed in this staff consultation paper? Are there any unintended consequences not already identified that might result from the alternatives?

42. To what extent would the potential alternatives help to improve audit quality or reduce the incidence of undetected misstatements, audit deficiencies and fraud?

As we indicated earlier, we believe the alternatives could result in the following adverse unintended consequences:

We believe smaller firms could be deprived of needed objective expert advice as valuation firms are acquired by the larger firms, resulting in diminished audit quality for the industry as a whole.

We believe the alternatives could lead to diminished expertise as acquired valuation firms would be unable to spread their research costs across multiple clients.

We believe that if audit firms are forced to use a specialist to review the work of the company's engaged specialist, fewer companies would retain their own specialists and would instead rely on the auditor's engaged specialist in order to avoid paying for the same work twice. We believe this would deprive companies of the ability to discuss complex financial issues unrelated to the audit with objective experts.

We thank the PCAOB for the opportunity to share our views on these matters and would be happy to provide additional insight.

Sincerely,



Douglas M. Winn, President and Co-Founder



Frank Wilary, Principal and Co-Founder



July 31, 2015

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Staff Consultation Paper: *The Auditor's Use of the Work of Specialists*

Dear Office of the Secretary:

We welcome the opportunity to comment on *Staff Consultation Paper 2015-01 – The Auditor's Use of the Work of Specialists* (the Consultation Paper). We concur with the Staff's observations that the use and importance of specialists have increased in recent years, in part due to the increasing complexity of business transactions and the information needed to account for those transactions. We appreciate the concepts and questions raised in the Consultation Paper. As a smaller firm dedicated to audit quality, we are committed to ensuring that auditing standards are both responsive to inherent financial reporting risks and scalable to entities of varying size and complexity.

Wolf & Company, P.C. is a regional accounting firm with approximately 185 employees and 18 shareholders. We offer audit, tax and risk management consulting services, and audit approximately 22 public companies and five broker-dealers.

Overview

We support enhancements to existing auditing standards that are first and foremost principles-based, and that provide for audit responses grounded in the auditor's risk assessment. We believe that auditing standards should be scalable to issuers of varying complexity. Reference is made to Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*.

Retention of AU336

Most audit firms, other than the large national/regional firms, do not employ specialists; but either engage specialists or use the work of the company's engaged specialist. We support the consideration of changes to existing standards, and believe that such changes should be through the enhancement, and not the rescission, of AU336, *Using the Work of a Specialist*. We believe that the proper application of the concepts embedded in AU336 reflect an appropriate level of audit responsibility for the auditor to evaluate the work of a specialist, yet we encourage enhancements that clarify and provide guidance to auditors. In this regard, we encourage consideration of the approach taken in ISA620, *Using the Work of an Auditor's Specialist*, where the requirements and application guidance can offer enhancements to AU336 that are responsive to many of the concepts included in the Consultation Paper. Of significance is the foundation of AU336, whereby 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. The appropriate application of AU336 allows smaller audit firms to respond to the risks of material misstatement in a manner that elevates audit quality. If the ability to use the work of a specialist was substantively eliminated or curtailed, we believe that auditors of smaller firms would be precluded from auditing many, if not all, public companies.

Rule 2-01

The Consultation Paper outlines a potential amendment that would require an auditor-engaged specialist to comply with the requirements of Rule 2-01 of Regulation S-X. We believe that an engaged specialist would likely be unable or unwilling to comply with the level of quality control processes and procedures necessary for the monitoring and evaluation of relationships that might impair that specialist's independence, and that the objectivity of an auditor-engaged specialist can be effectively evaluated through inquiry and, in certain instances, through assessment of the specialist's results when they may not align with the auditor's expectation or other evidence.

Definition of Specialist

With respect to the definition of a specialist, we support the continued recognition of income tax and information technology as specialized areas of accounting and auditing, and the exclusion of those persons from the definition.

* * * * *

We appreciate the opportunity to comment on the Consultation Paper and appreciate the PCAOB's efforts in this regard. The use of specialists in the audit environment is significant and therefore worthy of due consideration when assessing new or revised standards. We would be pleased to respond to any questions you may have concerning this letter.

Sincerely,

A handwritten signature in black ink that reads "Wolf & Company, P.C." in a cursive script.

Wolf & Company, P.C

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on June 18, 2015 that relates to the Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*. The other topics discussed during the June 18, 2015 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at: http://pcaobus.org/News/Webcasts/Pages/06182015_SAG.aspx.

NEAL R. GROSS

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

+ + + + +

STANDING ADVISORY GROUP

+ + + + +

MEETING

+ + + + +

THURSDAY
JUNE 18, 2015

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The Standing Advisory Group met in the Federal Hall of the Washington Plaza Hotel, 10 Thomas Circle NW, Washington, DC, at 8:30 p.m., Martin Baumann, Standing Advisory Group Chairman, presiding.

PCAOB BOARD

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- JEANETTE M. FRANZEL, Board Member
- JAY D. HANSON, Board Member
- STEVEN B. HARRIS, Board Member

STANDING ADVISORY GROUP

- MARTIN F. BAUMANN, PCAOB, Chief Auditor and Director of Professional Standards, SAG Chairman
- JOAN C. AMBLE, President, JCA Consulting, LLC
- HON. RICHARD C. BREEDEN, Chairman and CEO, Breeden Capital Management, LLC
- LORETTA V. CANGIALOSI, Senior Vice President and Controller, Pfizer, Inc.
- PETER C. CLAPMAN, Senior Advisor, CamberView Partners, LLC
- WALTON T. CONN, JR., U. S. Partner and Global Head of Audit Methodology and Implementation, KPMG LLP

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Chief Accounting Officer, Graham Holdings
Company

MICHAEL J. GALLAGHER, Managing Partner, Assurance
Quality, PwC

SYDNEY K. GARMONG, Partner in Charge, Regulatory
Competency Center, Crowe Horwath LLP

KENNETH A. GOLDMAN, Chief Financial Officer,
Yahoo, Inc.

L. JANE HAMBLEN, Former Chief Legal Counsel,
State of Wisconsin Investment Board

ROBERT H. HERZ, CEO, Robert H. Herz LLC;
Executive-in-Residence, Columbia Business
School, Columbia University

PHILIP R. JOHNSON, Former Non-executive Director,
Yorkshire Building Society

JOYCE JOSEPH, Principal, Capital Accounting
Advisory and Research, LLC

JEAN M. JOY, Director of Professional Practice
and Director of Financial Institutions
Practice, Wolf & Company, P.C.

GUY R. JUBB, Global Head of Governance and
Stewardship, Standard Life Investments, Ltd.

DAVID A. KANE, Americas Vice Chair, Assurance
Professional Practice, Ernst & Young LLP

JON LUKOMNIK, Executive Director, Investor
Responsibility Research Center Institute;
Managing Partner, Sinclair Capital, LLC

DOUGLAS L. MAINE, Limited Partner and Senior
Advisor, Brown Brothers Harriman & Co.

MAUREEN F. MCNICHOLS, Marriner S. Eccles
Professor of Public and Private Management
and Professor of Accounting, Stanford
University

ELIZABETH F. MOONEY, Analyst, The Capital Group
Companies

LIZ D. MURRALL, Director, Stewardship &
Reporting, Investment Management
Association

RICHARD H. MURRAY, CEO, Liability Dynamics
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Policy, CFA Institute

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Practice, and Chief Quality
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1 PRESENTERS

2
3 JOUKY CHANG, Duff & Phelps
4 KEN LINING, Aon Hewitt
5 WENDY STEVENS, WeiserMazars LLP
6 J. EFRIM BORITZ, University of Waterloo
7 SUSAN DuROSS, Harvest Investments Ltd
8 ANDREAS OHL, PricewaterhouseCoopers LLP
9 DANIEL OLDS, Ryder Scott Company, L.P.

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11 PCAOB STAFF

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13 GREG FLETCHER, Associate Chief Auditor
14 GREG SCATES, Deputy Chief Auditor
15 JOY THURGOOD, Associate Chief Auditor
16 JESSICA WATTS, Associate Chief Auditor
17 KEITH WILSON, Deputy Chief Auditor
18

1 MR. BAUMANN: So we're ready to move to our next
2 section of the discussion, and that is addressing the
3 consultation paper that we issued and sent to SAG members
4 about three weeks ago on the auditor's use of the work of
5 specialists.

6 There are a number of slides that were in your
7 package that were sent to you that provided some background
8 at a high level about existing standards. In the interest
9 of time I'm not going to go through those. And that
10 material is just a summary, if you will, of what was in
11 the consultation paper on existing standards. But we're
12 going to move directly to the panel discussions and turn
13 it over to Greg Scates and team to do that.

14 First thing I'd like to say though is the technical
15 people have asked if everybody could please make sure that
16 they speak directly into the microphones for the benefit
17 of everybody, both here and listening. Thank you.

18 MR. SCATES: Thanks, Marty. First I'll give the
19 disclaimer that the views expressed by the presenters are
20 their own personal views and not necessarily those of the
21 PCAOB, members of the Board, or the PCAOB staff.

22 The agenda for using the work of a specialist, this

1 morning we will have a panel to discuss the company's
2 specialist. And we'll run to around noon or a little bit
3 after noon. You'll have a break for lunch and then after
4 lunch we'll have our second panel that will discuss the
5 auditor's specialist.

6 MR. BAUMANN: I'll just add the panel won't run
7 until noon. The discussion will run to noon.

8 MR. SCATES: What we'd like to do with this panel --
9 this panel again is focused on the company's specialist,
10 how they use the work of a company's specialist, how the
11 specialist performs that work, then how the auditor
12 evaluates the company's specialist as well as the findings
13 of the specialist. So that's the focus again of the
14 panelists' remarks.

15 And now what I'd like to do is introduce our panel
16 for the discussion of the company's specialist. First,
17 we have Loretta Cangialosi. She is a member of our
18 Standing Advisory Group and is Senior Vice President and
19 Controller of Pfizer, a Fortune 50 biopharmaceutical
20 company.

21 Next to Loretta is Jouky Chang. Jouky is a
22 managing director in the Washington, D.C. office of Duff

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1 & Phelps, a global valuation and corporate financial
2 advisor. Jouky is a member of the Valuation Advisory
3 Services Practice.

4 Next we have Ken Lining. Ken is a consulting
5 actuary in the Chicago office of Aon Hewitt, a global
6 talent, retirement, and health solutions provider.

7 And then next to Ken is Wendy Stevens. Wendy is
8 a partner in the registered accounting firm of
9 WeiserMazars and is in charge of the firm's quality
10 assurance.

11 What I'd like to do is for -- they will provide their
12 remarks. And then if you'll hold your tent cards until
13 after the remarks, then we'll enter into a dialogue. So
14 I'd like to start our remarks with Loretta.

15 MS. CANGIALOSI: Good morning and thank you for
16 giving me the opportunity to discuss this important topic
17 with the SAG.

18 I am going to cover the use of specialists from the
19 financial statement preparer perspective, hopefully to
20 provide you with some insight into how preparers interact
21 with their specialists and what our interactions are with
22 our auditor specialists.

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1 We are actively engaged in discussions with the
2 specialists we hire. I want you to just have a little
3 background. We are a very large company. We had revenues
4 of 49.6 billion last year. Our assets are 169 billion.
5 When we get to kind of things that would come under fair
6 value and valuation measures, we had financial assets at
7 a fair value of about 44 billion, intangible assets of 35
8 billion, goodwill of 42 billion, and employee benefit
9 obligations of 10 billion. So we have lots of fair value
10 flowing through and measures, financial measures.

11 So we actually have pretty routinely the
12 specialists and valuation consultants primarily for our
13 intangibles, goodwill, actuaries for the employee benefit
14 plans, and then third party pricing services, which is
15 really for our financial instruments.

16 I'm going to make this statement. Don't know
17 whether other companies should feel the same way, but I
18 will make this statement because in all cases Pfizer
19 management accepts responsibility for the preparation and
20 the fair presentation of our financial statements, and
21 Pfizer management takes ownership of the amounts and
22 values developed in consultation with our third party

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1 specialists. So this is not a throw-it-over-the-wall
2 exercise where you employ a specialist and you never talk
3 to them.

4 In connection with our annual external audit
5 process we routinely interact with specialists employed
6 by our audit firm. We don't engage those specialists.

7 Our auditor uses specialists employed by their own
8 firm; so if you have looked at the diagram, that would be
9 Specialist No. 1, to assist with auditing the work
10 performed by specialists employed or engaged by our
11 company, who are Specialists 3 and 4 in the diagram. My
12 comments today will be limited to the use of our
13 specialists in the valuation of non-financial assets,
14 reporting units and businesses.

15 The first thing we've been asked to address is how
16 do we assess the specialist's skill and knowledge? Well,
17 when hiring a specialist, obviously we will review their
18 qualifications, not only their firm qualifications, but
19 of the professionals, the qualifications of the
20 professionals who they intend to have perform the work on
21 our engagement.

22 My apologies to Jouky, but I must confess that we

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1 tend to engage valuation specialists at large public
2 accounting firms that do not perform our audit engagement
3 for two main reasons: One, they're credentialed in the
4 area and they serve as specialists to auditors in their
5 respective firms. That means that they have an
6 understanding of U.S. GAAP and what it requires and how
7 those valuations are different than, different kinds of
8 valuations for instance, a valuation that might be done
9 in assessing whether to purchase a business, very
10 different than this.

11 Two, we have used their services for many years,
12 so we tend to use the same group. We're well acquainted
13 with their methods and they are well acquainted with how
14 we work. This ensures that our specialists will use only
15 generally accepted valuation methodologies and have the
16 global reach that we need when we do global transactions
17 and that there's an appropriate application of U.S. GAAP
18 valuation principles. So those are the FAS -- sorry, I
19 don't know the ASC, but FAS 157 concepts.

20 During the procurement process and at the
21 initiation of each engagement we hold discussions with our
22 valuation specialists: the specific facts and

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1 circumstances surrounding the engagement, the particular
2 issues that we believe will need to be addressed. For
3 example, the unit of account versus the unit of valuation
4 issues, unique assets or liabilities that we might have,
5 or think we have.

6 We look at the staffing plan to ensure that the
7 expertise and experience of the engagement team members
8 are well matched to the expected issues, and the existence
9 of alternative approaches and methodologies. So while we
10 look at credentials, we also try to understand do they have
11 a robust understanding of our industry, the pharmaceutical
12 industry, because it does have very specific issues with
13 valuing these kinds of assets, intangible assets.

14 And we also look at do they understand the life
15 cycle of pharmaceutical products? Because most of these
16 assets that we are attempting to value are constructed
17 based on 10 to 20-year forecasts into the future. So this
18 is a -- I have to say it's a subjective methodology. You
19 have to come up with a forecast on something that you don't
20 know. And as I've stated many times, the only thing I know
21 about a 20-year forecast right now is it will be wrong.
22 There is no way. I don't have a crystal ball.

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1 Do they understand things like the probability of
2 technical and regulatory success? We call it PTRS in the
3 industry. That's quite important when selecting discount
4 rates and understanding. So there's a lot that goes on
5 in attempting to evaluate them.

6 I've been asked about what controls we have in place
7 around the work of a specialist and conflict of interest
8 issues. My organization, the controller's organization,
9 actually is responsible for the review of all inputs
10 provided to the valuation specialists, our specialists.
11 And we ensure that other functions within our company that
12 provide inputs: long-range forecasts, working capital
13 assumptions, have the proper documentation and support for
14 those inputs.

15 I want to be clear that my group is actually the
16 neutral zone. We have no bias one way or another. We are
17 not the business development people. We don't have to
18 prove that the deal is great. And we are not the business
19 people who might have to live with the results of those
20 valuations subsequently. So our only view is to try to
21 get to a right number.

22 We hold discussions with our valuation specialists

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1 and the different colleagues who are providing inputs.
2 Lots of questions are asked. So you get together the
3 people with the professional specialty with the people
4 with the data. Make sure that everybody understands what
5 the data means.

6 We discuss with the valuation specialists the
7 methodologies, approaches, the application of certain
8 inputs to ensure that our company is using consistent
9 methodologies and approaches in our valuation efforts of
10 the same nature. We review the outputs of the valuation
11 specialists' work for reasonableness.

12 As far as conflicts of interest, we do consider
13 whether the firm may have conflicts of interest as a result
14 of any other work that they might be doing within Pfizer.
15 Again, we don't drive to any result. We just try to
16 understand what the inputs are, what the outputs are and
17 get to a number that is reasonable.

18 Because we're getting to a point estimate in a
19 process where there is an inherent likelihood that there
20 is a range of reasonable amounts because of the 20-year
21 forecast, discount rates and many, many assumptions, like
22 I said, the probability of technical success, Pfizer

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1 scientists may evaluate that differently than
2 Bristol-Myers scientists might. So you could come up with
3 different numbers. And we just try to understand if there
4 are biases, what the basis of changes are in forecasts so
5 that we better understand and can reconcile those views.

6 I've been asked to address what do we do with the
7 specialists' work? Okay, once the work is complete and
8 we have reviewed the outputs from our own specialists, we
9 review the completed model, the outputs, methodologies.
10 We reach out to both the valuation specialist and our
11 internal colleagues responsible for the inputs to resolve
12 any questions and ensure that we have the proper
13 documentation. So documentation is very important in
14 this exercise because you're going to live with these
15 values for a long time.

16 We ensure consistency, as I said. To further test
17 the outputs produced we discuss the outputs with the
18 valuation specialists that we employ and ask that
19 sensitivity analyses be performed on critical assumptions
20 so that we can understand what changes in discount rates
21 do and how sensitive they are to these factors.

22 Finally when the work of the valuation specialist

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1 has a significant impact on our financial statements; like
2 if we did a multi-billion dollar acquisition, the type of
3 work performed is a non-recurring nature, we will receive
4 active or written confirmation from the various functions
5 in our company that own the assets and liabilities valued
6 that there is agreement throughout the company that the
7 final inputs and outputs are reasonable and reflect the
8 best information. There's a lot that goes on.

9 We have also been asked to address question 6B in
10 the paper. Just for a reminder, they asked whether figure
11 1 in section 2A accurately describes it and if it's
12 inclusive. We believe the list is inclusive of the main
13 activities where an auditor uses the work of a company
14 specialist. Again, our accounting firm uses their own
15 internally-employed valuation and actuarial specialists
16 for all except very small transactions where they will use
17 the work of our specialists and review it.

18 We've been asked on question 8 -- this is --

19 MR. SCATES: No, Loretta, why don't we move on to
20 the next one maybe?

21 MS. CANGIALOSI: Okay.

22 MR. SCATES: Okay. Yes.

1 MS. CANGIALOSI: Okay. Fine.

2 MR. SCATES: And some of those we can respond to
3 with the questions.

4 MS. CANGIALOSI: Very good.

5 MR. SCATES: Okay. And next we have Jouky Chang.
6 The rest of the panelists, if you can, keep your comments
7 to about five to seven minutes, your remarks. Then we'll
8 move on.

9 Jouky?

10 MR. CHANG: Great. Thank you, Greg, and thank you
11 for having me here today.

12 So, I'll take this opportunity to quickly outline
13 the processes that we at Duff & Phelps have put together
14 for the successful execution of the thousands of valuation
15 engagements that we perform each year.

16 And before I do so, though, I thought I'd take a
17 minute to kind of share with you a little bit about who
18 we are and how we are organized. We're a global valuation
19 and corporate finance advisory firm. We have over 2,000
20 professionals around the world in more than 70 offices.
21 In 2014 we performed more than 7,500 engagements for 3,000
22 clients of which over 40 percent were S&P 500 and 80 percent

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1 of the largest hedge funds and private equity funds. We
2 are, we believe, one of, if not the largest provider of
3 independent valuation services.

4 Now, our professionals possess skills in a broad
5 range of expertise in areas of valuation advisory,
6 corporate finance, dispute and legal management
7 consulting, compliance and regulatory consulting and tax
8 services. As Greg mentioned, valuation advisory is the
9 unit that I reside in and it is also our core business.

10 Now valuation advisory includes traditional
11 corporate valuation products such as purchase price
12 allocations, goodwill and intangible asset impairments
13 and tax evaluations. It also includes alternative asset
14 advisory, real estate valuations, and fixed asset
15 management and insurance solutions.

16 So how do we ensure then that each engagement is
17 executed successfully with appropriate rigor? Well, our
18 process starts with a cross-functional organization
19 structure. First, our industry program focuses our
20 efforts into seven industry verticals each of which is led
21 by a seasoned managing director. The industry leader's
22 role is to ensure that we bring together teams that match

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1 the particular needs of our clients and that understands
2 their business, their drivers of value and the issues that
3 they face.

4 Second is the involvement of our product line
5 leaders in ensuring best practices are utilized by the
6 engagement teams. The product leaders and the entire
7 valuation advisory practice are supported by our Office
8 of Professional Practice, which we call OPP. And OPP is
9 our version of the National Offices of the Public
10 Accounting Firms.

11 Now, OPP is comprised of senior level professionals
12 that support engagement teams on a myriad of technical
13 valuation issues. Members of OPP also serve, observe
14 and/or advise regulators and standard-setting bodies on
15 valuation issues and best practices. Further, the office
16 is responsible for the development of training materials
17 for our staff, as well as the publication of various
18 technical titles.

19 We have also designed systems and procedures to
20 maintain the independence and objectivity, to identify
21 potential conflicts and protect confidentiality. For
22 example, our Compliance Department oversees the personal

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1 investment policy that restricts trading the securities
2 of publicly listed clients and prospects of Duff & Phelps.
3 It also manages the information barriers that restrict
4 access to and maintain protection of client data. And
5 administers the document retention policy to ensure
6 adequate record keeping of all engagements.

7 And our Office of Risk Management identifies,
8 evaluates, and mitigates financial, reputational, and
9 regulatory risk that is inherent in our day-to-day
10 operations. Specifically ORM identifies and evaluates
11 engagement risk, promulgates and implements related
12 policies and procedures, and assesses compliance with its
13 directives.

14 At the engagement level each engagement is led by
15 an engagement managing director that is responsible for
16 all aspects of the engagement. A concurring MD with the
17 requisite industry and technical experience performs
18 important oversight duties throughout the engagement.

19 Now in the context of an M&A transaction where we
20 assist management with the acquisition method of
21 accounting for business combinations, this would be a
22 multi-discipline team most often comprised of

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1 professionals that specialize in valuations of business
2 interests and intangible assets, real property, and
3 personal property. For transactions that involve complex
4 securities and contingent consideration arrangements our
5 in-house derivatives and financial engineering
6 specialists would also be part of the engagement team.

7 The team will then develop and execute a work plan
8 that befits the project requirements. The work plan for
9 a purchase price allocation engagement would include
10 elements that Loretta has already covered in some extent.
11 It includes meetings with management to understand the
12 purchase consideration that was paid, the rationale for
13 the acquisition, the important attributes of the
14 transaction. All of these will facilitate the
15 identification of the assets and liabilities that may
16 require valuation and a clear delineation and definition
17 of the scope and responsibilities. Meetings with the
18 audit team to ensure agreement on the scope of services
19 and the evaluation approaches and procedures to be
20 employed, meetings with leaders or representatives of the
21 business units to discuss the engagement process, timing,
22 involvement of personnel, and other project management

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1 issues and hosting weekly status calls with appropriate
2 company and audit team personnel to review engagement
3 progress and address any challenges and obstacles that
4 have come along the way.

5 And during the course of our work we will have
6 significant interaction with the company's finance,
7 accounting, and tax departments. In addition, we will
8 also meet with personnel from corporate development, sales
9 and marketing, research and development, operations and
10 maintenance, and investor relations. These interviews
11 allow us to better appreciate the attributes of the subject
12 assets and liabilities and assess the relevance of the
13 information provided by management. That assessment is
14 also informed by our research into market expectations for
15 the subject assets and liabilities. That is to say, we
16 will independently test the reasonableness of
17 management-provided projections and assumptions against
18 relevant market data and our industry experience.

19 As the team performs the analyses there will be
20 numerous discussions with management to vet the
21 significant underlying assumptions. This step ensures
22 that our team has properly interpreted the information

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1 provided by management or for management to understand the
2 basis for the assumptions being applied. Further, it is
3 important for management to be fully informed as to a
4 valuation process and conclusions so they can take
5 appropriate ownership and responsibility for the
6 preparation of their financial statements.

7 Let me turn a little bit now lastly, to our quality
8 control process. The quality control process at Duff &
9 Phelps is imbedded into our overall work plan. It starts
10 with the careful selection of key personnel with a need
11 of product and market disciplines that understand not only
12 the subject assets or liabilities, but also the
13 appropriate methods and market factors to take into
14 consideration in their work.

15 During the project execution phase we use industry
16 best practice guides as a primary reference to maintain
17 the consistency and quality of our valuations. Further,
18 we will model varying scenarios and alternative
19 assumptions to assess sensitivities and key valuation
20 parameters.

21 Our executive review process by MDs and directors
22 pays close attention to market comparable intelligence,

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1 unique asset or liability attributes, and the
2 sensitivities that are modeled by our colleagues before
3 forming their tentative conclusions. The models are also
4 subject to at least one full tick and tie validation by
5 Duff & Phelps professionals that are independent of the
6 engagement team.

7 Before our work product is shared with the client,
8 an independent review of the analysis and findings is
9 conducted by the concurring MD. The review includes an
10 assessment of work paper defensibility, comparability to
11 and consistency with other engagement work products, an
12 assessment of the market conditions considered, and the
13 uniqueness of the asset or liability.

14 A work product is then released to and reviewed by
15 the company and its audit team. The work product is
16 presented in the form of a written report accompanied by
17 supporting exhibits. Our experience shows that the
18 combination of auditor involvement at the onset and
19 throughout the engagement, the contents of the written
20 report and the exhibits, and our responses to the auditor's
21 queries has provided auditors with sufficient basis upon
22 which to sign off on our work.

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1 I've probably exceeded my allotted time, but let
2 me just note that our work with alternative asset managers
3 follows similar processes as we validate management's
4 estimates of fair value.

5 So, I hope this overview has been informative to
6 you on the role of a company specialist. The breadth of
7 practice demonstrates the assistance we provide to
8 companies as they seek to obtain best practice valuation
9 assistance and we look forward to the discussions that
10 follows.

11 MR. CHANG: Thank you, Jouky. Now, let's turn to
12 Ken Lining.

13 MR. LINING: Thank you, Greg, and I appreciate the
14 opportunity to be here in front of this distinguished group
15 today to talk about the role of the actuary as a company's
16 specialist.

17 So I've been in this profession now for over 30
18 years. I'm a member of the American Academy of Actuaries,
19 which subjects me to certain continuing education
20 requirements, and also we have a discipline structure set
21 up for certain types of dealings.

22 The role of an actuary really can be summarized I

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1 think as a business professional who measures risk.
2 You've heard -- my colleague here has mentioned employee
3 benefit plans. So, we primarily, in the pension area is
4 calculate what the liabilities are that the company, you
5 know, must, first of all fund, and then, second of all,
6 record on their balance sheets and annual expense.

7 So, you know, we're working with liabilities.
8 We're using mathematical and finance principles to make
9 these calculations primarily free of interest and what we
10 call life contingencies. And then we make these
11 calculations in accordance with applicable laws, so on the
12 funding side in the U.S., we follow the Internal Revenue
13 Service ERISA requirements. On the accounting side,
14 we're looking to the FASB. And if we're making
15 international calculations, the IASB to make those
16 calculations. In general, we are specialists engaged by
17 the company, so we're independent and objective.

18 So, my outline is really is three points. No. 1,
19 the work that we perform; No. 2, the education, skills,
20 and quality controls; and then No. 3, our role as a
21 company's specialist.

22 So, as you probably know, there are many types of

1 actuaries. There's life insurance actuaries, property
2 and casualty actuaries, health benefit actuaries. And
3 then what I do is in the pension and post-retirement. So
4 it'd be defined benefit pension plans, what are called
5 retiree medical and life insurance plans that pay those
6 types of benefits to folks after they have retired from
7 a company. We perform a very wide range of work, and we
8 have many stakeholders that are involved in the products
9 that we deliver.

10 In terms of education, there's a lot of educational
11 requirements: skills, certifications, ongoing continuing
12 education requirements.

13 In terms of quality control, my experience is that,
14 you know, my firm and all the other firms I've worked for
15 in my career take this very, very seriously. We do our
16 work, check our work, have it reviewed. And then in
17 working for different companies, we are typically retained
18 to do the types of calculations that require our special
19 knowledge and skill. And of course in the course of our
20 work we also do our best to stay alert for potential
21 conflicts of interest.

22 So go next slide. So, a little bit more on the work

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1 that we perform. Actuaries in terms of myself, for
2 example, we're under the Joint Board with ERISA, which is
3 the Department of the Treasury, which then gives us the
4 ability to make the calculations regarding the funding,
5 the cash funding the companies have to make for their
6 plans. So they have to make annual filings via Form 5500.
7 We certify to the contributions and to those calculations.

8 Secondly, we make the accounting calculations that
9 are needed for balance sheet disclosure and for income
10 statement expense. These are reviewed by a lot of
11 different stakeholders: stock and bond holders,
12 regulators, rating agencies. And then also there are many
13 other types of work that actuaries perform that are not
14 necessarily as -- this group may not be as interested in
15 those. For example, things like certain benefit
16 calculations, non-discrimination testing requirements.
17 But there is a wide range of things that we do perform.

18 One of the things I wanted to point out was that
19 we typically do get involved with some of the corporate
20 transactions: mergers and acquisitions, due diligence.
21 You've already many of our colleagues have mentioned
22 things like purchase accounting and business

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1 combinations. And we are typically with those types of
2 things as well, those types of calculations.

3 Regarding education and skills, it's a long road.
4 Most actuaries; not all, but most have college degrees in
5 areas like actuarial science, mathematics, computer
6 science, probability and statistics. Then there is
7 ongoing work experience that's required to be performed
8 under a supervising actuary. In addition, I mentioned the
9 continuing education requirements. We have to be
10 qualified to issue what's called a Statement of Actuarial
11 Opinion, which requires annual certification.

12 Our work is peer-reviewed by other actuaries
13 including perhaps some committees when we're perhaps
14 outside of a guideline on a particular assumption. So in
15 general we take our work very seriously and do our best
16 to perform both on the behalf of the participants, the
17 companies, and then the other interested parties that are
18 stakeholders.

19 So when we get to our role as a company's
20 specialist, as I mentioned, we're performing the
21 accounting calculations that govern the profit and loss
22 statement and the balance sheet disclosure. Companies

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1 typically will select their assumptions with input from
2 their actuaries and then concurrence from their auditors.
3 So the actuaries will generally have to certify the results
4 that they're providing for balance sheet disclosure
5 purposes. Therefore, we have a responsibility to
6 document our work, to provide reconciliations of changes
7 and things like liabilities, assets, and also to quantify
8 the main factors that can cause variances from year to year
9 in the actual versus expected results.

10 Because we're making forward-looking assumptions,
11 there are always going to be variances from the actual
12 experience to the expected. And companies and other
13 interested parties typically want to know the main drivers
14 of those. For example, is it a discount rate change, a
15 mortality table change? Did the assets perform better or
16 worse than expected?

17 And then actuaries are considered as trusted
18 business partners in many situations to assist companies
19 with things like M&A, union negotiations, and other types
20 of accounting transactions.

21 It is important that we maintain awareness for
22 potential conflicts of interest. For example, I was

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1 involved a couple years ago where I had a client that was
2 looking at an acquisition and it just happened that the
3 actuary for the other party was also employed by the same
4 company. So we set up a Chinese wall and provided
5 applicable disclosures of our objectivity and
6 independence for each of us.

7 To specifically comment on the questions in the
8 staff paper, there was a question 6B, is that diagram
9 accurate? And we think yes, qualified actuaries should
10 be calculating the pension and OPEB obligations for
11 companies.

12 If an auditor has access to models, is the access
13 sufficiently detailed? Actuaries generally use
14 proprietary systems, however, they will provide
15 illustrative models to auditors if needed. The more
16 typical situation is 8B where the auditors will review and
17 test select items, critical assumptions, reconciliations,
18 asset statements and those kinds of things.

19 Is it appropriate for the auditor to consider the
20 knowledge; that's question 14, and experience and skill?
21 Yes. And note that we're typically required to certify
22 to this assumption.

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1 Then question 15, how do auditors obtain an
2 understanding? The company specialist actuaries will
3 typically invest time helping the auditors understand the
4 material effects of various assumptions, the
5 sensitivities to the various assumption changes.

6 And I want to close with a comment that many of the
7 large accounting and auditing firms will employ their
8 in-house actuaries. So the question was raised right
9 before the break about the auditor then having their own
10 specialist. We find this is a very common thing to happen.
11 So there are a lot of issues and discussion we can have
12 around that. We can pick that up maybe in the questions.

13 MR. SCATES: Thank you, Ken. Now, we'll turn to
14 Wendy.

15 MS. STEVENS: Okay. So, I have the dubious
16 distinction of being the only thing before you get to ask
17 your questions, so I will try to be as quick as possible.

18 I thank you to the chief auditor of the PCAOB and
19 his staff and the PCAO Board for the opportunity to
20 participate on this panel today. The views I express
21 today are my own and not necessarily those of WeiserMazars,
22 LLP, despite my frequent use of the word "we".

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1 For those of you who are not familiar with
2 WeiserMazars, we are an accounting and advisory firm with
3 approximately 700 professionals and over 100 partners in
4 the U.S. We are also an independent member firm of the
5 Mazars Group International Network and a member of the
6 Praxity Global Alliance of Independent Firms. We provide
7 services to clients in a variety of industries. Currently
8 the largest segments we serve are manufacturing and
9 distribution and financial services. Our issuer and
10 broker/dealer clients would be characterized as smaller
11 businesses and primarily operate in these two segments.
12 We must comply with the PCAOB auditing standards in
13 performance of these engagements, and they're also subject
14 to the applicable rules and regulations of the SEC.

15 At WeiserMazars we strive to have the professionals
16 in place with the knowledge and experience to audit in
17 these industries. We operate with a high level of focus
18 on continuous improvement and quality. We are constantly
19 providing training to deepen our auditor skills and their
20 ability to audit the more complex areas of our clients'
21 financial statements. We evaluate the performance of our
22 partners and professionals in terms of technical depth and

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1 adherence to the firm's quality policies and procedures.

2 We fully support the work of the PCAOB in its
3 efforts to enhance audit quality in order to provide
4 investors and other financial statement users with
5 increased transparency and financial reporting. We also
6 appreciate very much the outreach currently taking place
7 with regard to the use of specialists and auditing
8 estimates and fair value measurements.

9 We encounter both management-employed and engaged
10 specialists within our practice. The staff's
11 consultation paper accurately addresses the circumstances
12 that specialists are used. We compiled this list in terms
13 of frequency. And I'm not going to read the list.

14 So how do we address use of a company specialist?
15 During the planning phase of an engagement, among other
16 things, we identify risks and assess whether these risks
17 could result in material misstatement of the financial
18 statements. As it relates to accounting estimates, this
19 consideration includes but is not limited to the nature,
20 method of computation, controls in place, who prepared the
21 estimate, as well as complexity, subjectivity, and
22 uncertainty inherent in the results. Our initial planned

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1 audit response is designed based on the synthesis of all
2 this information and the procedures are determined based
3 on the significance of the risks identified. This
4 includes preparer risk.

5 Specifically, if a specialist is involved, we
6 consider the relationship of the specialist to the client,
7 the qualifications -- and now that you both talked about
8 quality control, we might actually ask those questions in
9 the future, because I think they are critical as to how
10 we actually would use the specialist results -- the methods
11 used in the current year and as compared to the prior year,
12 the objectives, scope, and assumptions used, and our
13 ability to test the source data. Our audit response would
14 be altered if we are not satisfied with the responses and
15 the results either in planning, during, or when we are
16 concluding our audit.

17 Our application of the existing use of specialist
18 standards sometimes does result in more rigorous
19 procedures when our evaluation of risk warrants a more
20 extended approach. We do however recognize there is room
21 for improvement in the current auditing standards that
22 address the use of specialists.

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1 And I do want to make a point about management and
2 audit committees. They should continue to have the
3 ultimate responsibility for accuracy and reliability of
4 estimates used in financial reporting. Auditors are
5 required to come to certain conclusions with regard to the
6 assertions underlying the financial statements, so any
7 revisions should not remove or change where the
8 responsibilities lie. Revisions to the existing
9 standards and complementary guidance and/or FAQs should
10 avoid any unintended consequences that would limit
11 responsibility of any of these parties or
12 disproportionately move the responsibility to the
13 auditor.

14 Limiting the ability to use auditor's judgment to
15 rely on a company specialist may not result in measurable
16 improvement to audit quality, but will likely result in
17 additional cost. Taking the judgment away from auditors
18 may in fact also have the unintentional consequence of
19 reducing the focus and tenacity by which auditors and
20 possibly management and/or the audit committee challenge
21 the most complicated and risky computations. We believe
22 there may be cases where recomputation by another

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1 specialist is required, but view this to be subject to the
2 auditing process in evaluation of risk, appropriate audit
3 response, and evaluation of the relevance and reliability
4 of audit evidence.

5 In closing, it should be clear we support
6 improvement in the current principle-based standard for
7 use as specialists. We recommend clarity in the
8 definition of specialist, greater alignment with other
9 existing standards in use by auditors and PCAOB guidance
10 and/or FAQs issued to support effective implementation of
11 the revised standard. Thank you.

12 MR. SCATES: Thank you, Wendy. And thank you, all
13 the panelists.

14 Before we get into the discussion and questions of
15 panelists, I'd also like to remind the SAG members that
16 we had two alternatives that were discussed in the
17 consultation paper. The first alternative with respect
18 to using the work of a company's specialist was with
19 respect to should we amend 336? And when we say "amend,"
20 it would be removing certain provisions that we consider
21 to be limiting the auditor's responsibilities.

22 The second alternative would be to completely

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1 rescind 336, and then this would require the auditor to
2 evaluate the evidence that's provided by the company's
3 specialist just like the evidence that's provided by
4 others within the company.

5 So those are the two alternatives that are
6 discussed in the paper, we'd like to get your views on that
7 as well as other questions you have of the panelists. So
8 I'd like to open it up now for discussion among the members
9 of the Standing Advisory Group if you have questions of
10 the panelists or have comments on these two alternatives.

11 MR. BAUMANN: Jeremy Perler?

12 MR. PERLER: Thanks. I was interested to read all
13 this, and thank you for all the comments. I mean, the one
14 question that stuck out in my mind was why would auditors
15 cede the responsibility over appropriateness and
16 reasonableness on any very sensitive estimates,
17 particularly the most sensitive estimates? I understand
18 the logistics behind what goes on now, but I was in reading
19 it, I seemed to be in favor of Alternative 2 and just bring
20 that responsibility over to the auditors.

21 MR. BAUMANN: Can you expand on that a little bit,
22 Jeremy?

1 MR. PERLER: The financial statements are full
2 of -- I mean, every line in the financial statement is an
3 estimate. Depreciation is an easy one. Useful life is
4 an easy estimate, and you can look historically. But
5 estimates on future -- on valuation of asset and
6 liabilities are based on future variables that I recognize
7 need specialists to opine on. But particularly in the
8 case of a company engaged or employed specialists for the
9 auditor to not have significant judgment on the
10 reasonableness of it, I think that there is a significant
11 amount of risk of material misstatement in the process.

12 MR. BAUMANN: Thanks. Sri Ramamoorti?

13 MR. RAMAMOORTI: I appreciated Wendy's question at
14 the end about seeking clarity on the definition of who a
15 specialist is. And it has always bothered me that beyond
16 the fact that the international standards would offer them
17 as experts and we in the U.S. tend to call them specialists.
18 There is this fundamental question of we need to know who
19 is hiring whom for what purpose.

20 And so, from the academic literature on expertise,
21 we talk about two types of experts. There are substantive
22 experts, and there are normative experts. So substantive

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1 experts are very goal-oriented and domain-specific and
2 applications-relevant. Normative experts are subject
3 matter experts and they're more process-oriented. And
4 what that leads to is an example that will probably clarify
5 what I'm trying to say here.

6 So you could have technology for tax accounting
7 where tax accounting is the substantive domain and
8 technology is the helper or the specialist in the way we're
9 using it. But when you talk about tax accounting for
10 technology, now it is technology that's the goal, that's
11 the domain, and the expert or the specialist is the tax
12 accountant.

13 So the problem I'm having with the definition right
14 now of specialist is that it says these are folks who have
15 expertise outside of accounting and auditing, and that's
16 not really true. Because there could be accountants and
17 auditors who could serve in the capacity of specialists
18 where the domain is other than accounting and auditing.

19 MR. BAUMANN: Maybe you could expand a little bit
20 more on that point you're trying to make. Is it that you
21 want to include other parties in the list of specialists?

22 MR. RAMAMOORTI: No, no, no, no. All I'm saying

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1 is that we need to understand what kind of expertise is
2 being called for and who is serving whom. So in the sense
3 who is the core? Who is the goal here for which we are
4 doing this? So to the extent we're talking about
5 financial reporting being the domain, anything else like,
6 you know, statistics or computers or, you know, valuation,
7 anything outside, sure, you know, they all are the
8 normative experts because they're all functional
9 process-oriented, et cetera.

10 But where you have technology, let's say, as the
11 domain for which tax accounting is the specialist, then
12 when Google would hire a tax accounting consultant to do
13 some of their kind of valuations or whatever from a tax
14 perspective, the Google folks are the substantive folks
15 and the tax accountants are the specialists because the
16 domain has changed. It's not accounting. And so to the
17 extent we say in the standard that this is specialists as
18 in people who are outside of accounting and auditing,
19 that's not technically correct because there are other
20 applications in which accountants and auditors could be
21 the specialists.

22 MR. BAUMANN: Okay. Thank you very much for that

1 insight.

2 Liz Murrall?

3 MS. MURRALL: Thank you, Marty. In considering
4 whether or not auditors could rely on the work of company
5 specialists, the auditor is to gather adequate audit
6 evidence to form an opinion on the financial statements.
7 And I think as investors we do have concerns that the
8 engagement relationship with the company, with the company
9 specialist, whether that specialist is engaged or
10 employed, does create a threat to their independence.

11 And I actually agree with the staff paper which says
12 that auditors should evaluate in the same way as other
13 information provided to the company. I think it's very
14 important to distinguish between auditors' employed and
15 engaged specialists and companies' employed and engaged
16 specialists. And in particular, in following that model
17 it's also consistent internationally with ISA 620. And
18 I think that's very important investors invest
19 internationally, and companies are international and can
20 two listings.

21 MR. BAUMANN: I think Guy teed up a question before
22 lunch, and Jeremy's comment and your comment follow up on

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1 that, which is the question really was does the auditor
2 have to understand the models and methods that were used
3 by this company specialist? And I think we can go back
4 to the, maybe to Wendy or to the group here to talk about
5 how proprietary their work is.

6 But I think the point that's being made is if some
7 of their work is proprietary and, there's a black box that
8 the auditor's not looking into, you're questioning is that
9 acceptable for the auditor, therefore, to accept the
10 results of that work as audit evidence if the auditor
11 doesn't really understand maybe what was calculated inside
12 that black box.

13 Is that the essence of your question, and yours,
14 Jeremy, and yours earlier, Guy?

15 MR. JUBB: Yes, with the addition in my question
16 related also to where it was relating to the black box used
17 in a subsidiary company that may not have been audited by
18 the lead auditor.

19 MR. BAUMANN: So I think there's common questions
20 there that maybe we can give back to the panel and to Wendy
21 in terms of an auditor using that. I think Doug's card's
22 up, but if you don't mind, I'm going to go to Jeanette

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1 Franzel and ask Jeanette.

2 MS. FRANZEL: Thanks, Marty. I do have a
3 follow-up question for Wendy, if you could elaborate a bit
4 on something you brought up. You mentioned that, based
5 on risk and other circumstances, you may make a
6 determination that you need your own auditor's specialist
7 to go out and review what management specialists did.
8 Could you elaborate a little bit more on what kind of a
9 scenario, you know, that would represent? And then what
10 procedures would your specialist do then to review
11 management specialists' work?

12 MS. STEVENS: Do you want me --- can I answer it
13 now? Yes? Okay, because I'm still a little confused on
14 the first couple of questions that were asked, so I'll
15 answer Jeanette's question first.

16 When we go through the planning process; and so I
17 will use what Loretta was talking about and all of the
18 things that she does, we will understand the process that
19 takes place. And I'm going to specifically narrow it down
20 to let's say business combinations so that we can be
21 talking about a specific example.

22 So we will go through with the client what they did

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1 in terms of gathering the data, what their part of it was,
2 what the specialist's part of it was. There's a big
3 difference between what Loretta describes and what she
4 owns and what her input into the process is; and I mean
5 you and your group, versus when we -- and we encounter this
6 often with a smaller company where they basically just
7 off -- and now I'm talking about they've hired a specialist
8 and they have provided all the information.

9 So there's not a lot of -- I won't use the word
10 "independence," because that's probably overused, and
11 that's not the right word to use, but they don't own the
12 knowledge, internally, before they go hire the specialist.
13 So we would be much more skeptical of the objectivity.
14 Okay? So there's one circumstance.

15 Another circumstance in that same scenario is we
16 have an unsophisticated client and we perhaps don't have
17 them hiring Duff & Phelps. It's a valuation expert that
18 was chosen for the least cost, because that's usually a
19 red flag to us that maybe they don't possess the
20 qualifications. And, you know, the point I made earlier
21 about the quality control at the specialists had come up
22 when we were vetting it internally. That would be quite

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1 important to us. So, we may ask that question in the
2 future.

3 But in the past, although we didn't specifically
4 ask that question, I would say if we were skeptical on the
5 quality, we won't spend a lot more time trying to figure
6 out if the specialist -- we do have the in-house expertise,
7 and we would probably pair them up with the specialist and
8 the client. And he may or may not rerun it. The inputs
9 also become very critical, and that's where the
10 sensitivity analysis comes in. We may suggest that the
11 specialist do it, or we may do it.

12 But there's a number of circumstances. And again
13 it comes down to your overall judgment, the materiality,
14 how risky the range is. But that's a couple of examples
15 of where we might hire our own specialist or use somebody
16 in the firm.

17 The other questions about the expectation gap, I
18 want to say, of what the auditor does versus what the
19 specialist does, from my perspective when I was an auditor
20 and the partner signing the opinion, there would not be
21 a circumstance where I would off-load my responsibility
22 to understand the risks inherent in an estimate from an

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1 auditing perspective to a specialist because I was
2 comfortable with their competence and some ticking and
3 tying of inputs and outputs. To me, and it falls under
4 other standards, but it is not different from the tax
5 provision.

6 Now that I'm on the other side in a compliance role,
7 I have had circumstances where I've had issues or questions
8 on the tax provision and the partner might say to me, which
9 is unacceptable, well, that's not my responsibility.
10 It's the responsibility of the tax partner. And I will
11 tell you the engagement team still has ultimate
12 responsibility for understanding the assertions within
13 the financial statements. And from an auditor's
14 perspective, what's most important is risk ranking them.
15 So if the area of the estimate that a specialist was used
16 is not that inherently risky, we wouldn't spend the same
17 amount of time as if there's a wide range of possible
18 outcomes. So, I hope that addressed some of the
19 questions.

20 MR. BAUMANN: Let me just follow up on that, if I
21 may. What you're saying, I think, was; and it sounds good,
22 that you, as the audit partner, conclude that the

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1 assumptions that the management specialist used are
2 reasonable and you conclude that the methods and their
3 calculation and their models -- you know enough about it
4 so you've concluded that's reasonable so you can then
5 evaluate that estimate. I think that's what you've said.

6 MS. STEVENS: That's correct.

7 MR. BAUMANN: So, and if that's the case, that's
8 good, but I think some people here should understand that
9 that's I believe beyond what AU 336 might require.

10 MS. STEVENS: Only in the circumstance that we have
11 a judgment that we're not comfortable with what was
12 presented to us.

13 And I also want to make one other comment. Based
14 on my conversations with a lot of audit teams, we do not
15 encounter a lot of pushback on being able to speak to the
16 specialist or the underlying methods, assumptions, what's
17 referred to as proprietary. We believe we've had full
18 access to everything that we've needed to be able to come
19 to our audit conclusions.

20 MR. BAUMANN: Yes, so again I would just say I think
21 that sounds very good. And it's not bad that it's beyond
22 AU 336, because we think AU 336 -- at least we're teeing

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1 up in this consultation paper that the auditor should audit
2 the evidence produced by the specialist or my management
3 in a similar way. And it sounds like you're auditing it
4 in a similar fashion. You're gaining an understanding of
5 methods and models, assumptions and concluding on the
6 reasonableness of that. And that would lead me to say to
7 meet your baseline our standards should be elevated to your
8 baseline.

9 MS. STEVENS: The only difference I think in what
10 you're saying and what I'm saying is I think we are
11 following the standards, and I think the standards allow
12 you to go further should the circumstances suggest. So
13 we don't think that should be mandated. We think that only
14 in the circumstances where we are skeptical on the results
15 would we take it further.

16 MR. BAUMANN: I understand. Okay. Thank you.

17 I think Jay Hanson's card is up. Let me take Jay.
18 Doug, you're definitely next.

19 MR. HANSON: Well, I've got a question I really
20 want to pose to some of the auditors, and I'll let Wendy
21 off the hook and maybe focus on a larger engagement. One
22 of the alternatives in the staff consultation paper is

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1 treat anything you get from management the same. So I
2 think -- and it's been a long time since I've actually been
3 in the field as an auditor, but as a young auditor you learn
4 how to deal with accounts receivable, for example. That
5 you get the listing from your client. You do something
6 to make sure the listing actually adds up to the number
7 at the end, you reconcile it to the general ledger, you
8 select items to test, you send confirmation letters, you
9 test the aging, you test the accounts related to that. And
10 so that's within the skills of an auditor.

11 So, in contrast; I'm going to look at Ken here,
12 let's say that Ken's firm performed an actuarial valuation
13 on a defined benefit pension plan covering 15,000 people
14 at a given company. I know what I used to do when I'd get
15 that valuation report, and I can imagine what happens
16 today, but I'm just wondering for the major firm
17 representatives especially if they could maybe give us a
18 practical illustration of the difference or the types of
19 things that would be required to do that, treat it the same
20 as if it was that list of accounts receivable and test it
21 in the same way that an auditor tests that list of something
22 they do have the skill set to do, what it would actually

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1 take to essentially re-perform what Ken's firm had done
2 on that actuarial valuation.

3 MR. LINING: So is this for me to answer?

4 MR. BAUMANN: Who wants to go first? I think he
5 was asking some of the auditors in the audience if any of
6 them -- Bill or Mike or Sydney or anybody wants to take
7 the microphone.

8 MR. GALLAGHER: I'm happy to take a shot, and Bill
9 can correct me if I go off track.

10 So, Jay, I think the way we would look at it is
11 obviously everything is done in the context of the relative
12 materiality and risk of the estimate, but you would look
13 at the quality of the expert. What's their professional
14 reputation? You'd look at potential independence
15 factors. Are they truly coming in and independent? For
16 example, if the company that they're doing work for is one
17 of 10 clients or is their largest client and represents
18 50 percent of their billings, that's probably something
19 that would catch our attention.

20 If they're one of thousands of clients and strong
21 professional reputation and the like, independent in every
22 other way, we would look at certainly the information

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1 provided to the expert, because it's garbage in/garbage
2 out. I'm probably violating the rule about not talking
3 into the microphone. And so making sure that they have
4 the right information on which they can perform the
5 calculations pursuant to their expertise. You would look
6 at whether the numbers are reasonable. You'd look at the
7 history. How close have they been in the past based upon
8 historical information as a sense as to how accurate
9 they've been, how good they've been.

10 We --- and the large firms typically -- when you're
11 talking about actuaries, we typically have our own
12 actuaries on staff. And so you have expert-to-expert
13 conversations. So everybody's kind of talking the same
14 language. I think that the issue that we're talking
15 about; and Marty teed it up and others as well, is what
16 does that mean in terms of going into the black box and
17 how much detail do you get into going into the black box?
18 And that level really depends I think on everything that
19 I just spoke about. What's the risk? What's the history?
20 What's the reputation and quality of the outside experts?
21 And you could get a different answer depending on the
22 answers to those earlier questions.

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1 So maybe not a terribly fulfilling answer, but it
2 depends on facts and circumstances. But hopefully that
3 helps.

4 MR. HANSON: And Mike, just to clarify, were you
5 just giving a rendition of what happens today, or your
6 vision of, gee, if you said you have to audit the same way
7 you audit a list of accounts receivable in the future?

8 MR. GALLAGHER: I think that's kind of how we look
9 at things today, Jay, that -- and again, sliding scale
10 based on materiality and risk, but I think that's how we
11 would look at things today.

12 MR. HANSON: Yes, and I'm really kind of curious
13 as to how much thought you've given to, gee, if this really
14 were to change the paradigm and audit it like you do
15 anything else, how much more work it would be to do that
16 exercise.

17 MR. GALLAGHER: Yes, and I do worry a little bit
18 about the notion that it's like anything else and it
19 assumes that an auditor can't consider -- and maybe that's
20 not what we're talking about here, but I would hope we're
21 not taking it to the point where the auditor can't consider
22 the technical expertise and independence of the expert as

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1 a factor in weighing the amount of work that the auditor
2 would do.

3 MR. BAUMANN: Thank you very much for that response
4 to Jay's good question, but it sounded a little bit almost
5 like Wendy's answer that -- sounded very good, but it did
6 sound also --

7 MR. GALLAGHER: Thank you, Marty.

8 (Laughter)

9 MR. BAUMANN: Noted for inspections, right?
10 Sounded very good, but it also sounded potentially beyond
11 what is simply in the book on 336, that procedures are more
12 risk-based and in certain cases would go beyond what it
13 says, obtain an understanding of what the specialist did.
14 But in cases where you think the risk of material
15 misstatement is greater, that understanding would be how
16 reasonable are the assumptions? How reasonable are the
17 methods and testing that by your own actuary or your on
18 specialist in those circumstances. So your sliding scale
19 was very risk-based, maybe more than AU 336, the existing
20 standard, is.

21 But you're nodding your head, so I'm going to say
22 Mike was saying yes.

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1 MR. GALLAGHER: Yes, I think that's fair. And
2 again, similar to Wendy I think that you've got enough
3 flexibility under 336 to make those judgments.

4 MR. BAUMANN: Doug Maine has been -- his card's up
5 there for a few minutes. I promised him he would be next.

6 MR. MAINE: Thank you, Marty. While I'm certain
7 that the employees that are the specialists for Duff &
8 Phelps and Aon and the accounting firms and others are
9 professional and conscientious and qualified, in my mind
10 it takes a real leap of faith to believe that and also to
11 believe that they won't simply tell management what
12 management wants to hear.

13 So question I have for the panelists is how would
14 they feel about some sort of certification process? Now
15 I know actuaries have that, but as far as I know the other
16 ones don't. Setting aside for the moment the
17 practicalities about who would provide the testing, how
18 that would work and so forth, how would you feel about a
19 certification process? Because to me as a hirer it would
20 demonstrate a level of expertise. And also if the person
21 failed to perform, they could lose their certifications
22 or their license.

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1 MR. CHANG: So I appreciate that question. And in
2 fact the profession, there is a movement now towards moving
3 towards trying to bring some better uniformity and
4 consistency and in essence some form of certification to
5 represent that.

6 I think you're probably --- Greg, I think you're
7 probably going to try and raise that in the afternoon
8 panel? Is that correct?

9 MR. SCATES: We will be talking about valuation
10 specialists also with respect to when the auditor uses a
11 specialist.

12 MR. BAUMANN: Yes, but I think it's a good question
13 right now for if the auditor's going to look to
14 management's specialist, actuaries have the broad
15 certifications that we're talking about and peer reviews
16 and things like that. I think Doug's question is if
17 management's going to use specialists, and auditors are
18 going to use that work, should the valuation specialists
19 and other engineering specialists and others that are used
20 be subject to certifications? Would that change the
21 landscape and make Doug and others feel more comfortable
22 in that area? And it sounds like you're saying there's

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1 some movement towards that, but for the valuation
2 specialists there's not yet a certification, peer review
3 program, things like that?

4 MR. CHANG: That's right. I mean, it's a
5 conversation that's been going on for quite a few years,
6 and a speech by Paul Beswick at the time in 2011 at the
7 AICPA conference really kickstarted that movement, if you
8 will. And this is a group, to my understanding, that is
9 led by the valuation professional organizations, the
10 various organizations that are involved here in the U.S.
11 to really look at how can we put some structure around it,
12 how can we put some standards and practices around it to
13 provide that assurance. And it's my understanding that
14 that group has met with the FASB Board has met with the
15 SEC and has met with the PCAOB as well.

16 And so when I say "movement," it's trying to get
17 there. I think as a professional we sort of recognize that
18 the -- whether it's the voices that are louder, that
19 looking for, that type of assurance or -- and "assurance"
20 again might be over-using the term, but that sort of ---
21 to give some more confidence behind what we have done to
22 help with sort of that perception, right? Because as I

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1 described, we as a firm do have in my mind some pretty good
2 processes in place and policies to ensure that we are in
3 fact independent, at least from -- whether it's personal
4 financial holdings and what not.

5 And then when it comes to how do we defend our work
6 product; I think I'll leverage a little bit to what Mike's
7 response was earlier, is we serve thousands of clients and
8 if we can't defend our position for one client, it has a
9 ripple effect on our ability to defend the position for
10 another client. Right? So we really need to be able to
11 stand on our own in terms of the conclusions we've reached
12 is reflective of the facts and circumstances that are
13 associated with each estimate that we provide.

14 MR. BAUMANN: Thanks for that response. I'm going
15 to jump if I can to David Tweedie. He's put his card up
16 and given your role on the International Valuation
17 Standards Committee, and maybe you want to continue this
18 dialogue?

19 MR. TWEEDIE: Thanks, Marty. I think it's very
20 difficult now for auditors in the sense that if you look
21 back 15 years ago the subjectivity in financial statements
22 was much, much less than it is now. The standard setters,

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1 the accounting standard setters have tried to control that
2 a bit. As far as intangible concerned, we don't allow you
3 to have homegrown ones because it's very difficult to
4 value. When it comes to business acquisitions, you've
5 written a check and, all right, you might have fair values
6 of intangibles, but there's a cap on it. It's almost an
7 allocation exercise within the total amount.

8 Where it's got really difficult has been as we've
9 moved more and more into financial instruments. And
10 that's where we're going to have a lot of problems.
11 Somebody is often saying that we should really take the
12 financial instruments figures, the deferred tax figures
13 and the intangibles and net them off together and then we'd
14 only have one damn silly figure in the accounts instead
15 of three.

16 And the sort of thing that you've got in financial
17 instruments, it's easy when you've got markets. When you
18 move into levels 2 and 3 you can have exotics. And I was
19 listening to Loretta; and she won't be dealing too many
20 financial instruments, but we check the credentials first.
21 We haven't got any. These are pointy-headed
22 whirling-eyed astrophysicists doing some of this stuff.

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1 And there is no check on them. And that's one of the real
2 concerns we have now.

3 Jouky was talking about the work that's going on
4 mainly in business valuations to say, well, what do we do
5 to have a credential that people recognize? In the United
6 States there are 45 real estate organizations linked to
7 the appraisal foundation. All have got their own
8 qualifications. Paul Beswick was talking about five
9 different business qualifications. And the move is now
10 can we just bring them together to say that here is going
11 to be a common credential. And you've got to have these
12 entry requirements, these exams, CPD, discipline, ethics.
13 And we're going to see a few of them hanging from trees
14 when they get it wrong. And that's not there at the
15 moment.

16 So it's very difficult to look at the credentials
17 and see what's happening. And in financial instruments
18 there are none. AICPA is talking about trying to do
19 something. But then you've got to persuade the banks to
20 get their guys in to take these credentials. And that's
21 going to be difficult.

22 So I do think the auditor is in a very difficult

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1 position, because we know from looking at the evidence of
2 some of the financial institutions that when they do these
3 more exotic financial instruments, they're not even close
4 to each other. And we're talking about sometimes hundred
5 percent differences. Well, we'll never get it down to
6 three decimal places, but we've got to get into the same
7 ballpark.

8 So I think there is a move for the firms with the
9 professional organizations. The banks are staying out of
10 it. They quite like it the way it is. And they have
11 proprietary information and sometimes they require the
12 auditors not to reveal any of that to anybody else. And
13 it's very difficult to get the comparatives in these
14 situations.

15 So, I personally, and I've said it before publicly,
16 I think we have a lacuna in financial regulation. We've
17 got the accounting standards which say use fair value.
18 And we pinched Bob's standard at 157. It's IFRS 13. It's
19 the same standard. What it doesn't do is to say, okay,
20 once you use this, what's the fair value? And now we're
21 discovering, as we did in the crisis, that the values are
22 miles apart.

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1 Now, how do we start pulling that in together? And
2 one of the things we're talking about is can we get the
3 firms and the financial institutions and the users and the
4 VPOs together to say, right, what's causing these
5 differences? What can we do to try and eliminate them?
6 But that is going to take some time to do. And I sympathize
7 with the auditors, because you have specialists such as
8 Ken who's coming from a recognized profession. You've got
9 lawyers who are in -- well, I suppose it's a profession --

10 (Laughter)

11 MR. TWEEDIE: -- and the accountants. They are
12 really identifiable. But you've got a new professions out
13 there that haven't really found themselves yet. And
14 that's where I think you're in real trouble, and that's
15 where it's very, very tough for the auditor. Is it
16 reasonable? Yes, but this one's also reasonable and
17 they're miles apart.

18 MR. BAUMANN: Right. Good comments. Thanks to
19 David.

20 Brian Croteau?

21 MR. CROTEAU: Thanks, Marty. Just quickly.
22 Again, my own views particularly here. Again, I would

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1 certainly associate myself with Paul's remarks in this
2 regard, and I appreciate sort of the comments here relative
3 to the efforts that some are undertaking including the
4 AICPA. I think this is complicated and probably going to
5 take awhile for real progress on this. And I'm not trying
6 to promote any particular path that they or anyone else
7 might go down. I think it requires careful coordination
8 with lots of different elements and valuation-type
9 professionals.

10 And so my sense of it is that this isn't something
11 that will happen overnight. And if that's the case,
12 continuing to think about other ways to advance that more
13 quickly or advance efforts like that more quickly or get
14 some momentum behind it I think is personally I think is
15 important. And again, not looking to endorse any
16 particular approach. I think it's early, really early
17 stages on this, but certainly I would associate myself with
18 the remarks that Paul made.

19 MR. BAUMANN: Thanks. A couple of the panelists
20 have had their cards up. I know some of the other SAG
21 members have, too, but I think they wanted to respond
22 potentially to some comments made. So why don't we let

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1 Loretta and then Ken do that?

2 MS. CANGIALOSI: Yes, I had two comments. One is
3 on the whole idea of some kind of certification for the
4 valuation folks. I would absolutely support that. I
5 mean, as I said in my remarks, we do try to go for people
6 who understand what this exercise is all about and how it's
7 done. I think it would be really helpful for the auditors
8 to have that to say, okay, you know, these people have this
9 certification that presumably they have continuing
10 education, they're knowledgeable about the methodologies.
11 You know, there are some whatever standard-type
12 methodologies to be used in the U.S. GAAP valuation. I
13 think having those things would be extremely helpful for
14 the auditors in the amount of work that they have to do.

15 Second thing is I just wanted to make it clear that
16 when our auditors come in and look at the valuations, they
17 certainly understand the assumptions and all the rest, but
18 they do do a re-performance. They actually take all the
19 inputs, because they get all the flat files -- they have
20 their own internal model that they've developed. They
21 input them in and then they look at the outputs and then
22 they build a bridge back to our specialists' outputs. So

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1 that's an extensive exercise.

2 It hasn't resulted in any major adjustments. It's
3 really an understanding. They understand their models.
4 The specialists understands their model. That's how
5 they're getting that understanding of the model. But it
6 seems like that's an awful lot of work considering that
7 these are groups that supposedly should be using similar
8 types of methodologies.

9 MR. BAUMANN: I'll just comment again that whether
10 you think it's too much work; or maybe it is or maybe it
11 isn't, what you said they're doing is beyond what I
12 consider to be the minimum requirements in AU 336, which
13 it sounds like a lot of people are saying, yes, they have
14 to go beyond that, which I think goes to what we're raising
15 in the consultation paper, does there need to be something
16 stronger than AU 336? And it sounds like most auditors
17 are often doing more than that, coming in and testing those
18 models.

19 So I think Ken had his card up.

20 MR. LINING: Thank you. There was a comment made
21 on page 30 of the paper that reads: "In cases where the
22 auditor does not have the specialized knowledge or skill

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1 to perform more rigorous procedures, the auditor might
2 need to employ or engage his own specialist." This was
3 a comment that was raised before the break. So I'll try
4 to make some comments here which I hope will try to tie
5 together some of the questions here.

6 Generally, when we're going through a year-end
7 audit for one of our client's plans, it's a pretty typical
8 case that, you know, we will prepare the information, the
9 reconciliations, the PBO asset disclosures and then send
10 all this to the company. Typically also they want to
11 receive it directly --- the auditors typically will also
12 want to receive this directly from us. We will receive
13 several follow-up questions about how did you select these
14 assumptions? For example, discount rates, expected rates
15 of return, mortality table.

16 And as we mentioned before, many of the large
17 auditing firms also employ their own actuaries. So we
18 typically will discuss these items through with them. In
19 some of the cases, some of the plans I work on the benefit
20 obligations will actually exceed the market cap of some
21 of the companies that we work for. So there's a very large
22 exposure. The SEC certainly is interested in making sure

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1 those numbers are correct.

2 We want to make sure that the auditor's specialists
3 understand the methods, the assumptions, the data, that
4 our reports are fully documented in terms of exactly what
5 we're showing so that they can come back and then, you know,
6 ask us questions about those. I don't think there's a ---
7 in terms of testing certainly, we expect them to do some
8 sample testing. We will typically send them things like
9 cash flow streams and spot yield curves so they can come
10 up with relatively similar liability and discount rate and
11 that kind of thing.

12 I'm not sure it's necessary for the auditor or the
13 specialist to actually replicate our work, but certainly
14 to test it and become comfortable with those results.
15 Thank you.

16 MR. BAUMANN: Thanks. Joan Amble, Phil
17 Santarelli, then Bruce Webb are the cards that I have.

18 MS. AMBLE: Okay, thank you. I guess a couple
19 things, and some of this I'm probably just stating the
20 obvious, but kind of underscore what we've heard. I do
21 think it's important that if you start first with the
22 preparers -- and actually this would apply both to the

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1 auditors if they're engaging a specialist -- I think it's
2 important to understand who does the engagement of the
3 specialist in terms of the independence. And my
4 experience has always been when you're in a company and
5 let's say you're wanting to check how they're valuing
6 derivatives or something in a capital transaction or
7 goodwill or intangibles, you generally don't want that
8 function that owns it to engage the specialist. It's much
9 better to have an independent group, whether it's the chief
10 accounting officer, which is what I've typically seen.
11 Because I think having the specialist know who they're
12 reporting to really helps in the whole independence issue,
13 number one.

14 And obviously when you evaluate that you're going
15 to look at them for their independence. And for me I don't
16 know if it's as much as how much revenue are they bringing
17 in, but rather do they have the backbone to give a position
18 that may be contrary to what management might expect. And
19 I think that's a matter of looking somebody in the eye and
20 having a very senior person, whether it's management; and
21 it ought to be somebody from management, but also a very
22 senior person within the auditing profession that knows

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1 how to grill the individual to make sure that they
2 understand that they want them to do this completely in
3 accordance with whatever valuation model is appropriate.
4 So that really speaks to the independence, the competency.

5 I think the third thing to look at is who's
6 controlling the output. And particularly as it comes back
7 to the company, it's one thing to have either an employee
8 within the firm or somebody that they've engaged, but who
9 makes the final call? If I look at pensions for example,
10 what scares me is that I think a lot of people don't
11 understand pensions. And quite frankly, it's not that
12 difficult if you just take the time.

13 And I think that making sure that you understand
14 who determines who's going to be moving these assumptions
15 and whoever owns it within the company understands it as
16 well as the auditors. I do think the auditors need to
17 understand the -- they don't have to be a specialist, but
18 if they engage a specialist, they need to understand the
19 output. Because if they don't, I'm not sure -- I'm on
20 audit committees now. I wouldn't feel very comfortable
21 if my auditors didn't understand what the specialists had
22 done. So to me that's bare bones minimum.

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1 And so I guess that -- because I don't think you can
2 abdicate the responsibility either as a preparer or an
3 auditor.

4 So that being said, I guess where I'm a little bit
5 confused is I know we've teed it up of do we want to amend
6 or rescind 336, and I guess I'd just challenge -- and maybe
7 I just don't have enough knowledge of the 336, but if firms
8 are already expanding it to get to an answer that will
9 enable them to ensure that they understand the output,
10 they've determined independence, et cetera, and
11 competency and control, is it a circumstance where instead
12 of amending or rescinding, it could be an interpretation
13 and/or an articulation of expectations or best practices?
14 And I just throw that out there because I think maybe that's
15 easier than amending or rescinding.

16 Now if we think that people going above and beyond
17 is clearly above and beyond and it's not an interpretation
18 of that, takes that off the table. But if it could, I think
19 that might be an easier thing to come through.

20 And the last point I wanted to make was in the
21 document; and I would see this as a best practice, if it
22 could be, we articulate the representations that we think

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1 the specialists should make, whether they're specialists
2 in any of the terms, whether it's the specialist within
3 the company or somebody that the company engages or
4 somebody that the auditor engages. Rep letters are a form
5 of art that are already out there. A lot of people do it
6 already. I mean, the firms get it from the CFO, the chief
7 accounting officer, and the CEO, but quite frankly, they
8 get it from a ton of people in the company. At least that's
9 always been my experience.

10 And I'm almost wondering if the nomenclature can
11 make something like that a little bit easier to accept as
12 well, that you would expect that whoever that specialist
13 is, that they would have a defined set of representations.
14 And again, they would give that to the auditor. And
15 because I do think having that individual understand who
16 they're ultimately reporting to helps in really
17 understanding what their role and responsibility is.
18 And, gee, I didn't understand. And quite frankly, we kind
19 of get that already today.

20 If you think about an estimate we haven't talked
21 about, which can be huge, are legal liabilities. And, you
22 know, in-house attorneys and sometimes external attorneys

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1 provide that all the time. And, you know, that's kind of
2 a black box sometimes, too, until you really delve into
3 it and really push how are you doing it? These are the
4 rules, et cetera.

5 MR. BAUMANN: A lot of good comments. Thanks very
6 much, Joan.

7 I think I said Phil was next, right?

8 MR. SANTARELLI: Thank you, Marty. I'd like to
9 speak as a representative of smaller auditing firms who
10 by extension represent smaller issuers and advocate for
11 retention of 336 with potentially some enhancements.
12 I've heard a lot spoken about how somehow the auditors in
13 many cases are extending 336, or how 336 is applied. I
14 don't necessarily agree with that. I think there exists
15 in 336 a paragraph 12 the concept that if the auditor finds
16 the conclusions of the specialist to be unreasonable, they
17 can't really accept them. And in some of those cases they
18 may have to employ their own specialist to go further.

19 I think some of Wendy's comments as far as the risk
20 assessment is really an extension of what's in 12, what's
21 in the spirit of 12. You can't really --- in many cases
22 where you've got a company like Pfizer, what Loretta's

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1 doing with her specialists, it is not uncommon in the
2 smaller issuer world where the ICFR over their use of their
3 specialists is just not good enough. And auditors need
4 to address that appropriately and in some cases challenge
5 management to do better or in fact bring someone else,
6 either someone they have internal to their firm or not.
7 So I think 336 provides for that currently.

8 The other issue I would want to put on the table
9 is one of the fundamental concepts in 336 that goes back
10 to when the standard was developed is that auditors are
11 not expected to have expertise out of auditing. Okay?
12 They're not expected to have -- they have business sense.
13 They understand the clients that they're auditing. But
14 if you move to rescinding 336 and put it into the way we
15 would audit the rest of management's information, a
16 re-performance type scenario, I think you're now making
17 that requirement that the firm will in fact have to have
18 that expertise, and that becomes, in my view, fairly
19 burdensome for the smaller firms. And whether or not the
20 universe of people that can do this work exists to be hired
21 or employed by the firms is an open item.

22 So paragraph 6 talks about that. I think we have

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1 to retain that concept that auditors have their expertise
2 and should be savvy enough to be able to challenge the
3 results of the use of the specialists. But something in
4 the nature of a staff audit practice alert that we've found
5 as a firm to be extremely helpful in going about our
6 business with guidance on how do you evaluate the
7 competency of the specialist, how do you test the inputs
8 that they get from management, and considerations when
9 evaluating the assumptions inherent in that can go a long
10 way to improving the quality that exists when using
11 specialists. Thank you.

12 MR. BAUMANN: Thanks, Phil.

13 Bruce Webb, and then I have Philip Johnson and David
14 Kane.

15 MR. WEBB: Well, Phil stole a lot of my thunder,
16 but -- and thank you for that. But I really want to keep
17 my comments pretty narrow in terms of the question at hand
18 is should we amend AU 336 or rescind it? I strongly
19 advocate that we amend it, that we bring it at least up
20 on par with ISA 500, 620, AU-C 500, 620, which I think are
21 stronger standards and would address some of the
22 deficiencies in 336 that you have identified, Marty.

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1 As Phil says, auditors are CPAs. We're not
2 geologists, we're not gemologists, we're not engineers.
3 So, to do a good audit an auditor is going to need to use
4 the work of specialists in certain situations. And you've
5 correctly identified the four ways that a specialist can
6 be utilized: either company- employed, company-engaged,
7 auditor-employed, auditor-engaged. Well, there's only
8 one of those four scenarios where the auditor has control
9 over the specialist, and that's when it's an
10 auditor-employed specialist.

11 So I think it would be a big mistake to sort of do
12 away with the guidance on how an auditor would supervise
13 and interact and use the work of a specialist, realizing
14 that, you know, as the paper has pointed out that the
15 auditor-employed specialist is subject to the supervision
16 requirements of AS 10. And that's always been the case.
17 So once again, I would just advocate very strongly for not
18 throwing the baby out with the bath water.

19 MR. BAUMANN: Yes, but amending and elevating it
20 to some of what we've really heard, closer to what the ISA
21 has.

22 MR. WEBB: Very supportive of that, Marty.

1 MR. BAUMANN: I think I said Philip Johnson next
2 and then David Kane.

3 MR. JOHNSON: Thanks, Marty.

4 MR. BAUMANN: And then Tom Selling.

5 MR. JOHNSON: My comments are very much on the line
6 that we've just been talking about, of not throwing it
7 away. I think there is definitely a time for a new
8 standard. IAASB did ISA 620 through the Clarity Project
9 in 2009 for basically 2010 year-ends. Fair values and the
10 use of specialists has increased since the current PCAOB
11 standard was issued. So I think it is important that we
12 bring it together, but I think that a lot of what was done
13 in ISA 620 did address some of the issues, or a lot of the
14 issues that smaller accounting firms, smaller audit firms
15 have. And so, I wouldn't throw out AU 336 in its entirety.

16 I think that when I was looking through the papers,
17 I was in agreement with lots of what was in the papers,
18 but it struck me that -- and as Mike said and as Wendy said,
19 best practice has moved on. But possibly one of the areas
20 that hasn't moved on quite as much as it should do and in
21 line with standards generally is documentation of what is
22 being done, particularly for the auditor-engaged rather

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1 than the auditor-employed. Because within the
2 auditor-employed, often they're just an integral part of
3 the audit team, particularly in very complex audits. So
4 I think documentation, both IAASB, when they did their
5 review and from your findings, the documentation is a weak
6 point. So I think that what you've got detailed in on
7 pages 37 and 38 with regard to documentation for
8 auditor-employed is important and should be emphasized.

9 I have a number of comments to make, but I'll drop
10 a note on those.

11 One of the things that's not --

12 MR. BAUMANN: Well, after lunch, we're talking
13 more about auditors-engaged or auditors-employed, so to
14 that extent you have time if that's your subject.

15 MR. JOHNSON: Okay. Okay. And so the only other
16 point that I was rais -- and I don't know whether you're
17 dealing with that, and that's with objectivity later on
18 in the paper. Is that going to be this afternoon?

19 MR. BAUMANN: Yes. Yes.

20 MR. JOHNSON: Okay, that's fine.

21 MR. BAUMANN: David?

22 MR. KANE: Yes, I don't want to pile on, Marty, but

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1 I think it is probably a good option in terms of AU 336
2 to up the game a little bit from the auditor perspective.
3 I think what's in the ISAs in terms of looking at the
4 relevance and the reasonableness of the findings, the
5 conclusions, the contrary evidence, the methods and
6 assumptions is being done in many cases today, not
7 completely all, but in many.

8 But I think to Jay's question about how is it
9 altogether different if you were to rescind AU 336 than
10 from, you know, just looking at the higher-level guidance
11 that 336 has. So I'm just thinking about like a pension
12 plan, for example. And if I had an AR listing and a pension
13 plan, a pension plan going down each participant, or like
14 an OPEB, tracing that through in terms of all the potential
15 benefits that that participant may get, tons of
16 assumptions, lots of calculations -- and if we don't have
17 access to that proprietary model as an auditor, and we
18 think about testing the estimate, it feels like we've got
19 a couple options, right?

20 One is looking at subsequent events, and that's
21 generally not going to be as helpful in this circumstance.
22 Can't really test the process anymore because we don't have

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1 access to that model as much as we would need to. So then
2 we're going to be kind of left with generating and
3 independent estimate. So when I just think about
4 developing our own model that's going to be consistent with
5 what the specialist has got and is providing to management
6 is a heck of a lot more work than it would be of looking
7 at the overall reasonableness of the assumptions, the
8 methodology, and doing some corroborative calculations
9 and some shadow calculations to make sure that what
10 ultimately the specialist is coming up with and what
11 management's using is in some sort of reasonable relevant
12 range.

13 And maybe just one last point, too, in just thinking
14 about this. If you were to rescind AU 336, feels like
15 companies would have to do a lot more as well. Because
16 for auditors to go in from an ICFR perspective and be
17 testing all the same -- sorry, a lot more data than what
18 the company's actually doing, and if the company's
19 applying more like an AU 336-type model itself, I don't
20 know if that's exactly on par, and I'm not quite sure that
21 makes a lot of sense.

22 MR. BAUMANN: Good. Thanks. Very helpful

1 comments.

2 We're probably about five more minutes. We're
3 over the time that we've allotted for the morning, but
4 there's a lot of cards up. Try to figure out how to handle
5 this because the content is so good that we're getting.
6 But let's try to limit it to five more minutes. Keep your
7 cards up if I don't call on you. And then after lunch we
8 can continue this dialogue.

9 Tom Selling and then Jean Joy.

10 MR. SELLING: I also agree that AU 336 should set
11 forth situations where the auditor's responsibilities can
12 be limited, but in principle I believe a necessary
13 condition should be that the specialist is independent
14 from management. If that's the case, then the auditor's
15 work can be efficiently limited to examining whether, for
16 example, following sort of David Tweedie's example of
17 physicist, that the specialist is qualified to perform the
18 task, that the auditor can verify that the expert is
19 independent in appearance, it can verify inputs that are
20 capable of verification, it tests calculations. However,
21 the auditor then cedes the judgmental issues to the
22 experts. The auditor shouldn't even be expected to

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1 perform a reasonableness evaluation of that judgment.

2 But of course what I just described and Doug Maine
3 alluded to already is that independence and certification
4 standards are key. So I would hazard that the critical
5 path to this discussion lies with parallel guidance
6 similar to Article 2 of Regulation S-X that should be
7 applied to experts. Fortunately, I'm sitting right here
8 next to Brian, and I think we should be able to draft the
9 needed amendments over the lunch break --

10 (Laughter)

11 MR. SELLING: -- and we'll get back to you then.

12 MR. BAUMANN: That was going to be my follow-on
13 question, is what independence rules did you have in mind
14 that all these specialist organizations should follow? I
15 did hear one of the -- Ken, you may have used this term.
16 At times with our clients we want to be trusted business
17 partners, or we are trusted business partners. Would that
18 be the same client that you might be doing an actuarial
19 calculation for, that you're sometimes also a trusted
20 business partner. And that might not jibe with the
21 independence.

22 MR. LINING: So, I think, you know, we will have

1 a high degree, a track record of accuracy and objectivity
2 with the client so that when they want an objective
3 business opinion about something, they will ask us.

4 MR. BAUMANN: Thank you.

5 MR. SELLING: Just last 10 seconds, but lacking
6 that I believe that the information that comes from
7 specialists should be seen as to be coming from management.
8 The auditing standards already say that it's management's
9 responsibilities for the estimates, and I believe that any
10 non-independent source should be treated the same whether
11 it comes from management or whether it's from specialists
12 the management's retained.

13 MR. BAUMANN: All right. So, we're going to have
14 Jean Joy, Jeremy Perler, and Bill Platt, and then we'll
15 have to call it for lunch. Thanks.

16 MS. JOY: Thank you, Marty. I don't want to
17 reiterate the comments that I agree with that Phil and
18 Bruce previously mentioned, and in particular with regard
19 to some of the smaller firm issues, because there is a lot
20 of reliance on AU 336 and its application. And I think
21 in practice it has been a very workable standard and has
22 worked for most. Obviously, enhancements would be

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1 supported wherever deemed appropriate, particularly with
2 independence and objectivity, and maybe further guidance
3 on how one gains an understanding of the methods and
4 assumptions.

5 But having said that, I do think that the use of
6 specialists is really key to audit quality, and to try to
7 have the auditors assume a specialist mentality, you know,
8 that's really not where we are, but the use of a specialist
9 is key to audit quality. And our ability to assess the
10 work of a specialist I think is also key.

11 So, if you have a situation where you don't think
12 you, as an auditor, could reasonably assess the results
13 of a specialist, you would be engaging your own or on a
14 much broader scale depending on the significance of the
15 issues. I think you'd have to look at that with client
16 acceptance procedures as well as to whether or not that's
17 really an environment that you should as an auditor be
18 operating in.

19 And, I guess lastly, a lot of times we have this
20 discussion about large firm/small firm, and there are
21 different ways that small firms and large firms deal with
22 AU 336. However, I don't really think it's a small

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1 firm/large firm issue. I think the application of the
2 standard should be consistent and what we're trying to get
3 to should be consistent. How we get there may be slightly
4 different, but I don't think there should be different
5 expectations from a small firm or a large firm. The
6 standard needs to be consistent.

7 MR. BAUMANN: Thanks, Jean. Jeremy Perler?

8 MR. PERLER: I had more of a question which is
9 probably better after lunch, so I'll yield my time to
10 lunch.

11 MR. BAUMANN: Good, you yield to Bill Platt for the
12 final word. And by the way, I didn't mean to infer that
13 others should take their cards down, that after we have
14 discussion of the auditor specialists later if you have
15 your cards still up, you'll be the first ones to be called
16 on.

17 MR. PLATT: Okay, knowing that I'm the impediment
18 to all of us heading to lunch, I guess I'll try to be quick.
19 I wanted to just reinforce several things that were said
20 here, particularly David Kane's comments.

21 But, you know, I find the conversation very
22 interesting and informative that we've had this morning.

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1 I do think though it's hard when one thinks about the
2 diversity in the types of estimates that specialists are
3 involved in or fair value measurements. It's hard to put
4 them all into thinking of them all as the same. And I think
5 that would be a mistake to think that the same approach
6 should apply to every measurement or to every type of
7 specialty.

8 I think also as Sri pointed out before is that, you
9 know, what we're dealing with are areas where it's beyond
10 what I would say the core expected expertise of your
11 typical accountant or auditor are. You know, the reason
12 why Loretta is going outside to employ specialists is
13 because it's beyond the core expertise of her team from
14 an accounting standpoint. And from an auditor's
15 standpoint, I think we'd be in the same position. So
16 therefore, they are unique and different than, Jay, you
17 asked about the accounts receivable before. So, I think
18 there is a difference there.

19 And I do think that that then means that eliminating
20 336, to my own personal view, would not be a desirable
21 outcome. I think enhancing it and looking to the ISA
22 standards I think is a good starting place to look to as

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1 to what might be done. But I think what we have to avoid
2 is ending up with sort of this one-size-fits-all solution
3 that all of a sudden we need to either get into every model
4 or recalculate in every situation. And we've talked a lot
5 about different situations where at times we do and at
6 times we don't. But I just don't want it taken away that
7 the audit profession has moved to a place where we're
8 always recalculating when we're involved specialists.

9 And a good area that David mentioned before is in
10 employee benefit obligations and actuaries. You know,
11 it's common for us to test assumptions. It's common for
12 us to engage in dialogue between our actuaries and the
13 company's actuary. And it's common for us to look at the
14 end result and say does it make sense given the change in
15 actuarial assumptions during that period but not going in
16 and actually trying to recalculate how their model works
17 or re-performing a valuation also. So I just I would say
18 that if we did move in that direction, I think we need to
19 evaluate the cost-benefit of it as we sort of look moving
20 in a direction like that.

21 But I think it's been a great dialogue, and I
22 appreciate the opportunity to make a few comments.

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1 MR. BAUMANN: Thanks, Bill. I think it's been a
2 great dialogue also. I thank the SAG members for
3 incredible input and advice on this. The wide range of
4 views were very, very valuable. And really appreciate the
5 panelists in helping kick-off the dialogue. And so, thank
6 you very much, all of you, for your willingness to be here
7 with us today and lead this conversation.

8 Lunch: Jessica will tell us details where to go for
9 lunch in a second, but let's try to be back here at about
10 1:15, if possible.

11 (Whereupon, the above-entitled matter went off the
12 record at 12:27 p.m. and resumed at 1:24 p.m.)

13 MR. BAUMANN: Thanks everybody for getting back so
14 promptly. We set 1:15 as a target. And we came pretty
15 close to the target. So, thank you very much.

16 So, this morning we talked about management using
17 a specialist. Whether that specialist is employed by the
18 company or management engages that specialist.

19 And how the auditor uses management specialists'
20 work as audit evidence. And we explored the extent to
21 which the auditor should perform procedures around the
22 work of management specialists.

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1 So, that's the subject we explored this morning.
2 And we had a very good discussion and a wide range of views.

3 A lot of people saying Amend 336. But, -- and in
4 many cases, people saying that went beyond the procedures
5 that are in 336 already.

6 This afternoon we're exploring when the auditor
7 uses his or her own specialist to audit an area where the
8 auditor may not have expertise.

9 So, the auditing standards also address the fact
10 that the auditor can employ a specialist or engage his or
11 her own specialist to assist the auditor in auditing
12 insurance company actuarial reserves. Or oil or gas
13 reserves or environmental liabilities. Or places where
14 auditors may not have particular expertise.

15 There are two standards as we laid out in the
16 consultation paper. If a specialist is employed by the
17 auditor, the auditor supervises that employed specialist
18 in accordance with AS 10.

19 But those requirements are really the same
20 supervisory requirements for somebody that the auditor has
21 a skill to supervise, such as another accountant. As it
22 would be for an employed specialist, who may have different

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1 skills.

2 So one of the questions is, should there be
3 different requirements for supervision under AS 10 when
4 you're supervising a specialist? And then if the auditor
5 engages a specialist, a third party, to assist him or her
6 as part of the audit, then the auditor is in AU 336 and
7 doesn't really supervise that specialist but follows the
8 procedures that we discussed this morning in AU 336.

9 Questions also arise that of course an auditor's
10 specialist who is employed, has to be independent pursuant
11 to PCAOB and AICPA rules. They're performing procedures
12 on the audit.

13 An auditor's engaged specialist is really doing the
14 same thing that an auditor's employee specialist is doing,
15 but pursuant to different standards, 336 versus AS 10.
16 And does not have to be independent, has to meet an
17 objectivity test.

18 So, these are all the questions we want to tee up
19 this afternoon about the use of an auditor's specialist.
20 Compared to this morning's management specialist.

21 We're going to have panelists which Greg Scates
22 will introduce in a moment. And then we'll take

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1 questions.

2 And again, as I mentioned before, those with cards
3 up will have the first rights for speaking rights for
4 questions. And your question can go either towards the
5 subject of auditor specialists or, if you wanted to follow
6 up on what you heard this morning about management
7 specialists.

8 So, I laid out a little bit of the ground rules for
9 the next couple of hours. And with that, Greg Scates.

10 MR. SCATES: Thank you, Marty. First I'll give
11 the disclaimer. The views expressed by the presenters are
12 their own personal views and not necessarily those of the
13 PCAOB, the members of the Board, or the PCAOB staff.

14 In this panel -- group of panelists, we have five
15 panelists for this discussion on the auditor's specialist.

16 This is focused on how an auditor's specialist
17 performs the work for the auditor. And how the auditor
18 then evaluates the specialist's knowledge, skill and
19 objectivity with respect to the engaged specialist.

20 And also how, the auditor then oversees or
21 supervises the work of the specialist. Including
22 reviewing the specialist's work and the conclusions.

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1 And now let me introduce our panelists today.
2 First we have Andreas Ohl from PricewaterhouseCoopers.
3 He's a Partner in the firm and leads the
4 PricewaterhouseCoopers Transaction Services Evaluation
5 practice in the United States.

6 Next to Andreas is Susie DuRoss. Susie is a Chief
7 Markets Officer and Partner at Harvest Investments. And
8 she oversees the securities evaluation process at Harvest.

9 Next is Dan Olds. Dan is a Managing Senior Vice
10 President and Petroleum Engineer at Ryder Scott in
11 Houston, Texas. A firm specializing in the evaluation of
12 oil and gas reserves.

13 And next to Dan is Efrim Boritz. He's a Professor
14 and Director of the Center for Information Integrity and
15 Information Systems Assurance at the University of
16 Waterloo in Waterloo, Ontario.

17 And next is David Kane, a member of our Standing
18 Advisory Group. Is a Partner at Ernst & Young. And is
19 The Americas Vice Chair of Assurance Professional Practice
20 at Ernst & Young.

21 And so I'd like for Andreas to get us started.

22 MR. OHL: Sure. Thanks Greg. Good afternoon

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1 everyone.

2 As Greg mentioned, I have responsibility at PwC for
3 what we call value measurements. So that's both preparing
4 for non-audit clients and reviewing for audit clients,
5 evaluations performed for financial reporting purposes.

6 We also do some evaluations for tax purposes.
7 Again, that would be both for audit and non-audit clients.

8 The other thing I do is, I serve on the Standards
9 Setting Board at the IVSC. The Evaluation Standard
10 Setting body in London that was mentioned this morning
11 where David Tweedie is also engaged there.

12 So, maybe just a little bit about our practice.
13 And then I'll get a little help, maybe our -- get people
14 to understand the role we play in the firm.

15 So, we sit in the assurance practice, which is also
16 where the audit practice sits. We're in a separate group.
17 We're not in with the auditors, but we are under the
18 assurance umbrella.

19 And that's important because that means that many
20 of the policies and procedures that apply to the assurance
21 prac -- or the audit practice applies to us as well.

22 So, we take a lot of the same training. We're

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1 subject to the CPE requirements. Obviously as a part of
2 the firm, we adhere to the independence requirements that
3 the firm adheres to.

4 And we're just on a lot of the same email
5 distributions and the like that the audit practice would
6 be. And I think what that does, it builds an awareness
7 amongst all of our staff as to what's going on in the
8 accounting and auditing community.

9 Obviously, most of the folks on our staff have a
10 finance background. Many of them do have some accounting
11 background. We have some dual majors.

12 In fact, that's something we try to target. Just
13 because, you know, I think it was referenced this morning,
14 having finance folks who have some appreciation for the
15 accounting world is helpful when you play in the space of
16 preparing evaluations and reviewing evaluations in the
17 financial reporting context.

18 So we have about 250 people. We do approximately
19 2,000 audit reviews per year. Those vary dramatically in
20 size.

21 They can be a couple of hours if it's a small company
22 and it's a plain vanilla stock option valuation. Too, it

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1 can be hundreds and hundreds of hours if it's a large
2 complex, cross-border transaction that has a lot of moving
3 pieces.

4 We have a number of standardized templates and
5 tools that we use for our audit reviews. Those get used
6 by everyone across our practice.

7 They depend on the nature of what we're looking at.
8 So we have separate tools for business combinations versus
9 impairments and things of that nature.

10 We've had those in place for a number of years. And
11 we update them all the time to reflect whatever the latest
12 developments are.

13 Maybe just to -- I'll preempt one of the questions
14 that I always get. So, I mentioned early on that we do
15 both prepare, and we review.

16 And one might ask well, why do we do that? Why
17 don't we just have people focus on reviews?

18 And the very simple answer to that is, our
19 experience has been that if you have people who actually
20 prepare the valuation and therefore have to start with a
21 clean sheet of paper and say, what are the assets? What
22 information do I need to figure out the values?

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1 That that kind of a thought process is exactly what
2 you want when somebody reviews. Because if you don't have
3 that, let me take a very broad perspective, your focus is
4 very much, what is on the piece of paper that someone has
5 already given me.

6 You know, they identified five assets. Well, I
7 want to always step back first and say, can I think of
8 something based on what I know about this industry, this
9 company, that isn't on this piece of paper that maybe
10 should be?

11 And that may be where my line of questioning starts.
12 So, we find that that perspective is very valuable. And
13 frankly, it's something we use when we recruit staff.

14 And it's very much embedded in the way we do our
15 training as well. All of our training courses have a mix
16 of preparing and reviewing concepts built into them.

17 I think maybe another thing that's important is,
18 obviously because we prepare evaluations, we have a number
19 of models that we've developed in-house for purposes of
20 valuing business and tangibles and other types of
21 interests, debt instruments, whatever it might be.

22 Those are the same tools and the data sources that

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1 we subscribe to that we use to prepare valuations, are the
2 same ones that we use in the audit process.

3 So, if we're running some sort of a sensitivity or
4 shadow calculation to get comfortable with something the
5 appraiser has done, when we're in a review capacity, we're
6 using our models that we would use in a non-audit capacity
7 to run those sensitivities.

8 So they're models that we've checked. All of our
9 staff are very familiar with. And we're following the
10 same process that we would when we're reviewing that we
11 would if we were preparing.

12 And I think that's important because I think a few
13 people have mentioned this already. The market is a bit
14 of a check on the non-audit work you do.

15 And so you get a high degree of comfort with your
16 models because of how they survive when they're challenged
17 by others when you're in the preparer capacity.

18 In terms of how the audit pro -- or the review
19 process works, you know, we work jointly with the audit
20 teams. We're often on calls together with them, with the
21 appraiser, with the client.

22 Understanding the models, the assumptions, the

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1 inputs. You know, I will say, there's a lot of discussion
2 around models. And, at least as it relates to business
3 valuation and tangibles, things like that.

4 While every firm has their proprietary models, at
5 the end of the day, they're not really that different. So,
6 the area of focus really is not so much, do I like their
7 model? Did they use the right model?

8 It's more on, where did the inputs come from? And
9 what level of diligence was done around those inputs?

10 So, there was a bunch of discussion this morning
11 on credentialing, so I get to take half of my notes away,
12 because I was going to talk about that at length. And it
13 sounds like there might be some more questions on that.

14 So, I'll talk about the other piece. Which is, one
15 of the crucial differences between the accounting /
16 auditing profession and the valuation profession, is that
17 while there are bits and pieces of standards around how
18 to perform a valuation, it's not nearly as comprehensive
19 or robust as what exists in the accounting and auditing
20 profession.

21 And so, that same process that has been started,
22 that has a lot of momentum behind it around credentialing,

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1 is also happening around what we would call performance
2 standards.

3 And to me the key piece of that is, if you're going
4 to sign something and say it's a valuation opinion, you
5 need to say it's in accordance with some set of standards.
6 Because right now, a lot of valuation opinions aren't
7 prepared in accordance with a specific set of standards.

8 They're basically prepared in accordance with firm
9 policies. Which obviously vary. And those performance
10 standards will have some real robustness around what does
11 one need to do with around diligencing inputs?

12 Do you need to come with alternative sources of data
13 beyond just taking inputs from whoever has engaged you?
14 And to me, whatever comes out of this process, I think needs
15 to encourage the profession to head down that path.

16 Because, where I'd really like to get to is a place
17 where the quality is built into the appraisal process.
18 And not that most of the quality is built into the review
19 process.

20 And I think right now, that balance may be a little
21 bit off. And I think it's driven largely because that
22 professional infrastructure and the valuation community

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1 isn't quite where it needs to be.

2 I think the valuation profession has gotten that
3 message. And it is moving rapidly in that -- moving
4 rapidly in that direction.

5 I think maybe a little bit more just on the process.
6 And then I'll pass it onto the next speaker.

7 So, we will do diligence around the inputs. We
8 will run math checks to make sure the model is, you know,
9 mathematically correct.

10 We will look at certain logic concepts in a cash
11 flow model. For example, there's just certain pitfalls
12 that you've seen 100 times before. Those are the kinds
13 of things that are on our check lists.

14 We'll also work very closely with the audit team
15 on the inputs. And that's where -- that is often a joint
16 exercise. There's certain inputs where we're better
17 equipped to question and challenge the appraiser or the
18 company on them.

19 There's others where the audit team is better
20 equipped. And in our documentation, we make very clear
21 which pieces we've got covered. Which pieces the audit
22 team needs to cover.

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1 That collaborative process, which I guess I would
2 describe as you want people to focus on the things that
3 they're best at. It's very hard to find somebody that's
4 good across that entire spectrum.

5 And so, that's the way we've sort of built up our
6 model.

7 MR. SCATES: All right. Susie?

8 MS. DuROSS: Susie DuRoss. I'm here on behalf of
9 Harvest Investments. I am -- again, the opinions and
10 comments that I have are my own. They're not firm
11 comments.

12 I'd like to start to say that Harvest as a firm does
13 agree with what the PCAOB has done with regard to improving
14 fair value. At Harvest we really aim to make the rules
15 understandable, easier to implement, and cost effective
16 for firms of all sizes.

17 Harvest is, to use the terms from the paper, an
18 engaged specialist that is engaged by the audit firms.
19 Most of our client base is the second tier and smaller audit
20 firms that struggle because they don't have a full internal
21 department to handle all of their valuation needs.

22 We have been in the business of fair value for audit

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1 clients and the reporting industry for more than 20 years.
2 We conduct all of our processes with regard to ASC 820 fair
3 value techniques.

4 All of our processes are manufactured internally
5 at Harvest. We do not resell any prices. So any Harvest
6 price that you get, you know it's independent. We've
7 created it and we've manufactured that price.

8 Our management team has vast financial experience.
9 We have ex-traders, portfolio managers, investment
10 systems development. So, we have kind of a broad array
11 of financial backgrounds.

12 We do present at a lot of the industry conferences.
13 Primarily the AICPA. But we attend and present at a lot
14 of the State conferences.

15 We do a lot of work with employee benefit plans.
16 A lot of speaking at some of those engagements. And I
17 really think in terms of an independent source, we're
18 probably one of the only that exists for reviewing products
19 such as alternative investments, insurance contracts,
20 synthetic GICs and the like.

21 Two of the management team did serve on the Pricing
22 Sources Task Force. And truly we do aim to bring clarity

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1 both to the complexities of the market and the complexities
2 of complying to the regulation.

3 I was asked to do a little bit about our process,
4 how we go about valuing our securities. Basically, our
5 process is intended to provide transparent, cost
6 effective, prices and fair values for our audit clients.

7 We basically look a little different than some of
8 the pricing sources that are out there. Because rather
9 than trying to price every security that exists in the
10 universe on a given day, we work on focusing our efforts
11 to our client's portfolios.

12 So, we'll get an audit client that sends their
13 client's portfolio to us. And then we work on those
14 securities and the values of those securities on the
15 valuation date.

16 In order to do that, we take the full portfolio and
17 we classify each individual security into a very, very
18 discrete market sector. Now, this doesn't just mean the
19 issuer sector.

20 I think there's a lot of misconceptions that, you
21 know, all agencies trade the same. All municipals trade
22 the same. All corporates.

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1 We really dig in and for valuation purposes, it's
2 very, very important to address the structural nuances of
3 each of the security types. That's what helps us
4 determine how to go about valuing each of the securities.

5 I would also like to point out that the market has
6 become more robust in the structures that are being used.
7 Prior to the financial crisis, we saw a lot of structuring
8 in the assets.

9 And then, we kind of saw it go away. And now, as
10 of the 2014 audit season, most of the CDs we saw were
11 structured items that had coupons linked to all sorts of
12 external indices.

13 And it would be very, very, very easy for a field
14 auditor to pass over those items. Similarly to how it's
15 very easy to pass over an alternative investment because
16 a lot of the names look just like a mutual fund.

17 So, we basically go about sectoring all these items
18 by subscribing to multiple sources. All of the basic
19 standard financial information. We subscribe to all of
20 that.

21 We use 200 data points on every single item in order
22 to appropriately define it into a sector. We also store

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1 all of the trading that occurs in the marketplace on a daily
2 basis.

3 We take all of the trades from the exchanges and
4 reporting systems and we store those in our internal
5 processes. And we use those as the basis for a lot of the
6 documentation for our prices.

7 The first thing that we do once we've sectored the
8 securities, is we do check every single security against
9 our vast database of traded securities to make sure if
10 something is traded.

11 We have very strict, consistent policies in terms
12 of what will pass our QA in order to use a trade or a roll
13 of a trade that occurred, that address value and proximity,
14 outlier trades, that sort of thing.

15 If we have the trades and the QAs, we go ahead and
16 we use that price. If we can't -- if we have an item that
17 doesn't have any trading, or if we have an item that doesn't
18 pass our QA, it does fall to kind of a modeled approach.

19 We go about pricing and determining the models
20 based on the structural features. So, if we have an item
21 that has a lot of options, we would use an option adjusted,
22 discounted cash flow model.

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1 I'd like to kind of reiterate what Andreas said,
2 every time I come to D.C., I hear a lot of talk about the
3 model and the model and the model. And I would say --
4 actually, I'm going to come out, I've been at Harvest for
5 12 years, I've never had a valuation variance that was the
6 result of a model.

7 It's always the input. And the key is really how
8 well you can document the input that you're using.

9 So once we get through, we basically pull of our
10 documentation from our inputs using the highest level
11 inputs that we can and that can be observed in the
12 marketplace. We use our database of comparable trades
13 that are sectored. And we can identify many and put them
14 together.

15 We look at specific deal performance. We look at
16 the credit features and structural nuances. There are
17 many checks along each of these different pieces. And
18 each is documented for our valuation system.

19 So, basically, we follow a very consistent process
20 that we're using the highest level inputs that are
21 available in the marketplace in order to come up with the
22 values for our securities.

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1 We do also help with -- oh, one important thing,
2 we level according to how the security is valued. So
3 according to the guidance, the level should be based on
4 the lowest level input used in a valuation.

5 At Harvest, we do do that. So, we know, because
6 we've documented each of the inputs. If there's one that
7 we can't document as strongly as we'd like, that security
8 will drop to a level three.

9 We do help our clients with follow up and
10 documentation. Right up front we give -- every price
11 comes with the model that we used, the level that we used,
12 a link to the general methodology for that sector.

13 So we have a kind of a lot of information in our
14 very basic report as to where the prices come from. So
15 you would know right up front if it's based on documented
16 trading in the exact security.

17 Or if it's based on trading in a like security. If
18 it's based on some sort of other model that would be listed.

19 We do make all of our pricing inputs available to
20 our clients. In addition, and probably more importantly,
21 we give the reason and the documentation and what you can
22 observe to support each of the inputs that we use.

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1 With regard to quality control, you know, we have
2 a lot of things in place. I would say the first thing is
3 that we have a preapproval process.

4 We're primarily engaged by the auditors. But we
5 do have quite a few direct clients that come to us in search
6 of some of our expertise.

7 We never take a direct client unless we confirm with
8 the audit client that it's okay. Most of that generally
9 comes from referrals from our audit clients. And we
10 always get preapproval before we move forward in that vein.

11 We work very carefully with each of our audit
12 clients. We do conduct preplanning. I wouldn't say
13 every single, but the majority of the firms we work with,
14 come onsite.

15 They talk with us. We review how the process is
16 going to go on an annual basis. We have preplanning
17 meetings. And we discuss their objectives. The scope
18 and expected volume of the work. The deliverables.

19 We review the Harvest reports and the samples that
20 we have, to show them exactly what they'll get. We discuss
21 issues that might affect timing and return of the prices.

22 We discuss our qualifications and our processes.

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1 We do do a sample review of several different security
2 types and the process that we go through to value those.

3 We also assist the audit firms with enforcing
4 national rules from the standards groups at the central
5 offices. We can assist when field auditors come to us,
6 in helping pick appropriate samples that address risk and
7 other features.

8 We do help with follow up work with regard to
9 variances. Again, most of the time, those variances
10 result from the actual input.

11 And you know, I think there's been several comments
12 about how widespread when you look at some of these level
13 two and level three type instruments, that the two
14 different prices are. I do think that's a little bit of
15 a challenge.

16 Because sometimes when we get to the bottom line
17 and we're looking at a level three, we're following the
18 guidance in terms of saying, when the level three guidance
19 came out, it specifically states that you are to use the
20 inputs that would compensate both the buyer and the seller
21 for the inherent risks in the deal. We adhere to that.

22 So basically what we're trying to get to is kind

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1 of a middle market price where a buyer and a seller would
2 execute a trade. Not the price where the client
3 necessarily wishes it was, or the price where someone could
4 for sure sell it to any number of people in ten minutes.

5 We're looking kind of for that cross level where
6 two people would be comfortable transacting.

7 With regard to independence, again, we do
8 manufacture all of our own prices. We document
9 everything. We're not a reseller.

10 We've given some thought to the staff consultation
11 paper with regard to conflicts of interest and investor
12 tests. We would be prepared to put in place some sort of
13 employee background investigation policy that could
14 potentially address material conflicts.

15 And we could potentially sort through that as the
16 reports came in the door to ensure that we wouldn't have
17 conflicts in that area.

18 We do have quality assurance steps at every single
19 stage of the process, data management and valuation. Some
20 of the checks are automated and some are human.

21 We never have an analyst only do a valuation.
22 Everything's always checked by two people.

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1 And lastly, with regard to skepticism, our analysts
2 are trained to apply skepticism. You know, I think that
3 what the engaged specialist might lack in terms of adhering
4 to 10 and following the firm independence rules, we do not
5 have any stake whatsoever in the results of the audit.

6 So, I think that there is a true independence that
7 comes from an engaged specialist that doesn't necessarily
8 exist with a lot of the other methodologies.

9 So, at that, I'm happy to answer any questions that
10 you have regarding our current practices and the
11 feasibility of some of the new practices that are
12 suggested. Thank you.

13 MR. SCATES: Okay. Thanks, Susie. Let's turn to
14 Dan Olds.

15 MR. OLDS: Okay. Well, good afternoon, everyone.
16 I'm Dan Olds. And I'm a Petroleum Engineer. I've been
17 doing valuation work for over 30 years.

18 Ryder Scott is one of the largest valuation firms
19 of its kind in the world. We've been around since 1937.
20 We've got about 130, 140 people in three offices. And we
21 work pretty much worldwide.

22 We worked for public companies. We worked for

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1 private companies. We worked for national oil companies.
2 We worked for governments. Chances are, if it's an oil
3 and gas project any place in the world, we've probably
4 taken a look at it.

5 So, with that, with the seven minutes I'm allotted,
6 I can't explain to you how we value oil and gas reserves.
7 So I'm not even going to try.

8 But I am going to try to focus on the things that
9 the PCAOB asked me to focus on. And the first thing here
10 is, how does the industry work?

11 Well, there's no SEC requirement to use a third
12 party firm like ourselves for reserves. Many companies
13 calculate their own reserves with their own internal
14 staff.

15 They all have their own engineers and geologists
16 to do the work. But, third party firms like Ryder Scott
17 may be engaged by companies to either calculate or part
18 of the reserves or audit their reserve calculations.

19 And let me add that some companies use multiple
20 consultants like us depending on the project and the
21 expertise that they're looking for. So we may be one of
22 many consultants that a large company might use.

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1 And why would a company want to use a third party
2 like us if the SEC says they don't have to? Well, an
3 independent objective view may be required by the Board
4 of Directors, the audit committee, or the financial
5 backers, the bankers, the investors may demand that the
6 company use an independent firm like ourselves.

7 We have specialized technical expertise or
8 specific experience in a particular area. Especially
9 since typical third party firms like ourselves get to see
10 many different projects around the world.

11 Familiarity with SEC requirements and latest
12 industry issues is also something that, you know, we do
13 this every day. Whereas companies' reserve engineers are
14 not necessarily doing SEC reserve work.

15 They're doing the internal kind of work necessary
16 for business planning, budgeting, and project
17 development, which SEC would be a subset of that. That's
18 a very specialized subset.

19 And of course outsourcing. You know, some
20 companies prefer to have us do all the work rather than
21 have the staff themselves.

22 Quality control, how do we do it at Ryder Scott?

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1 Well, I mean first of all, our staff is required to avoid
2 any investments in client companies or oil and gas
3 properties that would create or give the appearance of a
4 conflict of interest.

5 We have significant continuing education both
6 in-house and outside. You have to be a State licensed
7 engineer to be an officer of the company and to be able
8 to sign reports that go out the door.

9 The younger staff works under the direction of more
10 experienced staff. Company officers review final reports
11 before signing off.

12 And of course, it kind of goes without saying, is
13 when a project comes in, we look for expertise in the
14 company and assign that project to whoever we feel has the
15 best expertise in that area.

16 We have various error checking procedures used
17 throughout the process to ensure the integrity of reports.
18 Including frequent communication with the client.

19 And what I mean by that is that in many situations,
20 our clients are the real experts. They have, you know,
21 for a large oil company, they may have a staff of people
22 as large as what's in the room working on a large project

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1 year around.

2 So, they're the experts. They really know these
3 properties. When we come in, we may do the year end
4 reserve calculations, but it's somewhat of an integrated
5 process that we come up with a number and we show them what
6 our number is.

7 And they can say well, yes, we agree with that.
8 Or no, you've missed something. You know, because there's
9 so much data. We can't look at everything.

10 But, they can help us focus on the key points. And
11 help us to show us where we might have missed something.

12 And sometimes, we acknowledge that. And we say
13 yes, we see your point and we can adjust our numbers. And
14 then other times, we say well, we just have a fundamental
15 disagreement and we're just going to have to agree to
16 disagree on this.

17 Neither our employment to do the work nor the
18 compensation is contingent on our estimates or reserves
19 for the properties in our reports. You know, our pay is
20 not contingent on the answer that we come up with.

21 Certification was mentioned earlier today. There
22 is no industry certification for what we do that's

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1 mandatory.

2 I'm a State licensed engineer. I'm a petroleum
3 engineer. But, that doesn't really have specific
4 evaluation experience, it's more general. All petroleum
5 engineering aspects.

6 But, having said that, we do pursue some
7 certification in the form of I'm a member of an
8 organization that requires ten years of specific
9 evaluation experience and references. We encourage that.
10 We have addressed some of the certification issues that
11 were mentioned here earlier today.

12 Working for an audit firm. Well, I have a
13 background for nine years I worked for an audit firm as
14 a part of their energy consulting group.

15 And I can say with confidence that audit firms have
16 oil and gas staff well qualified to opine on accounting
17 issues and general SEC compliance. But, I would have to
18 say that, you know, in my experience, that the audit firms
19 may have limited or no staff with significant experience
20 to opine on detailed engineering issues.

21 For example, you know, even if you're not really
22 up on oil and gas, you're probably aware of the big shale

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1 projects that's going on worldwide. And specifically in
2 the United States.

3 And you know, that's one of the areas where we don't
4 have a lot of history. The oldest shale project in the
5 United States only started producing in the late '90s
6 really.

7 And we don't know how it's going to have a 50-year
8 life. Because we've not seen it yet. So, you know,
9 questions about the future performance on these kinds of
10 projects is something that I would not expect an accounting
11 firm to be able to look at with any level of expertise.

12 Situations that we encounter every day like the
13 appropriate determination of reserves, classifications
14 for undeveloped locations, that's always a big issue in
15 our industry. That's again, that's something that I would
16 expect accounting firms to have a general idea.

17 But to be able to argue the nuances of something
18 like that, would not be something that I would expect.

19 So, one of the questions that was put to me is, how
20 would working for an audit firm differ from working for
21 the company? And from my perspective, it wouldn't make
22 any difference.

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1 We don't couch our answer on who our employer is.
2 We want the right answer. So we would not differentiate.
3 We would expect to follow the same workflow and to arrive
4 at the same conclusions regardless of the client.

5 I would point out that we often work for multiple
6 companies who have interest in the same property. You may
7 not be aware that most oil companies manage their risks.
8 They manage their portfolio by not owning 100 percent of
9 these large projects.

10 There may be multiple owners. Many large oil
11 companies, maybe some national oil companies. Every deal
12 is different.

13 And it's not uncommon for us to be working for two
14 clients who have ownership in the same property. And in
15 that case, we have the same answer for both clients.

16 Working directly with the company generally
17 ensures better access to data and the company staff. As
18 I mentioned earlier, it's somewhat of an integrated
19 process.

20 The company's staff is really the number one
21 expert. And to think that we could come up with a good
22 answer without consulting with them, and again, I want to

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1 point out, not accepting their views in all cases.

2 But getting the benefit of their knowledge is an
3 important part of the process. And the other thing is
4 that, you know, reserve work goes on year round.

5 In talking about some of the issues here of, you
6 know, how would it differ if we were engaged by an audit
7 firm? Well, you know, there's not enough time at year end
8 to start the reserve work and get an answer.

9 You know, if we start on December 31, you know, it's
10 not going to work. We do a lot of projects in the summer
11 which is our -- we used to say that summer was the slow
12 season. But now it's just our less busy season.

13 But many large clients will have us work on special
14 projects, general engineering issues that will have some
15 applicability to year end reserve work. And so, you know,
16 we manage our work load by working on those kinds of
17 projects.

18 The reserve work goes on almost year round. And
19 so that would be an important thing to consider here.

20 And that's probably about all I can fit in my seven
21 minutes. But I look forward to any questions that you may
22 have later on. Thank you.

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1 MR. SCATES: Okay. Thanks Dan. And now we'll
2 turn over to David Kane.

3 MR. KANE: Thank you. I'm going to spend a couple
4 of minutes talking about how auditors use employed
5 specialists.

6 And just by necessity, I'm going to talk about it
7 more from one firm's perspective. But there will be some
8 similarities and differences I expect between firms,
9 whether large orient or smaller.

10 So, the first question here on the slide is, when
11 to involve a specialist? So, the audit team considers
12 several factors when deciding whether to involve an
13 employed specialist or internal specialist.

14 Complexity of and the judgement associated with the
15 estimate. The significance of the financial statement
16 assertion. Thinking about the risk of a material
17 misstatement, whether it's due to error or by fraud.

18 Effectiveness of the company's internal controls.
19 Whether the client in turn, has used a specialist. And
20 also, what's the team knowledge, past history, experience
21 with the estimate and experience with the client.

22 Importantly, once a decision is made to include a

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1 specialist, that specialist is viewed as part of the
2 engagement team and is subject to additional quality
3 control, review and procedures, just like everybody else
4 on the team, which I'll touch on in a moment.

5 So, when evaluating the specialist's
6 qualifications, teams are supposed to consider the
7 competence, the capability and the objectivity of the
8 specialist. But typically, teams will rely on the firm's
9 system of quality control in order to make those
10 determinations.

11 So here what are we thinking about? The
12 independence, monitoring and reporting. The firm's
13 internal recruitment and training programs. And the
14 training is particularly important.

15 So, specialists will go through foundation courses
16 on auditing that includes whatever the financial reporting
17 framework is. It might be U.S. GAAP. It might be IFRS.
18 Go through PCAOB standards in the firm's audit
19 methodology.

20 In addition, each year they are required to go
21 through a continuing professional education course
22 similar to what the auditors would go through.

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1 And here it gives us a chance to talk about hot
2 button issues, emerging trends, inspection issues,
3 whether it be internal or external and gives us a great
4 platform to reemphasize the need for audit quality and for
5 professional skepticism.

6 There's also a quality review program similar to
7 what we have on the audit side, where specialist work will
8 be selected and reviewed periodically.

9 Another key step here is thinking about the
10 agreement of the work to be performed. So I would say
11 there is probably three key aspects of that.

12 Early planning, the coordination and the
13 communication. And probably the last piece, which is the
14 most important, is the collaboration.

15 So, the planning begins up front. So typically,
16 there will be an estimates event, where the team will come
17 together with the specialist as part of making the risk
18 assessment and that determination.

19 And as part of that, they'll walk through, what's
20 the nature of the inputs, the processes, the assumptions,
21 the methods. As well as discuss what the client's
22 internal control looks like, both in terms of the

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1 development of the estimate as well as the ultimate review
2 of that.

3 And coming out of that will be an agreement about
4 the nature, timing and extent of the procedures that are
5 going to be performed in that area. There will also be
6 roles and responsibilities.

7 Communication protocols will be set up between the
8 audit team and the specialist. And also what the
9 documentation is going to look like.

10 So, typically the specialists have some standard
11 documentation that will be provided to the team, both up
12 front in terms of planning, as well as the end in terms
13 of conclusions, that typically describe the procedures
14 performed, results obtained, the scope and things similar
15 to that.

16 Once agreed, the other key part is collaboration.
17 So, what we've seen on positive quality events is when the
18 team works collectively and collaboratively to look at
19 methods and assumptions.

20 So Andreas mentioned earlier, discussions with the
21 client for example. Attending client meetings together.
22 And really, it's when the team truly understands the model,

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1 understands sensitivity of the inputs, and understands
2 most of the underlying economics of how the instrument is
3 priced in terms of the market.

4 So, several considerations here when evaluating
5 the specialist's work. First thing is, the specialist's
6 work is subject to a detail review by a more senior
7 specialist.

8 And will also be subject to a partner, principal
9 or executive director review by the specialist. It's also
10 subject to a general review by the audit team as well.

11 Key here, is that when we're talking to teams about
12 using the work of a specialist and evaluating it, you want
13 to be thinking about it the same way with professional
14 skepticism that you do as if the client handed it to you.

15 So we've been working with the specialist all along
16 the way in terms of the nature, timing and extent of the
17 procedures, and partnering with them all during the audit,
18 minimizes the chance for surprises at the end. Which I
19 think is very important in these circumstances.

20 So, what's the audit team looking at when they get
21 this? They're going to be looking at some of the things
22 that we talked about this morning.

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1 What's the relevance and the reasonableness of the
2 assumptions, of the inputs, of the methods? Making sure
3 that the conclusions ultimately support what the
4 objectives were and what the financial reporting or
5 financial statement assertion was.

6 They're also looking at the source data and making
7 sure that that was all appropriately covered as well.
8 Ultimately though, it's the audit team that's responsible
9 for determining what constitutes sufficient, appropriate
10 audit evidence.

11 If the team is satisfied that the results support
12 their conclusions, they could reasonably conclude that the
13 specialist work is adequate. So that concept comes out
14 of AU 336.

15 With respect to documentation, so when using an
16 internal specialist, we view that documentation no
17 different than if it was prepared by any other staff
18 member.

19 So, the documentation for the team as part of the
20 archive has to stand the evaluation of that an experienced
21 auditor with no, you know, history with a client, or with
22 the team, has to be able to come in and make a determination

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1 about whether the papers are clear about the nature, timing
2 and extent of the procedures, the results obtained and the
3 conclusions reached.

4 So again, no different than any other member of the
5 team. In terms of the auditor engaged specialist, less
6 common I suspect at the larger firms, key differences are,
7 that you can't rely on the system of quality control, so
8 you have to be here thinking about independence,
9 objectivity, competency and capabilities.

10 You also have to think about confidentiality to
11 make sure that the specialist is going to respect that.
12 And then there's a free exchange of information between
13 the auditor and the specialist.

14 A couple of observations here similar to what I made
15 this morning. I think there are some opportunities to
16 enhance AU 336 here and probably pick up some of the
17 language that's in ISA 620 and AU 620.

18 I think the other point here too, is the rescission
19 of AU 336 would probably have more significant
20 consequences for auditors and for companies. When I think
21 about ASC 820, and when that was issued, there was a lot
22 of discussion about fair value measurements.

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1 What's the framework? Thinking about market
2 participant assumptions. And specialists and auditors
3 really used that opportunity, I think, to up the game.

4 Where auditors understood much more in terms of the
5 framework and actually how these instruments are priced.
6 And I think coming out of that became better auditors.

7 No matter how much time you spend with an auditor,
8 you're not going to be able to convert them to a reserve
9 engineer with this. So, I think there has to be some
10 recognition and reliance on the fact that someone is a
11 specialist and outside of the auditor's expertise.

12 That's what I have. The big picture.

13 MR. SCATES: All right. Thank you, David. Now,
14 we'll turn to our last panelist, Efrim Boritz. Efrim?

15 MR. BORITZ: Thank you very much. And thanks for
16 inviting me to share some of my research with you.

17 The material that I'll be covering with you is the
18 result of the last two years of work by a team of four
19 people. It's based on 40 interviews of all Big Six firms,
20 including half auditors at the various levels, various
21 ranks, and specialists in various specialty areas.

22 So, I only have four main headings that I'm going

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1 to be covering with you. Planning, supervision,
2 coordination, review. Then some issues about the
3 definition of specialists and engagement teams. And then
4 some other observations.

5 One of the things that I observed in conducting
6 these interviews is that the audit teams have accepted the
7 notion that the audits are modules. They're modularized
8 like Lego pieces. Or someone used the example of IKEA
9 furniture.

10 So, the different parts of the engagement are
11 carved out and passed over to specialty groups in certain
12 areas. And this is not a criticism, but it's a certain
13 way of thinking.

14 Because with that modularization comes a handing
15 over of certain responsibilities. And that can raise some
16 issues that I'll get too later.

17 The modularization is not just modularization
18 sections of the audit, but you can think of it as a certain
19 slicing of layers. There are specialists who have
20 expertise and knowledge that other members of the audit
21 team do not.

22 So, there's -- they're just carved apart by virtue

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1 of the fact that they have different competencies. And
2 they have different languages and different ways of
3 talking. So, any standards have to take into account the
4 fact that there is this layering.

5 In many of the firms, the specialists are in
6 different business units or different divisions.
7 Although, when they're working on the audits, they
8 interact with the other members of the audit team.

9 They really have a different reporting chain, a
10 different way of being employed, quality controlled, and
11 they have their own review process as David has just
12 mentioned, that may not be transparent to the audit team.
13 There's a requirement for a lot of trust in the firm's way
14 of organizing itself and the quality control process.

15 And the modularization also exists in the archives
16 and databases that the firms use to manage their audits.
17 It's quite common for the specialists to write memos to
18 file summarizing the work they've done on their module and
19 deposit it in the archive.

20 And then it depends very much on the proactiveness
21 of the management team, the management of the audit, to
22 make sure that those things -- those modules click together

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1 properly. Because it's very common in the way today's
2 audits are managed for those to be really individually
3 manageable and individually completeable sections.

4 The participation in the engagement is very much
5 at the discretion of the partner in charge or the manager
6 in charge of the audit. The specialist's role is passive.
7 And they -- even when they have knowledge about the
8 industry, they may not be able to apply it.

9 They're often not in the position to question
10 whether their involvement -- their lack of involvement is
11 properly determined or not.

12 So, this is unsatisfying to many specialists. And
13 it does not necessarily lead to the team spirit or the
14 cohesive engagement team that we would want to imagine.

15 The integration of specialists into planning is not
16 always carried out consistently. Some specialists are
17 routinely brought into the planning meetings. And others
18 have their own separate meetings.

19 So for example, tax specialists and IT specialists
20 are routinely involved in up front planning. Valuation
21 specialists and forensics and others that are brought in
22 as plug-ins, may not.

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1 And so the integration that is necessary for a team
2 to be a team, is often not there. And should be addressed
3 in any kind of standard revision.

4 I'd also want to mention the distinction between
5 the involvement and scope. Many of the firms have
6 policies that specialists need to be involved in some
7 aspect of planning and so forth, and they are.

8 But, the distinction when you dig deeper into
9 discussions with the various participants, you find that
10 the difference between involvement and scope can be very
11 dramatic.

12 So, the -- so you need to know the language of the
13 auditors. And the specialists' involvement may be
14 insignificant. But it's checked off as involvement and
15 complies with firm policy.

16 The scope may be insignificant, but the involvement
17 is binary. So, it's something to be aware of.

18 My next set of points deal with supervision,
19 coordination and review. In our interviews, we became
20 aware of both auditors and specialists being concerned
21 about the coordination and communication.

22 Especially because of this modularization that I

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1 referred to, often specialists are given their assignment,
2 they're given a time line, maybe a budget. And they're
3 really then performed.

4 There is often not as much communication in that
5 process as both parties would like. That's obviously to
6 do with management and firm dynamics and busyness.

7 Again, this is not finding fault, but both
8 specialists and auditors complain about gaps in
9 communication. And of course, that means that there's not
10 the benefit of transferring information and knowledge
11 about issues as they arise in a timely manner and can lead
12 to issues.

13 The auditors often assume that review is done by
14 specialists. And from what my understanding is, and from
15 what I've heard David say, there is a separate review
16 process that exists within the specialist ranks.

17 And it might be very effective. But the auditors
18 are not very involved in that process. They have their
19 review process is much higher level. There is a process,
20 but it's much higher level.

21 And there is not as much transparency in the review
22 process that's carried out by specialists of specialists,

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1 in terms of the employed specialist teams as you would want
2 if the engagement team were truly charged with being
3 responsible for this. As being solely responsible as some
4 of the standards essentially assert.

5 Specialists are at times -- do at times accept the
6 audit work at face value. Some are not able to because
7 they don't have enough accounting or auditing training to
8 challenge the evidential quality of the data that they're
9 given to put into their models.

10 And for example, one of the examples that was used
11 frequently was that many tax specialists can provide an
12 assessment of the propriety of the provision. But they
13 can't actually evaluate the propriety of the disclosure
14 and the accounting for that provision.

15 And that's because some of them have a lot of tax
16 expertise, but not a lot of accounting or auditing
17 expertise.

18 Specialists believe that the auditors that they
19 work with do not have the capacity to thoroughly review
20 their work. This is not to say that they don't think the
21 work is carried out properly or that it's not reviewed,
22 it is reviewed.

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1 But, to the extent that the auditors, the audit team
2 is charged with driver -- of being in the driver's seat
3 and driving this process, they may not have the competency.

4 And you could imagine that this would have to be
5 the case. The reason they're using specialists in the
6 first place is because the specialists have knowledge,
7 skill and experience that they themselves don't have.

8 So, it would be asking for too much to demand that
9 they perform a detailed effective review.

10 My third main set of points deals with definitions.
11 I am not a fan of the definition of specialists in our
12 standards. That for example, use the phrase other than
13 accounting or auditing. But I could live with that.

14 I am certainly not a fan of the fact that what goes
15 into that other than accounting or auditing. I've already
16 mentioned IT specialists and tax specialists.

17 They're considered to be within the accounting and
18 auditing realm. And therefore, most of what we're talking
19 about here is not being addressed.

20 But, within the firms, those people are viewed as
21 specialists. They are in different business units in many
22 cases. They do have different reporting structures.

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1 And in some cases, increasingly I think, but this,
2 it would have to be verified by others who may know more
3 about this than I do, increasingly, the forensic, IT, tax
4 and even valuation specialists, do not have strong
5 accounting or auditing backgrounds.

6 They have backgrounds, deep backgrounds in their
7 field of specialization, valuation, finance, IT,
8 forensic, tax, but so this illusion that our standards have
9 that tax, IT and forensics for example, are a part of the
10 accounting or auditing background of large audits of
11 sophisticated companies, I think should be challenged.

12 It's true I think for smaller companies that this
13 is something that you can't often assume. But, for the
14 large type of audits and the people involved in those large
15 audits, both the auditors and the specialists, I simply
16 don't think that that's accurate.

17 And to the extent that we don't include them,
18 because they're just invisible in the standards right now,
19 because they're just an exclusion, we don't benefit from
20 having the standards provide guidance for people who work
21 in these specialties. And who are very, very important,
22 in some firms they are mandated to be involved on every

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1 audit, especially in the large firms.

2 I also have some issues with the definition of
3 engagement team. And that's because of things that I've
4 already said.

5 The engagement team I think, is a virtual team.
6 But it's not a team the way we think of as a football team
7 or a baseball team.

8 They don't work together in many cases. They do
9 sometimes. Sometimes the doorway to the client for a
10 valuation specialist is through the auditing member.

11 But once the door is opened, the valuation
12 specialist is basically there interacting with the client.
13 The IT specialist is basically there interacting with the
14 client.

15 So, it's not -- and of course, I'm sure that there
16 are instances where they work hand in hand and collaborate
17 and so forth. But in the large audits that have as the
18 consultation paper refers to, they may have four or five
19 different specialists working on it.

20 That type of collaboration I think is a luxury.
21 And it's just, from what I understand from the research
22 we did, it doesn't occur that often.

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1 So, there are barriers to team spirit as well
2 because the specialists don't want to be buried in the
3 engagement team. They have, as I say, they're part of
4 different divisions.

5 They have their own training. Increasingly,
6 that's more in their fields of expertise than accounting
7 or auditing.

8 And although in our research the auditors would
9 love to have the specialists integrated into their team,
10 the specialists are not keen on being integrated because
11 they have their own identities and view themselves as part
12 of a service.

13 In other words, they're almost like an engaged
14 specialist except that they're employed within the firm.
15 And of course, they're managed properly in that regard.

16 MR. SCATES: Efrim, if you could -- I think we'll
17 conclude there.

18 MR. BORITZ: This is my last slide.

19 MR. SCATES: If you could wrap it up in a minute
20 that would be very good.

21 MR. BORITZ: Okay. Thank you, yes.

22 MR. SCATES: Thanks.

1 MR. BORITZ: So, one of the observations I made is
2 that with the way of the modularizations taking place, I
3 believe that there is a deskilling of the regular audit
4 staff. And we should be aware of that.

5 Employed specialists have, as I've said, have
6 limited account knowledge and limited understanding of
7 professional ethics in some respects.

8 And however, we found a number of instances where
9 employed specialists appeared to be more skeptical than
10 members of the audit team because they did not have as big
11 of an investment in the client as the audit team did.

12 MR. SCATES: Okay. Well, thank you. Thank you,
13 Efrim. Thank you for all the panelists.

14 And what we'd like to do now is, I know you're going
15 to have questions of the panelists and an ongoing dialogue.
16 We have two sets of alternatives to consider with respect
17 to using the work of the auditor specialist.

18 The second set we'll just discuss in a few minutes
19 that has to do with the subject that we alluded to this
20 morning, and the panelists have brought it up, with respect
21 to independence and objectivity for the engaged
22 specialist.

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1 And we'll talk about that in a few minutes. What
2 I'd like to talk about now, is your views on alternatives
3 with respect to oversight or supervision.

4 The first alternative would be to develop a
5 separate standard that would apply to the work of both
6 employed and engaged specialists. And then the second
7 alternative would be to extend the existing supervision
8 requirements in AS 10 to the work of engaged specialists.

9 So now, I would like to open -- I think we want to
10 first address the tent cards we have from this morning.

11 MR. BAUMANN: But even if we were to extend on the
12 last slide, Greg, the AS 10 requirements to engaged
13 specialists, I think we also have teed up a question in
14 this consultation paper that is specialists are different
15 than accountants and auditors.

16 So should there be different or is it more specific
17 supervisory requirements in overseeing the work of a
18 specialist then in overseeing the work of an accountant
19 or auditor, given the fact that auditors who are doing that
20 supervisory work don't necessarily have the expertise in
21 the field of the specialty?

22 So with that, please your questions can go to us.

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1 Or comments can go to the management specialists, auditor
2 specialists.

3 But, Chuck Senatore, you had the first card up.

4 MR. SENATORE: Thanks Marty. It's a question and
5 a comment, and it was actually inspired by Sir David when
6 he talked a little bit earlier about sort about the
7 conundrum around specialists and estimates.

8 So, you know, the one thing that struck me from his
9 remarks was, you could have an estimated value that's here,
10 that's reasonable. You can have one that's here that's
11 reasonable.

12 And the delta could be quite severe. And he
13 mentioned that there's really -- so he felt bad for the
14 auditors in terms of having to face that.

15 But I guess, what I'm thinking about now, is not
16 only just feeling bad for the auditors, but feeling bad
17 for an investor in terms of having such a swag like that.

18 So, I guess my question is, is there a gap in the
19 standard? Now, I don't pretend to be a student of this,
20 and I basically just know what I read in the materials.

21 But when I look at the standards for AU Section 336,
22 so you think about that framework, because there's a three

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1 part test. The appropriateness and the reasonableness
2 and the method of the assumptions are the responsibility
3 of the specialist.

4 And then the auditor should obtain and
5 understanding of those methods and assumptions unless the
6 procedures lead him to believe that the findings are
7 unreasonable. And then once you hit that unreasonable
8 level, then, you know, you might want to take a look at
9 another specialist or other procedure.

10 So my question is, when you think about the fact
11 that estimates are inherently, you know, they're not
12 precise. You can have a number of different reasonable
13 estimates.

14 And they actually can vary quite a bit. It would
15 be a horrible outcome if an investor had no idea that there
16 was such a delta between a number of different reasonable
17 estimates.

18 So my question is, the way I read this is that,
19 there's a danger at least looking at this literally. That
20 once you get -- let's say you got to one of the reasonable
21 outcomes.

22 And let's assume, let's say -- I don't know whether

1 it was Phil or Doug that mentioned this, but let's assume
2 that, you know, we're talking about a specialist that's
3 really sort of tied to telling management what they want
4 to see or hear.

5 But once you get to that one really good for,
6 favorable to management, reasonable outcome, is it pencils
7 down under the standard? Because you basically -- it's
8 reasonable, we're done.

9 It feels like a gap to me. I don't know when you
10 look at Auditing Standard 10 where there's a little bit
11 more of a foundation for digging, at least the way I read
12 it in terms of the second element, where the auditor can
13 direct the specialist to bring issues to the attention of
14 the auditor so that the auditor can evaluate those issues.

15 I guess my question is, and maybe there are things
16 that happen in practice as we learned earlier that may go
17 beyond the threshold of what the standard requires.

18 But, it would seem to be a shame to have a
19 circumstance where an investor, when you think about the
20 hypothetical that Sir David talked about, not being aware
21 of a delta simply because applying a standard, with the
22 auditor basically found a reasonable outcome without

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1 really investigating whether there was another reasonable
2 outcome, and it was pencils down.

3 So I guess it's really more of a question in terms
4 of whether that there's a gap in the standard in light of
5 that possibility?

6 MR. BAUMANN: Well, it's a really good question.
7 And it's really I think at the heart of what we're exploring
8 here.

9 Not only in this project, but in the estimates in
10 fair value projects. And you'll hear more about this
11 again this afternoon.

12 AU 336, part of the issue is that it was written
13 some years ago. And written before the risk assessment
14 standards.

15 So if you just looked at 336 by itself, you might
16 say pencils down if you found that specialist work to be
17 not unreasonable. The engaged specialist's work to be not
18 unreasonable.

19 However, the risk assessment standards say
20 estimation uncertainty is something the auditor should
21 take into account in assessing the risk of material
22 misstatement.

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1 So if there's a wide degree of estimation
2 uncertainty or a wide range of possible outcomes there,
3 the auditor should take that into account in terms of their
4 nature, extent, and scope of audit procedures.

5 And therefore, 336 right now is not directly linked
6 to the risk assessment standards. One of the issues in
7 terms of our need to update the standard.

8 Because to your point, and many commenters on the
9 previous consultation paper on estimates and fair value
10 said they've encountered situations where estimation
11 uncertainty can actually be wider than materiality
12 established by the auditor for the financial statements
13 as a whole.

14 And what do we do when estimation uncertainty, any
15 of those outcomes in there seem reasonable, but that
16 estimation uncertainty is wider than the materiality we've
17 established? Well one thing hopefully is that the
18 financial statements disclose that estimation
19 uncertainty.

20 But what else should the auditor be doing? They
21 can't narrow it, the estimation uncertainty.

22 But what procedures should they be performing to

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1 determine that management has determined most reasonable
2 estimate within there, or how management has rejected
3 other alternative assumptions, you know, within that wide
4 range.

5 So, your question, I think I don't have an answer
6 to it. It's part of this whole project of improving our
7 standard around specialists. And improving our standards
8 around fair values and estimates to say yes, I have to
9 pursue that further. It's not just pencils down.

10 MR. SENATORE: I guess this -- my only other point
11 here and it's a follow up, is a wrinkle in terms of the
12 specialist scenario. Because by definition, there's a
13 great deal of reliance.

14 We just talked about how there's no inherent
15 expertise in some areas. And you are relying on somebody
16 else.

17 So the question to me is, does the standard need
18 to reflect some degree of accountability, control or
19 ability to kind of see when you are relying so much on
20 another party to even know if you have a window of different
21 estimates that might end up falling into what you talked
22 about.

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1 I just don't know whether that's present.

2 MR. BAUMANN: That's a really good question as
3 well. Because, does the auditor know that the specialist
4 has a wide range of estimation uncertainty?

5 The auditor may not know that unless that's
6 properly communicated from the specialist to the auditor.
7 So there are a lot of good questions there that you've teed
8 up for us to consider as part of our standard setting.

9 Next was John Lukomnik. I probably say that wrong
10 every time John.

11 MR. LUKOMNIK: John is fine.

12 (Laughter)

13 MR. LUKOMNIK: So this also goes back to the
14 discussion before lunch. But it probably has more
15 relevance now, so I'm glad it got held.

16 The discussion before lunch was sort of incremental
17 modifications to 336. And I'd like to suggest that you
18 consider what I would call a low cost chicken soup
19 approach.

20 Which is, you know, something that couldn't hurt.
21 I would say probably would help. But at lunch we were
22 having a discussion about the definition of probability.

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1 So I'll say might help.

2 There is no requirement in 336 for requiring
3 communications from the auditor to the specialist.
4 That's important for a couple of reasons.

5 Number one, there's all sorts of behavioral studies
6 that's just a, when you remind someone of what they're
7 supposed to do ethically, they actually -- there's an
8 increase statistically in ethical behavior.

9 But more importantly, and this gets exactly to your
10 point and to one of the things Susie said, for company
11 hired, for company employed or engaged specialists, their
12 estimations are done for a purpose other than for audit
13 usually.

14 They're done for valuation of a merger or a sale
15 and acquisition as Loretta had mentioned. I've been
16 engaged as a risk manager on financial products, and Susie
17 gave her thing, which was, it's not a clearing price in
18 ten minutes where you can sell everything. Neither is it
19 what management should be.

20 But if you're a risk manager, you may in fact be
21 saying okay, if there's a liquidity constraint situation,
22 what's the market clearing a price for this strange

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1 derivative within five days, which is what you've promised
2 people? Which may be different than fair value.

3 If in fact there's no required communication from
4 the auditor to the company either engaged or employed
5 specialist, there's no reason to assume that they will
6 understand what the purpose of their estimation is.

7 And I think it would be very helpful, you can't
8 control what someone not in the employ of the auditor does
9 necessarily. But you can certainly influence behavior by
10 saying, here is how we are planning to use it.

11 Here is the purpose to which it is to be used. Here
12 are the standards that we think we are applying. Do they
13 match that? Or are you in fact, did you do it, did you
14 value it for a different purpose?

15 And so, I would like to see whether you -- however
16 you strengthen 336, for there to be a set of required
17 communications from the auditor to the specialist that
18 explain how those estimations are to be used as an audit
19 context.

20 Because without that there is, I think, a high
21 probability that a large number of the specialists will
22 give -- will have perfectly valid, as you say, reasonable

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1 estimates. And they may be for different purposes.

2 And that's another reason, not just the
3 assumptions, but the constraints around them, and the
4 goals of the purpose that give you a wider variety than
5 would otherwise be necessary.

6 MR. BAUMANN: Those are good points. Because
7 those are the elements of -- part of the elements of AS
8 10, supervision, the communication that you would have
9 with employed specialists in directing them and
10 communicating with them as to what they need to do.

11 So, that's a key improvement to 336. Bob Herz?

12 MR. HERZ: I guess my comments start with the
13 presumption or more experience that how you write the
14 standards. And then how the auditors will react and how
15 your inspectors will react to those words, have very
16 important behavioral consequences.

17 So you have to be very -- you're never going to get
18 a complete Goldilocks up front on all that. But, there
19 are some things you can, I think from experience do.

20 But you're trying to at least get to that, you know,
21 not too much, not too little. Do the right amount to get
22 the comfort.

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1 In that regard, I think as David Kane mentioned,
2 you know, one of the big issues that came up when we were
3 setting what was then 157, was around the level three
4 valuations of how much is enough to get reasonable inputs,
5 particularly to, you know, kind of say take a market
6 participant type view?

7 And you know, in particular, you know, there were
8 concerns by the preparers at that time that if we left it
9 kind of just without some guidance, that the auditors would
10 engage in a search and destroy exercise to find almost
11 anything that, you know, they could hang their hat on and
12 put in a work paper and the like.

13 And some of that -- so the words in 157, they're
14 around level three valuations, you know, talk about
15 management using its best estimate, but not ignoring
16 market evidence that's readily available.

17 And that does not mean that you've got to, I can't
18 remember the exact words, but do a search and destroy
19 exercise. And so, I was thinking of that in this context.
20 And the prior discussion of the two alternatives you were
21 considering. And it might apply to both.

22 But I was thinking in the first instance, if you

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1 removed -- rescinded AU 336, what might that do to that
2 kind of behavior? Particularly since, you know, you're
3 very much emphasizing in some of your standards and
4 inspections that the need for the auditor to consider, you
5 know, contrary information.

6 And I'm not prejudging one way or the other. It's
7 just the issue of getting to the right -- to the right
8 balance there. I think that goes back to some of these
9 things that some of the valuation folks talked about.

10 Is that -- like Andreas talked about, that you know,
11 they're -- within even a level three valuation, there are
12 some assumptions that can be triangulated or market
13 corroborated. There are others that cannot.

14 And it's often very fact specific to the type of,
15 you know, asset and the type of financial instrument or
16 whatever. And there's no way you're even going to be able
17 to prescribe all that stuff. That should be in the
18 valuation standards that develop.

19 But, I guess my overall encouragement is to just
20 think about that, you know, that behavioral balance.

21 MR. BAUMANN: That's an important consideration.
22 And I think we've gotten a lot of that advice today I think,

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1 and similar advice in different ways that moving maybe
2 towards the IASB in this area, which has, not as far as
3 we've possibly said is some of the options in the
4 consultation paper, but it has potential other
5 improvements that are pretty close to it.

6 Sort of getting to your Goldilocks. They're
7 trying to get it just right. It's looking at the various
8 -- what they have in the ISA compared to what we're talking
9 about today. Thanks.

10 MR. SCATES: Bob, are you thinking that maybe we
11 should do more in the review and supervision from the
12 auditor's perspective when they're reviewing the work of
13 the specialist?

14 MR. HERZ: I'm thinking, well first, I start from
15 the premise that on the one hand, the preparer's got to
16 do the financial statements. And they've got to do
17 whatever they need to do to get comfortable with that.

18 And that is their responsibility to do that. So
19 they need to do that. But, on the other hand, the
20 auditor's got to come after that and make a judgment.

21 But you want the level of inherent process and
22 scrutiny over that process to be consistent between what

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1 gets done by the preparer and what gets done by the auditor,
2 with the auditor still looking at it. And doing what they
3 think is necessary.

4 And you know, we found there have been the
5 consequences of the way standards are written, the way
6 inspections are done, the way auditors interpret things
7 that have very big behavioral consequences that probably
8 weren't initially intended by the standards, you know, the
9 way they were written.

10 So I'm just saying, you know, think about that.

11 MR. BAUMANN: And finally, just to follow up more
12 time, and that is, I guess we want to certainly avoid having
13 the auditor do more work around the work of the specialist
14 than management has to do around the work of their
15 specialist for preparing the financial statements.

16 That's certainly part of what you're saying.
17 Right? Thank you.

18 Maureen McNichols? Oh you? Your card's down,
19 sorry. Liz Mooney?

20 MS. MOONEY: Thank you. You know, this project
21 just strikes me as really important, you know, for the
22 profession and for the future.

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1 I mean, this is the future with more and more
2 estimates and judgments. And these are numbers that are
3 in the financial statements, unlike the non-GAAP issues
4 we were talking about earlier.

5 So, I think it would be useful to have the auditors,
6 you know, test the evaluation inputs and review the
7 methodologies by specialists, whether they're employed by
8 management or the auditors. And I would expect investors
9 would be happy to pay for it.

10 I mean, and I don't think you'd get complaints about
11 a higher audit fee to have better assurance about these
12 numbers. I think they expect these numbers are audited
13 already, so.

14 MR. BAUMANN: Yes. So if management is using a
15 specialist to prepare a complex oil and gas estimate the
16 auditor can't necessarily review that, the auditor should
17 be using his or her own specialist your saying to work under
18 the auditor to review that.

19 Is that your point? Right? Okay.

20 MR. MOONEY: Right.

21 MR. BAUMANN: Thank you. Jeremy Perler?

22 MR. PERLER: Thanks. This has been helpful and

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1 informative.

2 I just have a question, last from the prior session,
3 but applicable now too. And I'm distinguishing between,
4 and maybe I shouldn't, but there's been a lot of discussion
5 on -- about these black box and propriety and geologic type
6 specialist work.

7 Which I understand is highly complicated and you
8 would never expect an accountant to understand that. But
9 then, there's also been discussion on using a specialist,
10 and maybe I have this wrong, but for things that feel to
11 be more in the wheelhouse of an accountant, like purchase
12 price allocations, perhaps PP&E valuation.

13 And, you know, specifically with the purchase price
14 allocation, restructuring reserves are now liabilities or
15 weird situations where accounts receivable and deferred
16 revenue are revalued to map altered revenue recognition
17 patterns, which I've seen a lot recently.

18 But I guess my question is, are those accounting
19 style decisions being made at the specialist level? Or
20 at the auditor level? Is a simple purchase price
21 allocation audited or not?

22 And I'm a bit confused on that now. And yes, I

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1 guess that's my question.

2 MR. BAUMANN: I don't know if any of the auditors
3 want to respond. I assume the purchase price allocation
4 is audited.

5 But sometimes it's audited by -- with assistance
6 from specialists if that purchase price allocation
7 includes core deposit intangibles or some other type of
8 intangible assets that are hard to value by the auditor.

9 I don't know, Bill, you want to take a shot?

10 MR. PLATT: Yes. I think that's a fair summary
11 Marty. It's, you know, obviously with a large
12 acquisition, it has some material impact on the financial
13 statements.

14 There will be auditing of the allocation of the
15 purchase price to make sure that it was allocated in
16 accordance with the accounting standards that are
17 applicable.

18 Now some of that allocation will be things that are
19 clearly in, you know, the auditor's wheelhouse. You know,
20 you take something like accounts receivable, there might
21 be some minor adjustments for fair value.

22 But, you know, auditing, you know, are those valid

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1 receivables? And are they stated at the right amount on
2 the day it was acquired? There's probably things done by
3 the core audit engagement team.

4 Then you've got other things. I mean, Loretta
5 spoke before, if she had IPR&D coming in as a result of,
6 you know, a development stage pharma product or drug, then
7 that would involve valuation people.

8 And looking at, you know, how you go through that
9 modeling to the fair value that IPR&D. And likely she may
10 be engaging valuation specialists to help her on one hand.

11 And we would have valuation specialists, I mean
12 Deloitte -- within Deloitte, who would then work with the
13 engagement team in auditing whether what was done by the
14 company was appropriate in the circumstances or not.

15 And doing the kinds of things that Andreas talked
16 about before in terms of what were the critical inputs into
17 it? Who's auditing which assumptions? And things like
18 that.

19 And so I think all of that's being done today. But,
20 if -- you know, if you had something that was truly outside
21 of the skill sets, I mean, I guess I don't specialize in
22 oil and gas, but if you had some type of value that

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1 required, you know, a specialist, an engineering
2 specialist in that respect, you know, then that would
3 probably be a little bit different exercise in terms of
4 looking at that.

5 MR. BAUMANN: Can I follow up just a little bit
6 further? And David, maybe you can get engaged as well
7 since you talked about both employed and engaged
8 specialists.

9 So in the situation that Bill just described, and
10 Bill you can talk to it or David, how would -- would the
11 supervision differ? And how would the supervision differ
12 between when the engagement partner or whoever you
13 delegated this work to, supervise that accounts receivable
14 staff reviewing that work?

15 And whether or not the accounts receivable were
16 collectible? Or do they need an allowance? Or the
17 valuation of the intellectual property, which is done by
18 some specialist, how would you supervise that person who's
19 valuing the intellectual property on your engagement team?

20 How different is that supervision? Maybe you
21 could help us with that?

22 MR. KANE: I'll take a crack at that to begin with.

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1 So, let's take an example where they have to work together
2 on prospective financial information.

3 So, that's going to be a key part of a purchase price
4 allocation. Both parties, both the audit team and the
5 specialists who have to come together, the audit team is
6 going to have a much better knowledge about the company,
7 its strategic direction, where it's going.

8 The specialist is probably going to have a broader
9 perspective from a market participant observable
10 standpoint. In terms of what would a market participant
11 look like in terms of the inputs and the assumptions.

12 So typically, you know, if you look at the memos,
13 the specialist will indicate that the audit team will take
14 responsibility for the PFI. But it's really both pieces
15 working together.

16 If the audit team in terms of the PFI thought it
17 was a little bit more conservative or a little bit more
18 aggressive, you need to talk to the specialist. Because
19 that's going to directly impact what the discount looks
20 like.

21 So both pieces really do have to come together on
22 that. So, I'm sort of indirectly answering your question

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1 here, Marty.

2 Just in terms of the review and supervision,
3 because both the audit side and on the specialist side,
4 both have to work collaboratively as part of that review
5 and supervision, in order to make sure that those basics
6 are covered.

7 MR. BAUMANN: Yes. Any further comment on this
8 question of differences or similarities and supervision?
9 Bill, I'll get to you in a second.

10 MR. PLATT: Yes. I mean the only thing I'll add
11 just in terms of the supervision, is it's clear when it's
12 an employed specialist. You know, we have protocols in
13 place where there are, you know, there are planning
14 documents prepared that would articulate, you know, the
15 responsibilities of the specialists and the
16 responsibilities of the core engagement team.

17 We do have, similar to what was mentioned before,
18 you know, we have levels of review within our specialist
19 teams where, you know, specialists are reviewing
20 specialist's audit work before it's turned over to the
21 non-specialist, let's say a lead partner in an engagement
22 team.

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1 And so, all those protocols are in place in terms
2 of supervision and review. Honestly, I don't have as much
3 experience and, you know, if we happen to hire Susie's
4 company, you know, come up with a series of valuations for
5 us, that were used by the engagement team.

6 I don't really have a lot of experience in terms
7 of what then supervision or review we would do of her work
8 and her team.

9 But, my guess is that it may be much different given
10 the differences between having somebody employed as part
11 of the firm, and somebody who's maybe, I'll put it,
12 outsourced a service to provide a value. But I can't
13 comment specifically on that.

14 MR. BAUMANN: That's the question we're interested
15 in and a lot of comments on as part of this consultation
16 paper. How different or similar should that level of
17 supervision be for an employed specialist versus an
18 engaged specialist?

19 I think Dan, your card went up first. And then
20 Susie.

21 MR. OLDS: Well, I would just like to make a
22 comment, that as a specialist, one of the functions that

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1 I do when I'm working with clients, and whether it's the
2 oil and gas client, or you're talking to their accounting
3 firm.

4 I may be talking to a lawyer at a law firm. I may
5 be talking to an investment banker. But I'm always
6 cognizant of the fact that I'm probably dealing with
7 something that doesn't have the technical background that
8 I do.

9 And an important part of my job is to make sure that
10 I communicate with them. And can convey issues that I may
11 see or issues that I have or concerns that I have.

12 Or things that I think that they need to know. Is
13 what I see as an important part of my job is to make sure
14 that I can convey that to them in a language that they can
15 understand.

16 MR. BAUMANN: Susie?

17 MS. DuROSS: I was just going to comment on some
18 of the questions about how the process works. I mean,
19 maybe I wasn't very clear on that in my original
20 statements.

21 But, generally speaking, the firms that work with
22 us, we do the preplanning --

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1 MR. BAUMANN: The audit firms?

2 MS. DuROSS: The audit firms that we work with.
3 Which are primarily the second tier and then there's
4 smaller.

5 And I will say, there is some difference between
6 the two. Within the second tier audit firms, they
7 generally have some valuation experience somewhere in the
8 firm.

9 So, when they get our prices and our inputs, they
10 generally do two things. They review each of the kinds
11 of securities that we've priced.

12 So they pull a sample and they collect all of the
13 inputs. And then they review each of those inputs and make
14 sure that they can make sense of those inputs.

15 They come back to us. They ask questions. You
16 know, sometimes they have a real financial background and
17 a financial experience.

18 Other times, it's questions that are just common
19 sense. You know, this CLO is rated A and this whole loan
20 is rated BB. Why is this spread, you know, X minus Y?

21 So, you know, so things that just kind of makes
22 sense. You know, you want to know why one product would

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1 trade at a different yield than another.

2 And those are the follow up questions that we do.
3 The secondary thing that all of our firms do, and we
4 actually suggest, when we run into items that have
5 variances that are outside of our threshold, we reach out
6 to the audit staff, basically the field auditor and we
7 suggest that they collect the inputs.

8 Most of the firms, well, it's all different. But
9 some of the firms automatically request when that happens
10 that they get the inputs.

11 And others follow up kind of on an as is basis if
12 it's material or not. And that's entirely up to them.

13 All of the information that we provide, the auditor
14 is making the final determination. So, you know, they're
15 using our fair value estimates to test the accuracy of
16 their clients'.

17 So when variances arrive, they really do need to
18 dig in. So, it is kind of a two pronged approach where
19 they're reviewing our procedures generally speaking. And
20 also reviewing when there is variances.

21 MR. BAUMANN: Is there much variation among the
22 different audit firms and how deep they dig into your work

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1 from very extensive to -- assuming a similar risk of
2 material misstatement, how deep they dig into it compared
3 to others?

4 MS. DuROSS: There is. Some dig very deeply. I
5 think it's, you know, sometimes, you know, how much money
6 and time they have to put into some of these things.

7 How many SEC clients, SEC issuer clients they have.
8 We don't sell any valuation reports to SEC issuers that
9 don't have a sampling of all of our inputs.

10 So the size of the sample is entirely up to them.
11 How to choose the sample, it's entirely up to them.

12 But, that would be a standard. There wouldn't be
13 a firm, no matter what size, that wouldn't get a follow
14 up that we would suggest that they follow up and collect
15 the input sample size.

16 I think that for the smallest firms, you know,
17 sometimes they don't even have a Bloomberg, they don't have
18 anyway to substantiate the information that we put out
19 there.

20 So, there's a pretty big difference between, you
21 know, a top second tier firm and the resources that they
22 have with regard to the financial markets. And someone

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1 that's much smaller that maybe only has one or two SEC
2 issuer clients.

3 MR. BAUMANN: Thanks, Susie. Rick, I think you're
4 next on the list. But first, Jay, did you have a follow
5 up on this?

6 MR. HANSON: I just want to make an observation of
7 some of what I hear here. And I am thinking this is a very
8 different description of what I'm hearing from some of the
9 firm representatives about what happens.

10 Compared to what Professor Boritz said about the
11 survey of what's actually happening. And it feels like
12 on the one hand, we're hearing the highlight reel. On the
13 other hand, we're hearing the out take clippings.

14 And I just -- it feels like to me like if we could
15 raise the standard to describe what the highlight reel is
16 describing, as well as, and I'm looking at Joan's spot,
17 she walked out of the room, but do something collectively.

18 Whether it's PCAOB, whether it's firms, whether
19 it's whatever, to bring the practice on the out takes up
20 to the highlight reel. We'd go a long, long way towards
21 effectiveness.

22 And we'll never solve this problem. But

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1 addressing the majority of the issues, there are findings
2 from inspections show a fair bit of the out take reel
3 results.

4 But yet, we do have some that we observe the
5 highlight reels too. So, it's how do we get practice to
6 be evolved more towards the highlight reel that's being
7 described?

8 MR. BAUMANN: I agree with that. Rick, I said
9 you're next. And you're up.

10 MR. MURRAY: Thank you, Marty. I'll be as brief
11 as I can. If I were wiser, I'd probably understand whether
12 all my questions have been answered already by other wiser
13 people.

14 If we start with the assumption that what we're
15 seeking to do here is to improve the quality and the
16 credibility of decision relevant information for
17 investors and other users of financial statements. And
18 that the issue is where can audit standard setting
19 contribute in this area to that process.

20 I assume there is a kind of unstated assumption that
21 what audit standard setting is capable of doing, is
22 increasing the homogenization of a fairly, disorderly is

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1 not a kind word, a fairly incongruent, inconsistent world
2 of activity at the moment in which solutions are sought
3 on an evolving basis.

4 The key question that I think that the papers raise
5 for us is, what form of regulation would be preferable to
6 go about that? I wonder if we don't also need to add a
7 filter of asking how much regulation.

8 One contemplates that the sources of messiness in
9 the environment that we're dealing with, are multiple.
10 They lie in the nature of the issue, the way it's shaped,
11 where information bears on evaluation.

12 How a company goes about doing it substantively and
13 procedurally. What's going on in the expertized market.
14 How it processes. How it connects in both sides of the
15 panels here.

16 And by the way, I think this has been an excellent
17 set of panel presentations in giving us a real visceral
18 picture of what the challenges are. There is
19 differentiation within the expert community and it's
20 standards and criteria.

21 And a diversity of approaches within firms by size
22 and by their own protocol. Some, but far from all of that

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1 diversity and messiness, is accessible through the ways
2 auditors go about conducting their work and therefore
3 accessible through the audit standard setting process.

4 The questions that I wonder if we shouldn't also
5 be paying some attention too in the process, are what's
6 capable of being effectively reached through the audit
7 process? Some clearly is.

8 Also, at what point does the homogenizing benefit
9 of standard setting create a potential adverse consequence
10 of over homogenizing that which is by its nature incapable
11 of responding well to it?

12 And thirdly, whether those kinds of questions are
13 amenable to a role for economic analysis in trying to
14 measure the net value consequences of what's proposed.

15 MR. BAUMANN: I think you've summarized some of the
16 big -- some of the challenges in front of us. So, thank
17 you.

18 But you're right. There's a -- we've heard a lot
19 of very disparate practice. And I think we want to reach
20 the right level in audit standard to narrow that disparate
21 practice.

22 But yet, let there be some scalability for

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1 different risks and different sizes as appropriate. So,
2 I think trying to do all of that within the -- and
3 demonstrate the economic support behind all of that is
4 what's in front of us.

5 But, we're getting a lot of great input today, I
6 think to do that. So, thanks for your comments.

7 Andreas, you put your card up. As one of the
8 panelists on one of these questions that jumped up. So
9 I thought maybe you had -- wanted to contribute.

10 MR. OHL: I think it maybe address a number of the
11 comments. And, you know, I think there's been a lot of
12 discussion about disparity and approach.

13 And you know, maybe addressing the world that my
14 two panelists operate in, because I don't operate in that
15 space. I really do want to emphasize that where I see the
16 greatest disparity, is not in the audit process that we
17 apply.

18 It's in my team certainly. It's in the nature of
19 the work that's done in the original appraisal. You know,
20 the scope of what the appraisers engaged to do, can vary
21 pretty substantially.

22 And sometimes that's a fee question. Sometimes

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1 that's a materiality or there could be other
2 considerations that are coming into play.

3 So, that scope, and a lot of times the variability
4 in scope is really getting to what Bob was talking about,
5 which is how much of that research is being done to identify
6 what are the most appropriate inputs.

7 And, that's where I see the vast majority of the
8 variability. And then to the extent there's variability
9 in the audit process, it often is basically through the
10 audit process getting the client and the appraiser to go
11 back and do some of those things that I guess we wish they
12 would have done in the first place.

13 And so, again, whatever -- I don't have a point of
14 view on kind of View A or View B. It's more that I would
15 strongly encourage that whatever construct we come up
16 with, that it addresses the -- what I think is the
17 underlying issue.

18 Which is the variability and the work that's being
19 done in the first place that's subject to audit. As
20 opposed to the variability in the audit process itself.

21 MR. BAUMANN: Great. Thank you. Sri?

22 MR. RAMAMOORTI: Well maybe, but I -- you want me

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1 to defer? Okay.

2 MS. PETERS: I guess, you know, one thing that
3 occurred to me, we chatted about a little bit at my table
4 at lunch. And what I think is really hard for investors,
5 is that we're having this whole dialogue and they -- it's
6 all sort of behind the curtain.

7 And they don't actually see who the company engaged
8 as a specialist. Nor what the auditor thinks of it.

9 And I think to decide or to even comment, you know,
10 as I look at how we might comment on this formally, the
11 real question is, it would be hard to ask some investors
12 because they don't know that this is going on. They don't
13 actually see it.

14 They don't see the problems that the auditors are
15 having. And they don't have insight into that
16 information.

17 And, but it also concerns me from the profession's
18 perspective, because as I think most people -- most
19 investors would like it the way that Loretta described it
20 this morning, in the sense of they do work, they engage
21 specialists where they feel they need to, and they have
22 auditors who basically reperform the work.

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1 I would guess if I asked, that would be the answer
2 that I would get. But, as she rattled off the size of the
3 balances that were subject to that, it was probably \$100
4 of \$150 billion of the assets.

5 And I think if you told investors that, they would
6 be very surprised that the auditors would have to engage
7 specialists to that degree of the balances associated in
8 particular institutions.

9 And it goes to a point that Professor Boritz made
10 about sort of the perception of deskilling the profession.
11 And something that Sri made about what's the normative set
12 of skills?

13 Is it normative accounting in auditing? Or is
14 valuation perceived by investors to be part of the
15 normative skill of accountants and auditors today?

16 And I think to some degree it is. And there needs
17 to be better articulation or communication to them of what
18 in fact the degree of specialists that's used. And it goes
19 to the conversation this morning of communication of that
20 in the auditor's report.

21 I think that I've experienced having been an audit
22 partner and having been a preparer, where we've done

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1 goodwill valuations at an insurance company. And I've
2 experienced the same thing that Loretta has.

3 But I've also experienced the scenario that
4 Professor Boritz, in that there's a lack at times of
5 integration of the auditor. That there -- of the
6 specialist, they're considered to be off there.

7 And it's super important that the language of
8 accounting and the language of finance merge. I just find
9 it really challenging in that how do we comment on this,
10 because I don't think all but even the most sophisticated
11 investors, I'm not certain completely understand the level
12 of work done by specialists, by the company, and probably
13 even more importantly in their eyes, by the auditor.

14 And I think it's a super -- it's an important part
15 of communicating both by the audit committee and the
16 auditor with investors.

17 MR. BAUMANN: Thanks Sandy. It's sort of what I
18 heard you say was, right now, investors see a set of
19 financial statements with \$150 billion of assets and have
20 no transparency into the fact that the auditors needed the
21 -- didn't have the expertise in a lot of those areas to
22 audit that work themselves.

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1 And needed to such an extensive amount, the
2 assistance of third party -- of specialists, whether
3 employed or engaged, to help them.

4 And you think that would be important information
5 to investors.

6 MS. PETERS: I think that they would be very
7 interested in that. And the percentage of fees that were
8 paid to audit the -- I mean, I know we'll never get there.

9 But I think if you ask them, they'd be like well,
10 how much did we pay for the auditing of those? Because
11 those are the most important things to us.

12 I worry that the accounting and auditing profession
13 is going to be left with the things that aren't filled with
14 judgment and are the lowest skilled tasks that Professor
15 Boritz, I think there was one point on his skill to that
16 -- or on his slides to that effect.

17 I think these are the things that investors care
18 most about. They are forward looking. They are the
19 things that set value.

20 The past transactions are over and done with. And
21 while they're interesting, they're trying to figure out
22 the price for the future.

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1 MR. BAUMANN: How would you as an investor use the
2 information if you found out that the company has \$150
3 billion of assets, specialists were needed to value or to
4 assist the auditor for \$100 billion of those assets.

5 And for \$50 billion of those were used management
6 specialist work. And for \$50 billion we use our employed
7 specialists?

8 MS. PETERS: I think that they would perceive these
9 as the greatest risk areas. I think the conversation
10 about ranges and those disclosures about the ranges.

11 I mean, we said this when we commented back on 157.
12 That's ASC 820 now, I guess, right? That we don't want
13 necessarily sensitivity analysis. But we'd like to
14 range. We'd like a range and where do you sit in that
15 range.

16 Because they're going to take those numbers and
17 they're going to adjust what they perceive. And they're
18 going to look at where people sit over time.

19 It's not just is this estimate right. But how
20 straight up is management with me over time in coming up
21 with these that gives management street cred. In that I
22 know that they're always a little conservative or they're

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1 always a little aggressive.

2 And investors make their own assumptions about how
3 they're going to adjust for that.

4 MR. BAUMANN: Thanks Sandy. Sri, you're up.

5 MR. RAMAMOORTI: Thanks Marty. I want to go back
6 after hearing all this to my earlier comment. That the
7 distinction between substantive expertise and nominative
8 expertise is actually pretty important.

9 That's what I'm gathering. And the reason is, it
10 is a substantive expert who leads. The nominative expert
11 is the one who will be taking orders from the substantive
12 expert.

13 And the substantive expert in our, you know,
14 scenario here is the audit engagement partner, who's
15 ultimately responsible in what works going on there.

16 I want to draw attention in this regard to what
17 Andreas said about getting a sense of what are the issues
18 by preparing some of these reports yourself, not just
19 review them. Because I think the process of preparation
20 helps you understand how you can go beyond the information
21 given.

22 But if you just work with the information that's

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1 given to you, then I think you become almost lazy
2 intellectually. You're not thinking, you know, what
3 other things might be out there.

4 But if you prepared it, then yes, you know, you
5 understand all the difficulty with which, you know, you're
6 dealing with.

7 So all that is leading me to say, back to my
8 question, who is engaging whom for what purpose? So that
9 is the key question here.

10 Who is engaging whom for what purposes? And what
11 are the structures that we decide? The key criteria there
12 would be the fitness for purpose. How do people get
13 engaged and was the fitness for purpose achieved?

14 After that, the one other comment I have here is,
15 I was a little concerned with Efrim's characterization of
16 the breakdown in communications between auditors and
17 specialists. And this is a very unfortunate behavioral
18 thing.

19 Stanford psychologist Leon Festinger has talked to
20 us about the law of social comparisons. And it is very
21 common among human beings to show what is known as
22 disciplinary chauvinism.

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1 I am better than you because I'm intellectually
2 superior. This is very common. And so, you are going to
3 have some fights, absolutely.

4 And in those fights, what I'm trying to say is, the
5 substantive expert wins. Because they are at the top of
6 the heap. There's no question.

7 So that's why that distance is important. But I
8 think John Lukomnik's idea of the required communications
9 from auditors to specialists is critical. But I think AS
10 10 has taken care of that, so that's great.

11 So I think that's a wonderful, you know, way to try
12 and, you know, resolve some of these issues.

13 MR. BAUMANN: For at least employed specialists.

14 MR. RAMAMOORTI: I'm sorry? Oh, I see. I see.
15 Okay. But, there is because here a cultural translation
16 problem here. You know, they don't speak the same
17 language, these folks.

18 So that's why this required communication is
19 critically important. Because it hopefully resolves the
20 cultural translation issues that might exist between
21 auditors and specialists.

22 This is my final kind of point here. And why all

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1 this discussion is so, so critical as I see it.

2 So, in the medical profession, there is a very
3 famous lament. The operation was successful, but the
4 patient died. It's very famous. Very well known.

5 So, it's a real concern, if we aren't careful in
6 this area, there is going to be increased public skepticism
7 about audits. And that's a very dangerous situation to
8 be in.

9 And so you want to think about this very, very
10 carefully. And so part of this whole initiative should
11 be how do we educate the investing public about, you know,
12 some of this complexity that's, you know, happening, but
13 they aren't privy to it.

14 They don't understand. Maybe they don't want to
15 understand after we explain. But, you know, I think we
16 should try because it's very important to our profession.

17 And where it could really go off kilter is with
18 respect to the growing concern opinion, where, going with
19 this, you know, operation was successful kind of comment,
20 we do not want folks to start concluding that every time
21 there is a business failure, obviously there was an audit
22 failure too.

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1 We don't want that conclusion. I mean, obviously
2 it's a wrong conclusion. But it is an inference that would
3 be an unfortunate inference that people will draw.

4 So, that's all I have. Sorry for being so long in
5 my comments.

6 MR. BAUMANN: No. That's fine. And a very good
7 comment. And we appreciate that valuable input.

8 Wally Cooney?

9 MR. COONEY: Just briefly to respond to the idea
10 that the auditors may -- or investors would be interested
11 in information with respect to how much work's being done
12 by specialists in the audit.

13 Not to address what's in the auditor's report, but
14 I just wanted to emphasize that management in preparing
15 their financials in MD&A has significant disclosure and
16 discussion about intangibles, impairments, the relative
17 materiality of those.

18 Pension accounting, to the extent it's
19 significant, the balances related to that, and there are
20 extensive disclosures as well outside of the MD&A, outside
21 of the critical audit matters in the MD&A that are in the
22 footnotes too.

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1 So there is a lot of information in the reports on
2 those particular topics. Not to say that investors might
3 be -- may be interested as well in what the auditor's
4 involvement with those are.

5 But, more to some of the discussion today. I just
6 wanted to step back and provide sort of my general
7 observations. And I think it's been a great discussion
8 today.

9 You know, in my view, the standards, whatever's
10 done with 336 and some of the other items we're looking
11 at, I really think they need to be principles-based. I
12 don't think a one size fits all in the current environment
13 with different types of specialists involvement in new
14 areas really will work.

15 So, I think it should be flexible for different
16 types of items. It should be risk based.

17 Certainly, I mean, I would support retaining 336
18 for company engaged specialists, with improvements as
19 desirable. And some of the things we talked about in terms
20 of enhancing communication, certifications, management
21 reps, development of industry, standard frameworks for
22 reporting, I think those can all kind of happen. And be

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1 worked on in conjunction with that.

2 But, I think, you know, where I'm coming from on
3 this is, the two areas where we use specialists a lot is
4 actuaries and business valuations. And while those are
5 challenging areas, and from where I sit, those -- the audit
6 process seems to work fairly well.

7 And Loretta talked about the process that she goes
8 through. There is a lot of management ownership of these
9 areas. There's a lot of scrutiny and questions and robust
10 review process going on between the auditors.

11 And so I think with respect to some of these
12 specialists, these areas where specialists have been used
13 for a fairly long period of time, it's generally working.
14 There may be instances to Jay's point where, you know,
15 execution may not be where we want it to be.

16 I don't think that's really an issue with the
17 standard per se. But, I would not want the end result to
18 be where there's a lot of replication, duplication of work
19 in areas like pension accounting and business valuations
20 that perhaps are properly scoped and are done properly.

21 We don't -- I don't think we want your auditors
22 engaging specialists to do full-blown valuations and

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1 business valuations and full blown actuarial reviews.
2 Those generally seem to be working now.

3 And I think we want to leverage the work that's
4 being done in those areas. And prioritize audit effort
5 on higher risk areas.

6 And with respect to specialists, maybe in level
7 three investments, those are the types of areas where maybe
8 additional time and energy needs to be spent.

9 MR. BAUMANN: Thanks Wally. I see two more -- Rick
10 is your card up from before or again? Thanks.

11 So I see two cards left up. Liz Murrall and Guy
12 Jubb. And I have to take Liz and Guy and then I'll wrap
13 this session up.

14 MS. MURRALL: Thank you. Yes, in the UK we've had
15 better insight into the work that's being performed by
16 specialists following the new audit report. And I think
17 that's been very welcome.

18 But what investors don't -- haven't been able to
19 appreciate or haven't understood, is the extent to which
20 the auditor reviews and oversees that work.

21 And I was concerned going through the papers to see
22 the difference between the role of the auditor in relation

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1 to employed specialists and engaged specialists under 336.

2 And also now, I'm increasingly concerned to hear
3 about the divergence in practice as to what goes on. And
4 I think it would be very helpful if that was -- could be
5 addressed.

6 And maybe in the UK going forward, we can have more
7 transparency as to that in the audit report. But I also
8 think it needs to be very clear that the auditor owns this
9 work if it's going into them forming their audit opinion.

10 And I suppose one of the issues that I had when I
11 was going through the papers, was well, who actually owns,
12 particularly in relation to an engaged specialist, an
13 auditor's engaged specialist, who actually owns those
14 papers?

15 And can the auditor actually refer to that work in
16 their audit report? Which is their report. And if not,
17 is that something that needs to be addressed?

18 MR. BAUMANN: Well, the auditor, to the extent
19 they're using the work as part of -- to support their audit
20 effort, they need to have sufficient documentation around
21 that work. Which would include taking papers and a report
22 from the engaged specialist to support their audit

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1 opinion.

2 So the auditor does own the responsibility for that
3 engaged specialist's work. And needs to have in the
4 papers, reports from that engaged specialist or other
5 documentation that would support the work done and the
6 review of that work, consistent with AU 336.

7 So that's the answer to one of your questions. And
8 as you said, CAMs are a way potentially to disclose.

9 They have been in the UK I gather, where specialists
10 are being used. And that could be a way to disclose the
11 use of specialists in the United States as well, if we go
12 forward with CAMs.

13 Guy Jubb, I think you've got the final word on this.

14 MR. JUBB: Thank you. And I'd like to encourage
15 the PCAOB in its development of these standards to give
16 due weight to the comments by Dr. Boritz in relation to
17 the supervision, coordination and review. The points
18 listed on his slide there.

19 I do recognize that these are execution issues.
20 But I do believe that they are execution issues that --
21 in terms of the financial information that comes out of
22 issues.

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1 It is information which the standards should
2 address in terms of ensuring that the auditors for example,
3 Dr. Boritz says auditors may not have the capability to
4 effectively supervise or review the work of the
5 specialist.

6 And that is something which I think that has to be.
7 It's very important that that should be nailed firmly in
8 the standards.

9 Bearing in mind that many audit engagement
10 partners, in particular are selected because they are
11 perceived to have sector specialty themselves, special
12 sector expertise. And the ability to recognize failings
13 in this respect may be quite challenging.

14 And finally, in terms of the disclosures, which
15 were also listed in that slide, I think it is very important
16 to investors that the disclosures are not only appropriate
17 in relation to the financial amounts, but are complete in
18 relation to providing their presentation of the factors
19 that can are attributable to these complex instruments.

20 Thank you.

21 MR. BAUMANN: Thanks Guy. Those are good
22 comments. The standards do require today that auditors

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1 need to have the specialized skill and understand the
2 industry that they're auditing and sufficiently to perform
3 that audit.

4 And they also need to have sufficient skill to be
5 able to direct the work of specialists when they use the
6 work of the specialists. And to understand enough about
7 that industry to use their work of specialists.

8 But, whether there needs to be more specificity
9 around that is one of the things certainly we're exploring
10 here as part of that.

11 So thanks everybody. And you'll see in the next
12 session, after we come back from break, which will be the
13 continuation of our discussion of our other standards that
14 we're addressing at the same time, auditing and accounting
15 estimates and fair value measures.

16 Everything we've talked about here around
17 specialists in this discussion goes right to use of
18 specialists in complex estimates and fair value measures.
19 The two projects are really closely wedded together in
20 terms of how we take them forward.

21 So, when we come back we will talk about the status
22 of our project on auditing estimates and fair value

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1 measures. And some of the important decisions left open.

2 But I think as indicated in our standard setting
3 agenda we put out last March, we will look at potentially
4 bringing these two projects together as we do standard
5 setting. Because it seems to me that specialist project
6 and the estimates project have a very close connection in
7 terms of putting out anything from the PCAOB on this.

8 I want to thank all of the SAG members again for
9 significant comment and input throughout this entire
10 discussion. That was incredibly valuable to us.

11 And of course, as you know, there's a transcript
12 of this entire -- I mean, of all of our meetings. And we
13 look at that carefully as we go through and ultimately do
14 the next round of standards settings.

15 So, thank you for that. And to the panelists,
16 thank you very much for your contribution. Your
17 willingness to join us today and all the value you added.

18 So, thank you very much. It's 3:25. We should be
19 back by 3:45. That's our goal. Thank you.

20

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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FRIDAY

NOVEMBER 13, 2015

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The Advisory Group met in the Academy Hall within the offices of FHI 360, located at 1825 Connecticut Avenue, Northwest, Washington, D.C., at 8:30 a.m., James R. Doty, Chairman, presiding.

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1 (...)

2 MR. BAUMANN: Well, thank you very much. I want to
3 thank the Panel for your willingness, again, to take on
4 the task of identifying critical emerging issues that
5 could affect audits and the PCAOB. You did an outstanding
6 job in doing that. You triggered great breakout sessions
7 and I really appreciate what you've done. And the SAG
8 members for their participation in the breakouts. So, we
9 learned a lot and we have a lot of follow-ups on our end
10 to consider as a result of that.

11 Let me turn to the final item on our agenda. And
12 that's a discussion of the use of specialists. Just by
13 way of background, what we've been doing over the past
14 several meetings, and including the Staff Consultation
15 Paper, is trying to put a lot of transparency around the
16 development or the possible development of standards with
17 respect to auditing estimates and fair value measures and
18 then the use of specialists and auditors.

19 We issued a Staff Consultation Paper, got a lot of
20 comments back, and then we've used the SAG meetings to
21 discuss those Consultation Papers and to get your views
22 on those issues and the need for standard-setting. And

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1 as I responded to a question from Joan yesterday, do we
2 think we have that information? I said, I think at this
3 point in time, we've got a lot of good information about
4 the need for standard-setting and potential
5 standard-setting approaches in these areas, so we can
6 march forward reasonably expeditiously.

7 So, again, it's to keep this Standing Advisory
8 Group advised of where we're going along the way with a
9 transparent approach to standard-setting in this area.
10 And we'll continue to do that. And so today is to discuss,
11 what are the themes that we heard back about that Staff
12 Consultation Paper on specialists? And then we'll
13 continue the dialogue going as we advance this project.
14 Greg Scates?

15 MR. SCATES: All right. Thanks, Marty. What I'd
16 like to do first is, as Marty mentioned yesterday in the
17 standard-setting update session yesterday afternoon, the
18 Paper was issued, Staff Consultation Paper, back in May.
19 We've also had the, as you'll recall, the SAG discussion,
20 we had several panels. The panelists consisted of
21 specialists, the firms, SAG members, and others, and also
22 academics. And we had a good discussion in June and we

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1 also had a discussion at the IAG meeting. So we've had
2 a lot of input to the Paper and a number of commenters.

3 The agenda today, I just want to go over briefly
4 background and get your input on two items. One is with
5 respect to the auditor's specialist and the other one with
6 respect to the company's specialist. As background
7 though, as I said, we did get a number of commenters that
8 weighed in on the Staff Consultation Paper. We had 44
9 comment letters came in, as you can tell from the list
10 there. To no surprise, a number of the firms as well as
11 a number of specialists gave their views on the Paper
12 itself and they were very valuable to us as we move forward
13 on this project.

14 As far as the key themes, one of the items we wanted
15 to focus on, we focused on this early on in the Paper, it
16 was the need for the project. And we articulated that on
17 the first couple of pages of the Staff Consultation Paper.
18 And the commenters came in and said, as you can tell from
19 the pie chart there, there were a number of commenters that
20 said, yes, you need to do this project, this is a viable
21 project to go forward.

22 But also, in addition to that, as Marty mentioned

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1 yesterday, they said, yes, this project is important, but
2 you need to align this with the fair value estimates
3 project. And so that's what we've done. We've discussed
4 this with the Board to align these two projects so that
5 when we have deliverables to go out to the public, and we
6 anticipate those will go out in 2016, they will go out on
7 the same date.

8 The next few slides are talking about using the
9 work of an auditor's specialist. The commenters
10 generally supported aligning the requirements with the
11 existing standard, the ISA standard, ISA 620. And
12 commenters were generally supportive of that. Others
13 said, you could also make amendments to 336. You could
14 accomplish it either way. And so, we think it's the
15 direction we would like to go and we want to get your views
16 on that in just a few minutes about aligning it with the
17 620 of the ISA.

18 Also, we had a specific question there about should
19 the supervision requirements under AS 10, should they be
20 extended to the auditor's engaged specialist? And there
21 was actually only one commenter that actually voiced that
22 opinion and said that it should be extended. So most

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1 commenters, obviously, were opposed to that. They were
2 opposed to extending the supervision requirements under
3 AS 10 to an engaged specialist.

4 On the next item, we had another discussion in the
5 Consultation Paper with respect to the independence versus
6 objectivity. As you know, the employed specialist, the
7 specialists employed by the firms are required to be
8 independent, required to comply with all independence
9 requirements of the SEC as well as the PCAOB. But the
10 engaged specialists are not.

11 And so we entertained that question in the Paper
12 itself, should engaged specialists similarly be required
13 to be independent or should they continue to be subject
14 to the existing or more rigid objectivity requirement?
15 And very few people actually supported the independence
16 requirements. There were like four commenters who
17 weighed in saying that you should at least consider the
18 independence requirements with respect to the engaged
19 specialists.

20 Twenty-one of them that weighed in, 21 of the
21 commenters said, no, they should not be subject to those
22 requirements, but you should, obviously, consider more

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1 rigid objectivity requirements. So that's the direction
2 we're considering going is to consider more rigid
3 objectivity requirements for the engaged specialists.

4 MR. BAUMANN: I think I would note that we didn't
5 hear from a lot of investors in the Consultation Paper.

6 MR. SCATES: Right.

7 MR. BAUMANN: So the comment there is few supported,
8 but it did include an investor. And in the commentary,
9 the accounting firms were primarily the respondents in
10 this who had the view that the engaged specialists should
11 not be subject to independence, but they should be subject,
12 I think, to enhanced objectivity requirements.

13 MR. SCATES: Right.

14 MR. BAUMANN: Is that fair?

15 MR. SCATES: Yes. Brian Croteau?

16 MR. CROTEAU: I was just going to ask if maybe you
17 wanted to give some color as to, since the number isn't
18 always important in terms of who supports or not, kind of
19 more of the substance of why people did or didn't support?
20 Hopefully to give a better discussion here this morning.

21 MR. SCATES: Well, as far as the -- let me lay it
22 out in a little more detail. The four commenters that

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1 supported applying the independence requirements, as
2 Marty mentioned though, it really consists of the one
3 investor that weighed in on the Consultation Paper, one
4 regulator, one academic, and one specialist. So you can
5 see clearly that the firms didn't weigh in on that at all.
6 Of course, their view was towards the second bullet with
7 respect to the enhanced objectivity requirements. And I
8 mentioned the 21 commenters that weighed in on that, it
9 was, I'll give you more detail there, it was 12 accounting
10 firms, six associations of accountants, two regulators,
11 and one specialist firm that weighed in on that one.

12 MR. BAUMANN: I think getting to the question a
13 little bit was, and maybe you can comment on this, is those
14 who commented and said enhanced objectivity is the
15 preferred way to go was because the independence rules were
16 written for auditors and large organizations that are not
17 auditors are not familiar with the independence rules.
18 And trying to determine that they have complied with the
19 independence rules would create quite a burden on the
20 auditors to see that they did.

21 And what the monitoring procedures might be on that
22 would be challenging as well, as auditors having

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1 monitoring procedures with respect to independence, would
2 we expect those other organizations to have monitoring
3 procedures? And so a lot of questions were raised about
4 the ability to do that and could we essentially get to a
5 very similar point, I think, with enhanced objectivity
6 requirements that dealt with similar concepts, but not
7 quite as rigid application of monitoring? Would that be
8 a fair assessment?

9 MR. SCATES: Yes.

10 MR. FLETCHER: Well, just to add a little more color
11 to that. This is where we got most of our economic
12 arguments, when it came to independence for an engaged
13 specialist. I think a lot of the view of the people who
14 commented was that this could actually tend to drive
15 engaged specialists out of the audit support business
16 because they would be unwilling to incur the cost of trying
17 to develop systems to be able to track the independence
18 of the various specialists that work with them.

19 MR. SCATES: There were more commenters that
20 expressed that view of the unintended negative
21 consequences that could happen and it could clearly take
22 some of these specialists, some of those firms, out of the

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1 market if we were to require them to put or if they would
2 be required to put in some type of system to address the
3 independence requirements.

4 And then the last item is the commenters did
5 support certain modifications with respect to the
6 requirements, and this is more in line with Paragraph 12
7 of ISA 620 about evaluating the knowledge and skill of the
8 auditor's specialist, informing them of their
9 responsibilities, and evaluating the work of the auditor's
10 specialist. Those are the requirements that we want to
11 focus on.

12 So, what I'd like to do is look at our first
13 question with respect to the members of the SAG. And this
14 first question, again, the background is Paragraph 12 of
15 ISA 620 that says, the auditor should evaluate the adequacy
16 of the auditor's expert, of course the IAASB uses expert,
17 we of course use the word specialist, work for the
18 auditor's purposes, including those three bullets, the
19 relevance and reasonableness of the findings, the
20 specialist or expert's work involves use of significant
21 assumptions and methods, and then as well as evaluating
22 the expert's work, the source of data, and the relevance,

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1 completeness, and accuracy of that data.

2 So that is taken right out of Paragraph 12 of ISA
3 620, and we'd like your views on the appropriateness of
4 using similar requirements as a basis for a potential PCAOB
5 standard on using the work of an auditor's specialist. So
6 should we consider similar requirements as a foundation
7 or basis for a standard on using the work of an auditor's
8 specialist?

9 MR. BAUMANN: Comments? Guy Jubb?

10 MEMBER JUBB: All right. Speaking as an investor
11 and mindful you didn't get many investor responses to the
12 Consultation, I would certainly be supportive of that
13 providing that minimum foundation. I think an investor
14 would expect nothing less than that the auditor would apply
15 that type of evaluation to determine that adequacy. And
16 if it didn't do, it would be regarded as a significant
17 matter, as far as by implication, the financial matter
18 being reported is a material one.

19 If I could maybe just ask a supplementary question
20 though to build on that, has there been any discussion or
21 views regarding, in the same way that the partners rotate
22 from time to time, whether experts should also be subject

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1 to similar type of rotational matters, bearing in mind that
2 sometimes experts will be defensive of previous views
3 expressed and a fresh pair of eyes can bring some challenge
4 to previously held assumptions?

5 MR. SCATES: Well, that's certainly an interesting
6 point for us to consider. We had not presented that in
7 the Paper itself, but you do raise some good points because
8 they will want to -- the natural inclination of anyone to
9 protect their work product going forward. And so if
10 they're challenged in a subsequent period, then if they're
11 still the same specialist, then there's not much of a
12 challenge there to the previous work, you're right. So
13 there's something we should at least consider. And we can
14 consider that also when we're developing the text around
15 the enhanced or more rigid objectivity requirements.
16 Certainly we should consider something like that, or at
17 least have that in mind as we work through that process.

18 MR. BAUMANN: I think that's a good point, the
19 element of objectivity is how objective are you when you're
20 looking at similar information and getting similar views
21 the same year, year after year? But that didn't really
22 come up in the comments otherwise. David Kane?

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1 MEMBER KANE: Yes. Greg, we generally thought that
2 620.12 would be appropriate for the Staff to consider in
3 developing a new standard. It retains the basic elements
4 of what's in 336 and expands upon them, I think, in some
5 good ways. Couple other observations though is to also,
6 while you're looking at 620, maybe pick up 620.08, which
7 talks about the need for the auditor to consider aligning
8 the procedures with the Risk Assessment Standards. So
9 ultimately, the auditor will make a determination of the
10 nature, timing, extent of the procedures based upon his
11 or her risk assessment.

12 And I think the other point, won't spend too much
13 time on it, but that you mentioned earlier, is that
14 ultimately whatever comes out of this project to make sure
15 it doesn't discourage the use of specialists. Because no
16 matter how hard an auditor might try, we just will not have
17 the specialty get in there and perform the procedures that
18 a specialist would, and just take oil and gas for example,
19 along the lines we talked about at the last SAG meeting.
20 So just to make sure it just supports that overall
21 principle and objective.

22 MR. SCATES: Thanks, David. Because we certainly

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1 want to encourage the firms to use the work of specialist.
2 And as we know today, and as it's documented in our
3 Consultation Paper, there are more instances now than ever
4 where specialists are needed. And so we certainly want
5 our standards to encourage the use and certainly not
6 discourage. And we certainly appreciate your comments on
7 that point.

8 MR. FLETCHER: And just on the question of the
9 risk-based standards. Again, that wasn't really a
10 question we asked, but we got a lot of commentary about
11 that and the commentators all believed that we should make
12 sure that whatever we do aligns with the Risk Assessment
13 Standards and is risk-based.

14 MR. BAUMANN: Tom Selling -- Selleck, I'm sorry.

15 (Laughter.)

16 MEMBER SELLING: I am really sorry I made that joke.

17 (Laughter.)

18 MEMBER SELLING: I agree with Guy's views about
19 investors' expectations. But with all due respect, I
20 don't think they go far enough. Investors have a right
21 to expect the same level of skepticism from auditors that
22 they apply to management representations, unless the

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1 information comes from other independent sources. And I
2 don't understand why that, that principle is not upheld.
3 I understand that we want to encourage the use of experts
4 for many of these complex matters, but I still really think
5 that we have to hold to the time honored principle of
6 independence when determining the degree to which an
7 auditor may examine the information and rely on it.

8 MR. BAUMANN: Thanks, Tom. Megan Zietsman?

9 MS. ZIETSMAN: Thanks, Marty. I just really wanted
10 to point out that there is some stuff in ISA 620 that
11 supports Paragraph 12. So Paragraph 12 is the
12 requirement, but there's also about seven or eight
13 paragraphs of application guidance, which give a lot more
14 context to those requirements. So, certainly would, I
15 think, be things to look at. And one of the questions
16 might be whether you would want to actually embellish the
17 requirements by having some of that application guidance
18 be more specifically incorporated. Which is something,
19 I think, that the IAASB is starting to think about.

20 And the other point, and I think it goes to David's
21 point about not discouraging the use of specialists, one
22 of the things that the IAASB is specifically looking at

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1 in the context of its estimates project is, should there
2 be something more to really steer the use of or the
3 involvement of experts for particular types of experts?
4 So, as they commence with that project -- and I think that
5 just points to why the two projects are connected. So I
6 just really wanted to point out those two things. Thanks.

7 MR. BAUMANN: I think the team just picked a key
8 paragraph here for -- rather than putting every thought
9 we had about using the ISAs into this discussion today
10 given the limited time. But I think all those points are
11 well taken to consider the application material and 612.08
12 and other things, I think the team is doing that. But your
13 other point you made about the IAASB is considering whether
14 to -- was that to elevate certain of the application
15 material on the use of specialists? Did I understand that
16 or not?

17 MS. ZIETSMAN: Yes. Maybe, I don't want to
18 prejudge where we're going, but really just to signal that
19 we are starting in the context of a number of the projects
20 that are on the work plan which deal with 540, as well as
21 responsibilities of the engagement team and having the
22 right level of people involved. I think it's going to call

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1 into question some of those questions. So we don't
2 specifically have a project to amend 620, I don't want to
3 set anyone off to think that we're doing something like
4 that.

5 But, I think, in the context of looking at the
6 projects around quality control, quality control at the
7 engagement level, as well as 540, some of those questions,
8 I think, are going to arise. I really just wanted to make
9 sure that I pointed to the application guidance and I have
10 no doubt that the team is very carefully looking at all
11 of that. It was just as a kind of a recommendation or a
12 potential thought of something that could be valuable.

13 MR. BAUMANN: Good. Thanks for that clarification
14 and help. Sydney Garmong?

15 MEMBER GARMONG: Yes. And, Marty, I appreciate
16 your comments about how this was just a starting point,
17 but the other thing too that I was struck by is this says,
18 evaluate the adequacy, and then it talks about methods,
19 which presumably are models, and I just wondered if there
20 was a contemplation on providing some more clarity and
21 guidance on what that means. And just as I think about
22 like an actuary and whether auditors are really in a

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1 position to evaluate a model. Just wanted to offer that.

2 MR. BAUMANN: Do you have any further views as to
3 how it should be written instead?

4 MEMBER GARMONG: I don't, I just know that we can
5 evaluate significant assumptions, but when it comes to
6 modeling, I'm not so sure.

7 MR. BAUMANN: Thank you. Joan Amble? And, Guy, is
8 your card still up or is that from before? Okay. Joan
9 and then Guy.

10 MEMBER AMBLE: Okay, thank you. One thing I would
11 ask you to think about including is when you talk about
12 the how of how they evaluate third party specialists is
13 to have in their toolkit kind of the consideration from
14 a risk perspective of the independence and reliability of
15 the information by giving some consideration to who does
16 the hiring of the expert. So, for example, if the issue
17 is in a model on credit or some other evaluation issue,
18 you may want to have the Chief Accounting Officer as
19 opposed to the Credit Officer hire that person. Or you
20 may want to have them engaged in the process. So, I guess,
21 who kind of controls that process is something to consider.
22 I don't think it's determinative in all cases to be one

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1 way or another, but a factor to be taken into kind of your
2 toolkit of risk assessing the information.

3 MR. BAUMANN: Great. Thank you, Joan. And Guy
4 Jubb?

5 MEMBER JUBB: Just to follow through on Tom's
6 intervention. For clarification, I fully support the
7 view expressed as an investor around that degree of
8 skepticism, appropriate skepticism, being brought to
9 bear. My own comments were regarding this is the
10 foundation from which to build, but I wanted to give
11 explicit support to that notion of skepticism applying.

12 MR. BAUMANN: Support noted, thank you. We move on
13 then?

14 MR. SCATES: All right. Let's move to the next
15 discussion with respect to the company specialist.
16 Again, the commenters, a number of them, 11 commenters
17 actually supported aligning our requirements with similar
18 requirements in the ISA 500, Audit Evidence Standard. If
19 not there, they said, well, you could also amend 336 and
20 strengthen the procedures in 336 for evaluating that work
21 of the company specialist. And there were nine commenters
22 that weighed in on that. So you've got then a total of

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1 20 commenters weighing in saying, change is applicable,
2 change should be made here, strengthen the requirements.
3 And that's what we plan to do going forward.

4 So, what we've done here is we looked at, okay, we
5 looked at the existing standard that the ISA has, ISA 500
6 on audit evidence, and we looked at, similar to what we
7 do with the auditor's specialist, we're doing with the
8 company specialist for going forward is, we looked at
9 Paragraph 8 and the requirement is that in order for the
10 auditor to evaluate the audit evidence provided by the
11 company specialist, Paragraph 8 requires the auditor to
12 evaluate the competence, capabilities, and objectivity of
13 that expert, obtain understanding of that work of that
14 expert, and then evaluate the appropriateness of that
15 expert's work as audit evidence with respect to the
16 particular assertion. So the question, similar to
17 auditor's specialist, now with the company specialist,
18 what are your views on the appropriateness of using similar
19 requirements as a basis for a potential PCAOB standard on
20 using the work of a company's specialist?

21 MR. BAUMANN: Phil Santarelli?

22 MEMBER SANTARELLI: Greg, I would generally agree

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1 with using 500.08. I think there's an additional factor
2 here when employing or when relying on the evidence
3 produced by the company specialist, a risk factor is
4 management's internal control for financial reporting
5 over the measurements that, that specialist provides to
6 them. Management could fall into the same trap that some
7 auditors might by taking a specialist's reports, sticking
8 it in the work paper so to speak, and making the mark. So
9 I think that auditors need to consider ICFR over
10 management's use of the specialist and then calibrate
11 accordingly their procedures with respect to the
12 reliability of that evidence.

13 MR. BAUMANN: I think that's really valuable advice
14 and we'll make sure we take that to heart. Bob's card is
15 going up and when we talk about ICFR, Bob usually pops in.
16 So why don't I turn it directly to you, Bob?

17 MEMBER HIRTH: I'm going to not talk about that,
18 but, Greg, I think the idea of using both of the other
19 standards is good and in looking at, does that content make
20 sense? What I noted when I looked at those, they've both
21 been in effect for some time. So I'd encourage you to look
22 at, not just what do they say, but how have they gone and

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1 do people actually believe that what is written in those
2 two standards that you might follow has been effective or
3 what pitfalls have they found in the standard? So I think
4 it's a great idea and we've got the opportunity to do a
5 look-back as to how has it really gone.

6 MR. BAUMANN: We do have that benefit, Bob, and
7 that's an excellent point. We have the benefit to do that
8 and with our collaboration with the IAASB, I know they do
9 a review and have been doing a review of the clarified ISAs
10 and have identified some where they are going back and
11 taking a look at the standards themselves and potential
12 refresh of them, maybe. I think the good news here is I
13 don't think they've identified these standards at this
14 point as something where you think you need to do some
15 additional work. Is that fair, Megan?

16 MS. ZIETSMAN: Yes. And I think that is fair and
17 that they're not specifically on the work plan. But like
18 I just mentioned, I think that it's hard, but given that
19 we are currently going to be doing something around 540,
20 which is estimates, I think it's hard to keep that from
21 moving into questions around involvement of specialists.
22 And then specifically also the use of specialists by

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1 management. But I think there is some information in the
2 2013 ISA post-implementation monitoring study, which
3 obviously would be informative. But I think that's a good
4 point.

5 MR. BAUMANN: Well, as our project of specialists
6 is coordinated with fair values, I certainly understand
7 your point that, in your looking at 540 again, specialists
8 could crop up in that regard. Yes, Bob?

9 MEMBER HIRTH: I didn't want to be flippant, sorry,
10 on the ICFR comment and Phil's comment, which I agree with.
11 So I think I was thinking about that this morning, that
12 I guess depending on the significance of the specialist
13 or specialists that are used, if there are a lot of them
14 that are used, there actually might be a process and a
15 procurement process and evaluation process. So I think
16 the ICFR implications of this will vary by company, but
17 it is a good thing to kind of walk through mentally to see
18 if there is enough there to create internal control
19 processes around specialists.

20 MR. BAUMANN: Thank you. Tom Selling?

21 MEMBER SELLING: In principle, my comment about
22 independence still stands. But if it doesn't, then I

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1 think that the Board needs to make a distinction between
2 types of experts. I think one type of expert can generally
3 be seen as one who is an expert in markets. And then there
4 is someone who's an expert in estimates that in my view
5 are somewhat ineffable. For example, if you were
6 measuring the market value of your exposure to Portuguese
7 loan losses, that would be one thing. But if you're trying
8 to measure the allowance for loan loss in accordance with
9 GAAP, that's very different.

10 And I think in the latter case, I don't think the
11 standards should view management's expert as any different
12 from management itself. In the former case, I might be
13 able to see some acknowledgment of an expertise when there
14 is actual market data as a reference point. But there are
15 many, many estimates for which people are supposedly
16 experts, but I think it's a bigger stretch to rely on that
17 type of estimate.

18 MR. BAUMANN: We had teed up the question about when
19 using the work of a specialist and a specialist of course
20 is doing work in an area, who is an expert outside of
21 accounting and auditing, whether or not their work should
22 be evaluated as if it was prepared by management with the

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1 same degree of rigor? Or given the nature of the fact that
2 it's work outside of the expertise of the auditor, to have
3 separate standards like 500.08? And we didn't get back
4 a lot of support in our comments for, test that as if it
5 was performed by management. If that's your point here?

6 MEMBER SELLING: I'm afraid it is my point.

7 MR. BAUMANN: Yes, that's what I thought. All
8 right. So it's been out, we've been soliciting views on
9 that and we have a number of comments pro and con on that
10 approach. Rick Murray?

11 MEMBER MURRAY: Greg, at our June meeting, Loretta
12 Cangialosi made the opening panel presentation on behalf
13 of issuers. I think her point was pretty clearly, hey
14 guys, the numbers are ours and the responsibility for
15 getting them right is ours. There is an audit role, but
16 don't let it become part of our numbers developing process
17 or get in the way of them.

18 Why would that not suggest that the three
19 provisions of ISA 500 that you note would be expressed as
20 having the auditor evaluate the company's attention to
21 those three issues as opposed to reaching through the
22 company and out into company source data for separate

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1 evaluation? And what happens if the auditor comes to a
2 different view than the company does in an area where minds
3 could differ?

4 MR. BAUMANN: What was the last question, that what
5 would happen if what, Rick?

6 MEMBER MURRAY: What happens if the auditor takes
7 a different view -- if the auditor is required to reach
8 back through the company to the source material and make
9 its own determination and what happens if the auditor has
10 a different conclusion than the company did within the
11 boundaries of reasonable minds can differ?

12 MR. BAUMANN: Well, I think, just one response is,
13 I think the auditor has a responsibility to do an
14 independent evaluation of the management conclusions and
15 if it's necessary to reach beyond what management did and
16 to look at the work of the specialist, then I think that's
17 a necessary aspect of an independent audit. So I think
18 that's the way we're approaching this.

19 So I think we're not approaching it, at least in
20 this suggestion, to test certain information with the same
21 rigor as if it was prepared by management, but saying that
22 if this is important work in terms of management reaching

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1 their conclusion and recording their accounting estimate,
2 then the auditor has certain obligations to evaluate the
3 work of management's specialist, consistent, I think, with
4 the way ISA 500.08 has been doing it.

5 MEMBER MURRAY: I understand that's the basis of
6 this approach. What I'm questioning is, is it necessary
7 or is it an excessive application of the scope of audit
8 regulation in the area that is basically issuer
9 responsibility rather than auditor responsibility?

10 MR. BAUMANN: Okay. Thank you for that comment,
11 we'll take it into consideration. Phil?

12 MEMBER SANTARELLI: Yes. I just wanted to follow
13 up on Rick's comment. Actually, when I think about
14 management's ICFR over specialist measurement, I really
15 think that part of it is, this is what they need to be doing.
16 So before they hire a specialist, they need to be thinking
17 about and evaluating the competencies, understanding what
18 that expert or specialist is trying to do, and then
19 themselves evaluate the appropriateness of what the
20 conclusions were of the specialist.

21 So from an auditor's perspective, if you, and it's
22 a scale, so if you come into a situation where management

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1 has done a very good job with that and we're comfortable
2 with the underlying source data that was used by the
3 specialist, that indicates a certain level of work that
4 we would have to do with respect to that report. If, on
5 the other hand, management has not done a good job of that,
6 has not evaluated, has really, as I said, basically taking
7 a specialist measurement and recorded it and paid their
8 bill, then the level of work that the auditor would have
9 to do scales up. And I think that's this risk assessment,
10 control risk assessment that enters into it. As well as,
11 of course, the inherent risk in the measurement, but the
12 control risk, I think, factors into the level of effort
13 that the auditor has to put in.

14 MR. BAUMANN: Thanks for that point. And, Rick, is
15 your card back up on this? And thanks for your comments
16 too, Rick.

17 MR. SCATES: I had one last question, we have just
18 a few minutes. With respect to the company's specialist,
19 there's something I want to, kind of with what Guy was
20 saying and you were saying about rotation, I want to look
21 at the -- the company specialist, they're either employed
22 or engaged, okay. But what -- in order for us to draft

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1 this standard, we're going to draft it and align it with
2 our Risk Assessment Standards. In order to do that then,
3 we're going to take a careful look, as we've been talking
4 about, objectivity and objectivity with respect to the
5 specialist.

6 But in doing that, and again aligning with our Risk
7 Assessment Standards, I'd like your views on the company's
8 employed specialist, their objectivity, versus the
9 objectivity of someone who's engaged from outside.
10 Obviously, the person inside is not going to get rotated,
11 the person outside could get rotated. I'm just tagging
12 on to what, Guy, you were saying about rotation. I know
13 that was with respect to auditor's specialists, but you
14 could take that also with respect to company specialists.

15 But should we, in drafting this standard, should
16 we take that into consideration that an engaged specialist
17 is more likely to be more objective than someone who is
18 employed by the company and who is going to, as I said
19 earlier, they would have a natural tendency to protect
20 their work product going forward?

21 MR. BAUMANN: Mike Gallagher?

22 MEMBER GALLAGHER: Thanks, Marty. Thanks, Greg.

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1 I think there is a difference. I think it would be hard,
2 even though if they're employed, they're experts and they
3 may have some certification or credentialing, it's hard
4 to say that the information provided by them is not
5 information provided by management, because they are. I
6 do think it's different if somebody's engaged versus
7 employed, inherently, and you have to look facts and
8 circumstances.

9 For example, if somebody's engaged and it's their
10 only client, well, that's not very different than being
11 employed. But if the company on which they're serving as
12 a client is one of 20,000 clients, they're likely not going
13 to put their credentialing and reputation and everything
14 else on the line to get to an answer that management would
15 like. They're going to be, I think, inherently are more
16 likely to be more independent.

17 MR. BAUMANN: I think that's a very good point and
18 essentially you're saying, evaluating objectivity as a
19 scale and the employed specialist is probably on a --
20 management's employed specialist is pretty low level on
21 that scale, the specialist that maybe has one or two
22 captive clients is not further away on that scale, but

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1 maybe up a little bit, and then that large company that
2 has 5,000 clients and they're just, none of them are
3 particular so important to that large company, that
4 they're pretty objective at that scale. So they're on a
5 scale and that risk-based assessment affects your view of
6 objectivity and, therefore, the amount of work. Kind of
7 your perspective?

8 MEMBER GALLAGHER: Yes.

9 MR. BAUMANN: Great. David Kane?

10 MEMBER KANE: Yes, just one other quick point on
11 that, Marty. Because there is some language in ISA 500,
12 I think on A42, talking about the scale that Mike is
13 discussing here and then the factors that we should be
14 thinking about in terms of employed versus engaged. So
15 I would encourage you to pick that up.

16 MR. BAUMANN: All right. Well, thank you very much
17 for that discussion, Greg. Thanks for leading that.

18 (...)

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

+ + + + +

THURSDAY
NOVEMBER 30, 2017

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The Advisory Group met in the Academy Hall, FHI 360, located at 1825 Connecticut Avenue, Northwest, Washington, D.C., at 8:30 a.m., James R. Doty, Chairman, presiding.

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1 MR. BAUMANN: Good. Thanks, Jennifer. We're now going to talk
2 about a couple of the recently proposed auditing standards that have gone
3 through actually a number of proposals, accounting estimates and fair-value
4 measures, and the work with specialists, the first two subject of staff-consultation
5 papers, significant discussions over time at -- with the SAG here, about those
6 consultation papers. A lot of comment letters. Then we've issued proposals,
7 and we've gotten responses to those proposals as well.

8 So, right now, Keith Wilson and Barbara Vanich and Lisa Calandriello
9 will talk about counting estimates and fair-value measures, and then the work of
10 specialists.

11 MS. VANICH: Okay. Thank you, Marty. I will get started as we get
12 to the slides here. Okay. As you heard Marty and Jim say yesterday, on June
13 1st, the board issued two proposals for auditor performance standards in areas
14 we view that are just vital to audit quality. First, auditing accounting estimates
15 and fair-value measurements. And second, the auditor's use of the work of
16 specialists.

17 The two proposals were developed in tandem, so that the proposed
18 rules can work together. For example, when using a specialist in auditing an
19 accounting estimate. The first proposal I'm going to spend a few minutes
20 updating you on would update and strengthen the standards for auditing
21 accounting estimates and fair-value measurements.

22 As Marty mentioned, both of the proposals were subject to extensive
23 outreach, and several commenters noted that they were very appreciative of the
24 process followed by the staff in developing those. So, the comment periods

1 ended back in -- on August 30th.

2 So, by way of review at a high level, the proposed standard on
3 estimates would enhance and strengthen the requirements for auditing
4 accounting estimates and fair-value measurements in the following ways. First,
5 the proposal would replace three existing overlapping standards developed over
6 the years with a single standard that streamlines and strengthens the direction to
7 auditors in this important area.

8 Specifically, the proposed standard would replace AS 2501 on auditing
9 accounting estimates and supersede AS 2502 on fair-value measurements and
10 AS 2503 on auditing derivatives, hedges, and investments in securities. So, I'll
11 just refer to those collectively as the existing estimate standards.

12 The proposal also includes an emphasis on applying professional
13 skepticism. For example, the proposal would require the auditor to address in
14 the brainstorming session how the financial statements could be manipulated
15 through management bias, to consider in identifying the assumptions for testing
16 the assumptions that may be more susceptible to management bias, to consider
17 in evaluating the company's process for developing an estimate, whether the
18 company had a reasonable basis for its significant assumptions, and in
19 developing an independent expectation of accounting estimate, for the auditor to
20 have a reasonable basis for the assumptions that the auditor uses.

21 Second, this proposal builds on three existing approaches to auditing
22 accounting estimates that auditors are familiar with. Testing the company's
23 process, developing an independent expectation, and evaluating evidence from
24 subsequent transactions and events. The proposal enhances the requirements

1 for those approaches by, for example, providing additional direction on developing
2 an independent expectation, depending on the source of the information used by
3 the auditor to develop that expectation.

4 Third, the proposal would require a robust risk assessment of a
5 company's accounting estimates and response tailored to the assessed risks,
6 whether they relate to subjectivity, complex processes, or the risk of management
7 bias.

8 And fourth, the proposal updates PCAOB standards in light of
9 developments on auditing practices for fair values of financial instruments. For
10 example, auditors' evaluation of pricing services information has grown more
11 important over the years, yet the subject is lightly covered in the current
12 standards. This proposal contains an appendix on auditing fair-value
13 measurements that addresses, among other things, the auditors' use of pricing
14 service information to promote a proper evaluation of that information that builds
15 on existing requirements for evaluating the relevance and reliability of audit
16 evidence under PCAOB standards.

17 So, we received 37 comment letters on the proposal. As you can see,
18 it's from a various group of constituents. Commenters across many affiliations,
19 with the exception of trade groups, in general supported the board's efforts to
20 strengthen auditing practices and update its standards. Investor groups
21 supported the proposal, noting that the proposal would strengthen auditors'
22 responsibilities, improve audit quality, and further investor protection. There was
23 also strong support for retaining the three existing approaches for auditing

1 estimates, and for more specifically addressing financial instruments, including
2 the use of pricing services.

3 The comments received on the proposal primarily suggested
4 clarifications and refinements to specific requirements, which I'll now touch on
5 briefly.

6 So, the objective of the proposed standard emphasizes the
7 fundamental aspects of auditing accounting estimates under the existing estimate
8 standards, specifically, testing and evaluating whether accounting estimates are
9 reasonable in the circumstances, have been accounted for and disclosed in
10 conformity with the applicable financial reporting framework, and are free from
11 bias that results in material misstatement. Some commenters expressed
12 concern about referencing freedom from management bias as a distinct element
13 of the audit objective, because it could, for example, suggest a broader obligation
14 than in their view is required under the existing standards.

15 Another area of the proposal receiving specific comments and
16 suggestions related to testing a company's process for developing accounting
17 estimates. The proposal would retain the requirements from AS 2502 for testing
18 a company's process, which includes evaluating the method, evaluating
19 significant assumptions for reasonableness, and testing data used.

20 The principal comments on these aspects of the proposal related to the
21 requirements for evaluating the methods used to develop the accounting
22 estimates and for identifying and evaluating significant assumptions. The
23 proposed standard would require the auditor to evaluate whether the company's

1 methods are in conformity with the requirements of the applicable financial
2 reporting framework and appropriate for the nature of the related account or
3 disclosure and business, industry, and environment in which the company
4 operates.

5 Some commenters expressed concerns about evaluating whether the
6 company's methods are appropriate for the business, industry, and environment
7 in which the company operates, because, for example, the requirement could be
8 read to presume that all companies within a particular industry use or should use
9 the same method.

10 The proposal sets forth factors relevant to identifying significant
11 assumptions used by the company. The requirement also provided that if the
12 company has identified significant assumptions, the auditor's identification of
13 significant assumptions should include those identified by the company as
14 significant.

15 Some commenters indicated that one of the factors relevant to
16 identifying significant assumptions, whether the assumptions otherwise are
17 related to and identified in assessed risk of material misstatement of the estimate,
18 is too broad and could result in all assumptions being identified as significant.

19 Some commenters also expressed concerns that the requirement for
20 the auditor to include all assumptions identified by the company as significant may
21 not be practical. For example, because management is not subject to any
22 specific requirements for identifying significant assumptions.

23 The proposed standard also set forth requirements for evaluating the

1 reasonableness of significant assumptions, including evaluating whether the
2 company has a reasonable basis for the significant assumptions used. In
3 addition, for critical accounting estimates, the proposed standard would require
4 the auditor to obtain an understand of how management analyzed the sensitivity
5 of its significant assumptions to change based on other reasonably likely
6 outcomes that would have a material effect. The auditor would take that
7 understanding into account when evaluating the reasonableness of significant
8 assumptions and potential management bias.

9 With respect to critical accounting estimates, a few commenters
10 suggested that the requirement to obtain an understanding of how management
11 analyzed the sensitivity of significant assumptions should be recast as a risk
12 assessment procedure, rather than as a substantive procedure.

13 Developing an independent expectation of the estimate. The majority
14 of comments received on that area related to developing that expectation as a
15 range. So, under the proposed standard, the auditor's responsibilities, with
16 respect to developing an independent expectation of the estimate, depends on
17 the sources of the method, data, and assumptions used by the auditor.

18 When the auditor's independent expectation consists of a range rather
19 than a point estimate, the proposed standard would require the auditor to
20 determine if the range is appropriate for identifying a misstatement of the
21 accounting estimate and supported by sufficient appropriate audit evidence.

22 Some commenters asked for clarification or guidance on determining
23 that a range is appropriate for determining a misstatement, especially when there

1 is a large degree of measurement uncertainty. And several commenters
2 expressed concern that the proposed requirement might imply a level of precision
3 within a range that might not be feasible.

4 As I mentioned, Appendix A of the proposed standard primarily sets
5 forth requirements for evaluating the relevance and reliability of audit evidence
6 when using pricing information from a pricing service, multiple pricing services
7 and broker-dealers.

8 A large portion of the comments on Appendix A related to requests for
9 clarification about the unit of testing, with commenters expressing concern that, as
10 drafted, the requirements in the Appendix suggested that procedures could be
11 read to say that they must be applied to each individual financial instrument.

12 Some commenters requested clarification or guidance on the
13 additional procedures to be performed when evaluating the process used by a
14 pricing service, while others called for clarification regarding how the
15 requirements apply when a centralized pricing desk is used.

16 Others asked for clarification on certain factors used to assess the
17 reliability of pricing information from pricing services along the proposed
18 requirements for using information from multiple pricing services.

19 And, lastly, a few commenters suggested retaining portions of AS 2503
20 that in their view provided helpful guidance on auditing derivatives and other
21 financial instruments.

22 With respect to the proposed amendments that accompanied the
23 standard, proposed Appendix A to AS 1105 would retain and update certain

1 requirements from AS 2503 to better align the required procedures to evaluate
2 evidence obtained regarding the valuation of investments based on the investee's
3 financial condition or operating results within the risk-assessment standards.

4 The primary comments received on the proposed appendix were
5 questions on the intent of the requirement to obtain an understanding of whether
6 the report of the investee's auditor indicates that the audit was performed under
7 PCAOB standards. Concerns that there's certain procedures that involve
8 interaction with investee management or the investee auditor might not be
9 practicable, because the investment company's auditor might not have access to
10 those parties. And suggestions for alternative procedures relating to testing, the
11 investor management's process.

12 With respect to the proposed amendment on AS 2401 on retrospective
13 review, extant AS 2401 requires the auditor to perform a retrospective review for
14 significant accounting estimates reflected in the prior year financial statements.
15 Proposed amendment to AS 2401 would clarify that requirement by removing
16 extraneous language that distracts from the actual requirement and aligning the
17 language of the requirement more closely with the proposed standard.

18 Several commenters expressed concern that the proposed
19 amendments would expand the population of accounting estimates subject to the
20 retrospective review, resulting in excessive work.

21 Other areas of comments related primarily to requests for additional
22 guidance, for example, on how to apply the requirements to certain accounting
23 estimates. Others, as noted earlier, asked for certain guidance in AS 2503 to be

1 retained.

2 Commenters who commented on a potential effective date generally
3 supported an effective date of two years after SEC approval of final requirements,
4 asserting that this would allow firms sufficient time to develop tools, update
5 methodologies, and provide training on the new requirements.

6 And, lastly, the proposal noted that the IAASB published an exposure
7 draft of proposed ISA 540 in April 2017. And a number of regulators, accounting
8 firms, and professional associations recommended greater alignment of the
9 proposal and the IAASB's exposure draft on ISA 540 to achieve greater
10 consistency in practice.

11 MR. BAUMANN: We'll take any comments or thoughts about this
12 proposed auditing standard, which we hope to move towards adoption 2018,
13 either right now or -- Lisa is going to comment now on the auditor's use of the work
14 of specialists. And, as was mentioned by Barbara, commenters on both the
15 consultation paper on auditing estimates and on separate consultation paper on
16 specialists said, given the role of specialists in complex estimates and fair-value
17 measurements that when we adopt these two standards, they think that we should
18 adopt them in tandem, as they should work together. So, again, if you have
19 comments on these or what Barbara presented, please get your tent cards up,
20 and we'll respond. And -- or wait until Lisa is finished on specialists.

21 Lisa.

22 MS. CALANDRIELLO: Thanks, Marty. Good morning. The
23 proposal on specialists would enhance the requirements of the auditor's use of the

1 work of company specialists and for the supervision of auditor specialists, whether
2 employed or engaged in audits under PCAOB standards.

3 So, for some background. Currently, PCAOB standards primarily
4 apply to the -- auditors use two PCAOB standards, currently apply to the auditor's
5 use of the work of specialists. The general standard on supervision, AS 1201,
6 applies to auditor-employed specialists. Another standard, AS 1210, applies to
7 the use of the work of company specialists and auditor-engaged specialists.

8 Furthermore, two fundamentally different approaches apply to the use
9 of auditor specialists, depending on whether they're employed or engaged, even
10 though they do fundamentally the same work. So, this proposal addressed the
11 odd pairing.

12 Proposing to improve PCAOB standards in two basic ways,
13 establishing a uniform, risk-based approach to testing and evaluating the work of
14 company specialists in amendments to the standard on audit evidence, AS 1015.

15 The proposal would require auditors to, for example, evaluate the data,
16 methods, and assumptions used by the company specialists. Importantly, the
17 amount of required audit effort to evaluate that work would vary based on four
18 factors, the risk of material misstatement, the significance of that specialist's work
19 to the auditor's conclusions, the professional qualifications of the specialist, and
20 the susceptibility of that specialist to company influence or bias.

21 The second fundamental changes would be to establish a common
22 supervisory approach for auditor specialists, whether employed or engaged by
23 amending AS 1201 and replacing the current AS 1210 with new requirements for

1 using the work of auditor-engaged specialists. The proposal provided more
2 direction on how to apply the general supervisory principles of AS 1201 to the
3 supervision of specialists, whether employed or engaged by the auditor. The
4 proposal also had tailored requirements in certain areas where it's appropriate to
5 differentiate between auditor-employed and auditor-engaged specialists, such as
6 evaluating the qualifications of those specialists.

7 We received 34 comment letters across a range of constituencies on
8 the proposal, as you can see here. Generally received a number of comments in
9 a variety of areas. There was -- many commenters supported aligning the
10 requirements for using specialists with the risk-assessment standards and
11 presenting separate requirements for company specialists, auditor-employed
12 specialists, and auditor-engaged specialists. A few commenters, though,
13 expressed concerns over replacing the extant 1210 with a new standard, primarily
14 because of potential burdens imposed on smaller firms and certain smaller
15 companies.

16 There was general support for retaining the existing meaning of the
17 term, specialist. All those who commented on this topic agreed with or didn't
18 object to applying the proposal to those specialists currently covered by existing
19 AS 1210.

20 Some commenters suggested that the board extend the scope to
21 specialists in areas of information technology and tax or entirely eliminate the
22 current distinction between expertise inside or outside the field of accounting and
23 auditing.

1 The proposal sought comment on rescinding the current -- auditing
2 interpretation 11, using the work of a specialist, which relates to using a specialist
3 with transfers of financial assets. Most commenters contended that the
4 interpretation continues to provide useful guidance to auditors and supported
5 retaining the interpretation in some form.

6 One of the last bigger areas of comment was the economic impact on
7 smaller accounting firms. Many expressed concerns over the proposal's impact
8 on smaller firms, its unintended consequences, and the potential cost impact.
9 Specifically, commenters asserted that the cost of the proposal would be relatively
10 greater on smaller firms and certain smaller companies. The proposal would
11 adversely affect smaller firms' ability to compete in the audit-services market.
12 And that the incremental cost of certain aspects would outweigh any increase in
13 audit quality.

14 And, lastly, from this perspective, that the proposal could result in a
15 shortage of qualified specialists, largely due to the proposed requirements for
16 assessing objectivity of the auditor-engaged specialist.

17 And then, as another high-level theme, some commenters suggested
18 clarifications or guidance to specific requirements in the proposal. For example,
19 how to apply the terms auditor-employed and auditor-engaged specialists when
20 specialists are employed by affiliates of the audit firm, how to tailor the nature and
21 extent of procedures for testing management's process when management uses
22 a specialist, and how the auditor would test the appropriate use of data by the
23 company specialist.

1 We also receive comments on specific aspects of the proposal. First
2 area there is testing and evaluating the work of the company specialist. There
3 were mixed views on the concept that the auditor should test and evaluate the
4 work of a company specialist.

5 Comments on specific provisions in this area related primarily to the
6 requirements to evaluate whether data was appropriately used by the specialist,
7 testing and evaluation when the specialist uses proprietary models, and
8 interaction of the requirements of the estimates proposal for testing
9 management's process when management uses a specialist.

10 Specifically, requirements for understand methods and assumptions
11 used by the company specialist and evaluating whether data was used
12 appropriately by the company specialist.

13 We also receive comments about assessing the relationship of the
14 company specialist to the company. Some commenters here ask for clarification
15 of the boards expectation for the necessary level of effort to obtain information
16 from the company-engaged specialist on the relationship to the company.

17 Others asserted that there could be practical challenges in the
18 application of the requirement, as the entity that employs the specialist may lack a
19 system to track the relationships, or the auditor may not have access to those
20 systems, even if they exist.

21 Some commenters also expressed a preference for retaining the term,
22 objectivity, with respect to the company specialist. Several commenters also
23 asserted that the proposal did not adequately account for differences between

1 company-employed and company-engaged specialists and that the nature and
2 extent of the audit procedures with respect to the work of a company-engaged
3 specialist with the necessary knowledge, skill, and objectivity, should not
4 necessarily be the same as those of a company-employed specialist.

5 We also received specific comments around assessing the objectivity
6 of an auditor-engaged specialist. Commenters expressed concern about the
7 statement of the proposed standard, that an auditor should not use a specialist
8 who lacks the necessary objectivity.

9 Some of these commenters asserted that objectivity should be viewed
10 along a spectrum, rather than as a binary decision, and that the auditor should be
11 able to use the work of a less objective specialist, as long as the auditor performed
12 additional procedures to test and evaluate that work.

13 Other areas of comment on the specialist proposal included guidance,
14 as I mentioned earlier, which includes how to assess the objectivity of the entity
15 that employs the specialist, what constitutes sufficient, appropriate audit evidence
16 to support the assessment of objectivity, and how to apply the requirements when
17 a company specialist uses a proprietary model.

18 We also received comments on the effective date. Similar to those
19 comments on the estimates proposal that Barb just talked about, and some
20 commenters emphasized the importance of having the same effective date for
21 any new standards on using the work of specialists and auditing accounting
22 estimates.

23 MR. BAUMANN: Thanks Lisa and Barbara. Let me just make a

1 couple of comments on this. And see if this triggers any further discussion
2 among the group.

3 These are first of all two very important standards, as I mentioned
4 earlier. And I think as you realized, a set of financial statements is largely a
5 conglomeration of estimates and fair value measures.

6 There are very few numbers in financial statements that are precise
7 numbers. There are estimates and fair value measures.

8 So, that standard is very important as estimates are growing more and
9 more complex. And there's a greater use of estimates in financials, complex
10 estimates and complex fair value measures.

11 So a critically important standard to update. And my perception of the
12 comments, my view entirely, is very good comments we received.

13 But in my view, I think these are comments that are largely around the
14 edges of things that we can address, and deal with, and move ahead. Good
15 comments.

16 We have to deal with them. But I think we can move ahead with them.

17 The specialist in these complex estimates and fair value measures,
18 more and more specialists are being used in audits. The point that Lisa was
19 making about, and this came up as a real important distinction here, competitive
20 factors.

21 Large firms typically, and maybe I see some cards up from a couple of
22 large firms. Large firms often employ specialists.

23 And so they can supervise the actuaries and evaluation specialists

1 who are on that audit. Specialists are used because the auditor may not have
2 those actuarial skills, evaluation skills for instance, and use the work of those
3 specialists as part of their completion of their necessary audit procedures.

4 Smaller firms often don't have these people on their staffs. And don't
5 engage them. But instead use the work which is currently permitted under extant
6 standard of the company specialist who may have done work for the company in
7 developing that accounting estimate or fair value measure.

8 The proposed standard said that -- put a higher bar on the extent of
9 work that the auditor had to do to evaluate the work of that company specialist
10 regarding the reasonableness of their assumptions, the data, et cetera.

11 After all, it's the auditor's opinion, not the company specialist's opinion
12 on the financial statements. And that's where we were going with that.

13 So, that's an issue that was raised as to what type of work is
14 appropriate with respect to the company specialist when that work is used by the
15 auditor typically in a smaller firm as part of the audit.

16 And it really goes around the extent of testing those significant
17 assumptions, valuating those methods, or relying on the work of that company
18 specialist.

19 And as I said, in my own opinion, it's the auditor who's giving the
20 opinion. And the auditor needs to understand those assumptions, methods,
21 sufficiently to give an opinion on the financials.

22 That is an important area for us to address. And we'll work through
23 that one. But, I think it's a -- we will work through it and come up to a good

1 answer.

2 Whose card was up first? David Kane.

3 MR. KANE: Thanks, Marty. And thanks to the staff. I thought it was
4 a very good summary.

5 These comments are in our comment letter, so I don't want to belabor
6 them. But just to punctuate.

7 I think on the specialist the auditing interpretation number 11, so this
8 has to deal with the legal isolation criteria in order to get financial assets
9 derecognized. Auditors need a legal letter today.

10 And having lived through many of those types of transactions, I can tell
11 you that we need those letters. We're not bankruptcy specialists.

12 We spent a lot of time with the legal community developing those
13 letters. I think lawyers are very familiar with them.

14 They understand exactly what the requirements are. Trying to take
15 those away, I'm fearing could actually create a vacuum for us on that.

16 And I think on the same lines, auditing interpretation 28, dealing with
17 tax work papers that was going to get proposed. Yet I think many of the concepts
18 are in the document itself.

19 But, I think what we currently have is more targeted and specific. So I
20 would recommend to the extent that we can retain that, I would be and advocate
21 for that.

22 I appreciate that. Thank you.

23 MR. BAUMANN: Thanks for those comments. Just to clarify though,

1 they're somewhat different than the points I was making.

2 But you're just clarifying that there are interpretations that exist today
3 that you think should continue to exist.

4 MR. KANE: Exactly.

5 MR. BAUMANN: Len?

6 MR. COMBS: Yes. First of all I would like to commend you guys for
7 the job you've done on both of these standards. I think you've done a great job
8 on two standards that cover difficult areas. And I know a lot of hard work over a
9 long period of time has gone into that.

10 Certainly when we responded to the IAASB on their similar standard on
11 estimates, we told them it may be beneficial for them to look to the PCAOB's
12 proposed standard. Because we thought the framework was appropriate. And
13 it was well written. So, thank you for that.

14 One thing I would just like to reiterate, and I think it was well
15 summarized in both standard summaries, is in certain cases where we need to
16 look to other third parties whether it's pricing services, whether it's, you know,
17 other auditors of equity method investees, whether it's specialists engaged by the
18 company and how much we need to assess their relationships with the company,
19 or the methods used, I think there just needs to be careful consideration.

20 I know you guys are. But I just want to reemphasize this about our
21 ability to influence and access others. Because we may not have that ability.
22 So, the words around these are really important. I think they've been well
23 captured in the responses. And I would just encourage you to really think about

1 that and continue to focus on that as you finalize. But well done on both the
2 summaries and the standards where they stand so far.

3 MR. BAUMANN: Thanks, Len for those comments. So these are
4 very complex areas, very technical standards. We've again, had a number of
5 discussions with the SAG about these. We've had a lot of outreach.

6 The consultation paper has a lot of comment. The proposal is a has of
7 comment. And so we have a lot of information to work with as we move ahead.

8 And so thanks to you for your comment letters.

9 ...

10 MR. JOHNSON: Marty, I waited just because I didn't want to go back
11 to the previous recitation until there is ample opportunity for people to make
12 comments about this.

13 But, there was one thing that Lisa said that concerned me. And you
14 started to raise the issue. And that was in relation to the economic impact on
15 smaller firms where they use a specialist. And I'd just like some clarification.

16 Because in the complex world that we're in, and you mentioned it a
17 number of times that fair value estimates, et cetera, impact the financial
18 statements. I can't see any reason where a specialist wouldn't be appointed.
19 Whether it be internal or external in those circumstances. Irrespective of the size
20 of the firm.

21 And could you just clarify what your thought processes might be here?
22 We talked -- you know, we talked about scalability of auditing standards.

23 But it just worries me that if you're playing in the game, in a complex

1 situation, then you've got to abide by the rules irrespective of size of audit firm.

2 So I'm just a bit concerned when I read those comment letters or the
3 impact of those comment letters where economics are coming into the equation.

4 And I don't see the -- I was protective of the smaller firms yesterday, vis
5 a vis software providers and making sure that they weren't exposed.

6 But I think that the markets will get exposed if smaller firms are not
7 prepared to invest in specialists. So, could you just clarify for me the thought
8 processes.

9 I know you raised it as a potential issue when you needed to cover it.

10 MR. BAUMANN: I can. But Keith looks like he's ready to take a shot
11 at it as well. So go ahead.

12 MR. WILSON: Well, I was going to say to your point about how big an
13 issue this is, this is something we are actually trying to look at now and gather
14 data.

15 We definitely understand the point about smaller firms needing to be
16 able to do this. And I think that the record we get through the comments is really
17 rather mixed.

18 Some of it is simply a function of people reading some of the
19 requirements in a way that they think means hey, I have to go in as an auditor and
20 re-perform exactly everything step by step that that specialist did. Which is not
21 what the intent of the proposal is.

22 But, you know, when they read it that way, they think hey, I can't --
23 there's no way that I could possibly do this. This is a small firm.

1 I have to go out and try to find my own specialist. That's really difficult
2 sometimes in some maybe remote location, it's difficult to get a second specialist.

3 So they're raising these practical concerns that are in some part driven
4 by a perception of what we're requiring. There are some others who are -- who
5 really just have a very fond view of our existing standard that essentially allows
6 something a little bit more like just a straight reliance on a company specialist.

7 So, there's a balance there that we're working through and trying to
8 carefully understand the comments. Trying to think about how clear we can be
9 on the requirements related to that.

10 And also trying to understand, I think this is a -- these are issues that
11 are probably more confined to specific industries and specific types. And so,
12 we're trying to get a handle on that right now.

13 MR. BAUMANN: So, again, the company specialist is working for the
14 company and developing information for the company to record in their financial
15 statements that the company itself probably can't do and it's relying on the
16 specialist to calculate their actuarial liability, their benefit reserves, evaluation of
17 some of their instruments, whatever it might be.

18 And the debate is between, well how much can the auditor rely on the
19 evidence produced by that company specialist which is really they're producing
20 information to be part of the financial statements. Versus how much audit testing
21 do we have to do of that company specialist's work.

22 And that's where that balance has to be drawn. And we think we've --
23 we think we drew a good balance. But some read it that you had to completely

1 re-perform what that specialist did versus maybe testing that work.

2 But, certainly at the far end of the extreme it's rely on it and do
3 nothing, which is highly questionable. Right?

4 And the other end of extreme is don't rely on it at all and just get your
5 own specialist and completely re-perform. So.

6 MR. JOHNSON: But the auditor has to be able to understand the
7 output as well as what the inputs are. And that was my concern.

8 That it's that understanding that this, you know, the specialist has of
9 that information. Whereas any -- any practitioner, whether it's large firm or small
10 firm, may not have that understanding.

11 And that's just the area that concerns me. Now what is -- what is the
12 output? Do I really understand it? And therefore, can I rely on it?

13 And that's the judgement that causes me some concern.

14 (Off mic comment)

15 MR. BAUMANN: Right. So the auditor has to understand that we're
16 concluding. How as it done? And what were the key assumptions? And the
17 key methods that were used?

18 Otherwise, you're sort of outsourcing part of the audit work to a
19 third-party. Right. I do agree with you.

20 ...

21 MS. STEVENS: Thank you, Marty. And as a smaller firm we've
22 been pretty involved in the dialogue and the reach out and the response to the
23 earlier ones that you were bringing up.

1 So I just -- I wanted to make sure and be clear that there's not going to
2 be -- that the request from the smaller firms isn't for special dispensation to not do
3 the procedures that are going to be prescribed.

4 It's more in the principals and the criteria of it's not one size fits all. So
5 let's not default to one place. That's what the comments are related to.

6 And I think an import -- what I get out of this, what is very important is
7 for investors and particularly audit communities to ask the questions and you'll
8 have the opportunity in the CAMs.

9 Because a lot of the CAMs are going to be surrounded, are going to be
10 with respect to estimates. And by definition also to use a specialist.

11 So, I encourage audit communities to ask the questions. And to ask
12 what the auditors are doing in their procedures in that context.

13 Because I think those dialogs are going to be elevated as ARM roles
14 out in the practice phase that was recommended yesterday, as well as for real.

15 ...

16 MS. JOY: Thank you. I just wanted to reiterate the issue with the
17 smaller firms and the use of a specialist.

18 And I think at the outset of the project there was concern that we
19 wouldn't have the ability to use specialists in the manner that we had used them
20 previously.

21 Meaning that the level of work to be able to rely on them would
22 basically place the small firm outside of being able to use the specialist.

23 But I don't think anybody was trying to not adhere, you know, to the

1 proposal. I think the issue was making sure that the level of work that was
2 required recognizing that there's a reason -- there is the use of a specialist.

3 You know, and when does the auditor become the specialist? And
4 that's really kind of the sliding scale, I think that had some of the smaller firms
5 concerned.

6 That the pendulum would swing to a point where we effectively had to
7 become the specialist. And then we were at a significant disadvantage in the
8 resources that the smaller firms had.

9 But I think over the years just under the current standards, the use of a
10 specialist and what the auditors are doing has been substantially increased just in
11 practice anyway.

12 So I concur with the fact that you can't blindly use a specialist. You
13 have to have a certain level of knowledge and a level of testing for reliance.

14 But it was the scale of that that I think was questionable.

15 MR. BAUMANN: And your comments refer to the company
16 specialist?

17 MS. JOY: The company specialist. Yes. Yes.

18 MR. BAUMANN: Which is the -- generally the issue. Because most
19 of the large firms have specialists on their staff to evaluate these complex areas of
20 valuation, actuarial and things of that nature.

21 MS. JOY: Exactly.

22 MR. BAUMANN: All right. Well thank you everybody for -- the
23 presentations team on these very important proposed standards which we look to

1 move forward.



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AMENDMENTS TO AUDITING STANDARDS)
FOR AUDITOR'S USE OF THE WORK OF) PCAOB Release No. 2018-006
SPECIALISTS) December 20, 2018
)
) PCAOB Rulemaking
) Docket Matter No. 044
)
)

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting amendments to its auditing standards that strengthen the requirements that apply when auditors use the work of specialists in an audit. The amendments are designed to increase audit attention in areas where a specialist is used and to align the applicable requirements with the PCAOB's risk assessment standards.

Board

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Amendments:

The Board is adopting amendments to its standards and auditing interpretations that:

(1) Revise:

- AS 1105, *Audit Evidence*;
- AS 1201, *Supervision of the Audit Engagement*;
- AS 2101, *Audit Planning*;
- AS 2110, *Identifying and Assessing Risks of Material Misstatement*, and
- AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*;

(2) Replace AS 1210, *Using the Work of a Specialist*, and retitle the standard as *Using the Work of an Auditor-Engaged Specialist*, and

(3) Make additional conforming amendments.

TABLE OF CONTENTS

I. Executive Summary 1

II. Background..... 5

 A. Rulemaking History 6

 B. Overview of Existing Requirements 7

 C. Existing Practice 10

 D. Reasons to Improve Auditing Standards..... 18

III. Overview of Final Rules 23

IV. Economic Considerations 28

 A. Baseline 29

 B. Need for the Rulemaking 40

 C. Economic Impacts..... 46

 D. Alternatives Considered, Including Key Policy Choices 59

V. Special Considerations for Audits of Emerging Growth Companies 64

VI. Applicability to Audits of Brokers and Dealers..... 69

VII. Effective Date..... 70

APPENDIX 1: Amendments Relating to the Auditor's Use of the Work of Specialists

APPENDIX 2: Other Related Amendments to PCAOB Auditing Standards

APPENDIX 3: Additional Discussion of Amendments



I. Executive Summary

The Board is adopting amendments to its standards for using the work of specialists (i.e., a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing), including amendments to two existing auditing standards and the retitling and replacement of a third standard with an updated standard. The amendments are intended to enhance investor protection by strengthening the requirements for evaluating the work of a company's specialist, whether employed or engaged by the company, and applying a supervisory approach to both auditor-employed and auditor-engaged specialists. The amendments are also designed to be risk-based and scalable, so that the auditor's work effort to evaluate the specialist's work is commensurate with the risk of material misstatement associated with the financial statement assertion to which the specialist's work relates and the significance of the specialist's work to that assertion. These amendments should lead to more uniformly rigorous practices among audit firms of all sizes and enhance audit quality and the credibility of information provided in financial statements.

Companies across many industries use specialists to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors frequently use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

As financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements, accounting estimates have become both more prevalent and significant. As a result, the use of the work of specialists also continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

To address this challenge, the Board is amending its auditing standards that primarily relate to auditors' use of the work of specialists. First, AS 1105, *Audit Evidence*, is being amended to add a new Appendix A that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards.

New Appendix A of AS 1105:

- Supplements the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, including requirements related to:
 - Obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls;
 - Obtaining an understanding of, and assessing, the knowledge, skill, and ability of a company's specialist and the entity that employs the specialist (if other than the company) and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
 - Performing procedures to evaluate the work of a company's specialist, including evaluating: (i) the data, significant assumptions, and methods (which may include models) used by the specialist, and (ii) the relevance and reliability of the specialist's work and its relationship to the relevant assertion.
- Aligns the requirements for using the work of a company's specialist with the risk assessment standards and the standard and related amendments adopted by the Board on auditing accounting estimates, including fair value measurements.
- Sets forth factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.

Second, the Board is also amending AS 1201, *Supervision of the Audit Engagement*, to add a new Appendix C on supervising the work of auditor-employed specialists, and retitling and replacing AS 1210, *Using the Work of a Specialist* ("existing AS 1210"), with new AS 1210, *Using the Work of an Auditor-Engaged Specialist* ("AS 1210, as amended"), which sets forth requirements for using the work of auditor-engaged specialists.

New Appendix C of AS 1201:

- Supplements the requirements for applying the supervisory principles in AS 1201.05–.06 when using the work of an auditor-employed specialist to assist the auditor in obtaining or evaluating audit evidence, including requirements related to:

- Informing the auditor-employed specialist of the work to be performed;
 - Coordinating the work of the auditor-employed specialists with the work of other engagement team members; and
 - Reviewing and evaluating whether the work of the auditor-employed specialist provides sufficient appropriate evidence. Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and whether the specialist's findings and conclusions are consistent with, among other things, the work performed by the specialist.
- Sets forth factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.

AS 1210, as amended:

- Establishes requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence;
- Includes requirements for reaching an understanding with an auditor-engaged specialist on the work to be performed and reviewing and evaluating the specialist's work that parallel the final amendments to AS 1201 for auditor-employed specialists;
- Sets forth factors for determining the necessary extent of review of the work of the auditor-engaged specialist;
- Amends requirements related to assessing the knowledge, skill, ability, and objectivity of the auditor-engaged specialist; and
- Describes objectivity, for these purposes, as the auditor-engaged specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit, and specifies the auditor's obligations when the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity.

The final amendments strengthen the requirements for evaluating the work of a company's specialist and for supervising and evaluating the work of both auditor-employed and auditor-engaged specialists. The amendments also eliminate certain provisions of existing PCAOB standards, under which:

- The auditor has the same responsibilities under existing AS 1210 with respect to both a company's specialist and an auditor-engaged specialist, even though those specialists have fundamentally different roles (i.e., the company uses the work of its specialist in the preparation of the financial statements); and
- Auditor-employed specialists, but not auditor-engaged specialists, are subject to risk-based supervision, even though both serve similar roles in helping auditors obtain and evaluate audit evidence.

The Board is adopting the final amendments after substantial outreach, including two rounds of public comment. In May 2015, the PCAOB issued a staff consultation paper to solicit views on various issues, including the potential need for standard setting. In June 2017, the Board requested comments on proposed amendments to the standards on using the work of specialists. The Board received comments on the staff consultation paper and the proposal. The Board's Standing Advisory Group ("SAG") also discussed this issue at several meetings. Commenters generally supported the Board's objective of improving the quality of audits involving specialists, and suggested areas to further improve the amendments, modify proposed requirements that would not likely improve audit quality, and clarify the application of the amendments. In adopting these amendments, the Board has taken into account all of these comments and discussions, as well as observations from PCAOB oversight activities.

In its consideration of the final amendments, the Board is mindful of the significant advances in technology that have occurred in recent years, including increased use of data analysis tools and emerging technologies. An increased use of technology-based tools, together with future developments in the use of data and technology, could have a fundamental impact on the audit process. The Board is actively exploring these potential impacts through ongoing staff research and outreach. For example, the staff is currently researching the effects on auditing of data analytics, artificial intelligence, distributed ledger technology, and other emerging technology, assisted by a task force of the SAG.¹

In the context of this rulemaking, the Board considered how changes in technology could affect the use of specialists by companies, the use of the work of

¹ See PCAOB, *Changes in Use of Data and Technology in the Conduct of Audits* (available at <https://pcaobus.org/Standards/research-standard-setting-projects/Pages/data-technology.aspx>).

companies' specialists by auditors as audit evidence, and the use of auditor-employed and auditor-engaged specialists by auditors to obtain and evaluate audit evidence. The Board believes that the final amendments are sufficiently principles-based and flexible to accommodate continued advances in the use of data and technology by both companies and auditors. The Board will continue to monitor advances in this area and any effect they may have on the application of the final amendments.

The amendments will apply to all audits conducted under PCAOB standards. Subject to approval by the Securities and Exchange Commission ("SEC" or "Commission"), the amendments take effect for audits for fiscal years ending on or after December 15, 2020.

II. Background

Companies across many industries use various types of specialists to assist in developing accounting estimates in their financial statements.² Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. In addition, auditors frequently use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

The use of fair value measurements and other accounting estimates continues to grow in financial reporting with, for example, increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.³ If a specialist's work is not properly overseen or evaluated, however, there is heightened

² As used in this release, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

³ See, e.g., Karin Barac, Elizabeth Gammie, Bryan Howieson, and Marianne van Staden, *The Capability and Competency Requirements of Auditors in Today's Complex Global Business Environment*, at 83 (Mar. 2016) (report commissioned by the Institute of Chartered Accountants of Scotland and the Financial Reporting Council) (stating that "audit teams now include many more experts than in the past, and for some industries, particularly financial services, this was a welcome development.").



risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

The amendments in this release to the standards for using the work of specialists are intended to improve audit quality by strengthening the requirements for evaluating the work of a company's specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists. These enhancements should also lead to improvements in practices, commensurate with the associated risk, among audit firms of all sizes. The expected increase in audit quality should also enhance the credibility of information provided to investors.

A. Rulemaking History

The final amendments to the auditing standards reflect public comments on both a staff consultation paper and a proposal. In May 2015, the PCAOB issued a staff consultation paper to solicit comments on various issues related to the auditor's use of the work of a company's specialist and an auditor's specialist, including possible approaches for changes to PCAOB standards and the potential economic impacts of those alternatives.⁴

In June 2017, the PCAOB issued a proposal to solicit comments on amendments to PCAOB standards to strengthen the requirements for the auditor's use of the work of specialists.⁵ The Proposal was informed by comments on the SCP. The Board received 35 comment letters on the Proposal from commenters across a range of affiliations. The final amendments are informed by comments on the Proposal. Those comments are discussed throughout this release.

In addition, the Board's approach has been informed by, among other things: (1) observations from PCAOB oversight activities and SEC enforcement actions; (2) the International Auditing and Assurance Standards Board's ("IAASB") and the American Institute of Certified Public Accountants' Auditing Standards Board's auditing standards

⁴ See PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015) ("SCP").

⁵ See *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2017-003 (June 1, 2017) ("Proposal").

and IAASB's post-implementation review;⁶ (3) substantial outreach, including discussions with members of the SAG;⁷ and (4) the results of academic research.

B. Overview of Existing Requirements

The primary standard that applies when auditors use the work of auditor-engaged specialists or company specialists is existing AS 1210. The primary standard that applies when auditors use the work of auditor-employed specialists in an audit is AS 1201. Existing AS 1210 was adopted by the Board in 2003 shortly after the PCAOB's inception.⁸ AS 1201 was one of eight risk assessment standards adopted by the Board in 2010.⁹

Existing AS 1210 provides that a specialist is "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing."¹⁰ Existing AS 1210 also states that income taxes and information technology ("IT") are specialized areas of accounting and auditing, and therefore are outside the scope of the

⁶ See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review*, at 44–45 (July 2013).

⁷ See SAG meeting briefing papers and webcast archives (Nov. 29–30, 2017, Nov. 30–Dec. 1, 2016, Nov. 12–13, 2015, June 18, 2015, Oct. 14–15, 2009, and Feb. 9, 2006), available on the Board's website.

⁸ See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003). AS 1210 was originally adopted by the PCAOB as AU sec. 336. The PCAOB renumbered AU sec. 336 as AS 1210 when it reorganized its auditing standards. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015).

⁹ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010). Prior to 2010, auditors supervised employed specialists under AU sec. 311, *Planning and Supervision*. Additionally, paragraph .16 of AS 2101, *Audit Planning*, requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

¹⁰ See existing AS 1210.01.

standard.¹¹ Existing AS 1210 applies when (1) a company engages or employs a specialist and the auditor uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions or (2) an auditor engages a specialist and uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions.¹²

AS 1201 establishes requirements for the supervision of the audit engagement, including supervising the work of engagement team members.¹³ The auditor supervises a specialist employed by the auditor's firm who participates in the audit under AS 1201.¹⁴ As members of the engagement team under PCAOB auditing standards, auditor-employed specialists are to be assigned based on their knowledge, skill, and ability.¹⁵ AS 1201 also applies in situations in which persons with specialized skill or knowledge in IT or income taxes participate in the audit, regardless of whether they are employed or engaged by the auditor's firm.¹⁶

Using the work of a company's specialist and an auditor-engaged specialist under existing AS 1210. Existing AS 1210 requires that the auditor perform the following procedures when using the work of a company's specialist or an auditor-engaged specialist:

- Evaluate the professional qualifications of the specialist;¹⁷

¹¹ See footnote 1 of existing AS 1210.

¹² See existing AS 1210.03.

¹³ See AS 1201.01.

¹⁴ See AS 1201.05–.06.

¹⁵ See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*. In addition, the requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing the independence of auditor-employed specialists. See AS 2101.06b.

¹⁶ See footnote 1 of existing AS 1210.

¹⁷ See existing AS 1210.08.

- Obtain an understanding of the nature of the specialist's work;¹⁸
- Evaluate the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity;¹⁹ and
- In using the findings of the specialist:²⁰
 - Obtain an understanding of the methods and assumptions used by the specialist;
 - Make appropriate tests of data provided to the specialist; and
 - Evaluate whether the specialist's findings support the financial statement assertions.

*Using the work of a company's specialist when auditing fair value measurements under AS 2502.*²¹ In circumstances when a company's specialist develops assumptions used in a fair value measurement and the auditor tests the company's process, the auditor is required to evaluate the reasonableness of those assumptions as if the assumptions were developed by the company,²² as well as to comply with the requirements of existing AS 1210.

Supervising the work of auditor-employed specialists under AS 1201. This standard establishes requirements regarding the auditor's supervision of an audit engagement, including supervising the work of auditor-employed specialists and other members of the engagement team. AS 1201, as it relates to the supervision of auditor-employed specialists, provides that:

¹⁸ See existing AS 1210.09.

¹⁹ See existing AS 1210.10–.11.

²⁰ See existing AS 1210.12.

²¹ AS 2502, *Auditing Fair Value Measurements and Disclosures*, is being superseded in a companion release. See *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2018-005 (Dec. 20, 2018) ("Estimates Release").

²² See footnote 2 of AS 2502.

- (1) The engagement partner and others who assist the engagement partner in supervising the audit should:
- Inform engagement team members of their responsibilities;
 - Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities; and
 - Review the work of engagement team members to evaluate whether:
 - The work was performed and documented;
 - The objectives of the procedures were achieved; and
 - The results of the work support the conclusions reached.²³
- (2) The necessary extent of supervision depends on, for example, the nature of the work performed, the associated risks of material misstatement, and the knowledge, skill, and ability of those being supervised.²⁴

C. Existing Practice

The PCAOB's understanding of audit practice at both larger audit firms²⁵ and smaller audit firms²⁶ under existing PCAOB standards has been informed by, among

²³ See AS 1201.05.

²⁴ See AS 1201.06.

²⁵ Unless otherwise indicated, the term "larger audit firms" refers to U.S. audit firms that are registered with the PCAOB and issue audit reports for more than 100 issuers (and are therefore annually inspected by the PCAOB). This term also refers to non-U.S. audit firms that are registered with the PCAOB and affiliated with one of the six largest global networks, based on information on network affiliations reported by non-US. audit firms on Form 2 in 2017 and identified on the "Global Network" overview page, available on the Board's website.

²⁶ Unless otherwise indicated, the term "smaller audit firms" refers to PCAOB-registered audit firms that do not meet the definition of a "larger audit firm" as provided

other things, the collective experience of PCAOB staff, observations from oversight activities of the Board, enforcement actions of the SEC, comments received on the Proposal, and discussions with the SAG, audit firms, and specialist entities.

These discussions have included outreach by the PCAOB staff to audit firms and specialist entities to obtain information on: (1) how auditors evaluate the competence and objectivity of auditor-engaged specialists and company specialists; (2) how auditors evaluate the work performed by an auditor-employed specialist, an auditor-engaged specialist, and a company's specialist; and (3) economic and demographic considerations relating to the market for services provided by specialists. The outreach has informed the PCAOB's understanding of existing practice at both larger and smaller audit firms. Most commenters who addressed the topic agreed that the Proposal accurately described existing audit practices regarding the use of the work of specialists. Commenters also generally supported the PCAOB's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements.

1. Overview of Existing Practice

When existing AS 1210 was originally issued in the early 1970s, the use of the work of specialists was largely confined to pension obligations, insurance reserves, and extractive industry reserves. Since then, the use of the work of specialists has increased in both frequency and significance.

Companies across many industries use the work of specialists to: (1) assist them in developing accounting estimates, including fair value measurements presented in the companies' financial statements; (2) interpret laws, regulations, and contracts; or (3) evaluate characteristics of physical assets, as shown in Figure 1 below. In those circumstances, the reliability of a company's financial statements may depend in part on the quality of the work of a company's specialist.

in footnote 25. These firms generally consist of firms that issued audit reports for 100 or fewer issuers and are not affiliated with any of the six largest global networks identified on the "Global Network" overview page, available on the Board's website.

Figure 1: Examples of Activities that Involve the Work of Specialists

Valuation

Assets acquired and liabilities assumed in business combinations
Environmental remediation contingencies
Goodwill impairments
Insurance reserves
Intangible assets
Pension and other post-employment obligations
Impairment of real estate or other long-term assets
Financial instruments

Legal interpretations

Legal title to property
Laws, regulations, or contracts

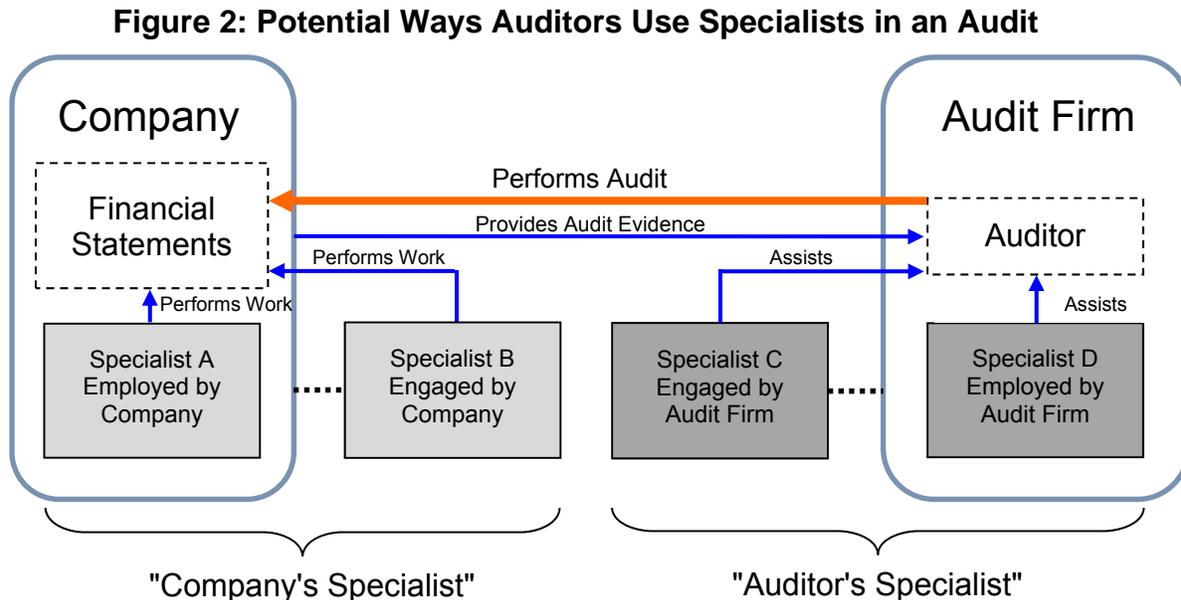
Evaluation of physical and other characteristics

Materials stored in stockpiles
Mineral reserves and condition
Oil and gas reserves
Property, plant, and equipment useful lives and salvage values

Auditors also increasingly use the work of specialists in their audits. Auditors may:

- Use the work of a company's specialist—employed or engaged—as audit evidence; or
- Use the work of an auditor's specialist—employed or engaged—to assist the auditor in obtaining and evaluating audit evidence.

Figure 2 illustrates potential ways that auditors use specialists in an audit.



The company's specialist (A and B above) is employed or engaged by the company to perform work that the company uses in preparing its financial statements, which the auditor may use as audit evidence with respect to auditing significant accounts and disclosures. The auditor's specialist (C and D above) performs work to assist the auditor in obtaining and evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

The PCAOB understands that audit practices under existing PCAOB standards vary among smaller and larger audit firms when auditors use the work of a specialist in an audit.²⁷ For example, smaller audit firms are more likely to use the work of a company's specialist than to employ or engage their own specialist. Larger audit firms generally require their engagement teams to evaluate the work of the company's specialist, including the specialist's methods and assumptions, and often employ

²⁷ As discussed in Section IV.A.1, an analysis of inspection data by PCAOB staff suggests that larger audit firms generally use the work of specialists more often than smaller audit firms do.

specialists to assist their audit personnel in evaluating that work.²⁸ The following paragraphs discuss in more detail the practices of smaller firms and larger firms in audits of issuers, brokers, and dealers under existing PCAOB standards.

Smaller firm practices. Smaller firm practices generally are based on the required procedures in existing PCAOB standards, primarily existing AS 1210. Smaller firms typically evaluate the competence, relationships to the company, and work of the company's specialist through inquiries of the company's specialist. For example, smaller firms may send a company's specialist a questionnaire to obtain information regarding the specialist's professional qualifications and the existence of relationships with the company that could impair the specialist's objectivity. Further, smaller firms typically do not evaluate the appropriateness of a specialist's methods (it is not required by existing AS 1210), and any evaluation by smaller firms of the assumptions of a company's specialist is generally confined to circumstances when the specialist develops assumptions used in a fair value measurement covered by AS 2502.

In circumstances when smaller firms engage an auditor's specialist, some firms perform the procedures specified in existing AS 1210. Other firms perform procedures similar to those in AS 1201 for supervising members of the engagement team. For example, some firms evaluate whether the auditor-engaged specialist's work supports the financial statement assertions, while other firms go further by also evaluating whether (1) the specialist's work was performed and documented, (2) the objectives of the specialist's procedures were achieved, and (3) the results of the specialist's work support the conclusions reached. One commenter noted that smaller firms may also use an auditor's specialist in evaluating the work of a company's specialist.

Larger firm practices. Some larger audit firms evaluate the methods and assumptions used by company specialists when they test the company's process for developing accounting estimates, even though this evaluation is currently required only for significant assumptions developed by the company's specialist in conjunction with fair value measurements and disclosures.²⁹ Many larger firms employ their own

²⁸ An analysis by PCAOB staff indicates that smaller firms predominantly use the work of an auditor's specialist in valuation areas, and seldom use the work of an auditor's specialist in other areas, whereas larger firms tend to use the work of an auditor's specialist in a wider range of audit areas, even though they also primarily use the work of specialists in valuation areas.

²⁹ See footnote 2 of AS 2502.

specialists, who serve on engagement teams and assist with the evaluation of the work of company specialists.

Auditor-employed specialists at larger firms are generally involved early in the audit, usually during planning meetings with other members of the engagement team. Also, in planning the audit, auditors generally reach an understanding with auditor-employed specialists, documented in a memorandum, regarding the scope of work to be performed and the respective responsibilities of the auditor and the specialist. The items covered in that memorandum typically include: (1) the nature, scope, and objectives of the specialist's work;³⁰ (2) the role and responsibilities of the auditor and the specialist;³¹ and (3) the nature, timing, and extent of communication between the auditor and the specialist.³² The auditor communicates with the specialist as the work progresses to become aware of issues as they arise. When the specialist completes his or her work, the auditor reviews the specialist's work, which is typically documented in a separate report or memorandum.

In some instances, larger firms may use the work of a company's specialist without involving an auditor's specialist, particularly when the risk of material misstatement is low or the firm does not employ a specialist with expertise in the particular field. Alternatively, although infrequently, larger firms may engage a specialist with expertise in the particular field. When larger firms engage specialists, some firms perform the procedures specified in existing AS 1210 described in Section II.B. Other firms perform procedures in such situations that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

³⁰ Examples include whether the specialist is testing (or assisting in testing) the company's process for developing an accounting estimate or developing (or assisting in developing) an independent expectation of the estimate.

³¹ For example, the documentation might identify the respective responsibilities of the auditor and the specialist for evaluating data, significant assumptions, and methods used by the company or the company's specialist.

³² Examples include administrative matters, such as the timing, budget, and other staffing-related issues relevant to the specialist's work, or the protocols for discussing and resolving findings or issues identified by the specialist.

2. *Observations from Audit Inspections and Enforcement Cases*

The Board's understanding of audit practice under existing PCAOB standards has been informed in part by observations from PCAOB oversight activities and SEC enforcement actions, including (1) audit deficiencies of both larger and smaller firms, and related remedial actions to address the deficiencies and (2) enforcement actions where the work of a specialist was used in the audit.

Inspections observations. Over the past several years, the observations from PCAOB inspections have included instances in which the auditor used the work of a company's specialist without performing the procedures required by existing PCAOB standards.³³ Recent findings include instances in which auditors did not: (1) evaluate the reasonableness of assumptions used by a company's specialist in developing fair value measurements; (2) obtain an understanding of methods or assumptions used by the company's specialist; (3) test the accuracy and completeness of company-provided data used by the company's specialist; or (4) evaluate the professional qualifications of the company's specialist.

Over the past several years, the observations from PCAOB inspections also have indicated that auditors, at times, did not fulfill their responsibilities under existing standards when using the work of an auditor's specialist. These findings were more common than those related to using the work of a company's specialist over the same period. The observations included instances in which auditors did not: (1) reach an understanding with the specialist regarding his or her responsibilities; (2) adequately evaluate the work performed by the specialist; or (3) consider contradictory evidence identified by the specialist or resolve discrepancies or other concerns that the specialist identified. More recently, PCAOB inspection staff have observed a decline in the number of instances by some firms in which auditors did not perform sufficient procedures related to the work of an auditor's specialist.

There are indications that some firms have undertaken remedial actions in response to the findings related to the auditor's use of the work of an auditor's specialist. In most cases, such actions included enhancements to firm methodologies to improve coordination between the auditor and the auditor's specialist through earlier and more frequent communications. These enhancements may have contributed, at least in part, to the decline in findings described above. Not all firms, however, have changed their methodologies, resulting in inconsistent practices in this area. In addition,

³³ See existing AS 1210 and AS 2502.

unlike the findings related to the auditor's use of the work of an auditor's specialist, inspections staff have not observed a similar change in the frequency of findings related to the auditor's use of the work of a company's specialist.

Enforcement actions. Both the SEC³⁴ and the PCAOB³⁵ have brought enforcement actions involving situations where auditors allegedly failed to comply with auditing standards when using the work of specialists. For example, such proceedings have involved allegations that auditors failed to (1) perform audit procedures to address the risks of material misstatements in a company's financial statements that were prepared in part based on the work of a company's specialist³⁶ or (2) comply with certain requirements of existing AS 1210 when using the work of a company's specialist (for example, requirements to evaluate the professional qualifications of the specialist, obtain an understanding of the methods and assumptions used by the specialist, evaluate the relationship of the specialist to the company, and apply additional procedures to address a material difference between the specialist's findings and the assertions in the financial statements).³⁷ Several of those proceedings were brought in recent years, suggesting that problems persist in this area.

³⁴ See, e.g., *KPMG LLP and John Riordan, CPA*, SEC Accounting and Auditing Enforcement Release ("AAER") No. 3888 (Aug. 15, 2017); *Miller Energy Resources, Inc., Paul W. Boyd, CPA, David M. Hall, and Carlton W. Vogt, III, CPA*, AAER No. 3673 (Aug. 6, 2015); *Troy F. Nilson, CPA*, SEC AAER No. 3264 (Apr. 8, 2011); and *Accounting Consultants, Inc., and Carol L. McAtee, CPA*, SEC AAER No. 2447 (June 27, 2006).

³⁵ See, e.g., *Tarvaran Askelson & Company, LLP, Eric Askelson, and Patrick Tarvaran*, PCAOB Release No. 105-2018-001 (Feb. 27, 2018); *Grant Thornton LLP*, PCAOB Release No. 105-2017-054 (Dec. 19, 2017); *KAP Purwantono, Sungkoro & Surja, Roy Iman Wirahardja, and James Randall Leali*, PCAOB Release No. 105-2017-002 (Feb. 9, 2017); *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045 (Dec. 5, 2016); *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007 (Apr. 1, 2015); and *Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA*, PCAOB Release No. 105-2011-003 (Apr. 8, 2011).

³⁶ See, e.g., *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007.

³⁷ See, e.g., *Grant Thornton LLP*, PCAOB Release No. 105-2017-054; *KAP Purwantono, Sungkoro & Surja*, PCAOB Release No. 105-2017-002; *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045; *Chisholm, Bierwolf, Nilson &*



D. Reasons to Improve Auditing Standards

The improvements to PCAOB standards being adopted are intended to direct auditors to devote more attention to the work of a company's specialist and enhance the coordination between an auditor and the auditor's specialist—employed or engaged. The final amendments also align with the Board's risk assessment standards and acknowledge more clearly the different roles of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. The Board believes that these improvements will enhance both audit quality and the credibility of the information provided in a company's financial statements.

1. Areas of Improvement

The Board has identified two important areas where improvements are warranted to existing standards, discussed below: (1) strengthening the requirements for evaluating the work of a company's specialist and (2) applying a risk-based supervisory approach to auditor-employed and auditor-engaged specialists.

a. Strengthening the requirements for evaluating the work of a company's specialist

Existing AS 1210 is the primary standard that applies when auditors use the work of an auditor-engaged specialist or a company's specialist. By its terms, existing AS 1210 applies when (1) a company engages or employs a specialist and the auditor uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions or (2) an auditor engages a specialist and uses that specialist's work as evidence in performing substantive tests to evaluate material financial statement assertions.

In practice, however, a company's specialist and an auditor-engaged specialist have fundamentally different roles: the company uses the work of a specialist in the preparation of its financial statements, whereas an auditor's specialist performs work to assist the auditor in obtaining and evaluating audit evidence. By imposing the same requirements for using the work of a company's specialist and an auditor-engaged specialist, existing AS 1210 does not clearly reflect the different roles of such specialists.

In addition, existing AS 1210 does not expressly require an auditor to evaluate the appropriateness of a company specialist's methods and assumptions.³⁸ Instead, it requires the auditor to obtain an understanding of the methods and assumptions used by the specialist, a less rigorous procedure. Existing AS 1210 also includes certain provisions that circumscribe the auditor's responsibilities related to the work of a specialist, including statements that: (1) the appropriateness and reasonableness of methods and assumptions used, and their application, are the responsibility of the specialist; (2) the auditor ordinarily would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.³⁹

When an auditor uses the work of a company's specialist, the requirements in existing AS 1210 allow the auditor to plan and perform audit procedures that may not be commensurate with the risk of material misstatement inherent in the work of the specialist, thereby allowing the auditor to use the work and conclusions of a company's specialist without performing procedures to evaluate that specialist's work. Some audit firms, primarily larger firms, go beyond the requirements in existing AS 1210 and generally require their engagement teams to evaluate the work of a company's specialist, including the specialist's methods and assumptions, and often employ specialists to assist their audit personnel in evaluating that work. Existing audit practices in this regard, however, vary among firms.

The foregoing factors indicate that improvements to PCAOB standards for using the work of a company's specialists are needed and that increasing auditors' attention to the work of a company's specialists with respect to significant accounts and disclosures will enhance investor protection. In the Board's view, investor protection will be enhanced by requiring auditors to do more than merely obtain an understanding of the methods and significant assumptions used by the specialist.

³⁸ The evaluation of the reasonableness of assumptions developed by a company's specialist is required only in circumstances when the specialist develops assumptions used in a fair value measurement in accordance with AS 2502. AS 2502 is being superseded as part of the Estimates Release.

³⁹ See existing AS 1210.12–.13.

- b. Applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists

The primary standard that applies when auditors use the work of an auditor-employed specialist in an audit is AS 1201. That standard establishes requirements regarding the auditor's supervision of the audit engagement, including supervision of a specialist employed by the auditor's firm who participates in the audit. While AS 1201 is risk-based and scalable, it does not specifically address how to apply its supervisory procedures to promote effective coordination between an auditor and a specialist and evaluation by the auditor of the work of an auditor-employed specialist.

The primary standard that applies when auditors use the work of an auditor-engaged specialist in an audit is existing AS 1210. The requirements in this standard differ from and are less rigorous than the requirements that apply when using auditor-employed specialists, even though auditor-employed and auditor-engaged specialists serve similar roles in helping auditors to obtain and evaluate audit evidence. For example, existing AS 1210 provides that the auditor should "obtain an understanding" of the nature of the work performed by an auditor-engaged specialist, including the objectives and scope of the specialist's work, whereas AS 1201 requires the auditor to review the work of an auditor-employed specialist to "evaluate" whether the work was performed and documented, the objectives of the procedures were achieved, and the results of the work support the conclusions reached.

The PCAOB's observations regarding existing audit practices in this area also reveal differences in the application of the auditing standards regarding the use of the work of auditor-employed and auditor-engaged specialists. For example, in circumstances when audit firms engage specialists, some firms perform the procedures specified in existing AS 1210, while other firms perform procedures that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

These factors indicate that investor protection can be enhanced by improving PCAOB standards for applying a risk-based supervisory approach to auditor-employed specialists, and extending those requirements to auditor-engaged specialists. This should promote a more uniform approach to the supervision of an auditor's specialists, whether employed or engaged, reflecting their similar roles. Specifically, investor protection can be enhanced by supplementing the existing supervision requirements under PCAOB standards with more specific direction on applying those principles when supervising the work of auditor-employed and auditor-engaged specialists. This includes, among other things, additional direction on reaching an understanding with auditor-employed and auditor-engaged specialists on the work to be performed and on reviewing and evaluating their work.

2. *Comments on the Reasons for Standard Setting*

Many commenters on the Proposal broadly expressed support for revisions to the Board's standards for using the work of specialists or stated that the Proposal would lead to improvements in audit quality. For example, some commenters agreed with statements in the Proposal that the increasing use of specialists, due in part to the increasing use of fair value measurements in financial reporting frameworks and increasing complexity of business transactions, warranted strengthening existing requirements. A number of commenters also indicated that the requirements for using specialists should be risk-based and more closely aligned with the Board's risk assessment standards than existing standards. One of these commenters stated that the Board should be proactive in addressing issues relating to auditors' use of the work of specialists through standard setting as an alternative to devoting additional resources to inspections and enforcement based on existing standards.

In addition, a number of commenters generally agreed with developing separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. One commenter noted that separating these requirements could lead to better application in practice, especially among smaller CPA firms, while another commenter indicated that providing separate guidance for using the work of company specialists, auditor-employed specialists, and auditor-engaged specialists would be an improvement over existing standards. One commenter stated that inspections of audits involving the use of specialists had shown a need for improvement, and that the rationalization and enhancement of existing requirements would improve the efficiency and quality of audits.

A few commenters on the Proposal questioned the reasons for revisions to PCAOB auditing standards relating to the use of the work of specialists.⁴⁰ One commenter stated that the Proposal presented no clear evidence that audit deficiencies found by the PCAOB relating to the use of specialists resulted from deficiencies in the auditing standards. Another commenter stated that inspection findings did not necessarily warrant revisions to auditing standards and that it continued to question whether a fundamental change in audit standards was necessary. A third commenter stated that it did not believe that the case had been made for having separate standards

⁴⁰ Some commenters provided comments or expressed concerns about specific aspects of the proposed revisions to the Board's existing standards for using the work of specialists. The Board's consideration of these comments is discussed further in Appendix 3 and elsewhere in this release.

for the use of auditor-employed and auditor-engaged specialists. Finally, a fourth commenter suggested that the Board should develop additional information on potential costs before proposing or adopting revisions to existing auditing standards, including through field testing of potential changes.⁴¹

The SAG has discussed specialist-related issues at a number of meetings.⁴² Many SAG members expressed support for: (1) greater auditor responsibility for evaluating the work performed by a company's specialists; (2) similar responsibilities when auditors use the work of auditor-employed specialists and auditor-engaged specialists; and (3) better communication between auditors and their specialists, whether employed or engaged. Some SAG members, however, questioned the need for changes to the existing standards, asserting that auditors may not always have the necessary level of expertise to evaluate the work of certain specialists and, as a result, may need to rely on the work of specialists.

In adopting the final amendments, the Board has taken into account the comments received on the Proposal, as well as its other outreach activities. The information available to the Board—including the current regulatory baseline, observations from the Board's oversight activities, and substantial outreach—suggests that investors would benefit from strengthened and clarified standards for auditors in this area. The Board notes that aspects of the required procedures in the final amendments are similar to current auditing practices by some larger and smaller audit firms. While the Board does not expect that the final amendments will eliminate inspection deficiencies observed in practice, the final amendments are intended to clarify the auditor's responsibilities and align the requirements for using the work of specialists more closely with the Board's risk assessment standards. The final amendments also reflect a number of changes that were made after the Board's

⁴¹ See Appendix 3 ("Additional Discussion of Amendments") for a more detailed discussion of the final amendments and clarifications of certain aspects of the proposed amendments, as set forth in the Proposal.

⁴² See SAG meeting briefing papers and webcast archives (Nov. 29–30, 2017, Nov. 30–Dec. 1, 2016, Nov. 12–13, 2015, June 18, 2015, Oct. 14–15, 2009, and Feb. 9, 2006), available on the Board's website.

consideration of comments received on the Proposal about the potential impact of the proposed requirements on auditors, issuers, and specialists.⁴³

III. Overview of Final Rules

The final amendments: (1) add an appendix to AS 1105 with supplemental requirements for using the work of a company's specialist as audit evidence; (2) add an appendix to AS 1201 with supplemental requirements for supervising an auditor-employed specialist; and (3) replace existing AS 1210 with an updated standard for using the work of an auditor-engaged specialist. The key aspects of these amendments, which are intended to enhance the requirements in existing standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, are discussed in this section. The ways in which the final amendments address the need for change from an economic perspective are discussed in Section IV.B.

The final amendments have been informed by the Board's outreach activities. They are aligned with the Board's risk assessment standards, so that the necessary audit effort is commensurate with, among other things, the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and the associated risk. Many commenters on the Proposal supported aligning any new standards on using the work of specialists with any new standards related to auditing accounting estimates, including fair value measurements. The final amendments are aligned with the Estimates Release.

Figure 3 summarizes the auditor's responsibilities and primary PCAOB standards for using the work of specialists applicable before and after the effective date of the final amendments.

⁴³ See Section IV ("Economic Considerations") for a more detailed discussion of economic considerations related to the adoption of the final amendments and Appendix 3 for a more detailed discussion of changes reflected in the final amendments.

Figure 3: Auditor Responsibilities and Primary Standards for Using the Work of Specialists

	Nature of Specialist's Involvement	<u>Before</u> Effective Date of Final Amendments	<u>After</u> Effective Date of Final Amendments
Company's Specialist	Specialist employed or engaged by the company	Auditor performs the procedures required by existing AS 1210	Auditor performs the procedures required by AS 1105 (including Appendix A), as amended
	Auditor-engaged specialist		Auditor applies the supervisory procedures required by AS 1210, as amended
Auditor's Specialist	Auditor-employed specialist	Auditor supervises the specialist under AS 1201	Auditor supervises the specialist under AS 1201 (including Appendix C), as amended

In brief, the final amendments make the following changes to PCAOB auditing standards:

- *Amend AS 1105.*
 - Add a new Appendix A⁴⁴ that supplements the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, related to:
 - Obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls;⁴⁵

⁴⁴ As proposed, these requirements would have been set forth as Appendix B to AS 1105.

⁴⁵ See AS 1105.A2, as adopted. Additionally, AS 2110, as amended, sets forth requirements for understanding company processes and controls related to the use of specialists.

- Obtaining an understanding of and assessing the knowledge, skill, and ability of a company's specialist and the entity that employs the specialist (if other than the company) and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
 - Performing procedures to evaluate the work of a company's specialist, including evaluating: (i) the data, significant assumptions, and methods (which may include models) used by the specialist,⁴⁶ and (ii) the relevance and reliability of the specialist's work and its relationship to the relevant assertion;
- Align the requirements for using the work of a company's specialist with the risk assessment standards and the standard and related amendments adopted by the Board on auditing accounting estimates, including fair value measurements,⁴⁷ and
 - Set forth factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.
- *Amend AS 1201.*
 - Add a new Appendix C that supplements the requirements for applying the supervisory principles in AS 1201.05–.06 when using the work of an auditor-employed specialist to assist the auditor in obtaining or evaluating audit evidence, including requirements related to:

⁴⁶ This evaluation is not explicitly required under the Board's existing standards, other than under AS 2502 with respect to the significant assumptions of a company's specialist regarding fair value measurements and disclosures.

⁴⁷ Certain provisions of the final amendments include references to a new auditing standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* ("AS 2501, as adopted"), which is being adopted in the Estimates Release.

- Informing the auditor-employed specialist of the work to be performed;
 - Coordinating the work of the auditor-employed specialists with the work of other engagement team members; and
 - Reviewing and evaluating whether the work of the auditor-employed specialist provides sufficient appropriate evidence. Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and whether the specialist's findings and conclusions are consistent with, among other things, the work performed by the specialist.
- Set forth factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.
- *Replace existing AS 1210.*
 - Replace with AS 1210, as amended, *Using the Work of an Auditor-Engaged Specialist*, which establishes requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence;
 - Include requirements for reaching an understanding with an auditor-engaged specialist on the work to be performed and reviewing and evaluating the specialist's work that parallel the final amendments to AS 1201 for auditor-employed specialists;
 - Set forth factors for determining the necessary extent of review of the work of the auditor-engaged specialist;
 - Amend requirements related to assessing the knowledge, skill, ability, and objectivity⁴⁸ of the auditor-engaged specialist; and

⁴⁸ Under the final amendments, the term "objectivity" is reserved for the auditor-engaged specialist and not used to describe the relationship to the company of a company's specialist or an auditor-employed specialist. See Section IV.D.3 below and Section IV.B.1 of Appendix 3 for further discussion of objectivity.

- Describe objectivity, for purposes of the standard, as the auditor-engaged specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit; and specify the auditor's obligations when the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity.

As discussed in a companion release, the Board is also adopting a single standard to replace its existing standards on auditing accounting estimates and fair value measurements and set forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.⁴⁹ Certain provisions of the final amendments in this release include references to AS 2501, as adopted.

Most of those who commented on the proposed requirements regarding the use of the company's specialist expressed support for strengthening the requirements for evaluating the work of a company's specialist and aligning them with the Board's risk assessment standards. For example, one commenter stated that it agreed with statements in the Proposal that the proposed requirements may result in some auditors gaining a better understanding of a company's critical accounting estimates related to relevant financial statements and disclosures. Another commenter stated that the application of a risk-based approach to the testing and evaluation of the work of a company's specialist would reduce the risk of an auditor failing to sufficiently address the risks of material misstatement.

A few commenters disagreed with the approach, or aspects of the approach, for evaluating the work of a company's specialist as described in the Proposal. One commenter asserted that additional clarification for using the work of a company's specialist was needed to address practicability issues and avoid unnecessary costs. Another commenter suggested that the amendments should place greater weight on the professional requirements and certifications for certain company specialists.

⁴⁹ As discussed in the Estimates Release, the Board is retitling and replacing existing AS 2501, *Auditing Accounting Estimates*, and superseding AS 2502 and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AS 2501, as adopted, also includes a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence.



The Board recognizes that the auditor does not have the same expertise as a person trained or qualified to engage in the practice of another profession. At the same time, establishing a uniform, risk-based approach for using the work of a company's specialist more clearly acknowledges the different roles of a company's specialist and an auditor's specialist and builds upon improvements observed in the practices of certain firms. The final amendments also clarify aspects of the proposed amendments, including the procedures for evaluating the work of a company's specialist, so that the required procedures are both practical and risk-based, and reasonably designed to lead to improvements in audit quality.⁵⁰

Commenters on the proposed requirements for using an auditor's specialist generally agreed with a risk-based supervisory approach for both auditor-employed and auditor-engaged specialists. For example, one commenter agreed that this approach would promote an improved, more uniform approach to the supervision of an auditor's specialists. Consistent with the view of these commenters, the final amendments apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists, which should enhance investor protection.

IV. Economic Considerations

The Board is mindful of the economic impacts of its standard setting. This economic analysis describes the baseline for evaluating the economic impacts of the final amendments, analyzes the need for the final amendments, and discusses potential economic impacts of the final amendments, including the potential benefits, costs, and unintended consequences. The analysis also discusses alternatives considered.

In the Proposal, the Board had requested input from commenters on their views pertinent to the economic considerations, including the potential benefits and costs, discussed in the Proposal. One commenter stated that it believed the Proposal can be effectively implemented with minimal cost. Several commenters expressed concern, however, that the cost of the Proposal would be relatively greater for smaller audit firms and certain smaller companies. Some commenters also asserted that the Proposal would adversely affect the ability of smaller firms to compete in the audit services market. A number of commenters suggested that the incremental cost of certain aspects of the Proposal would outweigh any increase in audit quality. Finally, some commenters expressed concern that the Proposal could result in a shortage of qualified

⁵⁰ See Section III of Appendix 3 for a more detailed discussion of the final amendments and clarifications regarding using the work of a company's specialist.

specialists due to, for example, a potential increase in the demand for specialists by some audit firms under the proposed requirements.⁵¹

The Board has considered all comments received, and has made certain changes to the final amendments to reflect those comments, including changes that mitigate some of the concerns expressed above with respect to the Proposal. The Board has also sought to develop an economic analysis that evaluates the potential benefits and costs of the final amendments, as well as facilitates comparisons to alternative Board actions. There are limited data and research findings available to estimate quantitatively the economic impacts of discrete changes to auditing standards in this area, and furthermore, no additional data was identified by commenters that would allow the Board to generally quantify the expected economic impacts (including expected incremental costs related to the Proposal) on audit firms or companies.⁵² Accordingly, the Board's discussion of the economic impact is qualitative in nature.

A. Baseline

Sections II.B-.C above discuss existing PCAOB requirements for using the work of specialists and existing practice in the application of those requirements. This section addresses from an economic perspective: (1) the prevalence and significance of audits involving specialists; (2) the existing audit requirements that apply to the use of the work of specialists; and (3) the quality of audits that involve specialists, based on observations from regulatory oversight and academic literature.

1. Prevalence and Significance of Audits Involving Specialists

a. Evidence from PCAOB Inspections Data

The Proposal observed that the PCAOB staff's analysis of inspections data for audits of issuers suggests that larger audit firms extensively use the work of specialists, in particular auditor-employed specialists, while smaller audit firms generally have a

⁵¹ See Section IV.C.3.e for a discussion of revisions to the proposed requirements in the final amendments to address this concern.

⁵² One commenter provided anecdotal data on certain aspects of the Proposal that was limited to the commenter's experience in one specialized area. The data provided by this commenter, therefore, could not be used to quantify expected economic impacts that would generally apply to the use of the work of specialists.

lower percentage of audit engagements in which they use the work of a company's specialist or an auditor's specialist.

The conclusion regarding larger audit firms was based on a staff analysis of the 274 issuer audits⁵³ by U.S. audit firms affiliated with global networks⁵⁴ that were selected for inspection in 2015. This analysis found that auditors used the work of at least one auditor-employed specialist in about 85 percent of those audits. For the 85 percent of those audits that involved the use of auditor-employed specialists, an average of four to five individual specialists performed some work on each audit. In addition, on each of those audits, specialists performed work in one to two fields of expertise on average.⁵⁵ The results indicate that such audits typically had more than one specialist performing work in the same area of expertise.

The Proposal further noted that PCAOB inspections data for issuer audits suggested that, in contrast to larger audit firms, smaller U.S. audit firms generally have fewer audit engagements in which they use the work of a company's specialist or an auditor's specialist. Specifically, the staff analyzed data from the 361 audits performed by U.S. audit firms not affiliated with one of the global networks that were selected for inspection by the PCAOB in 2015. Of those 361 issuer audits, the staff identified: (1) 36 audits (i.e., about 10% of the analyzed audit engagements) in which the auditor used the work of a company's specialist but did not use the work of an auditor's specialist; (2) 24 audits (i.e., about 7% of the analyzed audit engagements) in which the auditor used the work of an auditor's specialist but did not use the work of a company's specialist; (3)

⁵³ This analysis was performed on engagement-level data obtained through PCAOB inspections. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of the work of specialists across a broader population of companies. On average, the engagements selected for inspection are more likely to be complex (and thus more likely to involve the use of the work of a specialist) than the overall population of audit engagements.

⁵⁴ These firms consist of those U.S. audit firms that are registered with the PCAOB and affiliated with one of the six largest global networks, based on information on network affiliations reported by U.S. audit firms on Form 2 in 2017 and identified on the "Global Networks" overview page, available on the Board's website.

⁵⁵ The data used in this analysis did not indicate how frequently the auditor used the work of an auditor-engaged specialist.

30 audits (i.e., about 8% of the analyzed audit engagements) in which the auditor used the work of a company's specialist and an auditor's specialist; and (4) 271 audits (i.e., about 75% of the analyzed audit engagements) in which the auditor neither used the work of a company's specialist nor used an auditor's specialist.

A staff analysis of the 700 issuer audits by audit firms that were selected for inspection in 2017 is broadly consistent with the conclusions in the Proposal regarding the prevalence and significance of audits involving specialists.⁵⁶ The results of this analysis are summarized in the table below:

⁵⁶ The discussion in footnote 53 that applies to the 2015 analysis—regarding the selection of inspected audit engagements and how such engagements likely compare to the overall population of audit engagements—likewise applies to this 2017 analysis. Unlike the 2015 analysis, the engagement-level data selected for the analysis of PCAOB inspections performed in 2017 included data on issuer audit engagements conducted by non-U.S. as well as U.S. audit firms. In addition, this engagement-level data was based on specific focus areas, such as recurring audit deficiencies and audit areas that may involve significant management or auditor judgment, for issuer audit engagements selected for inspection. For a more detailed discussion of PCAOB inspection focus areas, see PCAOB, *Staff Inspection Brief: Information about 2017 Inspections*, Vol. 2017/3 (Aug. 2017).

Figure 4 - Audits performed by U.S. and non-U.S. audit firms that were selected for inspection by the PCAOB in 2017, categorized by use of the work of specialists

	<i>% (number) of audits by larger audit firms (U.S.)</i>	<i>% (number) of audits by smaller audit firms (U.S.)</i>	<i>% (number) of audits by larger audit firms (non-U.S.)</i>	<i>% (number) of audits by smaller audit firms (non-U.S.)</i>
(1) auditor used the work of a company's specialist but did not use the work of an auditor's specialist	8% (26)	10% (28)	8% (7)	6% (1)
(2) auditor used the work of an auditor's specialist but did not use the work of a company's specialist	20% (66)	2% (6)	34% (29)	0% (0)
(3) auditor used the work of both a company's specialist and an auditor's specialist	41% (136)	6% (17)	29% (25)	0% (0)
(4) auditor neither used the work of a company's specialist nor used an auditor's specialist ⁵⁷	31% (102)	81% (216)	29% (25)	94% (16)
Total ⁵⁸	100% (330)	100% (267)	100% (86)	100% (17)

Source: PCAOB

As indicated by Figure 4, auditors used the work of an auditor's specialist in 61% and 63% of the analyzed audit engagements (the sum of categories (2) and (3) above) by larger audit firms—U.S. and non-U.S. firms, respectively—selected for inspection in 2017. Auditors used the work of a company's specialist without also using the work of an auditor's specialist (category (1) above) in only 8% of the analyzed audit engagements of larger audit firms—both U.S. and non-U.S. firms, respectively—selected for inspection in 2017. These results are also consistent with the anecdotal evidence discussed in Section II.C (i.e., that larger audit firms generally require their

⁵⁷ The audit engagements not included in the preceding three categories were included in the fourth category.

⁵⁸ The total for the values shown in categories (1) through (4) may not add to 100% due to rounding.

engagement teams to evaluate the work of a company's specialist, including the specialist's methods and significant assumptions, and often employ specialists to assist their audit personnel in evaluating that work).

The results for smaller audit firms in Figure 4 are also consistent with the analysis in the Proposal and suggest that the work of an auditor's specialist or a company's specialist is used in relatively few audits. Specifically, in 81% and 94% of the audits by smaller audit firms—U.S. and non-U.S. firms, respectively—the auditor neither used the work of a company's specialist nor used an auditor's specialist (category (4) above), possibly because those audits did not involve circumstances that warranted the use of specialists by companies or their auditors. Consistent with the analysis of the issuer audits selected for inspection in 2015, the results for smaller audit firms in Figure 4 further suggest that, when smaller audit firms use the work of a company's specialist, they often use that work without concurrently using the work of an auditor's specialist. In 62% of the audits by smaller U.S. firms that involved the use of the work of a company's specialist, the audit firm did not concurrently use the work of an auditor's specialist.⁵⁹ An auditor's specialist also was not concurrently involved in the only audit by a smaller non-U.S. firm that involved the use of the work of a company's specialist (category (1) above).

b. Evidence from the Academic Literature

Consistent with the results of the staff analysis, the academic literature suggests that, when a company uses a company's specialist, some larger audit firms also tend to use the work of an auditor's specialist, at least in the context of audits involving challenging fair value measurements.⁶⁰ Furthermore, the academic literature also suggests that the use of valuation specialists is prevalent for at least some audits. One recent study of audits by the four largest firms that involved challenging fair value measurements found that 86% of audit teams used an auditor's specialist, including

⁵⁹ Specifically, out of the 45 audit engagements of smaller U.S. firms that involved the use of the work of a company's specialists (the sum of categories (1) and (3) in Figure 4), 28 engagements did not concurrently involve the use of the work of an auditor's specialist (category (1) in Figure 4).

⁶⁰ See, e.g., Nathan H. Cannon and Jean C. Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, 92 (4) *The Accounting Review* 81 (2017) (study using an experiential questionnaire involving audit partners and managers of Big 4 firms in audits involving challenging fair value measurements).

employed and engaged specialists.⁶¹ In addition, 60% of the companies in this study used a company's specialist, including employed and engaged specialists.⁶² The audits that were included in this study may not be representative of all audit engagements, because they were selected in order to study engagements that involved material, highly challenging fair value measurements. However, the results suggest that the use of an auditor's specialist is at least prevalent among audits performed by the four largest U.S. firms where a company's specialist is used to assist in the development of highly challenging and material fair value measurements, which may also be audit areas with a high risk of material misstatement and thus a need for greater audit attention.⁶³

Furthermore, the academic literature also corroborates the characterizations discussed in Section II.C regarding the current practice of audit firms when using specialists. Academic studies suggest that, at least among the audits that were studied where specialists were used, larger firms were more likely to use the work of auditor-employed specialists than auditor-engaged specialists in their engagements,⁶⁴ while

⁶¹ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field* 90. In another study of how auditors use valuation specialists, auditors from seven large U.S. audit firms who were interviewed stated that, on average, 61% of their engagements in the prior year involved a valuation specialist, including auditor-employed and/or auditor-engaged specialists. See Emily E. Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 13 (July 2016) (working paper, available in Social Science Research Network ("SSRN")).

⁶² See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field* 90.

⁶³ Another recent qualitative study conducted through interviewing audit partners, managers, and seniors also observed that auditors in the six large audit firms in Canada consider factors such as the "client's regulatory environment and other general risk factors," "lack of subject matter expertise within the audit team," and "complexity of the engagement" when determining whether to use a specialist. See J. Efrim Boritz, Natalia Kochetova-Kozloski, Linda A. Robinson, and Christopher Wong, *Auditors' and Specialists' Views About the Use of Specialists During an Audit* 28, 35 (Mar. 2017) (working paper, available in SSRN).

⁶⁴ See, e.g., Steven M. Glover, Mark H. Taylor, and Yi-Jing Wu, *Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy*, 36 (1) *Auditing: A Journal of Practice & Theory* 63, 75 (2017) ("[R]esults indicate that approximately two-thirds (one-

even among the larger firms there are differences in the extent of their use of the work of auditor-engaged specialists.⁶⁵

A possible explanation for the tendency of larger firms to use the work of auditor-employed specialists (instead of auditor-engaged specialists) is that larger firms, due to the greater number of their audit engagements or their existing non-auditing practices, have sufficient demand for the services of specialists to warrant hiring specialists who work for them full-time. In contrast, smaller firms may not have many audit engagements where the auditor requires the use of an auditor's specialist, so that engaging an auditor's specialist only as needed may be economically more advantageous. In addition, the tendency of smaller firms to look to the work of a company's specialist without using the work of an auditor's specialist may reflect the fact that existing AS 1210 enables the auditor to use the work of a company's specialist in a wide range of situations, without imposing obligations on the auditor that might call for the retention of an auditor's specialist.⁶⁶

third) of our participants reported that they use in-house (third-party) valuation specialists to support the audit work performed for *financial* FVMs [i.e., fair value measurements]. Moreover, approximately 87 percent (13 percent) of the audit partners indicated that they use in-house (third-party) valuation specialists to support the audit work for *nonfinancial* FVMs."); see also Emily E. Griffith, Jacqueline S. Hammersley, and Kathryn Kadous, *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice*, 32 *Contemporary Accounting Research* 833, 836 (2015) ("[A]uditors [from the U.S. audit firms affiliated with the six largest global networks] typically enlist audit-firm specialists in auditing estimates because they do not have valuation expertise...").

⁶⁵ See Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 58. In this study, all participating auditors from Big 4 audit firms indicated that they used internal valuation specialists (i.e., auditor-employed valuation specialists) and did not use any external valuation specialists (i.e., auditor-engaged valuation specialists). In contrast, only 40% of the auditors from the three other audit firms that participated in the study indicated that they exclusively used internal valuation specialists.

⁶⁶ Similarly, the final amendments enable the auditor to use the work of a company's specialist in a wide range of situations, without necessarily obligating the auditor to retain an auditor's specialist.

2. *PCAOB Auditing Standards Regarding Use of the Work of Specialists*

As discussed in more detail in Section II.B, under existing standards, the auditor's primary responsibilities with respect to a company's specialist are set forth in existing AS 1210. That standard also imposes the same responsibilities on auditors with respect to an auditor-engaged specialist, even though an auditor-engaged specialist has a fundamentally different role than a company's specialist. While the auditor's specialist performs work to assist the auditor in obtaining and evaluating audit evidence, the company's specialist performs work that is used by the company in preparing its financial statements and that the auditor may use as audit evidence.

The professional relationships between an auditor and a company's specialist, and between an auditor and an auditor's specialist, differ, among other things, in terms of who is employing or engaging the specialist (i.e., the company in the case of a company's specialist and the auditor in the case of an auditor's specialist). Therefore, the level of control and oversight an auditor is able to exercise over the specialist also differs. Given these differences, which expose a company's specialist and an auditor-engaged specialist to different incentives and biases (e.g., pressure to conform to management bias),⁶⁷ requirements would ideally differentiate between the two types of specialists, but existing requirements do not do so.

In contrast, existing PCAOB requirements for using the work of an auditor-employed specialist, who is subject to supervision under AS 1201, differ from the requirements that apply to using the work of an auditor-engaged specialist. Auditor-employed and auditor-engaged specialists may differ in their economic dependency on the auditor and, by extension, could face different incentives to acquiesce to certain auditor decisions, such as a decision by the auditor to downplay or suppress

⁶⁷ For a discussion of pressures facing a company's specialist, see Divya Anantharaman, *The Role of Specialists in Financial Reporting: Evidence from Pension Accounting*, 22 *Review of Accounting Studies* 1261, 1299-300 (2017) (concluding that "client pressure and opinion shopping" affect the work product of actuaries used by company management, which "suggests potentially greater effects for other specialists not subject to the same levels of oversight (e.g., experts in valuing complex financial instruments and other untraded assets)" and that "economically important clients of their actuaries use more aggressive (obligation-reducing) discount rates [than] less important clients of the same actuary").

unfavorable information in order to accommodate a conclusion sought by the auditor.⁶⁸ While anecdotal evidence from the academic literature related to a company's specialists suggests that employed specialists may face stronger incentives to do so than engaged specialists,⁶⁹ it is difficult to generalize as to whether auditor-employed specialists have a greater economic dependency on auditors than auditor-engaged specialists.⁷⁰ Any potential bias by auditor-employed and auditor-engaged specialists arising from economic dependency on the auditor may be mitigated by the responsibility imposed directly on the engagement partner under AS 1201 for supervision of the work of engagement team members and compliance with PCAOB standards, including those regarding using the work of specialists. In addition, AS 1220, *Engagement Quality Review*, requires the engagement quality reviewer to "evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report." Such significant judgments may include areas where auditors used the work of an auditor-employed or auditor-engaged specialist.

⁶⁸ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 32 ("[A]udit teams delete extraneous information in specialists' memos when that information contradicts what the audit team has documented in other audit work papers...") and 33 ("Auditors and specialists described several defensive behaviors by auditors that restrict specialists' access to information...Restricting specialists' access to information can influence how specialists do their work, what work they do, and what conclusions they reach.").

⁶⁹ See, e.g., J. Richard Dietrich, Mary S. Harris, and Karl A. Muller III, *The Reliability of Investment Property Fair Value Estimates*, 30 *Journal of Accounting and Economics* 125, 155 (2001) ("[O]ur investigation reveals that the reliability of fair value estimates varies according to the relation between the appraiser and the [company] (internal versus external appraiser)...We find evidence that appraisals conducted by external appraisers result in relatively more reliable fair value accounting estimates (i.e., lower conservative bias, greater accuracy and lower managerial manipulation).").

⁷⁰ The extent of economic dependency of an auditor-employed specialist on the auditor will depend, for example, on how much of the specialist's work and the specialist's compensation is related to audits (as opposed to non-audit services), which may vary for different auditor-employed specialists. Similarly, the extent of economic dependency of an auditor-engaged specialist on the auditor will depend on how much of the specialist's overall work or income is connected to the particular audit firm, which may vary for different auditor-engaged specialists.

Furthermore, auditor-employed and auditor-engaged specialists serve similar roles in helping auditors obtain and evaluate audit evidence. Given their similar roles, it seems appropriate that the auditor would follow similar requirements when using both types of specialists, though existing requirements differ for the two types of specialists. A notable difference in the relationship of the auditor with auditor-employed and auditor-engaged specialists, however, relates to the integration of auditor-employed specialists (as compared with auditor-engaged specialists) in an audit firm's or network's quality control system, which allows the auditor greater visibility into any relationships that might affect the auditor-employed specialist's independence, as well as greater visibility into the auditor-employed specialist's knowledge, skill, and ability. The final requirements with respect to evaluating the objectivity, as well as knowledge, skill, and ability, of an auditor-engaged specialist, therefore, sought to reflect that difference by providing the auditor with specific requirements to assess whether the auditor-engaged specialist has both the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and the level of knowledge, skill, and ability to perform the specialist's work related to the audit.

As discussed in more detail in Section IV.D.2.b, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. However, due to the differences in the auditor's ability to assess the specialist's independence, as well as the specialist's knowledge, skill, and ability, the Board is adopting separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist. It is expected that there would be few differences in the procedures undertaken by the auditor when using an auditor's specialist, whether employed or engaged, with such differences limited to the auditor's assessment of the knowledge, skill, ability, and objectivity of an auditor-engaged specialist (where the auditor may not be able to leverage an audit firm's or network's quality control system to perform these assessments).

3. *Quality of Audits That Involve Specialists*

As discussed in Section II.C.2, PCAOB oversight of audit engagements in which auditors used the work of a company's or an auditor's specialist and SEC enforcement actions have identified instances of noncompliance with PCAOB standards, e.g., situations where auditors did not appropriately evaluate the work of specialists. For issuer audit engagements, PCAOB staff have more recently observed a decline in the number of instances in which auditors at some audit firms did not perform sufficient procedures related to the work of an auditor's specialist. There are some preliminary indications that some, but not all, firms with observed deficiencies have undertaken remedial actions in response to such findings, which may have contributed, at least in

part, to improvements in audit quality related to the auditor's use of an auditor's specialist.

Relatively few empirical academic studies have explicitly examined the relationship between the use of specialists and perceptions of audit quality by investors and auditors.⁷¹ This may be because it is difficult, especially for investors, to assess the effect of using specialists on audit quality independently from the effects of other relevant factors, such as the quality of the company's financial reporting or internal controls.⁷² However, available studies have investigated the relationship between the quality of financial statement estimates, which often are provided with the assistance of a company's specialist, and the usefulness of such estimates to investors. These

⁷¹ See, e.g., Brant E. Christensen, Steven M. Glover, Thomas C. Omer, Marjorie K Shelley, *Understanding Audit Quality: Insights from Audit Professionals and Investors*, 33 *Contemporary Accounting Research* 1648, 1667 (2016) ("Audit professionals [that were surveyed as part of the study] associate the use of both external experts and internal specialists with higher audit quality."). Relatedly, one recent academic study examined the relationship between the use of forensic accountants (described by the authors as "specialists") and the value of their involvement as perceived by the auditor. While forensic accountants are not specialists within the scope of this standard, the authors of the study argued that the findings "likely translate into understanding other specialist domains." The authors suggested that the involvement of forensic accountants is accompanied by the "incremental discovery of ... material misstatements," and further stated that "our results indicate both auditors and forensic specialists recognize the value and additional comfort that come from forensic specialist involvement on audits." See J. Gregory Jenkins, Eric M. Negangard, and Mitchell J. Oler, *Getting Comfortable on Audits: Understanding Firms' Usage of Forensic Specialists*, *Contemporary Accounting Research*, in-press 4 (2017).

⁷² While not directly assessing the relationship between the use of specialists and perceptions of audit quality, academic literature has investigated factors that influence an auditor's approach to auditing accounting estimates, including the decision whether to use the work of specialists. See, e.g., Jennifer R. Joe, Scott D. Vandervelde, Yi-Jing Wu, *Use of High Quantification Evidence in Fair Value Audits: Do Auditors Stay in their Comfort Zone?*, 92 (5) *The Accounting Review* 89 (2017); Emily E. Griffith, *When Do Auditors Use Specialists' Work to Improve Problem Representations of and Judgments about Complex Estimates?*, 93 (4) *The Accounting Review* 177 (2018).

studies find that less reliable estimates tend to be less useful to investors.⁷³ Other studies suggest that some estimates are also more likely to be discounted by investors.⁷⁴ Because investors' perceptions of the credibility of financial statements are influenced by their perceptions of audit quality, the auditor's appropriate use of the work of specialists should increase the credibility of the accounting estimates included in the financial statements.

B. Need for the Rulemaking

From an economic perspective, the primary cause for market failure⁷⁵ that motivates the need for the final amendments is the moral hazard⁷⁶ affecting the

⁷³ See, e.g., Scott A. Richardson, Richard G. Sloan, Mark T. Soliman, and Irem Tuna, *Accrual Reliability, Earnings Persistence and Stock Prices*, 39 *Journal of Accounting and Economics* 437, 437-438 (2005) (finding that "less reliable accruals lead to lower earnings persistence ... leading to significant security mispricing").

⁷⁴ See, e.g., Chang Joon Song, Wayne B. Thomas, and Han Yi, *Value Relevance of FAS No. 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms*, 85 *The Accounting Review* 1375 (2010). Furthermore, the academic literature notes that auditing estimates with extreme uncertainty can pose significant challenges for auditors. See, e.g., Brant E. Christensen, Steven M. Glover, and David A. Wood, *Extreme Estimation Uncertainty in Fair Value Estimates: Implications for Audit Assurance*, 31 (1) *Auditing: A Journal of Practice & Theory* 127 (2012).

⁷⁵ For a discussion of the concept of market failure, see, e.g., Francis M. Bator, *The Anatomy of Market Failure*, 72 *The Quarterly Journal of Economics* 351 (1958); and Steven G. Medema, *The Hesitant Hand: Mill, Sidgwick, and the Evolution of the Theory of Market Failure*, 39 *History of Political Economy* 331 (2007).

⁷⁶ The moral hazard problem is also referred to as a hidden action, or agency problem, in economics literature. The term "moral hazard" refers to a situation in which an agent could take actions (such as not working hard enough) that are difficult to monitor by the principal and would benefit the agent at the expense of the principal. To mitigate moral hazard problems, the agent's actions need to be better aligned with the interests of the principal. Monitoring is one mechanism to mitigate these problems. See, e.g., Bengt Holmström, *Moral Hazard and Observability*, 10 *The Bell Journal of Economics* 74 (1979).

auditor's decisions on how to implement audit procedures related to the use of the work of a specialist, which increases the risk of lower audit quality from the investor's perspective.

As described in the Proposal, the moral hazard problem related to the use of the work of a specialist generally manifests in the auditor not performing appropriate procedures, even though such procedures would improve audit quality by increasing the auditor's attention, because the auditor may not perceive sufficient economic benefit (compared to the corresponding costs⁷⁷ and efforts) from such actions. Specifically, when auditors use the work of a company's specialist, moral hazard may take the form of the auditor failing to evaluate data, significant assumptions, and methods used by the specialist to an extent that would be commensurate with the risk of material misstatement inherent in the specialist's work. Moral hazard in the context of auditors using the work of a company's specialist might also take the form of the auditor failing to appropriately assess relationships between the company's specialist and the company.⁷⁸ In addition, when auditors use the work of an auditor's specialist, moral hazard may, for example, take the form of not performing procedures, or performing insufficient procedures, to communicate and reach an understanding with the specialist regarding the specialist's responsibilities and the objectives of the specialist's work, or insufficiently evaluating that work.⁷⁹

⁷⁷ For a discussion of the effect of cost pressures on audit quality, compare James L. Bierstaker and Arnold Wright, *The Effects of Fee Pressure and Partner Pressure on Audit Planning Decisions*, 18 *Advances in Accounting* 25, 40 (2001) (finding, as the result of their experiment, that "auditors significantly reduced budgeted hours ... and planned tests ... in response to fee pressure") with Bernard Pierce and Breda Sweeney, *Cost-Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004) (finding, in relation to the Irish market, that "dysfunctional behaviours" are related to time pressure and performance evaluation).

⁷⁸ See Anantharaman, *The Role of Specialists in Financial Reporting: Evidence from Pension Accounting*, at 1265 (describing empirical evidence that suggests that auditors "have difficulty in screening out relationships" that might impair the "objectivity" of company specialists).

⁷⁹ Alternatively, it is conceivable that, in some situations, moral hazard may take the form of the auditor either influencing the findings or conclusions that specialists reach or modifying the specialist's work after the fact to support the conclusions sought by the auditor. See text accompanying footnote 68.

In such contexts, moral hazard is made possible by the information asymmetry⁸⁰ that exists due to the lack of transparency about the nature of the auditor's work (i.e., between the auditor on the one hand, and investors on the other hand). Investors typically do not know whether an auditor used the work of a specialist and, if so, how the work of the specialist was used. Because of this information asymmetry, the auditor may face little to no scrutiny from investors or others (e.g., audit committees) regarding his or her audit procedures when using the work of specialists,⁸¹ and may perceive limited economic benefits (e.g., gains in revenue, gains in professional reputation, or a reduction in potential liability) in incurring costs to perform additional audit work. Hence, the moral hazard problem between the auditor and investors may have a detrimental impact on audit quality.⁸²

⁸⁰ Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party. For a discussion of the concept of information asymmetry, see, e.g., George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *The Quarterly Journal of Economics* 488 (1970).

⁸¹ This is true for other aspects of the audit engagement as well and hence the audit can be thought of providing investors with a credence service. Credence services are difficult for users of the service (such as investors in the context of company audit services) to value because their benefits are difficult to observe and measure. See Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 *Accounting Horizons* 631 (2012). See also Alice Belcher, *Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies*, 18 *Bond Law Review* 1, 5 (2006) (An "audit is a credence service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company.").

⁸² Additionally, such situations may occur because the auditor made an error in judgment assessing the audit risk involved when using the work of an auditor's specialist or a company's specialist. In situations in which "objectives and the actions needed to achieve them are complex and multifaceted, it is inevitable that different people...will...interpret...them in different ways..." See John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 *Academy of Management Review* 98, 107–108 (2002). When people are choosing their actions in such situations, Hendry argues that the predicted actions (and hence resulting problems) are more or less the same, whether one assumes that they are

Because market forces (e.g., pressure and demands from investors) may not be effective in making the auditor more responsive to investor interests with respect to the use of the work of specialists,⁸³ from an economic perspective, the situation absent standards would be characterized as a form of market failure. While existing standards regarding the use of the work of a company's specialist and an auditor-engaged specialist are intended to address and mitigate potential auditor moral hazard, they could be aligned more closely with the risk assessment standards, which could enhance audit quality. In addition, while auditor-employed specialists are supervised under a risk-based approach, specifying requirements for applying that approach when using an auditor-engaged specialist could promote an improved, more uniform approach to supervision. Additionally, if the work of an auditor's specialist is not properly overseen or evaluated (or the work of a company's specialist is not properly evaluated), there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.⁸⁴

Furthermore, the auditor does not engage or employ a company's specialist and does not supervise the work of a company's specialist. This makes the auditor's use of the work of a company's specialist different from the auditor's use of an auditor's specialist in several important ways. First, because of the different relationships the auditor has with a company's specialist and with an auditor's specialist, the auditor's assessment of the qualifications and relationships of a company's specialist requires greater effort by the auditor compared to the auditor's equivalent procedures with respect to an auditor's specialist. Second, the auditor's consideration of data, significant assumptions, and methods used by the company's specialist may also be more challenging (for example, due to the specialist's use of proprietary data), compared to equivalent procedures performed by the auditor when using a specialist with whom the auditor has an employment or contractual relationship. Third, an auditor is generally more likely to be familiar with an auditor's specialist than with a company's specialist

unselfish yet "prone to mak[ing] mistakes," or instead are self-interested and opportunistic yet unlikely to make mistakes. *Id.* at 100.

⁸³ The degree of responsiveness of the auditor to investor interests, such as increasing audit effort in some circumstances when using the work of specialists, may also be related to, among other things, the auditor's ability to pass on cost increases to companies (and, ultimately, to investors) in the form of higher audit fees. See footnote 101 for a further discussion of cost pass-through.

⁸⁴ See Section II.D.

(e.g., with the professional qualifications, reputation, and work), which reduces the costs associated with the ongoing monitoring of the specialist's work. Given these differences, the standards would ideally differentiate between the two types of specialists, but existing AS 1210 currently does not do so. Accordingly, the potential for moral hazard relating to the auditor's use of the work of a company's specialist is a particular focus of the requirements in the final amendments to AS 1105.

The need to enhance existing standards is further heightened by the fact that it may be particularly challenging for the auditor to evaluate the work of either an auditor's specialist or a company's specialist or to supervise an auditor's specialist. The work of a company's specialist or an auditor's specialist often involves professional judgment, the nature of which the auditor may not fully appreciate when evaluating the work of the specialist. In particular, the specialist's work is highly technical in nature and often is not entirely transparent to the auditor, who may not have complete access to the specialist's work⁸⁵ or the same level of knowledge and skill in the specialist's field.⁸⁶ Thus, due to the potential that an auditor would incur relatively higher cost to supervise an auditor's specialist or to evaluate the work of a company's or an auditor's specialist, the auditor may have incentives to forego procedures related to the use of the work of specialists that could be beneficial to investors.

The potential negative impact on audit quality of the auditor's incentives to forgo procedures is compounded by the possibility that an auditor's specialist may perceive little benefit (compared to the corresponding costs and efforts) in fully carrying out their

⁸⁵ For example, as further discussed in Sections III.C and IV.B of Appendix 3, some commenters on the Proposal expressed concern that the auditor may have limited access to proprietary information used by a company's specialist or an auditor-engaged specialist (as compared with information used by an auditor-employed specialist). The final amendments do not require the auditor to obtain such proprietary information, but instead to obtain sufficient information to assess whether the model is in conformity with the applicable financial reporting framework.

⁸⁶ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 23 ("[Results] show[] that many auditors review specialists' work for general understanding and sufficiency of the work performed, rather than reviewing in detail as they would in other areas of the audit. They approach the review this way because they cannot fully understand specialists' work.").

responsibilities, including the objectives of the work to be performed.⁸⁷ Alternatively, the specialist may in some instances believe that he or she faces few negative consequences (such as an increase in potential liability) when performing low quality work or, as one commenter on the Proposal asserted, an auditor's specialist may not set forth conclusions anticipated to be rejected by the auditor. However, any such concerns are at least partially alleviated to the extent specialists are subject to codes of conduct, standards, and disciplinary processes of their own profession or could perceive a risk of reputational damage.⁸⁸

The Proposal stated that enhanced performance standards regarding the use of the work of specialists might improve audit quality and benefit investors. One commenter asserted that the Proposal had not articulated a pervasive problem that would be solved by a change in auditing standards. This commenter further stated that it was not persuaded that a change in the audit framework for the auditor's use of specialists was necessary, based on its view that a significant amount of audit work is currently being performed. The Board believes, however, that the changes in the final amendments described in Section III are needed (and preferable to other policy-making approaches)⁸⁹ because market forces alone cannot mitigate the moral hazard problem described above.

Strengthening the requirements for evaluating the work of a company's specialist, as well as applying a risk-based supervisory approach when using the work of both

⁸⁷ To the extent that an auditor's specialist has a stronger relationship with the auditor (e.g., repeated business interactions between the specialist and the auditor), the potential for moral hazard arising in the context of the auditor using such an auditor's specialist could be higher. However, a stronger relationship between the auditor and the auditor's specialist may also result in the specialist's work being more commensurate with the risk of material misstatement associated with the financial statement assertion and, therefore, improve audit quality.

⁸⁸ See, e.g., Letter from American Academy of Actuaries (Aug. 29, 2017), at 1–2, available on the Board's website in Docket 044 (stating that the Academy's members "are subject to a code of professional conduct, standards of qualification and practice, and a disciplinary process" and that "our profession has a specific standard that defines appropriate practice for actuaries during the course of an audit").

⁸⁹ See Section IV.D.1 for a discussion of why the Board believes that standard setting is preferable to other policy-making approaches.

auditor-employed and auditor-engaged specialists, will prompt auditors to plan and perform audit procedures commensurate with the risk of material misstatement inherent in the specialist's work, and thereby mitigate the moral hazard problem. The final amendments direct more audit attention and effort, when using the work of specialists, to areas where the specialist's work is more significant to the auditor's conclusion on a financial statement assertion and the risk of material misstatement is higher.

Specifically, as discussed in Section III.C of Appendix 3, the final amendments mitigate the moral hazard problem by linking the auditor's responsibilities for determining the necessary evidence when evaluating the work of the company's specialist, including the data, significant assumptions, and methods used by the specialist, to four factors: the risk of material misstatement of the relevant assertion; the significance of the specialist's work to the auditor's conclusion regarding that assertion; the level of knowledge, skill, and ability of the specialist; and the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Further, the final amendments mitigate the moral hazard problem in the context of the use of the work of an auditor's specialists by clarifying the auditor's supervisory responsibilities over auditor-employed specialists and establishing parallel requirements when auditors use the work of auditor-engaged specialists, as discussed in Section IV of Appendix 3. In addition, the necessary extent of supervision under the final amendments depends on factors similar to those that govern the necessary auditor effort in evaluating the work of a company's specialist.

C. Economic Impacts

The magnitude of the benefits and costs of the final amendments will be affected by the nature of and risks involved in the work performed by specialists, because more complex work and work in areas of greater risk will likely require greater audit effort, holding all else constant. In addition, benefits and costs are likely to be affected by the degree to which auditors have already adopted audit practices and methodologies that are similar to those that the final amendments will require.⁹⁰

⁹⁰ Additionally, the new standard and related amendments in the Estimates Release may affect the future prevalence and significance of the use of the work of specialists and, therefore, have an impact on the benefits and costs of the final amendments discussed in this release.

The remainder of this section discusses the potential benefits, costs, and unintended consequences that may result from the final amendments the Board is adopting.

1. *Benefits*

The requirements in the final amendments are expected to benefit investors and auditors by directing auditors to devote more attention to the work of specialists and enhancing the coordination between auditors and their specialists. This should mitigate the problem of auditor moral hazard discussed in the preceding section and contribute to improved audit quality. The final amendments are intended to accomplish this, and increase the likelihood that auditors will detect material misstatements, through requirements that take into account current auditing practices by some larger audit firms and more strongly align auditors' interests with the interests of investors when auditors use the work of specialists. At the same time, by fostering improved audit quality, the final amendments should increase investors' perception of the credibility of a company's financial statements, and help address uncertainty about audit quality and the potential risks associated with the use of the work of company specialists, auditor-employed specialists, and auditor-engaged specialists.

The Board believes that investors will benefit from the final amendments because the application of the requirements should result in more consistently rigorous practices among auditors when using the work of a company's specialist in their audits, as well as a more consistent approach to the supervision of auditor-employed and auditor-engaged specialists. The current divergence in practices related to the auditor's use of the work of specialists, combined with a lack of information about such divergence, could mean that investors are unable to distinguish the quality of each audit separately, which in turn could lead investors to discount the quality of all audits. Conversely, greater consistency in such practices—such as would be promoted by the final amendments—could mitigate those concerns by both enhancing the quality of less rigorous audits and correcting the inappropriate discounting of more rigorous audits. From an investor's perspective, and as one commenter concurred, the increase in audit quality that should result from the final amendments should contribute to investor protection. Specifically, an increase in audit quality may increase the quality of the information provided in a company's financial statements and decrease the cost of

capital for that company,⁹¹ especially if less information is available about the company because it has a shorter financial reporting history.⁹²

From a broader capital markets perspective, an increase in the information quality of a company's financial statements because of improved audit quality can increase the efficiency of capital allocation decisions. In other words, an increase in the information quality of companies' financial statements can reduce the non-diversifiable risk to investors and generally should result in investment decisions by investors that more accurately reflect the financial position and operating results of each company.⁹³

⁹¹ See, e.g., Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 385, 386-7 (2007) ("[A]ccounting information influences a [company's] cost of capital ... where higher quality accounting information ... affects the market participants' assessments of the distribution of future cash flows"); see also Randolph P. Beatty, *Auditor Reputation and the Pricing of Initial Public Offerings*, 64 *The Accounting Review* 693, 696 (1989) ("Since auditing firms that have invested more in reputation capital have greater incentives to reduce application errors, the information disclosed in the accounting reports audited by these firms will be more precise, *ceteris paribus*. This reduction in measurement error will allow uninformed investors to estimate more precisely the distribution of firm value.").

⁹² See, e.g., Jeffrey A. Pittman and Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, 37 *Journal of Accounting and Economics* 113, 114 (2004) ("[E]ngaging [an audit firm with] a brand name reputation for supplying higher-quality audit that enhances the credibility of financial statements, enables young [companies] to reduce their borrowing costs...[O]ur research suggests that the economic value of auditor reputation declines with age as [companies] shift toward exploiting their own reputations to reduce information asymmetry.").

⁹³ See, e.g., Lambert et al., *Accounting Information, Disclosure, and the Cost of Capital* 388 (finding that information quality directly influences a company's cost of capital and that improvements in information quality by individual companies unambiguously affect their non-diversifiable risks.); Ahsan Habib, *Information Risk and the Cost of Capital: Review of the Empirical Literature*, 25 *Journal of Accounting Literature* 127, 128 (2006) ("A commitment to increased level [and quality] of disclosure reduces the possibility of information asymmetries and hence should lead to a lower cost of capital effect. ... In addition, high quality auditing ... could provide credible information in the market regarding the future prospect of the [company] and hence

In addition to the general benefits to investors and the capital markets described above, the final amendments should result in specific benefits to auditors. In particular, the final amendments should lead to improvements in the ability of auditors to supervise auditor-employed and auditor-engaged specialists and evaluate their work, to the extent that auditors devote more attention to the work of auditor-employed and auditor-engaged specialists and enhance the coordination with those specialists. The final amendments with regard to the use of the work of a company's specialist should also lead to improvements in the auditor's understanding of the data, significant assumptions, and methods used by the company's specialist. As auditors are better able to identify and detect potential risks of material misstatement, this may also spur companies and their specialists over time to improve the quality of financial reporting and their work.

The final amendments may also contribute to the aggregate benefits of the auditing standards (i.e., by enhancing auditors' understanding of, and compliance with, other PCAOB auditing standards), in addition to the other improvements in audit quality described above. For example, the final amendments to evaluate the work of a company's specialist should result in some auditors developing a better understanding of the company's accounting estimates in significant financial statement accounts and disclosures. In turn, this may also result in improved communications with audit committees.⁹⁴

The magnitude of the benefits discussed in this section resulting from improved audit quality will likely vary to the extent that current practices are aligned with the final amendments. Based on observations from the Board's oversight activities, most firms would need to enhance their methodologies, but to varying degrees. In general, both the greatest changes and the greatest benefits are likely to occur with auditors that need to enhance their methodologies the most.

could reduce the cost of capital in general, and cost of equity capital in particular." (footnote omitted)).

⁹⁴ See paragraphs .12c and .13c of AS 1301, *Communications with Audit Committees*, for the auditor's communication requirements related to the company's critical accounting estimates.

2. Costs

The Board recognizes that the benefits of the final amendments will come at additional costs to auditors and the companies they audit. As with any changes to existing requirements, it is anticipated that there will be one-time costs for auditors associated with updating audit methodologies and tools, preparing new training materials, and conducting training.⁹⁵ The final amendments could also give rise to recurring costs in the form of additional time and effort spent on any individual audit engagement by specialists and engagement team members.

The most significant impact of the final amendments on costs for auditors is expected to result from the requirements to evaluate the work of a company's specialist. This area of potential impact was also noted by some commenters on the proposed requirements for testing and evaluating the work of a company's specialist.

Compared with the existing requirements,⁹⁶ the auditor will be required under the final amendments to evaluate the significant assumptions used by the company's specialist whenever the specialist's work is used, rather than only in certain circumstances,⁹⁷ as well as the methods used by the specialist. In practice, these requirements may result in auditors performing more work or using an auditor's specialist to assist them in evaluating the work of a company's specialist. This may lead to significant changes in practice for some firms, particularly smaller firms that currently do not employ specialists and follow methodologies solely based on existing AS 1210, even though the final amendments do not require the auditor to use the work of an auditor's specialist.

⁹⁵ The PCAOB has observed that larger firms are likely to update their methodologies using internal resources, whereas smaller firms are more likely to purchase updated methodologies from external vendors.

⁹⁶ See existing AS 1210.12.

⁹⁷ In circumstances when an auditor is auditing fair value measurements and disclosures in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurements and disclosures.

Compared to the Proposal, however, the final amendments clarify the auditor's responsibility when evaluating the work of the company's specialist and, therefore, should further limit any incremental cost to circumstances where increases in audit quality can be reasonably expected. For example, as detailed in Section III.C of Appendix 3, the final amendments reflect changes to the Proposal relating to the auditor's evaluation of the data, significant assumptions, and methods used by the company's specialist. These revisions clarify that the focus of the auditor's evaluation does not require reperforming the specialist's work. Instead, the auditor's responsibility is to evaluate whether the specialist's work provides sufficient appropriate evidence to support a conclusion regarding whether the corresponding accounts or disclosures in the financial statements are in conformity with the applicable financial reporting framework.

In addition, some of the expected cost increases for auditors due to the final amendments are likely to be offset by the implementation of more risk-based audit approaches in practice (e.g., more targeted procedures when using the work of specialists). More risk-based audit approaches reduce the risk to the auditor of failing to detect material misstatement and thus could lead to a reduction in costs resulting from potential liability or reputational loss faced by auditors.

The final amendments' impact on costs for auditors could also vary based on the size and complexity of an audit engagement. Holding all else constant, anticipated costs generally would be higher for larger, more complex audits than for smaller, less complex audits.⁹⁸ As discussed in Section IV.A.1, a smaller portion of audits performed by smaller audit firms tend to involve use of the work of specialists, compared with audits performed by larger audit firms. Accordingly, it is reasonable to infer that relatively fewer audits of smaller firms will be impacted by the final amendments than audits of larger firms.

The impact of the final amendments would also likely vary, however, depending on the extent to which elements of the final amendments have already been incorporated in an audit firm's methodologies or applied in practice by individual engagement teams. For auditors that have already implemented elements of the final

⁹⁸ See Letter from American Academy of Actuaries (July 31, 2015), at 18, available on the Board's website in Docket 044 (stating that "smaller audit firms also tend to have clients that require fewer special needs" and thus implying that audit engagements of smaller audit firms tend to be less complex than audit engagements of larger audit firms).

amendments, the costs of implementing the final amendments will be lower than for firms that currently perform more limited audit procedures. For example, some firms employ procedures to reach and document their understanding with an auditor's specialist about, among other things, the responsibilities of the auditor's specialist and the nature of the work to be performed. Firms that do not already employ such procedures may incur additional costs under the final amendments.

Similarly, the incremental impact of the final amendments on costs incurred by auditors would likely vary depending on, among other things, how many of an audit firm's engagements involve the use of the work of specialists. Among audit firms that use the work of specialists on their engagements, the anticipated costs would likely be higher for those firms that use the work of specialists more frequently or extensively than for firms that do so less frequently or extensively. Larger audit firms generally perform a larger number of audit engagements, however, and the incremental impact of the final amendments on their costs per engagement should be lower than for smaller firms that generally perform a smaller number of audit engagements. This would be the case regardless of whether the audit engagements of the larger and smaller firms involve the use of the work of specialists, since larger firms, due to their existing economies of scale⁹⁹ and scope,¹⁰⁰ would tend to be able to distribute the overall cost impact of the final amendments over a larger number of audit engagements.

⁹⁹ See *Economies of Scale and Scope*, The Economist, Oct. 20, 2008 (available at <https://www.economist.com/news/2008/10/20/economies-of-scale-and-scope>) ("Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output [i.e., number of audit engagements] increases."). In this context, the average cost would likely fall with the number of audit engagements, because certain costs, such as the cost of employing specialists, are not directly related to the number of audit engagements that an auditor assumes. See also Simon Yu Kit Fung, Ferdinand A. Gul, and Jagan Krishnan, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing* 87 *The Accounting Review* 1281, 1287 (2012) ("For an audit firm, the scale economies can arise from substantial investment in general audit technology (e.g., audit software development or hardware acquisition) and human capital development (e.g., staff training), which are likely to be shared among all of their clients. Once these investments are in place, additional clients can be serviced at a lower marginal cost than the cost of servicing the first few clients.").

¹⁰⁰ See *Economies of Scale and Scope*, The Economist ("[E]conomies of scope [are] factors that make it cheaper to produce a range of products together than to produce

Some commenters argued that the Proposal could lead, in some instances, to significant (and potentially pervasive) increases in auditing costs, due to increased audit effort that would not necessarily be accompanied by corresponding increases in audit quality. In contrast, one commenter asserted that the requirements could be implemented effectively with minimal costs. In adopting the final amendments, the Board modified certain of the proposed amendments with the intent that the final amendments be risk-based and scalable, and that any cost increases be accompanied by commensurate improvements in audit quality. For example, as discussed earlier in this section, the final amendments reflect changes to the Proposal relating to the auditor's evaluation of the data, significant assumptions, and methods used by the company's specialist. These changes clarify that the focus of the auditor's evaluation does not require reperforming the specialist's work and thus should limit incremental costs to situations where more auditor involvement is necessary to address the identified risk of material misstatement.

The final amendments might result in additional costs for some companies, compared to costs incurred under current requirements, to the extent that the final amendments lead auditors to raise their audit fees.¹⁰¹ Such additional costs could vary for the same reasons as described above relating to the final amendments' potential impact on costs incurred by auditors. The final amendments could also give rise to new recurring costs for management, to the extent that the final amendments result in the

each one of them on its own. Such economies can come from businesses sharing centralised functions...").

¹⁰¹ It is not clear to what extent the final amendments will result in higher audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees and suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard setters have issued new standards and amended other standards during that period. See, e.g., Audit Analytics, *Audit Fees and Non-Audit Fees: A Fifteen Year Trend* (Dec. 2017). For a general discussion of cost pass-through, see, e.g., James Bierstaker, Rich Houston, Arnold Wright, *The Impact of Competition on Audit Planning, Review, and Performance*, 25 *Journal of Accounting Literature* 1, 12 (2006) (summarizing research on the market for audit services and finding "there is evidence of lower fee premiums when clients switch auditors, suggesting that auditors are less able to pass on the increased costs associated with new audits in a more competitive environment"); and RBB Economics, *Brief 48: The Price Effect of Cost Changes: Passing Through and Here to Stay* 1, 3 (Dec. 2014).

need for companies to devote more time and resources to respond to auditor inquiries and requests. Some commenters on the Proposal expressed concern about the potential cost to companies, including smaller companies. For example, one commenter suggested that companies might need to provide more support for their discount rate assumptions under the proposed amendments. On the other hand, another commenter suggested that, in the context of the size of the U.S. fixed income market, consistent use of methodologies compliant with fair value accounting requirements by companies would be a small cost to bear.

For many companies (and, indirectly, investors), however, the final amendments should not result in significant additional costs or significantly increased audit fees, particularly recurring costs, as their auditors, especially if they are larger audit firms, may have already incorporated many or all elements of the final amendments into their audit methodologies, and individual engagement teams may already be applying many or all of the final amendments in practice. In addition, the changes from the Proposal reflected in the final amendments, which clarify the auditor's responsibility when evaluating the work of the company's specialist, should mitigate some of the potential additional costs suggested by commenters.

3. *Unintended Consequences*

In addition to the benefits and costs discussed above, the final amendments could have unintended economic impacts, the possibility of which the Board has taken into account in adopting the final amendments. The discussion below describes the potential unintended consequences that were identified in the Proposal or by commenters, as well as the Board's consideration of such consequences in adopting the final amendments. The discussion also addresses, where applicable, factors that mitigate the potential negative consequences, including revisions to the proposed amendments reflected in the final amendments and the existence of other countervailing factors.

a. *Potential Adverse Impact on the Ability of Smaller Firms to Provide Audit Services*

In instances where the final amendments would increase the need of some audit firms to use the work of an auditor's specialist (rather than only use the work of a company's specialist under existing AS 1210), the final amendments might result in some smaller firms accepting fewer audit engagements that would require the use of an auditor's specialist. Relatedly, in such instances, some smaller firms might be inhibited from expanding their audit services for similar reasons. The Board had acknowledged the possibility of such unintended consequences in the Proposal, and some commenters also expressed the view that the proposed amendments might adversely impact the ability of smaller firms to provide audit services in certain situations.

In particular, to the extent that auditors at smaller audit firms have less experience evaluating the work of a company's specialist than auditors at larger firms, some auditors may have an increased need to use the work of an auditor's specialist for certain engagements. Potentially, such firms would be unable to take advantage of the economies of scale and scope available to larger firms (for example, if they did not employ their own specialists and had to identify and engage qualified specialists), and find it economically less attractive to accept such engagements. In addition, some commenters on the Proposal suggested more broadly that the ability of smaller firms to compete in the audit services market would be adversely affected. The Board acknowledges that the final amendments could have a more significant impact on smaller firms than on larger firms. However, the Board believes that two factors will lessen any such adverse impact of the final amendments on smaller firms.

First, as described earlier in this release, the evidence from PCAOB inspections data indicates that smaller audit firms generally have comparatively few audit engagements in which they use the work of a company's specialist or an auditor's specialist. For example, the results for smaller audit firms in Figure 4 of Section IV.A.1 indicate that the auditors did not use the work of either a company's specialist or an auditor's specialist in 81% and 94% of the audits of smaller audit firms—U.S. and non-U.S. firms, respectively—inspected in 2017, and that the auditors used the work of a company's specialist without also using the work of an auditor's specialist¹⁰² in only 10% and 6% of the audits of smaller audit firms—U.S. and non-U.S. firms, respectively—inspected in 2017.¹⁰³ These results suggest that the number of engagements where smaller firms might be faced with using an auditor's specialist for the first time to evaluate the work of a company's specialist under the final amendments is a relatively small proportion of audits subject to the Board's standards.

¹⁰² The fact that the auditor did not use the work of an auditor's specialist does not imply that the auditor should have used the work of an auditor's specialist.

¹⁰³ Furthermore, given that the engagements selected for inspection are on average more likely to be complex (and thus more likely to involve the use of the work of a specialist) than the overall population of audit engagements of smaller audit firms, the percentage results shown above for audits involving the use of the work of specialists are likely greater than the actual percentage of the overall population of audit engagements of smaller audit firms.

Second, there is some evidence that smaller and larger audit firms do not directly compete with one another in some segments of the audit market.¹⁰⁴ To the extent smaller audit firms compete in different segments of the audit market than larger audit firms, the competitive impact of the final amendments on smaller firms would be lessened.

Taking into consideration the factors described above, the final amendments further mitigate the potential adverse impact on the ability of smaller firms to provide audit services involving, or compete for audit engagements that require, the use of the work of specialists. For example, the clarifications in the final amendments for evaluating the work of a company's specialist, such as limiting the use of the term "test" to procedures applied to company-produced information used by the specialist, should alleviate concerns expressed by certain commenters on the Proposal that auditors would be required to reperform the work of a company's specialist. In addition, under the final amendments, auditors are allowed to assess the objectivity of an auditor-engaged specialist along a spectrum, rather than make a binary determination whether they can use the work of an auditor-engaged specialist.¹⁰⁵

b. Potential Diversion of Auditor Attention from Other Tasks that Warrant Attention

In some audit engagements involving specialists, the final amendments might lead auditors to devote more of their attention and resources to the work of a company's specialists (including the related training of audit personnel) and to enhancing the coordination with an auditor's specialists, and less time and resources to other tasks that warrant greater attention.

The potential impact on overall audit quality might vary as the re-orientation of attention would occur in different ways for each audit engagement. Any potential adverse impact on overall audit quality is mitigated, however, by the risk-based approach in the final amendments to using the work of specialists. To the extent that the re-orientation of the auditor's attention leads to more effort in areas with the greatest risk

¹⁰⁴ See, e.g., GAO Report No. GAO-03-864, *Public Accounting Firms: Mandated Study on Consolidation and Competition* (July 2003).

¹⁰⁵ Similarly, the final amendments recognize that a company's ability to significantly affect the judgments of a company's specialist may vary and provide for the auditor to evaluate along a spectrum the company's ability to significantly affect those judgments.

of material misstatement to the financial statements, overall audit quality would be expected to increase. Furthermore, if auditors devote more attention to the work of specialists and enhancing the coordination with their specialists, the final amendments will result in some auditors acquiring greater expertise, which could positively affect the quality of audit work performed by such auditors. Such auditor specialization could lead some audit firms to seek fewer audit engagements involving specialists, while other firms might seek more such engagements. In such a market, the competitive effects of increased specialization would likely be highly dependent on the circumstances.

c. Potential for Unnecessary Effort by the Auditor or the Auditor's Specialist

Under the final amendments, the potential exists that auditors might interpret the final requirements to suggest that they should use the work of an auditor's specialist in situations where the auditor had already obtained sufficient appropriate evidence with respect to a relevant assertion of a significant account or disclosure. The Proposal also identified this potential consequence, and some commenters expressed concern that auditors might feel compelled to do more work than was necessary or optimal under the proposed requirements. This unintended consequence might also arise under the final amendments if an auditor had already evaluated the work of a company's specialist, but decided to employ or engage its own specialist to perform additional procedures. For example, the auditor might ask an auditor's specialist to develop or assist in developing an independent expectation of an estimate in order to further demonstrate his or her diligence or err on the side of caution. In some instances, it is possible that the auditor might do so even though the auditor believes the costs of using the work of an auditor's specialist will outweigh the expected benefits in terms of audit quality.

The final amendments, however, mitigate this risk in several respects. In particular, the final amendments do not require the auditor to use the work of an auditor's specialist. Moreover, the final amendments regarding the nature, timing, and extent of the evaluation of the work of the company's specialist are designed to be risk-based and scalable to companies of varying size and complexity. In addition, as discussed above in Section IV.C.3.a, the final amendments clarify the requirements for evaluating the work of a company's specialist and assessing the objectivity of an auditor-engaged specialist, which should avoid unnecessary effort by the auditor or auditor's specialist. Accordingly, any increases in effort should be accompanied by improvements in audit quality.

d. Potential Shift in the Balance Between the Work of a Company's Specialist and the Work of an Auditor's Specialist

In audit engagements involving specialists, the potential exists that the final amendments could affect the balance between the work of a company's specialist and

the work of an auditor's specialist. The Proposal also identified this potential consequence, and some commenters expressed concern that companies might, in some instances, choose not to engage or involve a company's specialist if they expected that the auditor would use an auditor's specialist to perform additional procedures.¹⁰⁶

The final amendments do not change management's responsibility for the financial statements or their obligation to maintain effective internal control over financial reporting. Anticipating the use of an auditor's specialist for the audit engagement, however, some issuers may decide to use a company's specialist to a lesser extent (or not at all) when preparing financial statements and some company specialists may exhibit a reduced sense of responsibility. In such instances, the auditor's specialist may have to perform more work in order to adequately evaluate potential audit evidence provided by the issuer, including the work of a company's specialist if the issuer continues to use such a specialist. Alternatively the auditor may decide not to use the work of a company's specialist or use that work to a lesser extent. If the situations described above were to occur, audit quality might be reduced, not enhanced, in some instances.

The change in the balance between the work of a company's specialist and the work of an auditor's specialist, however, would likely be limited, as companies control the work of a company's specialist over information to be used in the financial statements, but lack similar control over an auditor's specialist. Companies generally are likely, therefore, to prefer to continue their use of a company's specialist. In addition, the final amendments do not require auditors to use an auditor's specialist when using the work of a company's specialist. Moreover, compared to the Proposal, the final amendments clarify the requirements for evaluating the work of a company's specialist. For example, the final amendments clarify the auditor's responsibilities for evaluating the methods and significant assumptions used by the company's specialist, and limit the use of the term "test" to procedures applied to company-produced information used by the specialist. These clarifications should alleviate concerns expressed by certain commenters.

¹⁰⁶ See, e.g., Letter from Duff & Phelps (Aug. 30, 2017), at 4, available on the Board's website in Docket 044 ("situations may arise where management may feel compelled to invest less time, costs and effort in supporting certain assertions in the financial statements by not engaging a specialist when one would otherwise be called for—especially given the expectation that the auditor's specialist would perform extensive testing and calculations as part of the audit").

e. Potential Reduction in the Availability of Specialists

Some commenters on the Proposal suggested that the proposed amendments, if adopted, would not affect the pool of qualified specialists available to serve as auditors' specialists. Other commenters, however, expressed concern that the proposed amendments might result in a shortage of, or strains on, the pool of qualified auditors' specialists, especially in situations where an audit firm currently uses the work of a company's specialist, but does not concurrently use an auditor's specialist.¹⁰⁷ Situations that involved the auditor's use of the work of a company's specialist, but did not concurrently involve the use of an auditor's specialist, comprised a small percentage of audit engagements, ranging from 6% to 10% of the audit engagements of smaller and larger audit firms—U.S. and non-U.S.—that were selected for inspection in 2017 (category (1) of Figure 4 in Section IV.A.1).

Similar to the proposed amendments, the final amendments do not require auditors to use an auditor's specialist when using the work of a company's specialist. Moreover, in comparison to the proposed amendments, auditors are allowed under the final amendments to assess the objectivity of an auditor-engaged specialist along a spectrum, rather than make a binary determination whether they can use the work of an auditor-engaged specialist.¹⁰⁸ This change should also reduce the possibility of a shortage of qualified auditors' specialists. Accordingly, the Board believes that the final amendments should not result in a shortage of, or strains on, the pool of qualified specialists available to serve as auditors' specialists.

D. Alternatives Considered, Including Key Policy Choices

The development of the final amendments involved considering a number of alternative approaches to address the problems described above. This section explains: (1) why standard setting is preferable to other policy-making approaches, such as

¹⁰⁷ Commenters did not specify whether such shortages would be permanent, or instead would reflect a temporary disruption to which the market would adjust over time.

¹⁰⁸ Additionally, the final amendments provide for the auditor to evaluate along a spectrum the company's ability to significantly affect the judgments of the company's specialist. Furthermore, as discussed above, the final amendments reflect changes to the Proposal relating to the evaluation of the data, significant assumptions, and methods used by the company's specialist that clarify that the focus of the auditor's evaluation does not require the auditor to reperform the specialist's work.

providing interpretive guidance or enhancing inspection or enforcement efforts; (2) other standard-setting approaches that were considered by the Board; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

1. *Why Standard Setting Is Preferable to Other Policy-Making Approaches*

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. One commenter stated that the Board should be proactive and supported the Board's preference for standard setting over other policy tools, while other commenters noted that other policy tools, such as the issuance of staff guidance and inspections activity, should also be considered.

While other policy tools may complement auditing standards, the Board has determined that providing additional guidance or increasing its inspection or enforcement efforts, without also amending the existing requirements regarding the auditor's responsibilities for using the work of specialists, would not be effective corrective mechanisms to address concerns with the evaluation of the work of a company's specialist, the supervision of an auditor's specialists, and the sources of market failure discussed in Section IV.B. In addition, while devoting additional resources to such activities might focus auditors' attention on existing requirements, it would not provide the benefits associated with improving the standards discussed in Section IV.C.1. Thus, the final approach reflects the conclusion that standard setting is needed to fully achieve the benefits resulting from improvement in audits involving specialists. The Board will, however, monitor the implementation of the final amendments by audit firms and, if appropriate, consider the need for additional guidance.

2. *Other Standard-Setting Alternatives Considered*

Several alternative standard-setting approaches were also considered, including: (1) retaining the existing framework but requiring the auditor to disclose when the auditor used the work of specialists in the audit; or (2) targeted amendments to existing requirements.

a. *Disclosing When the Work of a Specialist is Used*

As an alternative to amending AS 1105 and AS 1201 and replacing existing AS 1210 in its entirety, the Board considered amending existing AS 1210 to remove the current limitations in existing AS 1210.15 on disclosing that a specialist was involved in the audit. Under this approach, the auditor would have been required to disclose this fact. Investors might benefit from such a requirement, since it would inform investors, at a minimum, that the auditor had evaluated the need for specialized skill or knowledge in order to perform an audit in accordance with PCAOB standards. Such disclosures

could, in theory, positively affect audit practice, as auditors might face more scrutiny from investors regarding their decisions whether or not to use specialists.

Disclosure alone, however, would be unlikely to achieve the Board's objectives, which includes effecting more consistently rigorous practices among auditors when using the work of a company's specialist in their audits, as well as effecting a more consistent approach to the supervision of auditor-employed and auditor-engaged specialists. For example, with disclosure alone, some auditors might not evaluate the significant assumptions and methods of a company's specialist, even in higher risk audit areas.

Moreover, in a separate rulemaking, the Board has adopted a new auditing standard that requires the auditor to communicate in the auditor's report critical audit matters ("CAMs"). A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.¹⁰⁹ Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist. While it is not yet clear how frequently the use of the work of specialists will be disclosed in the auditor's report as part of CAMs, these disclosure requirements are complemented by amending AS 1105 and AS 1201 and replacing existing AS 1210 to improve performance requirements over the use of the work of specialists. As discussed in Section IV.B, this should directly mitigate auditor moral hazard and change certain elements of audit practice observed by PCAOB oversight activities that have given rise to concern, such as situations where auditors did not apply appropriate professional skepticism when using the work of specialists.

b. Targeted Amendments to Existing Requirements for Using the Work of an Auditor's Specialists

The Board considered, but is not adopting, two alternative approaches for an auditor's use of the work of an auditor's specialist, as discussed in further detail in the Proposal. The first alternative was to develop a separate standard for using the work of an auditor's specialist. This approach would have created a new auditing standard for

¹⁰⁹ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

using the work of an auditor's specialist, whether employed or engaged by the auditor, similar to the approach in International Standard on Auditing 620, *Using the Work of an Auditor's Expert*, ("ISA 620") and AU-C Section 620, *Using the Work of an Auditor's Specialist*, (and thereby separating the requirements for using the work of an auditor-engaged specialist from those for using the work of a company's specialist). One commenter on the Proposal supported this approach. The second alternative was to extend the supervisory requirements in AS 1201 to an auditor-engaged specialist. This approach would have amended existing AS 1210 to remove all references to an auditor-engaged specialist and amended AS 1201 to include all arrangements involving auditor-employed and auditor-engaged specialists.

Given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the Board determined that the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. Accordingly, the Board has adopted separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist related to reaching an understanding and evaluating the work to be performed. However, as discussed in Section IV.A.2, the auditor's relationship to an auditor-employed specialist differs in certain respects from the auditor's relationship to an auditor-engaged specialist, which may affect the auditor's visibility into the specialist's knowledge, skill, and ability, as well as into any relationships that might affect the specialist's independence or objectivity. Accordingly, the final amendments address these differences by requiring the auditor to perform procedures in AS 1210, as amended, to evaluate the knowledge, skill, ability, and objectivity of auditor-engaged specialists, while recognizing that the auditor evaluates the knowledge, skill, ability, and independence of auditor-employed specialists in accordance with the same requirements that apply to other engagement team members.

3. *Key Policy Choices*

Given the preference for creating separate requirements for using a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, the Board considered different approaches to addressing key policy issues.

a. *Scope of the Final Amendments*

The Board considered a variety of possible approaches to the scope of the final amendments, including the treatment of persons with specialized skill or knowledge in certain areas of IT and income taxes. See Section II of Appendix 3 for a discussion of the Board's considerations. In particular, after considering comments on the Proposal, the Board has clarified the scope and application of the final amendments in the rule text and discussion in this release. The Board, while mindful of advances in technology that could fundamentally impact the audit process (and hence what is understood to be

skill and knowledge in specialized areas of accounting and auditing), believes that the final amendments are sufficiently principles-based and flexible to accommodate continued technological advances that could impact audit practice in the future.

b. Evaluating the Work of a Company's Specialist

The Board considered a variety of possible approaches relating to the auditor's evaluation of the work of a company's specialist. See Section III.C of Appendix 3 for a discussion of the Board's considerations. In particular, after considering the comments on the Proposal, the Board is retaining the fundamental approach in the Proposal, under which the auditor evaluates the data, significant assumptions, and methods used by the specialist. The final amendments, including the revisions to the proposed requirements described in Section III.C of Appendix 3, retain the benefits resulting from the use of a risk-based audit approach, while at the same time directing the auditor to consider the quality of the source of information when determining his or her audit approach.

c. Evaluating the Qualifications and Independence of the Auditor-Employed Specialist

The Board considered a variety of possible approaches to evaluating the knowledge, skill, ability, and independence of auditor-employed specialists. See Section IV.A.3 of Appendix 3 for a discussion of the Board's considerations. In particular, after considering the comments on the Proposal, the Board eliminated from the final amendments certain paragraphs that could have been misinterpreted as suggesting a different process for evaluating the qualifications and independence of auditor-employed specialists than for other engagement team members. Instead, the final amendments acknowledge that an auditor-employed specialist is a member of the engagement team and that existing requirements for assessing the qualifications and independence of engagement team members apply equally to auditor-employed specialists.

d. Assessing the Qualifications and Objectivity of the Auditor-Engaged Specialist

The Board considered a variety of possible approaches to assessing the knowledge, skill, ability, and objectivity of auditor-engaged specialists. See Section IV.B.1 of Appendix 3 for a discussion of the Board's considerations. In particular, after considering the comments, the Board made revisions in adopting the requirements described in Section IV.B.1 of Appendix 3 to allow auditors to assess the objectivity of auditor-engaged specialists along a spectrum, rather than make a binary determination. The Board believes the final amendments in this area should limit any incremental cost to circumstances where increases in audit quality can be reasonably expected and thereby mitigate any adverse economic impact from potential unintended consequences



of the final amendments. For example, requiring the auditor to perform additional procedures to evaluate the data, significant assumptions, and methods used by the specialist when the specialist has a relationship with the company that affects the specialist's objectivity should increase audit quality and reduce the risk that a material misstatement could go undetected.

V. Special Considerations for Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, rules adopted by the Board subsequent to April 5, 2012, generally do not apply to the audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Securities and Exchange Act of 1934 ("Exchange Act"), unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."¹¹⁰ As a result of the JOBS Act, the rules and related amendments to PCAOB standards the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

The Proposal sought comment on the applicability of the proposed requirements to audits of EGCs. Commenters generally supported applying the proposed requirements to audits of EGCs. These commenters asserted that consistent requirements should apply for similar situations encountered in any audit of a company, whether that company is an EGC or not, as well as that the benefits described in the Proposal would be applicable to EGCs. One commenter suggested "phasing" the implementation of the requirements for such audits to reduce the compliance burden.

The Board also notes that any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs would require auditors to address the differing requirements within their methodologies, which would also create the potential for confusion.

¹¹⁰ See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), as added by Section 104 of the JOBS Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The final amendments do not fall within either of these two categories.

To inform consideration of the application of auditing standards to audits of EGCs, the staff has also published a white paper that provides general information about characteristics of EGCs.¹¹¹ As of the November 15, 2017 measurement date, the PCAOB staff identified 1,946 companies that had identified themselves as EGCs in at least one SEC filing since 2012 and had filed audited financial statements with the SEC in the 18 months preceding the measurement date.

Overall, the discussion of benefits, costs, and unintended consequences in Section IV.C is generally applicable to audits of EGCs. EGCs generally tend to have shorter financial reporting histories than other exchange-listed companies. As a result, there is less information available to investors regarding such companies relative to the broader population of public companies.¹¹²

Although the degree of information asymmetry between investors and company management for a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.¹¹³ To the extent that EGCs exhibit one or more of these properties, there may be a greater degree of information asymmetry for EGCs than for the broader population of companies, which increases the importance to investors of the external audit to enhance the credibility of management disclosures.¹¹⁴

¹¹¹ See PCAOB white paper, *Characteristics of Emerging Growth Companies as of November 15, 2017* (Oct. 11, 2018) ("EGC White Paper"), available on the Board's website.

¹¹² *Id.*

¹¹³ See, e.g., David Aboody and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *Journal of Finance* 2747 (2000); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995); Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101 (1988); and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 *Journal of Finance* 1041 (1988).

¹¹⁴ See, e.g., Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185, 189 (2004) ("[Academic studies] provide

The final amendments relating to the auditor's use of the work of specialists, which are intended to enhance audit quality, could contribute to an increase in the credibility of financial statement disclosures by EGCs.

When confronted with information asymmetry, investors may require a larger risk premium, and thus increase the cost of capital to companies.¹¹⁵ Reducing information asymmetry, therefore, can lower the cost of capital to companies, including EGCs, by decreasing the risk premium required by investors.¹¹⁶

Furthermore, an analysis by PCAOB staff, the results of which are summarized in Figure 5 below, suggests that the prevalence and significance of the use of the work of specialists in audits of EGCs is comparable to the prevalence and significance of the use of the work of specialists in audits of non-EGCs, for audit engagements by both smaller audit firms and larger audit firms.¹¹⁷

archival evidence that external assurance from auditors increases disclosure credibility...These archival studies suggest that bankers believe audits enhance the credibility of financial statements...").

¹¹⁵ See footnotes 91 and 93.

¹¹⁶ For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553 (2004).

¹¹⁷ The staff analysis was based on engagement-level data from the subset of 74 audit engagements of EGCs by U.S. and non-U.S. audit firms that were selected for inspection in 2017 presented in Section IV.A.1.

Figure 5 - Audits performed by U.S. and non-U.S. audit firms of EGCs that were selected for inspection by the PCAOB in 2017, categorized by use of the work of specialists

	<i>% (number) of audits by larger audit firms (U.S.)</i>	<i>% (number) of audits by smaller audit firms (U.S.)</i>	<i>% (number) of audits by larger audit firms (non-U.S.)</i>	<i>% (number) of audits by smaller audit firms (non-U.S.)</i>
(1) auditor used the work of a company's specialist but did not use the work of an auditor's specialist	0% (0)	9% (3)	11% (1)	13% (1)
(2) auditor used the work of an auditor's specialist but did not use the work of a company's specialist	8% (2)	0% (0)	22% (2)	0% (0)
(3) auditor used the work of both a company's specialist and an auditor's specialist	29% (7)	12% (4)	22% (2)	0% (0)
(4) auditor neither used the work of a company's specialist nor used an auditor's specialist ¹¹⁸	63% (15)	79% (26)	44% (4)	88% (7)
Total ¹¹⁹	100% (24)	100% (33)	100% (9)	100% (8)

Source: PCAOB

As indicated in Figure 5, the staff analysis observed that 41 (or about 55%) of the audit engagements were performed by U.S. and non-U.S., smaller audit firms. Among those 41 audit engagements, only four (or about 10%) involved the use of the work of a company's specialist but did not concurrently involve the use of the work of an auditor's specialist (category (1) above). In comparison, 33 of the 41 audit engagements (or about 80%) did not involve the use of the work of either a company's specialist or an auditor's specialist (category (4) above) and four of the 41 audit engagements (or about 10%) involved the use of both a company's specialist and an auditor's specialist

¹¹⁸ The audit engagements not included in the preceding three categories were included in the fourth category.

¹¹⁹ The total for the values shown in categories (1) through (4) may not add to 100% due to rounding.

(category (3) above). In none of those 41 audit engagements did the auditor use the work of an auditor's specialist without also concurrently using the work of a company's specialist (category (2) above). Among the 33 audit engagements of EGCs (or about 45%) performed by larger firms, both U.S. and non-U.S. firms, one (or about 3%) involved the use of the work of a company's specialist but did not concurrently involve the use of the work of an auditor's specialist (category (1) above); 19 (or about 58%) did not involve the use of the work of either a company's specialist or an auditor's specialist (category (4) above); nine (or about 27%) involved the use of both a company's specialist and an auditor's specialist (category (3) above); and four (or about 12%) involved the use of the work of an auditor's specialist, but did not concurrently involve the use of work of a company's specialist (category (2) above).

Thus, the Board believes that the need for the final amendments discussed earlier in Section IV.B and the associated benefits of the final amendments generally apply also to audits of EGCs.

While for small companies (including EGCs), even a small increase in audit fees could negatively affect their profitability and competitiveness, many EGCs are expected to experience minimal impact from the final amendments. In particular, some EGCs do not use a company's specialist and, for those EGCs that do use a company's specialist, the final amendments relating to the auditor's use of the work of such specialists are risk-based and designed to be scalable to companies of varying size and complexity.

In addition, the analysis presented in the EGC White Paper observed that about 40% of audits of EGCs are performed by firms that provided audit reports for more than 100 issuers and were required to be inspected on an annual basis by the PCAOB.¹²⁰ These firms tend to already have practices for using the work of specialists that are consistent with many or all elements of the final amendments. For such audit firms, the costs on a per engagement basis of adopting the final amendments should also be low, for the reasons discussed in Section IV.C.2.

For the other 60% of audits of EGCs, the staff analysis summarized in Figure 5 above suggests that the proportion of EGC audit engagements that involve the use of the work of company specialists, but do not involve the use of the work of an auditor's specialist, is small and comparable to the proportion of similar issuer audit engagements described in Section IV.A.1. As discussed in Section IV.C, auditors on such audit engagements may experience the most significant cost impact of the final

¹²⁰ See EGC White Paper, at 3.

amendments. However, only a small proportion of audits of EGCs are expected to be significantly affected by the final amendments. In addition, as discussed above in Section IV.C.3.a, the final amendments clarify the requirements for evaluating the work of a company's specialist and assessing the objectivity of an auditor-engaged specialist, which should avoid unnecessary effort by the auditor or auditor's specialist. Accordingly, any increase in effort should be accompanied by improvements in audit quality.

The Board is providing this analysis to assist the SEC in its consideration of whether it is "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation," to apply the final amendments to audits of EGCs. This information includes data and analysis of EGCs identified by the Board's staff from public sources.

For the reasons explained above, the Board believes that the final amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final amendments should apply to audits of EGCs. Accordingly, the Board recommends that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the final amendments to audits of EGCs. The Board stands ready to assist the Commission in considering any comments the Commission receives on these matters during the Commission's public comment process.

VI. Applicability to Audits of Brokers and Dealers

The Proposal indicated that the proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes-Oxley. The Board solicited comment on any factors specifically related to audits of brokers and dealers that may affect the application of the proposed amendments to those audits. Commenters that addressed the issue agreed that amendments to the standards for the auditor's use of the work of specialists should apply to these audits, citing benefits to users of financial statements of brokers and dealers and the risk of confusion and inconsistency if different methodologies were required under PCAOB standards for audits of different types of entities.

After considering comments, the Board determined that the final amendments, if approved by the SEC, will be applicable to all audits performed pursuant to PCAOB standards, including audits of brokers and dealers. The Board's determination is based on the observation that the information asymmetry between the management of brokers and dealers and their customers about the brokers' and dealers' financial condition may be significant and of particular interest to customers, as a broker or dealer may have



custody of customer assets, which could become inaccessible to the customers in the event of the insolvency of the broker or dealer.

In addition, unlike the owners of brokers and dealers, who themselves may be managers and thus be subject to minimal or no information asymmetry, customers of brokers and dealers may, in some instances, be large in number and may not be expert in the management or operation of brokers and dealers. Such information asymmetry between the management and the customers of brokers and dealers makes the role of auditing important to enhance the reliability of financial information.

Accordingly, the discussion in Section IV of the need for the final amendments, as well as the costs, benefits, alternatives considered and potential unintended consequences to auditors and the companies they audit, also applies to audits of brokers and dealers. In particular, staff analysis of PCAOB inspections data for audits of brokers and dealers indicates that auditors of brokers and dealers do not frequently use the work of specialists, whether company specialists or an auditor's specialists.¹²¹ Hence, the results suggest that only a small percentage of audits of brokers and dealers will be impacted by the final amendments. In addition, with respect to the impact of the final amendments on customers of brokers and dealers, the expected improvements in audit quality described in Section IV.C.1 would benefit such customers, along with investors, capital markets and auditors, while the final requirements are not expected to result in any direct costs or unintended consequences to customers of brokers and dealers.

VII. Effective Date

The Board determined that the final amendments take effect, subject to approval by the SEC, for audits of financial statements for fiscal years ending on or after December 15, 2020.

The Board sought comment on the amount of time auditors would need before any amendments would become effective, if adopted by the Board and approved by the

¹²¹ The staff analysis is based on 116 audit engagements of brokers and dealers performed by audit firms that were selected for inspection in 2017. The results of the analysis found that the auditor did not use the work of a specialist in about 90% of the broker or dealer audits. This analysis also found that auditors used the work of at least one auditor's specialist in about 8% of the audits analyzed and used the work of at least one company specialist in about 2% of those audits.



PCAOB Release No. 2018-006
December 20, 2018
Page 71

SEC. A number of commenters supported an effective date of two years after SEC approval of final amendments, asserting that this would allow firms sufficient time to develop tools, update methodologies, and provide training on the new requirements. A few commenters also emphasized the importance of having the same effective date for any new standards on using the work of specialists and auditing accounting estimates.

While recognizing other implementation efforts, the effective date determined by the Board is designed to provide auditors with a reasonable period of time to implement the final amendments, without unduly delaying the intended benefits resulting from these improvements to PCAOB standards. The effective date is also aligned with the effective date of the related standard and amendments being adopted in the Estimates Release.

* * *

On the 20th day of December, in the year 2018, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

December 20, 2018

APPENDIX 1

Amendments Relating to the Auditor's Use of the Work of Specialists

This appendix sets forth the final amendments to certain PCAOB auditing standards and auditing interpretations related to the auditor's use of the work of specialists. This table is a reference tool for the final amendments.

PCAOB Standard	Title	Paragraphs Amended
AS 1105	Audit Evidence	.08, .10, App. A (added)
AS 1201	Supervision of the Audit Engagement	.03, App. C (added)
AS 1210	Using the Work of a Specialist	Retitled and amended in its entirety
AS 2101	Audit Planning	.06
AS 2110	Identifying and Assessing Risks of Material Misstatement	.28A (added)
AS 2505	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	.08

For the reasons set forth in this release, the auditing standards of the Public Company Accounting Oversight Board are amended as follows:

- I. AS 1105 is amended by adding a note after the first bullet of paragraph .08:

Note: See Appendix A of this standard for requirements related to the evaluation of evidence from a company's specialist.

- II. AS 1105 is amended by revising footnote 3 to paragraph .10 to read as follows:

³ When using the work of a company's specialist, see Appendix A of this standard. When using information produced by a service organization or a service auditor's report as audit evidence, see AS 2601, *Consideration of an Entity's Use of a Service Organization*, and for integrated audits, see AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- III. AS 1105 is amended by adding a new Appendix A:

Appendix A – Using the Work of a Company's Specialist as Audit Evidence

.A1 This appendix describes the auditor's responsibilities with respect to using the work of a specialist, employed or engaged by the company ("company's specialist"), as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure. The requirements in this appendix supplement the requirements of this standard.

Note: For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. This appendix does not apply when the auditor uses the work of a person with specialized skill or knowledge in income taxes¹ or information technology as audit evidence.²

Note: This appendix does not apply to information provided by a company's attorney concerning litigation, claims, or assessments that is used by the auditor pursuant to AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*. This appendix applies when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.

¹ A note to AS 2505.08 describes the auditor's responsibility regarding the use of written advice or opinion of a company's tax advisor or a company's tax legal counsel as audit evidence.

² This is consistent with the treatment of persons with specialized skill or knowledge in income taxes and information technology who are employed or engaged by auditors. See Appendix C of AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*.

.A2 The requirements in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, for obtaining an understanding of the company's information system relevant to financial reporting include obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls.³

³ See AS 2110.28A.

Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

.A3 The auditor should obtain an understanding of the professional qualifications of the company's specialist in the particular field, and the entity that employs the specialist (if other than the company), and assess the level of knowledge, skill, and ability of the specialist in the particular field. Factors that are relevant to the assessment of the specialist's knowledge, skill, and ability include the following:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work performed, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

.A4 The auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise).

Note: Examples of potential sources of information that could be relevant to the auditor's assessment include, but are not limited to:

- Information obtained by the auditor from procedures performed pursuant to AS 2410, *Related Parties*;

- Engagement contracts between the company and the specialist, or the specialist's employer;
- Responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company;
- Information provided by the employer of a specialist regarding relationships with the company; and
- Disclosures about relationships with the company in the specialist's report, or equivalent communication, pursuant to requirements promulgated by the specialist's profession or by legislation or regulation governing the specialist.

.A5 The necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company in paragraphs .A3–.A4 depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.

Evaluating the Work of the Company's Specialist

.A6 Evaluating the work of a company's specialist involves evaluating:

- a. The data, significant assumptions, and methods used by the specialist; and
- b. The relevance and reliability of the specialist's work and its relationship to the relevant assertion.

Note: Paragraphs .16–.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed. This includes determining whether an auditor's specialist is needed to evaluate the work of a company's specialist.

.A7 The necessary evidence from the auditor's evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on:

- a. The significance of the specialist's work to the auditor's conclusion regarding the relevant assertion;
- b. The risk of material misstatement of the relevant assertion;

- c. The level of knowledge, skill, and ability of the specialist; and
- d. The ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Note: When evaluating the specialist's work, the auditor should obtain more persuasive evidence as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist in the particular field decreases.

.A8 The auditor should:

- a. Test the accuracy and completeness of company-produced data used by the specialist,⁴ and evaluate the relevance and reliability⁵ of data from sources external to the company that are used by the specialist;
- b. Evaluate whether the significant assumptions⁶ used by the specialist are reasonable as follows:
 - (1) For significant assumptions developed by the specialist, the auditor should take into account the consistency of those assumptions with relevant information.

Note: Examples of information that, if relevant, should be taken into account include: (1) assumptions generally accepted within the specialist's field; (2) supporting information provided by the specialist; (3) industry, regulatory, and other external factors, including economic conditions; (4) the company's objectives, strategies, and related business risks; (5) existing market information; (6) historical or recent experience, along with changes in conditions and events affecting the company; and (7) significant assumptions used in other estimates tested in the company's financial statements.

- (2) For significant assumptions provided by company management and used by the specialist, the auditor should look to the requirements set forth in paragraphs .16–.18 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.
- (3) If a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should look to the requirements set forth in AS 2501.17; and

- c. Evaluate whether the methods used by the specialist are appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework.

Note: Evaluating whether the methods are appropriate includes evaluating whether the data (paragraph .A8a) and significant assumptions (paragraph .A8b) are appropriately applied under the applicable financial reporting framework.

⁴ See paragraph .10 of this standard.

⁵ See paragraphs .07 and .08 of this standard.

⁶ See AS 2501.15 for procedures to perform when identifying significant assumptions. For purposes of identifying significant assumptions, the company's assumptions include assumptions developed by a company's specialist.

.A9 The auditor should evaluate the relevance and reliability of the specialist's work and whether the specialist's findings support or contradict the relevant assertion. Factors that affect the relevance and reliability of the specialist's work include:

- a. The results of the auditor's procedures over data, significant assumptions, and methods performed pursuant to paragraph .A8;
- b. The nature of any restrictions, disclaimers, or limitations in the specialist's report or equivalent communication; and
- c. The consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

.A10 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the auditor should perform additional procedures, as necessary, to address the matter.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's findings and conclusions are inconsistent with (i) other information, if any, in the specialist's report, or equivalent communication, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (2) the specialist's report, or equivalent communication, contains restrictions, disclaimers, or limitations regarding the auditor's use of the report or communication; (3) exceptions were identified in performing the procedures described in paragraph .A8 above related to data, significant

assumptions, or methods; (4) the auditor has doubt about the specialist's knowledge, skill, and ability, or about the company's effect on the specialist's judgments; or (5) the specialist has a conflict of interest relevant to the specialist's work.

IV. AS 1201 is amended by revising footnote 2 to paragraph .03 to read as follows:

² Appendix C describes further procedures to be performed with respect to the supervision of the work of auditor-employed specialists in conjunction with the required supervisory activities set forth below. AS 1210, *Using the Work of an Auditor-Engaged Specialist*, and Appendix A of AS 1105, *Audit Evidence*, establish requirements for an auditor using the work of an auditor-engaged specialist and a company's specialist, respectively, in performing an audit of financial statements.

V. AS 1201 is amended by adding a new Appendix C:

Appendix C – Supervision of the Work of Auditor-Employed Specialists

.C1 For engagements in which a specialist employed by the auditor's firm ("auditor-employed specialist") assists the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure, this appendix describes supervisory activities to be performed in conjunction with supervising the work of an auditor-employed specialist in an audit. The requirements in this appendix supplement the requirements in paragraphs .05–.06 of this standard.

Note: For purposes of this standard, a specialist is a person possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply to situations in which a person with specialized skill or knowledge in income taxes or information technology participates in the audit. Paragraphs .03–.06 of this standard apply in those situations.

.C2 The necessary extent of supervision of an auditor-employed specialist depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist.

Informing the Auditor-Employed Specialist of Work to be Performed

.C3 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:
 - (1) Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;
 - (2) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
 - (3) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.C4 Pursuant to paragraph .05a(3) of this standard, the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.¹

¹ See AS 1015.07–.09.

.C5 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with paragraphs .21–.26 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*;
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with AS 2501.09–.18; or
- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix A to AS 1105, *Audit Evidence*, and, for accounting estimates, AS 2501.19.

Evaluating the Work of the Auditor-Employed Specialist

.C6 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .C3d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.C7 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report, or

equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

VI. AS 1210 is retitled and amended in its entirety to read as follows:

AS 1210: Using the Work of an Auditor-Engaged Specialist

Introduction

.01 This standard establishes requirements regarding the use of a specialist engaged by the auditor's firm ("auditor-engaged specialist") to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.

Note: For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this standard does not apply to situations in which a person with specialized skill or knowledge in income taxes or information technology participates in the audit. AS 1201, *Supervision of the Audit Engagement*, applies in those situations.

Objective

.02 The objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

Assessing the Knowledge, Skill, Ability, and Objectivity of the Auditor-Engaged Specialist

.03 The engagement partner and, as applicable, other engagement team members performing supervisory activities¹ should assess the specialist's knowledge, skill, and ability in the particular field for the type of work under consideration. This includes obtaining an understanding of the following with respect to the specialist and the entity that employs the specialist:

- a. The professional certification, license, or professional accreditation of the specialist in the particular field;
- b. The specialist's experience in the type of work under consideration, including applicable areas of specialty within the specialist's field; and
- c. The reputation and standing of the specialist in the particular field.

Note: The auditor's assessment of the specialist's knowledge, skill, and ability affects the auditor's determination of: (1) whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform the type of work under consideration (paragraph .04); and (2) the necessary extent of the review and evaluation of the specialist's work (paragraph .10).

¹ See AS 1201.04.

.04 The engagement partner and, as applicable, other engagement team members performing supervisory activities should not use the work of a specialist who does not have a sufficient level of knowledge, skill, and ability.

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities should assess whether the specialist has the necessary degree of objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. This includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or other conflicts of interest relevant to the work to be performed.

Note: The auditor's assessment of the specialist's objectivity affects the nature and extent of the auditor's procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing.²

Note: The evidence necessary to assess the specialist's objectivity depends on the significance of the specialist's work and the related risk of material misstatement. Examples of potential sources of information that could be relevant to the auditor's assessment include, but are not limited to:

- Information obtained by the auditor from procedures performed pursuant to AS 2410, *Related Parties*;

- Engagement contracts between the company and the specialist, or the specialist's employer;
- Responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company;
- Written representations or other information provided by the specialist concerning relationships with the company; and
- Disclosures about relationships with the company in the specialist's report, or equivalent documentation, pursuant to requirements promulgated by the specialist's profession or by legislation or regulation governing the specialist.

² Paragraph .06 of this standard requires the auditor to establish and document an understanding with the specialist, including with respect to the data, significant assumptions, and methods the specialist is responsible for testing, evaluating, or developing. Paragraph .11 of this standard addresses how the specialist's objectivity affects the nature and extent of the auditor's procedures.

Informing the Auditor-Engaged Specialist of the Work to be Performed

.06 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate);
- c. The degree of responsibility of the specialist for:
 - (1) Testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company;

- (2) Evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and
 - (3) Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and
- d. The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

.07 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, and possible accounting and auditing issues.

.08 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with paragraphs .21–.26 of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*;
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with AS 2501.09–.18; or
- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix A to AS 1105, *Audit Evidence*, and, for accounting estimates, AS 2501.19.

Evaluating the Work of the Auditor-Engaged Specialist

.09 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation,

provided by the specialist pursuant to paragraph .06d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- a. The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- b. The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

.10 The necessary extent of the review depends on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, (2) the risk of material misstatement of the relevant assertion, and (3) the knowledge, skill, and ability of the specialist.

.11 If the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity, the auditor should perform additional procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing, pursuant to the engagement team's understanding with the specialist (paragraph .06), or should engage another specialist. The necessary nature and extent of the additional procedures depend on the degree of objectivity of the specialist. As the degree of objectivity increases, the evidence needed from additional procedures decreases. If the specialist has a low degree of objectivity, the auditor should apply the procedures for evaluating the work of a company's specialist.³

³ See AS 1105.A6–.A10.

.12 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include: (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions

the specialist used; or (5) the methods used by the specialist were not appropriate.

VII. AS 2101 is amended by adding footnote 3A to paragraph .06, such that revised AS 2101.06 reads as follows:

.06 The auditor should perform the following activities at the beginning of the audit:

- a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement,³
- b. Determine compliance with independence^{3A} and ethics requirements, and

Note: The determination of compliance with independence and ethics requirements is not limited to preliminary engagement activities and should be reevaluated with changes in circumstances.

- c. Establish an understanding of the terms of the audit engagement with the audit committee in accordance with AS 1301, *Communications with Audit Committees*.

³ Paragraphs .14–.16 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. AS 1110, *Relationship of Auditing Standards to Quality Control Standards*, explains how the quality control standards relate to the conduct of audits.

^{3A} Under PCAOB Rule 3520, *Auditor Independence*, a registered public accounting firm or associated person's independence obligation with respect to an audit client encompasses not only an obligation to satisfy the independence criteria applicable to the engagement set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Securities and Exchange Commission under the federal securities laws.

VIII. AS 2110 is amended by adding new paragraph .28A after paragraph .28:

.28A When a company uses the work of a company's specialist, the auditor should obtain an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and the related company processes, including:

- a. The nature and purpose of the specialist's work;
- b. Whether the specialist's work is based on data produced by the company, data obtained from sources external to the company, or both; and
- c. The company's processes and controls^{16A} for using the work of specialists.

^{16A} See paragraph .34 of this standard.

IX. AS 2505 is amended by adding a note at the end of paragraph .08:

Note: The opinion of legal counsel on specific tax issues that he or she is asked to address and to which he or she has devoted substantive attention, as contemplated by this standard, is sometimes necessary evidence to support the auditor's conclusions on significant income tax accounts and disclosures. However, the audit of income tax accounts and disclosures requires a combination of tax expertise and knowledge about the client's business that is accumulated during all aspects of an audit. Therefore, it is not appropriate for the auditor to rely solely on such legal opinion with respect to those tax issues without performing his or her own evaluation of matters related to the significant tax accounts and disclosures in the financial statements, taking into account the relevant tax and accounting requirements, his or her understanding of the company and its environment, and other relevant evidence obtained during the audit.^{5A}

Appendix A to AS 1105, *Audit Evidence*, applies when an auditor uses the work of a company's attorney as audit evidence in matters relating to legal expertise other than litigation, claims, and assessments (which are covered under this standard) and income taxes. For example, Appendix A to AS 1105 applies when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.

^{5A} Similarly, the written advice of a company's tax advisor on material matters affecting the tax accrual is sometimes necessary evidence to support the auditor's conclusions on the significant accounts and disclosures related to income taxes. As with legal opinions on tax matters, the auditor cannot rely solely on that written advice from tax advisors without performing his or her own evaluation of matters related to the significant tax accounts and disclosures in the financial statements.

APPENDIX 2

Other Related Amendments to PCAOB Auditing Standards

In connection with the final amendments to PCAOB auditing standards adopted by the Board in this release, the Board is adopting conforming amendments to several of its auditing standards. This table is a reference tool for these conforming amendments.

PCAOB Standard or Auditing Interpretation	Title	Paragraphs Amended
AS 1015	Due Professional Care in the Performance of Work	.06
AS 2301	The Auditor's Responses to the Risks of Material Misstatement	.07
AS 2310	The Confirmation Process	.03
AS 2401	Consideration of Fraud in a Financial Statement Audit	.54
AS 2610	Initial Audits—Communications Between Predecessor and Successor Auditors	.16
AT Sec. 601	Compliance Attestation	.43
AT Sec. 701	Management's Discussion and Analysis	.47
AI 11	Using the Work of a Specialist: Auditing Interpretations of AS 1210	Retitled, .04, .11, .17, .21
AI 28	Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations	.16, .18

For the reasons set forth in this release, the standards and interpretations of the Public Company Accounting Oversight Board are amended as follows:

- I. AS 1015 is amended by revising paragraph .06 to read as follows:

.06 Engagement team members should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining. The engagement partner should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client. The engagement partner is responsible for the assignment of tasks to, and supervision of, the members of the engagement team.⁴

- ⁴ See AS 1201, *Supervision of the Audit Engagement*.

- II. AS 2301 is amended by adding footnote 5A to paragraph .07, such that revised AS 2301.07 reads as follows:

.07 Due professional care requires the auditor to exercise professional skepticism.⁴ Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.⁵ Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor,^{5A} or examination of documentation from independent sources.

- ⁴ AS 1015.07–.09.

- ⁵ AS 2401.13.

^{5A} Refer to AS 1210, *Using the Work of an Auditor-Engaged Specialist*, and Appendix C of AS 1201, which establish requirements for an auditor using the work of an auditor-engaged specialist and an auditor-employed specialist, respectively, in performing an audit of the financial statements.

- III. AS 2310 is amended by revising paragraph .03 to read as follows:

.03 In addition, this section does not address matters described in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

- IV. AS 2401 is amended by revising the second sentence of the second paragraph of the third bullet of paragraph .54 to read as follows:

In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of an intangible asset), it may be appropriate to use the work of an auditor-employed specialist or an auditor-engaged specialist or develop an independent estimate for comparison to management's estimate.

- V. AS 2401 is amended by revising footnote 22 to paragraph .54 to read as follows:

²² Appendix C of AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*, establish requirements for an auditor using the work of an auditor-employed specialist and an auditor-engaged specialist, respectively, in performing an audit of financial statements.

- VI. AS 2610 is amended by revising paragraph .16 to read as follows:

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in AS 1205. Furthermore, the predecessor auditor is not an auditor's specialist, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16–.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- VII. AT 601 is amended by revising paragraph .43 to read as follows:

.43 In some compliance engagements, the nature of the specified compliance requirements may require specialized skill or knowledge in a particular field other than accounting or auditing. In such cases, the practitioner may use the work of a specialist and should comply with the requirements for using the work of specialists as set forth in PCAOB auditing standards.

VIII. AT 701 is amended by revising paragraph .47 to read as follows:

.47 In some engagements to examine MD&A, the nature of complex or subjective matters potentially material to the MD&A presentation may require specialized skill or knowledge in a particular field other than accounting or auditing. For example, the entity may include information concerning plant production capacity, which would ordinarily be determined by an engineer. In such cases, the practitioner may use the work of a specialist and should comply with the requirements for using the work of specialists as set forth in PCAOB auditing standards.

IX. AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, is amended by revising the title to read: AI 11, *Using the Work of a Specialist: Auditing Interpretations*.

X. AI 11 is amended by revising paragraph .04 to read as follows:

.04 *Interpretation*—During the audit, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter.

XI. AI 11 is amended by revising paragraph .11 to read as follows:

.11 The auditor also should consider the form and content of the documentation that the legal specialist provides and evaluate whether the legal specialist's findings support management's assertions with respect to the isolation criterion. FASB Statement No. 140's requirement regarding reasonable assurance that the transferred assets would be isolated provides the basis for what auditors should consider in evaluating the work of a legal specialist.

XII. AI 11 is amended by revising paragraph .17 to read as follows:

.17 *Interpretation*—No. In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements. Given the importance of the legal opinion to the assertion in this case, and the precision that legal specialists use in drafting such opinions, an auditor should not use as evidence a legal opinion that he

or she deems otherwise adequate if the letter restricts use of the findings expressed therein to the client or to third parties other than the auditor. In that event, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 140.

XIII. AI 11 is amended by deleting footnote 14 to paragraph .21.

XIV. AI 28 is amended by revising paragraph .16 to read as follows:

.16 In such circumstances, rather than inspecting and obtaining documentary evidence of the client's tax liability contingency analysis and making inquiries of the client, may the auditor consider the counsel as a specialist and rely solely on counsel's opinion as an appropriate procedure for obtaining evidential matter to support his or her opinion on the financial statements?

XV. AI 28 is amended by revising paragraph .18 to read as follows:

.18 The auditor's education, training, and experience enable him or her to be knowledgeable concerning income tax matters and competent to assess their presentation in the financial statements.

APPENDIX 3

Additional Discussion of Amendments

Contents of This Appendix

I. Introduction.....	A3-2
A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board	A3-3
II. Scope of Final Amendments	A3-4
III. Amendments Related to Using the Work of a Company's Specialist	A3-6
A. Obtaining an Understanding of the Work of the Company's Specialist	A3-7
B. Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company	A3-9
C. Evaluating the Work of the Company's Specialist.....	A3-16
IV. Amendments Related to Supervising or Using the Work of an Auditor's Specialist.....	A3-29
A. Amendments to AS 1201 for Supervising the Work of an Auditor-Employed Specialist	A3-30
B. Amendments to Existing AS 1210 for Using the Work of an Auditor-Engaged Specialist	A3-42
V. Other Considerations.....	A3-50
A. Auditing Interpretation AI 11, Using the Work of a Specialist: Auditing Interpretations of AS 1210	A3-50
B. Auditing Interpretation AI 28, Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations	A3-51
C. Certain Requirements of Existing AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Final Amendments	A3-52
VI. Other Aspects of the Final Amendments	A3-53

I. Introduction

This appendix discusses in more detail the amendments being adopted in this release ("final amendments" or "final requirements"), whether the specialist is employed or engaged by a company ("company's specialist"), employed by the auditor's firm ("auditor-employed specialist"), or engaged by the auditor's firm ("auditor-engaged specialist").

In brief, the Board is adopting amendments to:

- (1) Amend:
 - AS 1105, *Audit Evidence*; and
 - AS 1201, *Supervision of the Audit Engagement*, and
- (2) Replace:
 - AS 1210, *Using the Work of a Specialist*, ("existing AS 1210" or "existing standard") and retitle the standard *Using the Work of an Auditor-Engaged Specialist* ("AS 1210, as amended").

The final amendments add an appendix to AS 1105 with supplemental requirements, aligned with the Board's risk assessment standards,¹ for using the work of a company's specialist as audit evidence. The final amendments also add an appendix to AS 1201 with supplemental requirements for applying the supervisory principles in AS 1201 when using the work of an auditor-employed specialist (for example, in reaching an understanding with the specialist about the specialist's work and reviewing and evaluating the specialist's work). In addition, as amended, AS 1210, *Using the Work of an Auditor-Engaged Specialist*, sets forth requirements for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist and requirements that parallel the final amendments to AS 1201 for reaching an understanding with the specialist and reviewing and evaluating the specialist's work.

¹ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

Certain provisions of the final amendments include references to a new auditing standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* ("AS 2501, as adopted"), which is being adopted in a companion release.²

A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board

This appendix includes a comparison of the final requirements with the analogous requirements of the following standards issued by the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"):

IAASB Standards

- International Standard on Auditing 500, *Audit Evidence* ("ISA 500"); and
- International Standard on Auditing 620, *Using the Work of an Auditor's Expert* ("ISA 620").

ASB Standards

- AU-C Section 500, *Audit Evidence* ("AU-C Section 500"); and
- AU-C Section 620, *Using the Work of an Auditor's Specialist* ("AU-C Section 620").

The comparison included in the appendix may not represent the views of the IAASB or ASB regarding the interpretation of their standards. The information presented in this appendix does not cover the application and explanatory material in the IAASB standards or ASB standards.³

² See *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2018-005 (Dec. 20, 2018) ("Estimates Release").

³ Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement" but "is relevant to the proper application of the requirements of an ISA." Paragraph .A64 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally*

II. Scope of Final Amendments

The final amendments apply when an auditor uses the work of a "specialist." Thus, the scope of the requirements hinges largely on the meaning of the term "specialist." As described in the Proposal,⁴ the Board sought to carry forward the meaning of the term "specialist" from existing AS 1210, that is, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. The Board also sought to carry forward the concept from existing AS 1210 that income taxes and information technology ("IT") are specialized areas of accounting and auditing and thus are outside the scope of the final amendments.⁵ As discussed below, the final amendments retain, as proposed, the meaning of the term "specialist," including the concept regarding income taxes and IT.

Some commenters on the Proposal agreed with retaining the existing meaning of the term "specialist." Other commenters suggested that the Board extend the scope of the Proposal to include persons with specialized skill or knowledge in certain areas of income taxes and IT (e.g., unusual or complex tax matters, artificial intelligence, and blockchain). One of these commenters also asserted that income tax and IT professionals often support both audit and consulting practices and, as a practical matter, are treated as specialists by auditors. One commenter requested guidance for applying the proposed requirements when a legal specialist is involved, while another commenter suggested that the Board explain in the final amendments that an individual who specializes in complex taxation law would be a legal specialist.

One commenter suggested eliminating the distinction between expertise "inside" or "outside" the field of accounting and auditing with respect to an auditor's specialist because, in its view, determining when fields of expertise are outside of accounting and auditing is becoming more difficult. Another commenter stated that, in practice, it can be less than straightforward to differentiate between expertise in auditing and accounting and other areas. Other commenters, however, asserted that the Board should retain the concept in existing AS 1210 that an auditor is not expected to have the expertise of a

Accepted Auditing Standards, states that, although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

⁴ *Proposed Amendments to Auditing Standards for the Auditor's Use of the Work of Specialists*, PCAOB Release No. 2017-003 (June 1, 2017) ("Proposal").

⁵ See footnote 1 of existing AS 1210.

person trained or qualified to engage in the practice of another profession or occupation.

As used today, the term "specialist" is generally understood by auditors, and observations from PCAOB oversight activities do not indicate that there is significant confusion over the meaning of the terms "specialist" and "specialized area of accounting and auditing," as they have been used in the standards. After considering the comments received on the Proposal, however, the final amendments retain the meaning of the term "specialist" as proposed, with certain clarifications discussed below.

Specifically, the Board included a note to clarify when the final amendments apply to the work of an attorney used by the company.⁶ As under existing AS 1210, specialists under the final amendments include attorneys engaged by a company as specialists, such as attorneys engaged by the company to interpret contractual terms or provide a legal opinion. The final amendments apply when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework. The final amendments also clarify that the scope of these amendments does not apply to information provided by a company's attorney concerning litigation, claims, or assessments that is used by the auditor pursuant to AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Consistent with existing AS 1210, income taxes and IT are outside the scope of the final amendments because they are specialized areas of accounting and auditing. For example, while specialized areas of income tax law involve legal specialists, accounting for income taxes remains an area of accounting and auditing. The Board added a footnote to Appendix A of AS 1105 that references AS 2505.08, as amended.⁷ A note to AS 2505.08, as amended, clarifies the auditor's responsibility regarding the use of the written advice or opinion of a company's tax advisor or a company's tax legal counsel as audit evidence.⁸ Also, to the extent that IT is used in information systems, auditors will still need to maintain sufficient technical knowledge to identify and assess risks and design procedures to respond to those risks and evaluate the audit evidence obtained. Accordingly, the Board does not believe that the need exists at this time to

⁶ See second note to AS 1105.A1, as adopted.

⁷ See footnote 1 to AS 1105.A1, as adopted.

⁸ See note to AS 2505.08, as amended.

change the approach reflected in existing AS 1210 and designate particular areas of either income taxes or IT as outside the field of "accounting and auditing."

Comparison with Standards of Other Standard Setters

ISA 620 uses the terms "auditor's expert" and "management's expert" in a manner analogous to the term "specialist" in the final amendments. ISA 620, however, does not address whether IT is a specialized field outside of accounting and auditing. The term "management's expert" is also defined in ISA 500.

AU-C Section 620 and AU-C Section 500 use the word "specialist" instead of "expert."

III. Amendments Related to Using the Work of a Company's Specialist

The final amendments set forth requirements for using the work of a company's specialist as audit evidence. The amendments, which supplement the existing requirements of AS 1105, include:

- Obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls;
- Obtaining an understanding of and assessing the knowledge, skill, and ability of the specialist and the entity that employs the specialist (if other than the company), and the relationship to the company of the specialist and the entity that employs the specialist (if other than the company); and
- Performing procedures to evaluate the work of a company's specialist, including evaluating: (1) the data, significant assumptions, and methods (which may include models) used by the specialist; and (2) the relevance and reliability of the specialist's work and its relationship to the relevant assertion.⁹

⁹ Key principles from Auditing Interpretation AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, and Auditing Interpretation AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*, related to the auditor's use of the work of a company's attorney and the use of written tax advice or opinions as audit evidence have been incorporated in AS 1105.A1, as adopted, and a note added to AS 2505.08, as amended. See Sections V.A and V.B of this Appendix.

Commenters on the Proposal generally supported a risk-based approach for using the work of a company's specialist, as set forth in the proposed amendments. Many commenters also stated that there was a need to establish a separate standard for using the work of a company's specialist. However, a number of commenters questioned various aspects of the amendments, including the need for revisions to existing AS 1210 relating to the use of the work of a company's specialist. Additionally, some commenters requested clarifications or suggested changes to the proposed requirements. These and other comments are discussed in the sections that follow. A number of these comments resulted in revisions and clarifications to the final amendments.

A. Obtaining an Understanding of the Work of the Company's Specialist

See AS 1105.A2, as adopted, and AS 2110.28A, as adopted

The proposed amendments to AS 1105 provided that obtaining an understanding of the company's information system relevant to financial reporting would encompass obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls.¹⁰

Some commenters supported the proposed requirement because, in their view, an understanding of the company's processes for using the work of company specialists is integral to the auditor's understanding of the information system relevant to financial reporting. Two commenters asserted that such controls are important for the auditor to consider when evaluating the work of a company's specialist and determining the necessary audit procedures. One commenter expressed concern that the proposed requirement was too broad and suggested that the auditor's understanding should instead be part of the evaluation of the specialist's objectivity. In addition, two commenters questioned whether the Board intended to require the auditor to evaluate the design of controls over the use of company specialists, even if the auditor was not performing an audit of internal control over financial reporting or planning to rely on controls for the related assertions. These commenters and others suggested that placing the proposed requirement for obtaining an understanding of the specialist's work in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, would better link the requirement to the auditor's risk assessment procedures, thereby reducing the likelihood that auditors would consider only the factors in proposed AS 1105.B2 and fail to consider other relevant factors set forth in AS 2110.

¹⁰ See proposed AS 1105.B2.

The Board considered these comments and is adopting the requirement substantially as proposed, but relocating the requirement to AS 2110 as suggested by certain commenters.¹¹ The procedure builds upon a requirement in existing AS 1210 that the auditor obtain an understanding of the nature of the work performed or to be performed by a specialist,¹² but is more closely aligned with the required risk assessment procedures in AS 2110. The required procedure is important because it informs the auditor's evaluation of the work of the company's specialist, and not merely the assessment of the specialist's objectivity.

Placing the requirement for obtaining an understanding of the specialist's work and report(s), or equivalent communication, in AS 2110, and framing the required procedure as a risk assessment procedure, provides better direction regarding the necessary audit effort for the procedure. The necessary audit effort for performing this procedure is governed primarily by the general requirements in AS 2110 for obtaining a sufficient understanding of the company's internal control over financial reporting.¹³ This includes consideration of whether the auditor plans to use the specialist's work as audit evidence.

While the requirement, as adopted, likely will not represent a major change in practice, particularly for those firms whose practices already go beyond existing PCAOB standards, it should prompt auditors to appropriately consider the interaction of the specialist's work and the company's related processes and controls. For example, under the final amendments, the auditor should obtain an understanding of controls for using

¹¹ Specifically, the requirements are located in AS 2110.28A, as adopted.

¹² See existing AS 1210.09.

¹³ See AS 2110.18, which provides that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to: (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design further audit procedures. See also AS 2110.19, which further provides that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting. In addition, AS 2110.20 provides that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

the work of specialists that are relevant to the audit, including evaluating the design of those controls and determining whether those controls have been implemented.¹⁴

Comparison with Standards of Other Standard Setters

The requirements in ISA 500 and AU-C 500 have some commonality with the requirements in the final amendments. Paragraph 8(b) of ISA 500 states that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, obtain an understanding of the work of that expert.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

B. Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company

See AS 1105.A3–.A5, as adopted

The final amendments set forth requirements similar to existing AS 1210 for evaluating the knowledge, skill, and ability of the specialist and the relationship of the specialist to the company.¹⁵

1. Knowledge, Skill, and Ability

The Proposal set forth a requirement similar to that in existing AS 1210 for evaluating the professional qualifications of the specialist and generally provided the same factors for the auditor's assessment of the specialist's knowledge, skill, and ability.¹⁶

¹⁴ AS 2110.34 provides additional direction for determining controls relevant to the audit.

¹⁵ Existing AS 1210.08 and AS 1210.10–.11 require the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

¹⁶ Existing AS 1210.08 provides that the auditor should consider certain information in evaluating the professional qualifications of the specialist to determine that the specialist possesses the necessary skill or knowledge in the particular field. The information to be considered in that evaluation is: (1) the professional certification,

The Proposal differed from existing AS 1210, however, in certain respects. First, the Proposal extended the required understanding to expressly include the entity that employs the specialist, if the specialist is not employed by the company. Second, the Proposal expressly referred to the specialist's "level" of knowledge, skill, and ability. As with the auditor's assessment of competence under AS 2605, *Consideration of the Internal Audit Function*, this approach recognized that specialists may possess varying degrees of knowledge, skill, and ability. Third, the Proposal provided that the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist would depend on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. Under this approach, the persuasiveness of the evidence the auditor would need to obtain increases as the significance of the specialist's work to the auditor's conclusion or the risk of material misstatement of the relevant assertion increases.¹⁷

The Board is adopting the requirement for evaluating the professional qualifications of the specialist as proposed. Most commenters on this aspect of the Proposal acknowledged the need for the auditor to obtain an understanding of and assess the knowledge, skill, and ability of a company's specialist. One commenter asserted that the proposed requirement was not well-suited to assessing the qualifications of the entity that employs the specialist. The Board considered this comment and notes that the final requirement retains the concept in existing AS 1210 that a specialist may be an individual or an entity. Accordingly, auditors should be familiar with assessing the qualifications of entities that are specialists or employ specialists. Furthermore, a strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, an employer with a poor reputation or little expertise in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted.

Some commenters asked for more direction on how to obtain an understanding of the professional qualifications of the company's specialist and the entity that employs the specialist (for example, by including in the rule text the discussion from the proposing release of potential sources of information about a specialist's qualifications).

license, or other recognition of the competence of the specialist in his or her field, as appropriate; (2) the reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance; and (3) the specialist's experience in the type of work under consideration.

¹⁷ See Section III.C.2 of this Appendix for illustrative examples on the application of these factors when testing and evaluating the work of a company's specialist.

One of these commenters asserted that there are practical limits on obtaining evidence related to a company-engaged specialist's competence.

The Board considered these comments, but notes that the final requirement is similar to a requirement in existing AS 1210. Outreach to audit firms suggests that firms have policies and procedures for evaluating the qualifications of specialists, whether individuals or entities. Auditors should therefore be familiar with the process of assessing the knowledge, skill, and ability of entities that employ specialists.

As with existing AS 1210, the final amendments do not set forth specific steps to perform in assessing the specialist's knowledge, skill, and ability. It is not practicable to provide detailed direction in this area because of the variety of types of specialists that may be encountered. Examples of potential sources of information that, if available, could be relevant to the auditor's evaluation include:

- Information contained within the audit firm related to the professional qualifications and reputation of the specialist or the entity that employs the specialist (if other than the company) in the relevant field and experience with previous work of the specialist;
- Professional or industry associations and organizations, which may provide information regarding: (1) qualification requirements, technical performance standards, and continuing professional education requirements that govern their members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against, the specialist;
- Discussions with the specialist, through the company, about matters such as the specialist's understanding of the financial reporting framework, the specialist's experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- Information obtained as part of audit planning, when obtaining an understanding of the company's processes and identifying controls for testing;
- Information included in the specialist's report about the specialist's professional qualifications (e.g., a biography or resume);
- Responses to questionnaires provided to the specialist regarding the specialist's professional credentials; and
- Published books or papers written by the specialist.

Requirements applicable to a specialist pursuant to legislation or regulation also could help inform the auditor's assessment of the specialist's knowledge, skill, and ability.

Some of the examples listed above may provide more persuasive evidence than others.¹⁸ For example, relevant information from a source not affiliated with the company or specialist, the auditor's experience with previous work of the specialist, or multiple sources generally would provide more persuasive evidence than evidence from the specialist's uncorroborated representations about his or her professional credentials. Additionally, the reliability (and thus persuasiveness) of information about the specialist's credentials and experience increases when the company has effective controls over that information, e.g., in conjunction with controls over the selection of qualified specialists.

Some commenters asked for clarification as to how the company's controls and processes for using the work of a company's specialist should be considered when performing the assessment of knowledge, skill, and ability. As discussed earlier, the interaction of the specialist's work and the company's processes should be considered by the auditor in assessing and responding to risk in the related accounts and disclosures, especially when the specialist's work is significant to the auditor's conclusion regarding the relevant assertion and the accounts or disclosures have higher risk. Therefore, the company's controls and processes are considered in identifying and appropriately assessing the risks of material misstatement of the relevant assertion, which is one of the two factors that the auditor considers under AS 1105.A5, as adopted, in determining the necessary evidence for assessing the specialist's level of knowledge, skill, and ability.

2. *Relationship to the Company*

The Proposal provided that the auditor would assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise). The proposed requirement was similar to existing AS 1210.10, but expanded the list of matters that the

¹⁸ As previously discussed, the risk of material misstatement of the relevant assertion and the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion affect the persuasiveness of the evidence needed with respect to the knowledge, skill, and ability of the company's specialist.

auditor should consider to include financial and business relationships with the company.

The Board is adopting this requirement substantially as proposed, with the addition of a note that sets forth examples of potential sources of information that could be relevant to the auditor's assessment.

Some commenters supported the proposed requirement for the auditor to assess the specialist's relationship to the company and stated that it was appropriate. Two commenters, however, asserted that there could be practical challenges to assessing the relationship to the company of the entity that employs the specialist (e.g., if the entity that employs the specialist lacks systems to track such relationships or the auditor does not have access to those systems). The Board considered these comments, but notes that existing AS 1210 already requires an evaluation of the relationship of the specialist, whether an individual or an entity, to the client. Outreach to audit firms suggests that firms have policies and procedures for evaluating the objectivity of specialists, whether individuals or entities. Therefore, auditors should be familiar with assessing the qualifications of entities that are specialists or employ specialists.

Other commenters asked for additional direction regarding the necessary effort to obtain information regarding the specialist's relationship to the company. One commenter also emphasized the importance of considering ethical and performance requirements promulgated by a specialist's profession or by legislation or regulation governing the specialist. The final amendments do not prescribe specific steps to perform in assessing the specialist's relationship to the company, because additional specificity would make the requirements unnecessarily prescriptive. The Board has added a note to the final requirement, however, that includes non-exclusive examples of potential sources of information that could be relevant to the auditor's assessment of the relationship to the company of both the specialist and the specialist's employer (if other than the company).¹⁹ These examples include disclosures by the specialist about relationships with the company in the specialist's report, or equivalent communication, pursuant to requirements promulgated by the specialist's profession or by legislation governing the specialist.²⁰ As with the auditor's assessment of a specialist's knowledge,

¹⁹ See note to AS 1105.A4, as adopted. These examples were based on examples set forth in the Proposal, but have been refined to better reflect their application in practice.

²⁰ While the Proposal had suggested that information regarding such requirements could be relevant to the auditor's evaluation of the specialist's relationships to the

skill, and ability, certain sources of information may provide more persuasive evidence than others. In situations where more persuasive evidence is required under these requirements, it may be appropriate to perform procedures to obtain evidence from multiple sources.

Some commenters also expressed a preference for retaining the term "objectivity" with respect to a company's specialist and further acknowledging that objectivity may exist along a spectrum. Similar to the Proposal, the final amendments reserve the term "objectivity" for specialists engaged by the auditor to assist in obtaining and evaluating audit evidence. The work of a company's specialist is different in nature from the work of an auditor's specialist, since a company's specialist performs work that the company frequently uses as source material for one or more financial statement accounts or disclosures, including accounting estimates. With respect to the existence of objectivity along a spectrum, the final amendments recognize that a company's ability to significantly affect a specialist's judgment may vary and, as discussed below, provide a spectrum for evaluating the company's ability to significantly affect the specialist's judgments.

As was proposed, the final amendments provide that, if the auditor identifies relationships between the company and the specialist (or the specialist's employer, if other than the company), the auditor has a responsibility to assess whether the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings.²¹ Examples of the types of circumstances that might give the company the ability to affect the specialist's judgments include, but are not limited to:

- The reporting relationship of a company-employed specialist within the company;
- Compensation of a company's specialist based, in part, on the outcome of the work performed;
- Relationships a company-engaged specialist has with entities acting as an agent of the company;

company, disclosures about relationships pursuant to such requirements are more relevant to the auditor's assessment than merely information about the legal or professional requirements.

²¹ See AS 1105.A4, as adopted.

- Personal relationships, including family relationships, between the company's specialist and others within company management;
- Financial interests, including stock holdings, company specialists have in the company; and
- Ownership, business relationships, or other financial interests the employer of a company-engaged specialist has with respect to the company.

The auditor's assessment that the company has the ability to influence the specialist, however, does not preclude the auditor from using the work of a company's specialist, whether employed or engaged, as audit evidence. Rather, consistent with existing AS 1210, it is a factor in determining the necessary audit effort to evaluate that specialist's work.²² In general, the necessary audit effort increases as the company's ability to affect the specialist's judgments increases.

3. *Determining the Necessary Evidence*

The Proposal differed from existing AS 1210 in that it set forth scalable requirements for determining the necessary evidence for evaluating both the knowledge, skill, and ability of the specialist and the relationship of the specialist to the company. The Board is adopting these requirements as proposed. Under the final amendments, the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.²³

No commenters opposed the proposed framework for determining the necessary evidence. A number of commenters, however, asked for clarification on the application of the requirement when performing the relevant evaluations. The Board's analysis of

²² See AS 1105.A7–.A10, as adopted. Section III.C.2 of this Appendix includes examples that illustrate how relationships between the company and the company's specialist can affect the necessary audit effort in evaluating the work of a company's specialist under the final amendments.

²³ See AS 1105.A5, as adopted.

these comments is discussed above in connection with the required evaluations of the specialist's knowledge, skill, and ability, and the relationship of the specialist to the company.

Comparison with Standards of Other Standard Setters

Paragraph 8(a) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the competence, capabilities, and objectivity of that expert.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

C. Evaluating the Work of the Company's Specialist

See AS 1105.A6–.A10, as adopted

In general, a specialist's work involves using data, assumptions, and methods. The auditor's responsibilities under existing AS 1210 with respect to the data, assumptions, and methods used by the specialist are limited to (a) obtaining an understanding of the methods and assumptions used by the specialist and (b) making appropriate tests of data provided to the specialist.²⁴ In addition, the auditor should evaluate whether the specialist's findings support the related assertions in the financial statements.²⁵ Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead the auditor to believe the findings are unreasonable in the circumstances.²⁶ If the auditor believes the specialist's findings are unreasonable, he or she is required to apply additional procedures, which may include potentially obtaining the opinion of another specialist.²⁷ Notably, before the final amendments, PCAOB

²⁴ For fair value measurements, however, another standard requires the auditor to evaluate the reasonableness of significant assumptions of the specialist. See footnote 2 of AS 2502, *Auditing Fair Value Measurements and Disclosures*. This standard is being superseded in the Estimates Release.

²⁵ See existing AS 1210.12.

²⁶ *Id.*

²⁷ *Id.*

standards have not expressly addressed how to determine the necessary audit effort to be applied in performing those procedures.

The Proposal sought to enhance the requirements for testing and evaluating the work of the company's specialist by:

- Extending the auditor's responsibilities for evaluating the specialist's assumptions to include all significant assumptions used by the specialist (not just those used in fair value measurements);
- Expanding the auditor's responsibilities with respect to data to include evaluating external data used by the specialist (not just data provided by the company to the specialist);
- Adding a requirement for the auditor to evaluate the appropriateness of the methods used by the specialist, including whether the data was appropriately applied;
- Setting forth a requirement for the auditor to comply with the Board's proposed estimates standard²⁸ when the auditor tests management's process for developing an estimate and a company's specialist was used; and
- Providing direction for determining the necessary audit effort for testing and evaluating the specialist's work, based on the risk of material misstatement and other factors set forth in the standard.

Commenters expressed mixed views on the premise underlying the Proposal that the auditor should test and evaluate the work of a company's specialist. While a number of commenters supported that premise, other commenters opposed expanding the auditor's responsibilities with respect to the specialist's methods and assumptions beyond existing AS 1210. Some of these commenters expressed concerns that the auditor may not be qualified to evaluate the work of a specialist and recommended retaining the more limited audit approach reflected in existing AS 1210, including the statement that "the auditor is not expected to have the expertise of a person trained for or qualified to engage in practice of another profession or occupation."

²⁸ See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017).

A number of commenters also addressed specific aspects of the proposed requirements for testing and evaluating the work of company specialists. Some commenters questioned the proposal's general use of the term "test" in describing the auditor's responsibilities, as well as the proposed requirement to also comply with the proposed estimates standard in circumstances where the auditor tests management's process for developing an estimate and a company's specialist was also used. Those commenters asserted that the expected audit effort was unclear. Two commenters stated that the proposed requirements in this area could be interpreted as requiring reperformance of the specialist's work, which one of these commenters asserted would be beyond the expertise of most auditors and thus require auditors to use an auditor's specialist.

In addition, some commenters requested clarification on the expectations for evaluating a specialist's models, especially in situations where auditors are unable to gain access to proprietary models used by company-engaged specialists. Some commenters also expressed concern about the proposed requirement to evaluate whether data was appropriately used by the specialist. Some of these commenters asserted that this requirement appeared to require auditors to reperform the specialist's work and suggested clarifying or eliminating that requirement. Additionally, some commenters suggested allowing auditors to rely on the issuer's controls over the use of specialists in determining the necessary procedures for evaluating the specialist's work.

A number of commenters acknowledged that the proposed requirements were intended to be scalable. However, some commenters questioned whether they would be scalable in practice. Other commenters asked for guidance on tailoring audit procedures based on risk and the other factors set forth in the proposal, especially procedures under the proposed requirement to also comply with the proposed estimates standard. Also, some commenters asserted that the requirements did not adequately distinguish the audit effort based on whether the specialist was engaged or employed by the company.

After considering the comments on the Proposal, the Board is retaining the fundamental approach in the Proposal – under which the auditor evaluates the data, significant assumptions, and methods used by the specialist. This approach is intended to increase audit attention on the work of a company's specialist, particularly when that work is significant in areas of higher risk, to increase the likelihood that the auditor would detect material financial statement misstatements related to that work.

Taking into account comments on specific aspects of the proposed requirements, however, the final amendments reflect a number of clarifying revisions to eliminate or revise certain proposed requirements that may have been perceived by commenters as unnecessarily complex or prescriptive. The revisions address concerns expressed by certain commenters, while preserving the intended benefits of the final amendments, and include:

- Removing the word "test" from the requirements to evaluate the work of the company's specialist, except in relation to company-produced data; and
- Reframing the requirements for evaluating the data, significant assumptions, and methods used by the specialist to describe the key considerations in making those evaluations.

In addition, the final amendments clarify the applicability of the requirements in circumstances when the company's specialist is involved in developing an accounting estimate, such as developing assumptions and methods used in an accounting estimate. In such circumstances, the requirements in Appendix A of AS 1105 apply to evaluating the data, significant assumptions²⁹, and methods developed (or generated) by the specialist, or sourced by the specialist from outside the company, as well as to testing company-produced data. In contrast, for significant assumptions provided by management to the specialist, the auditor is required to look to the requirements in AS 2501, as adopted. The final amendments are discussed in more detail below.

1. *Evaluating the Specialist's Work: Data, Significant Assumptions, and Methods*

See AS 1105.A6 and .A8, as adopted

The revisions reflected in the final amendments clarify the auditor's responsibilities for evaluating the work of a company's specialist, and are intended to avoid potential confusion that the auditor is required to reperform the work of the company's specialist. Among other things, the revised requirements reserve the use of the term "test" for procedures applied to company-produced information used by the specialist, consistent with its usage in AS 2501, as adopted.³⁰

Notably, instead of requiring the auditor to comply with AS 2501, as adopted, the auditor would be required to apply a set of analogous procedures for evaluating data, significant assumptions, and methods that are tailored to situations in which specialists

²⁹ A footnote to AS 1105.A8, as adopted, refers the auditor to AS 2501.15, as adopted, for the procedures to perform when identifying significant assumptions. For purposes of identifying significant assumptions, the company's assumptions include assumptions developed by the company's specialist.

³⁰ See Estimates Release.

are used.³¹ For example, under the final amendments, the auditor's responsibilities with respect to data, significant assumptions, and methods used by the specialist generally are:

- *Company-produced data*: Test the accuracy and completeness of company-produced data used by the specialist (see AS 1105.A8a, as adopted);³²
- *Data from sources external to the company*: Evaluate the relevance and reliability of the data from sources external to the company that are used by the specialist (see AS 1105.A8a, as adopted);
- *Significant assumptions*: Evaluate whether the significant assumptions used by the specialist are reasonable:
 - (1) *Assumptions developed by the specialist*: taking into account the consistency of those assumptions with relevant information (see AS 1105.A8b(1), as adopted);
 - (2) *Assumptions provided by company management and used by the specialist*: looking to the requirements set forth in AS 2501.16–.18, as adopted (see AS 1105.A8b(2), as adopted);
 - (3) *Assumptions based on the company's intent and ability to carry out a particular course of action*: looking to the requirements set forth in AS 2501.17, as adopted (see AS 1105.A8b(3), as adopted); and
- *Methods*: Evaluate whether the methods used by the specialist are appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework (see AS 1105.A8c, as adopted).

Under the final amendments, the focus of the auditor's evaluation of the work of the company's specialist does not require reperforming the specialist's work or

³¹ A note to AS 1105.A6, as adopted, emphasizes that paragraphs .16–.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed. This includes determining whether an auditor's specialist is needed to evaluate the work of a company's specialist.

³² See also AS 1105.10 for procedures when the auditor uses information produced by the company as audit evidence.

evaluating whether the work complies with all technical aspects in the specialist's field. Instead, the auditor's responsibility is to evaluate whether the specialist's work provides sufficient appropriate evidence to support a conclusion regarding whether the corresponding accounts or disclosures in the financial statements are in conformity with the applicable financial reporting framework.

With respect to the specialist's methods, the auditor's responsibilities under PCAOB standards have historically been to understand the method used. The final amendments extend that obligation to encompass evaluating whether the method is appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework.³³ In many cases, evaluating a method's conformity with the applicable financial reporting requirements is the same as evaluating its appropriateness under the circumstances (e.g., if the applicable accounting standard requires a particular method for determining the estimate). However, if the applicable financial reporting framework allows more than one method, or if the appropriate method under the framework depends on the circumstances, evaluating conformity with the framework involves consideration of other relevant factors, such as, the nature of the estimate and the auditor's understanding of the company and its environment.

A note to the final amendments also clarifies that evaluating the specialist's methods includes assessing whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework.³⁴ Evaluating the application of the data encompasses, for example, whether the data is selected and adjusted in conformity with the requirements of the applicable financial reporting framework. Similarly, evaluating the application of significant assumptions encompasses evaluating whether the assumptions were selected in conformity with the requirements of the applicable financial reporting framework.

The final amendments do not require the auditor to obtain access to proprietary models used by the specialist. Rather, the auditor's responsibility is to obtain information to assess whether the model is in conformity with the applicable financial reporting framework. Depending on the model and the factors set forth in AS 1105.A7, as adopted, this might involve, for example, obtaining an understanding of the model, reviewing descriptions of the model in the specialist's report or equivalent communication, testing controls over the company's evaluation of the specialist's work, or assessing the inputs to and output from the model (if necessary, using an alternative model for comparison).

³³ See AS 1105.A8c, as adopted.

³⁴ See note to AS 1105.A8c, as adopted.

With respect to the specialist's significant assumptions, auditors have historically had an obligation under PCAOB standards to understand the assumptions³⁵ and, for fair value measurements, to evaluate the reasonableness of the assumptions.³⁶ The final amendments extend the auditor's obligation to include evaluating the reasonableness of significant assumptions used by the specialist. This involves comparing the assumptions to relevant information. The note accompanying AS 1105.A8b(1), as adopted, provides examples of information that, if relevant, should be taken into account: (1) assumptions generally accepted within the specialist's field; (2) supporting information provided by the specialist; (3) industry, regulatory, and other external factors, including economic conditions; (4) the company's objectives, strategies, and related business risks; (5) existing market information; (6) historical or recent experience, along with changes in conditions and events affecting the company; and (7) significant assumptions used in other estimates tested in the company's financial statements. These examples—including examples (1) and (2), which were suggested by commenters—point to information that generally would be available to the auditor (e.g., through other procedures performed on the audit or the auditor's knowledge or the company and its industry).

Furthermore, the final amendments provide that, if a significant assumption is provided by company management and used by the specialist, the auditor should look to the requirements in AS 2501.16–.18, as adopted. The final amendments also provide that, if a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should look to the requirements set forth in AS 2501.17, as adopted. This applies regardless of whether the significant assumption was developed by the company or the company's specialist.

2. *Determining the Necessary Audit Effort for Evaluating the Specialist's Work*

See AS 1105.A7, as adopted

Similar to the Proposal, the final amendments set forth four factors that affect the necessary evidence from the auditor's evaluation of the specialist's work to support a conclusion regarding a relevant assertion. Specifically, under the final amendments, the necessary evidence depends on the: (1) significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) risk of material misstatement of

³⁵ See existing AS 1210.09.

³⁶ See footnote 2 of AS 2502.

the relevant assertion; (3) level of knowledge, skill, and ability of the specialist;³⁷ and (4) the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Some commenters asked for additional clarification or direction on how to apply the four factors to determine the necessary audit effort for evaluating the specialist's work. One commenter requested that the Board elaborate upon certain terms (e.g., terms "extensively" and "less extensive procedures") that were used in two of the three examples that were included in the Proposal to illustrate how certain factors could affect the necessary audit effort in evaluating the work of a company's specialist. Another commenter requested that the Board provide additional examples of less complex scenarios.

In addition, some commenters asserted that the Proposal did not adequately account for differences between company-employed and company-engaged specialists. These commenters stated that the nature and extent of an auditor's procedures with respect to the work of a company-engaged specialist with the necessary knowledge, skill, and objectivity should not necessarily be the same as those for the work of a company-employed specialist. One commenter suggested expressly including in the list of factors performance standards that the specialist is required to follow.

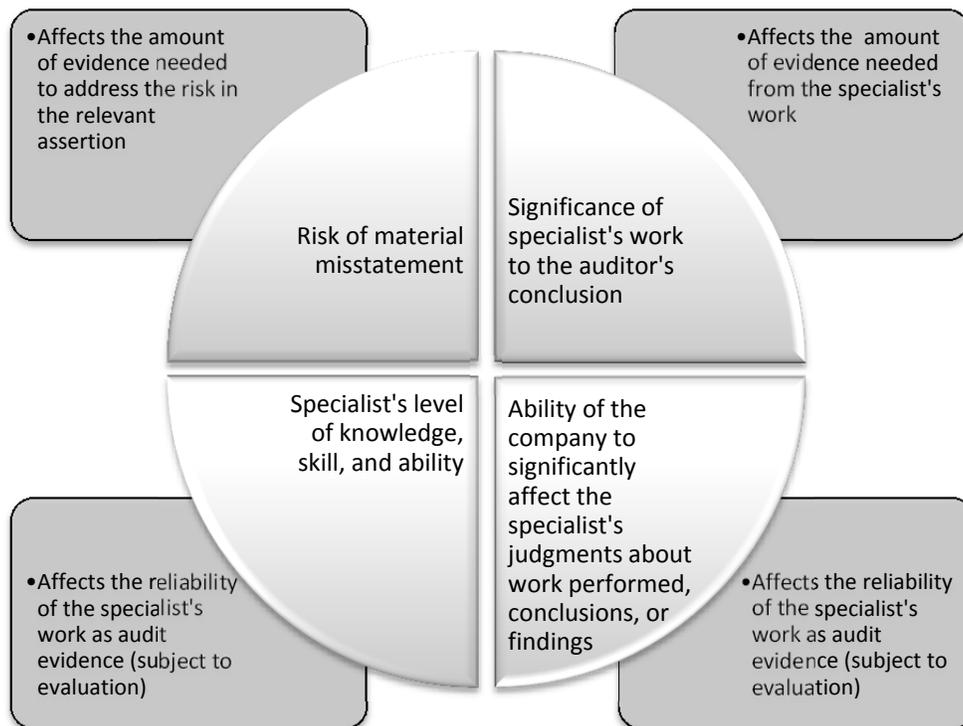
The requirements regarding determining the necessary audit effort for evaluating the specialist's work were adopted substantially as proposed. The changes to the procedural requirements for evaluating the data, significant assumptions, and methods used by the specialist should help address concerns about the necessary level of effort under the appendix. Also, the three examples included in the Proposal have been revised in this release to align with the final amendments and expanded to address factors that lead to more or less audit attention and illustrate how the additional attention may be directed under the circumstances.

With respect to the distinction between company-employed and company-engaged specialists, the Board believes that the final amendments provide an appropriate framework for distinguishing the work effort when using the work of such specialists. In particular, one of the four factors related to determining the necessary audit effort is the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings. This factor is discussed in more detail in Section III.B.2 of this Appendix.

³⁷ As noted previously, this factor includes consideration of professional requirements the specialist is required to follow.

Specifically, under the four factors set forth in the final amendments, the auditor should obtain more persuasive evidence as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist decreases. In general, the required audit effort when evaluating the work of a company's specialist would be greatest when the risk of material misstatement is high; the specialist's work is critical to the auditor's conclusion; the specialist has a lower level of knowledge, skill, and ability in the particular field; and the company has the ability to significantly affect the specialist's judgments. These factors are also illustrated in Figure 1, below.

**Figure 1: Factors that Affect the Necessary Evidence
From the Auditor's Evaluation of the Company's Specialist's Work**



Under the final amendments, the first two factors, in combination, relate to the persuasiveness of the evidence needed from the work of the company's specialist, as follows:

- Risk of Material Misstatement. Consistent with the risk assessment standards, under the final amendments, the higher the risk of material

misstatement for an assertion, the more persuasive the evidence needed to support a conclusion about that assertion.³⁸ Pursuant to existing PCAOB standards, tests of controls are required if the risk of material misstatement is based on reliance on controls.³⁹

- Significance of the Specialist's Work. The significance of the specialist's work refers to the degree to which the auditor would use the work of the company's specialist to support the auditor's conclusions about the assertion. Generally, the greater the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, the more persuasive the evidence from the specialist's work needs to be. The significance of the specialist's work stems from:
 - *The extent to which the specialist's work affects significant accounts and disclosures in the financial statements.* In some situations, the specialist's work might be used only as a secondary check for a significant account or disclosure, while in other situations that work might be a primary determinant in one or more significant accounts and disclosures in the financial statements.
 - *The auditor's approach to testing the relevant assertion.* When a company's accounting estimate is determined principally based on the work of a company's specialist, an auditor testing the company's process for developing the accounting estimate would plan to use the work of the company's specialist for evidence regarding the estimate. On the other hand, if the auditor tests an assertion by developing an independent expectation, the auditor would give less consideration to the work of the company's specialist.⁴⁰

³⁸ See paragraph .09a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

³⁹ See AS 2301.16, which addresses testing controls to modify the nature, timing, and extent of planned substantive procedures.

⁴⁰ As another example, the auditor might develop an independent expectation using certain assumptions or methods of the company's specialist. In those instances, the auditor's evaluation would focus on those assumptions or methods that the auditor used in developing his or her independent expectation.

The other two factors—the specialist's level of knowledge, skill, and ability, and the ability of the company to significantly affect the specialist's judgments—relate to the degree of reliability of the specialist's work as audit evidence (i.e., the extent to which the specialist's work could provide persuasive evidence, if relevant and found to be satisfactory after the auditor's evaluation).

In some situations, if the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments, the auditor might choose not to use the work of the company's specialist, instead of performing additional procedures with respect to evaluating the specialist's work. The final amendments do not preclude the auditor from pursuing other alternatives to using that specialist's work. Such alternatives might include developing an independent expectation of the related accounting estimate or seeking to use the work of another specialist.

The following examples illustrate various ways in which the factors discussed above can affect the necessary audit effort in evaluating the work of a company's specialist under the final amendments. The examples assume that the auditor will evaluate, as appropriate, the data, significant assumptions, and methods used by the specialist, and evaluate the relevance and reliability of the work of the company's specialist and its relationship to the relevant assertion.

Example 1 – An oil and gas production company employs an experienced petroleum reserve engineer to assist in developing the estimated proved oil and gas reserves⁴¹ that are used in multiple financial statement areas, including: (1) the company's impairment analysis; (2) depreciation, depletion and amortization calculations; and (3) related financial statement disclosures, such as reserve disclosures. A substantial portion of the engineer's compensation is based on company earnings, and the engineer has a reporting line to the company's chief financial officer. The auditor concludes that the risk of material misstatement of the valuation of oil and gas properties is high, and the reserve engineer's work is significant to the auditor's conclusion regarding the assertion. Thus, the auditor would need to obtain more persuasive audit evidence commensurate with a high risk of material misstatement, devoting more audit attention to the data, significant assumptions, and methods that are more important to the specialist's findings and more susceptible to error or significant management influence. On the other hand, relatively less audit evidence might be needed for the work of an individual reserve engineer if the company has several properties of similar risk, and the reserve studies are performed by different qualified reserve engineers who are either (1) engaged by the company, having no significant ties that give

⁴¹ See Rule 4-10(a)(22) of Regulation S-X, 17 CFR 210.4-10(a)(22).

the company significant influence over the specialists' judgments or (2) employed specialists for which the company has implemented compensation policies, reporting lines, and other measures to prevent company management from having significant influence over the specialists' judgments.

Example 2 – A financial services company specializes in residential mortgage and commercial mortgage loans, which are either sold or held in its portfolio. During the financial statement audit, the auditor may inspect appraisals prepared by the company's specialists for the real estate collateralizing loans for a variety of reasons, including in conjunction with testing the valuation of loans and the related allowance for loan losses. Under these circumstances, the persuasiveness of the evidence needed from (and the necessary degree of audit attention devoted to evaluating the methods, significant assumptions, and data used in) an individual appraisal would depend, among other things, on the importance of the individual appraisal to the auditor's conclusion about the related financial statement assertion. In general, more audit attention would be needed for appraisals used in testing the valuation of individually large loans that are valued principally based on their collateral than for appraisals inspected in loan file reviews for a portfolio of smaller loans with a low risk of default and a low loan-to-value ratio.

Example 3 – A manufacturing company engages an actuary to calculate the projected pension benefit obligation ("PBO") for its pension plan, which is used to determine the related accounts and disclosures in the financial statements. The auditor has assessed the risk of material misstatement for the valuation of the PBO as high and concluded that the actuary's work is significant to the auditor's conclusion. The actuary has extensive experience and is employed by a highly regarded actuarial firm with many clients. The actuary and actuarial firm have no relationships with the company other than performing the actuarial pension plan calculations for the company's financial statements. Under these circumstances, the necessary level of audit attention is less than it otherwise would be for a situation where a specialist has a lower level of knowledge, skill and ability, or the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings. When more audit attention is needed, the auditor would focus on those aspects of the specialist's work that could be affected by the issues related to the specialist's knowledge, skill, and ability or by the company's ability to significantly affect the specialist's judgments.

The three examples above are provided only to illustrate the auditor's consideration of the four factors set forth in the final amendments when determining the necessary audit effort for evaluating the work of the company's specialist. Differences in circumstances, or additional information, could lead to different conclusions. The examples are not intended to prescribe the specific procedures to be performed in

evaluating the work of a company's specialist in any particular situation, which should be determined in accordance with the final amendments.

3. *Evaluating the Specialist's Work: Findings*

See AS 1105.A9–.A10, as adopted

The Proposal set forth requirements for evaluating the relevance and reliability of the specialist's findings. The proposed requirements built upon the existing requirements to evaluate the specialist's findings and were aligned with the risk assessment standards.⁴² The Proposal also provided factors that affect the relevance and reliability of the specialist's work. Additionally, the proposed requirements described examples of situations in which additional procedures ordinarily are necessary. Commenters on this aspect of the Proposal generally supported the proposed approach. A few commenters asked for an explanation of the additional procedures to be performed. One commenter stated that certain restrictions, disclaimers, or limitations are common in specialists' reports and that auditors may have no choice but to accept them.

After considering the comments received, the Board is adopting the requirements as proposed with one modification discussed below. The final requirements in AS 1105.A10, as adopted, provide that the auditor should perform additional procedures, as necessary, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence. The final requirements also provide examples of situations in which additional procedures ordinarily are necessary, such as when the specialist's report, or equivalent communication,⁴³ contains restrictions, disclaimers, or limitations regarding the auditor's use of the report or the auditor has identified that the specialist has a conflict of interest

⁴² Existing AS 1210.12 requires the auditor to evaluate whether the specialist's findings support the related assertions in the financial statements. It does not specify, however, what might lead an auditor to conclude that he or she should perform additional procedures or obtain the opinion of another specialist.

⁴³ AS 1105.A9–.A10, as adopted, added the phrase "or equivalent communication," which was not part of the proposed amendments, because a company's specialist may communicate his or her findings or conclusions in a memorandum or other written alternative to a formal report. AS 1201, Appendix C, as adopted, and AS 1210, as amended, refer to a specialist's report "or equivalent documentation." The difference in terminology is intended to distinguish information provided by the auditor's specialist from information provided by the company's specialist.

relevant to the specialist's work. The final requirements do not prescribe specific procedures to be performed because the necessary procedures depend on the circumstances creating the need for the procedures.

A specialist's report may contain restrictions, disclaimers, or limitations that cast doubt on the relevance and reliability of the information contained in the specialist's report and affect how the auditor can use the report of the specialist. For example, a specialist's report that states "the values in this report are not an indication of the fair value of the underlying assets" generally would not provide sufficient appropriate evidence related to fair value measurements. On the other hand, a specialist's report that indicates that the specialist's calculations were based on information supplied by management may still be appropriate for use by the auditor to support the relevant assertion, since the auditor would already be required to test the company-supplied data used in the specialist's calculations.

The requirements in AS 1105.A10, as adopted, do not require the auditor to perform procedures specifically to search for potential conflicts of interest that a company's specialist might have, other than those resulting from the specialist's relationship with the company. However, the auditor may become aware of conflicts of interest arising from relationships with parties outside the company (e.g., through obtaining information about the specialist's professional reputation and standing, reading the specialist's report, or performing procedures in other audit areas). For example, in reviewing an appraisal of the collateral for a material loan receivable, the auditor may become aware that the appraiser has a substantial financial interest in the collateral. If the auditor becomes aware of a conflict of interest that could affect the specialist's judgments about the work performed, conclusions, or findings, the auditor would need to consider the effect of that conflict on the reliability of the specialist's work, and perform additional procedures if necessary to obtain sufficient appropriate evidence regarding the relevant financial statement assertion.

Comparison with Standards of Other Standard Setters

Paragraph 8(c) of ISA 500 provides that, if information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary and having regard to the significance of that expert's work for the auditor's purposes, evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

AU-C Section 500 contains requirements that are similar to those in ISA 500.

IV. Amendments Related to Supervising or Using the Work of an Auditor's Specialist

The final amendments set forth requirements for supervising or using the work of an auditor's specialist, taking into account differences in the auditor's relationship with

employed specialists and engaged specialists. A new appendix to AS 1201 applies to the supervision of auditor-employed specialists, and AS 1210, as amended, *Using the Work of an Auditor-Engaged Specialist*, applies when using the work of auditor-engaged specialists.

Commenters on the Proposal generally supported the proposed approach for overseeing and coordinating the work of an auditor's specialists, which was risk-based and set forth largely parallel requirements when using the work of both auditor-employed and auditor-engaged specialists. A few commenters, however, expressed concerns with the practicality and clarity of certain aspects of the proposed requirements. These comments and others are discussed below.

A. Amendments to AS 1201 for Supervising the Work of an Auditor-Employed Specialist

Appendix C of AS 1201, as adopted, supplements the existing requirements in AS 1201.05–.06 by providing more specific direction on applying the general supervisory principles in AS 1201 to the supervision of an auditor-employed specialist who assists the auditor in obtaining or evaluating audit evidence.

1. *Meaning of "Auditor-Employed Specialist"*

See AS 1201.C1, as adopted

The Proposal used the term "auditor-employed specialist" to mean a "specialist employed by the auditor's firm," consistent with existing requirements.⁴⁴ Two commenters asked for clarification of how to apply the terms "auditor-employed" and "auditor-engaged" specialists when specialists are employed by entities that are affiliated with the audit firm and those specialists are subject to the same quality control policies and procedures and independence requirements as employees of the audit firm.

The final amendments retain the existing concept that an "auditor-employed specialist" is a "specialist employed by the auditor's firm." Given that the terms "auditor-employed specialist" and "auditor-engaged specialist" in the final amendments are consistent with existing requirements, auditors should be familiar with this distinction. The Board recognizes, however, that there may be instances where an auditor uses the work of a specialist who is a partner, principal, shareholder or employee of an affiliated

⁴⁴ See existing AS 1210.05, which states that AS 1201 applies to situations in which "a specialist employed by the auditor's firm participates in the audit."

entity that is not an accounting firm and treats that specialist as if he or she were employed by the auditor's firm (i.e., as an auditor-employed specialist). While it is not practicable to address all the legal structures or affiliations between accounting firms and specialist entities that may give rise to such situations, the final amendments are not intended to change current practice where the specialist is employed by an affiliated entity that adheres to the same quality control and independence requirements as the auditor's firm. In such circumstances, the Board understands that the auditor would assess the qualifications and independence of that specialist in the same ways as an engagement team member employed by the firm.

Comparison with Standards of Other Standard Setters

ISA 620 covers the auditor's use of the work of both auditor-employed experts and auditor-engaged experts, but the requirements in ISA 620 for the auditor's evaluation of the objectivity of an auditor-employed expert differ from those for evaluating the objectivity of an auditor-engaged expert.

AU-C Section 620 is similar to ISA 620 in both respects.

2. *Determining the Extent of Supervision*

See AS 1201.C2, as adopted

The Proposal supplemented, in proposed Appendix C of AS 1201, the factors set forth in AS 1201.06 for determining the necessary extent of supervision of engagement team members in circumstances involving the use of the work of an auditor-employed specialist.⁴⁵

No commenters opposed the proposed requirement for determining the extent of supervision. One commenter stated that the proposed requirement for determining the extent of supervision appeared scalable to the size and complexity of the audit engagement. The Board is adopting this requirement as proposed. The final requirements provide that the necessary extent of supervision depends on: (1) the

⁴⁵ AS 1201.06 provides that, to determine the extent of supervision necessary for engagement team members, the engagement partner and other engagement team members performing supervisory activities should take into account, among other things: (1) the nature of the company, including its size and complexity; (2) the nature of the assigned work for each engagement team member; (3) the risks of material misstatement; and (4) the knowledge, skill, and ability of each engagement team member.

significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the auditor-employed specialist relevant to the work to be performed by the specialist.

Comparison with Standards of Other Standard Setters

Paragraph 8 of ISA 620 provides that, depending on the circumstances, the nature, timing and extent of the auditor's procedures will vary with respect to: (1) evaluating the competence, capabilities and objectivity of the auditor's expert; (2) obtaining an understanding of the field of expertise of the auditor's expert; (3) reaching an agreement with the auditor's expert; and (4) evaluating the adequacy of the auditor's expert's work. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

- (a) The nature of the matter to which that expert's work relates;
- (b) The risks of material misstatement in the matter to which that expert's work relates;
- (c) The significance of that expert's work in the context of the audit;
- (d) The auditor's knowledge of and experience with previous work performed by that expert; and
- (e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

3. *Qualifications and Independence of Auditor-Employed Specialists*

See AS 1015.06, as amended, and footnote 3A to AS 2101.06b, as amended

PCAOB auditing standards require that personnel be assigned to engagement teams based on their knowledge, skill, and ability.⁴⁶ This requirement applies equally to auditor-employed specialists and other engagement team members. In addition, auditor-employed specialists must be independent of the company.⁴⁷ Accordingly, the

⁴⁶ See AS 2301.05a and AS 1015.06, as amended.

⁴⁷ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client"

requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements apply to auditor-employed specialists.⁴⁸ Rather than add specific requirements for evaluating the qualifications and independence of auditor-employed specialists, the Proposal would have included two paragraphs in Appendix C citing the applicable requirements in existing standards.⁴⁹

Most commenters on this topic advocated for greater acknowledgment of the auditor's ability to use information from the firm's system of quality control when assessing the knowledge, skill, ability, and independence of an auditor-employed specialist. Specifically, some of these commenters recommended the inclusion of references to QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* ("QC 20"), in these requirements. In the view of these commenters, QC 20 more fully encompasses both the considerations related to the appropriate assignment of personnel to an engagement and the requirements related to independence, integrity, and objectivity. One commenter suggested that the standard provide that a firm's system of quality control pursuant to QC 20 would be sufficient to satisfy the requirements relating to the qualifications and independence of auditor-employed specialists. Another commenter stated that the necessary guidance was contained in QC 20 and that the references in the Proposal to applicable requirements in existing standards were duplicative.

The Board considered these comments in adopting the final amendments. The intent of the proposed paragraphs for assigning personnel based on their knowledge, skill, and ability, and for determining compliance with independence and ethics requirements, was to emphasize that auditors' responsibilities for assessing the qualifications and independence of the auditor-employed specialists are the same as for other engagement team members. To avoid any misunderstanding that a different

throughout the audit and professional engagement period, meaning that they must satisfy all independence criteria applicable to an engagement. In addition, under Rule 2-01 of Regulation S-X, 17 CFR §210.2-01, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

⁴⁸ See AS 2101.06b.

⁴⁹ See proposed AS 1201.C3–.C4; see also AS 2301.05a, AS 1015.06, and AS 2101.06b.

process was expected for assigning auditor-employed specialists and determining their compliance with independence and ethics requirements, the proposed paragraphs do not appear in the final amendments. Also, two related amendments to PCAOB auditing standards are being adopted. First, AS 1015.06 has been amended to clarify that engagement team members, which includes auditor-employed specialists, should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability, and that this requirement is not limited to the assignment and supervision of auditors. Second, in another conforming amendment, a footnote was added to AS 2101.06b to remind auditors of the obligations of registered firms and their associated persons under PCAOB Rule 3520.

Under the final amendments, auditors will continue to have the ability to use information from, and processes in, the firm's quality control system when assessing the knowledge, skill, ability, and independence of auditor-employed specialists. The fact that a system of quality control may have a process for making assignments of specialists does not relieve the engagement partner (with the assistance of appropriate supervisory personnel on the engagement team) of his or her responsibility to determine whether the assigned specialist has the necessary qualifications and independence for the particular audit engagement in accordance with AS 1015.06, as amended, and AS 2101.06, as amended. The relevant facts and circumstances, including the nature, scope, and objectives of the specialist's work, should be considered when performing this assessment. For example, a valuation specialist may have expertise in valuing oil and gas reserves, but not in valuing coal reserves. In that case, failure to consider the specialist's expertise when assigning the specialist work on an audit engagement in an extractive industry could result in the inappropriate assignment of significant engagement responsibilities.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that the auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities, and objectivity for the auditor's purposes.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

4. Informing the Specialist of the Work to be Performed

See AS 1201.C3–.C5, as adopted

The Proposal supplemented the requirements in PCAOB standards for informing the engagement team members of their responsibilities to address situations where

auditor-employed specialists are performing work in an audit.⁵⁰ Most commenters who commented on the supplemental requirements generally supported the proposed approach, asserting that it would foster effective communication between the auditor and the auditor's specialist. Some commenters, however, asked for clarification of certain aspects of the proposed requirement to establish and document an understanding with the specialist of the work to be performed. After considering the comments received, the Board is adopting the requirements substantially as proposed.

The final amendments include requirements for the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform the auditor-employed specialist about the work to be performed. These requirements include establishing and documenting an understanding with the specialist regarding the responsibilities of the specialist, the nature of the specialist's work, the specialist's degree of responsibility for testing data and evaluating methods and significant assumptions, and the responsibility of the specialist to provide a report, or equivalent documentation.

Some commenters requested clarification in the final amendments on the form of documentation of the auditor's understanding with the specialist. In addition, some commenters suggested removing the specific reference to the specialist's responsibility to provide a "report, or equivalent documentation" and allowing for more flexibility when the specialist's results are communicated to the auditor. Some of these commenters asserted that the proposed requirement connoted the preparation of a formal, signed report, which could discourage effective two-way communication between the auditor and the specialist. Another commenter suggested that the Board consider whether the auditor's understanding with the specialist should also include matters the specialist should communicate to the auditor, and the nature, timing, and extent of those communications. One commenter also expressed concern that use of the term "degree of responsibility" could be seen as a means for auditors to abdicate responsibility for audit work to specialists.

⁵⁰ AS 1201.05a sets forth requirements for the engagement partner and, as applicable, other engagement team members performing supervisory activities to inform engagement team members of their responsibilities. These matters include: (1) the objectives of the procedures that engagement team members are to perform; (2) the nature, timing, and extent of procedures they are to perform; and (3) matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues.

The final amendments do not include specific requirements for how to document the auditor's understanding with the auditor's specialist. Instead, the Board contemplates that the understanding with the specialist can be documented in a variety of ways, such as in planning memoranda, separate memoranda, or other related work papers. This approach should provide auditors with flexibility, while still requiring the documentation of the important aspects of the understanding reached by the auditor and the auditor's specialist. This approach also enables the specialist to communicate those matters specific to the work performed and does not limit the specialist's ability to communicate other items to the auditor.

The final amendments also require the auditor to establish and document an understanding with the specialist regarding the degree of responsibility of the specialist for: (1) testing data produced by the company, or evaluating the relevance and reliability of data from sources external to the company; (2) evaluating the significant assumptions used by the company or the company's specialist, or developing his or her own assumptions; and (3) evaluating the methods used by the company or the company's specialist, or using his or her own methods. The intent of this requirement is to enhance coordination of the work between the auditor and the auditor's specialist and facilitate supervision of the specialist by the engagement partner and others with supervisory responsibilities. For example, if the auditor's specialist assists the auditor in developing an independent expectation using data, assumptions, or a model provided by the auditor or auditor's specialist, the auditor would establish an understanding with the specialist regarding the specialist's responsibilities with respect to the data, assumptions, or model.⁵¹ Regardless of the specialist's degree of responsibility, the engagement partner and, as applicable, other engagement team members performing supervisory activities are responsible for evaluating the specialist's work and report, or equivalent documentation.⁵²

In addition, as proposed, the final amendments require establishing and documenting the specialist's responsibility to provide "a report, or equivalent documentation" to the auditor. This requirement should provide flexibility for auditors to obtain the necessary information about the specialist's procedures, findings, and conclusions through the specialist's report, other specialist-provided documentation, or

⁵¹ AS 1201.C5, as adopted, provides that the auditor should comply with AS 2501.21–.26, as adopted, when an independent expectation is developed. For example, the auditor's responsibilities with respect to using data or assumptions obtained from a third party are presented in AS 2501.23, as adopted. See Estimates Release.

⁵² See AS 1201.C6-.C7, as adopted.

a combination of the two. The requirement should also facilitate the auditor's compliance with other PCAOB auditing standards, such as those on engagement quality review and audit documentation.⁵³

The final amendments require establishing and documenting the auditor's understanding with the specialist regarding the "nature of the work that the specialist is to perform or assist in performing." As proposed, this requirement would have also encompassed the "specialist's approach to that work." Two commenters suggested that the Board clarify the difference between the two terms. The nature of the specialist's work would include, for example, testing data and evaluating the methods and significant assumptions used in developing an estimate when testing the company's process used to develop an accounting estimate or developing an independent expectation of an estimate. The specialist's approach to that work, in turn, might include the procedures the specialist performs to test management's process or develop an independent expectation, such as testing data and evaluating the methods and significant assumptions used in developing an estimate. Since the auditor's obligation to establish and document the specialist's degree of responsibility for performing similar procedures is addressed in other provisions of the final amendments,⁵⁴ the phrase "the specialist's approach to that work" has been omitted to avoid potential confusion.

As proposed, the final amendments also provide that, pursuant to AS 1201.05a(3), the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the auditor-employed specialist about matters that could affect the specialist's work.⁵⁵ This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism. Commenters did not offer suggestions on this provision, although one commenter stated that it concurred with the proposed requirement.

The final amendments also provide that the engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a

⁵³ See AS 1220, *Engagement Quality Review*, and AS 1215, *Audit Documentation*.

⁵⁴ See AS 1201.C3c, as adopted.

⁵⁵ See AS 1201.C4, as adopted.

proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion.⁵⁶ One commenter requested clarification of the term "measures," as used in this context. The final requirement emphasizes that the auditor is responsible for complying with relevant auditing standards, including, when applicable, AS 2501, as adopted, and Appendix A of AS 1105, as adopted.⁵⁷ This requirement is intended to prompt the auditor to coordinate with the specialist to make sure that the work is performed in accordance with the applicable standards, including the requirement to consider relevant audit evidence, regardless of whether it supports or contradicts the relevant financial statement assertion. For example, in auditing an accounting estimate under AS 2501, as adopted, measures taken by the auditor could include either performing, or supervising the auditor's specialist in performing, the required procedures with respect to testing and evaluating the data, and evaluating the methods and significant assumptions used in developing that estimate.⁵⁸

Comparison with Standards of Other Standard Setters

Paragraph 11 of ISA 620 provides that the auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

- (a) The nature, scope and objectives of that expert's work;
- (b) The respective roles and responsibilities of the auditor and that expert;
- (c) The nature, timing, and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and
- (d) The need for the auditor's expert to observe confidentiality requirements.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

⁵⁶ See AS 1201.C5, as adopted.

⁵⁷ See AS 1201.C5, as adopted. In response to comments, this paragraph was revised in the final amendments to provide that, if an auditor's specialist is used to evaluate the work of a company's specialist, measures should be implemented to comply with Appendix A of AS 1105, as adopted, and, for accounting estimates, AS 2501.19, as adopted.

⁵⁸ See AS 2501, as adopted, and Estimates Release.

5. *Evaluating the Work of the Specialist*

See AS 1201.C6–.C7, as adopted

The Proposal supplemented, in Appendix C, the requirements in AS 1201.05c for reviewing the work of the engagement team in circumstances in which auditor-employed specialists are used.⁵⁹ It provided that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Commenters generally agreed with these requirements, noting that the requirements are appropriate and, in the view of some commenters, would improve audit quality. Two commenters asked for additional guidance on how the auditor should evaluate methods and assumptions used by an auditor-employed specialist. One commenter recommended providing additional guidance on the specific procedures to be performed by auditors to evaluate a specialist's work. After considering the comments, the Board is adopting the requirements substantially as proposed.

The final amendments provide a principles-based framework for reviewing and evaluating the work of the specialist. Under the final amendments, the engagement partner and, as applicable, other engagement team members performing supervisory activities should review the specialist's report or equivalent documentation describing the work performed, the results of the work, and the findings or conclusions reached by the specialist, as provided for under AS 1201.C3d, as adopted.⁶⁰

This approach links the scope of the auditor's review to the report or equivalent documentation that the specialist agreed to furnish to the auditor under AS 1201.C3, as adopted. The principles for the necessary extent of supervision, discussed earlier, also apply to evaluating the work of the auditor-employed specialist, including the report or

⁵⁹ AS 1201.05c provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities should review the work of engagement team members to evaluate whether: (1) the work was performed and documented; (2) the objectives of the procedures were achieved; and (3) the results of the work support the conclusions reached.

⁶⁰ See AS 1201.C6, as adopted.

equivalent documentation provided by the specialist. Accordingly, auditors should be familiar with this approach and how to apply this requirement in practice.

The necessary extent of review and evaluation of the auditor-employed specialist's work depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist. In performing the review, the auditor also should evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

- The specialist's work and report, or equivalent documentation, are in accordance with the auditor's understanding with the specialist; and
- The specialist's findings and conclusions are consistent with results of the work performed by the specialist, other evidence obtained by the auditor, and the auditor's understanding of the company and its environment.

AS 1201.C7, as adopted, provides that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue. The final requirement also provides examples of situations in which additional procedures ordinarily would be necessary, including:

- The specialist's work was not performed in accordance with the auditor's instructions;
- The specialist's report, or equivalent documentation, contains restrictions, disclaimers, or limitations that affect the auditor's use of the report or work;⁶¹
- The specialist's findings and conclusions are inconsistent with (1) the results of the work performed by the specialist, (2) other evidence

⁶¹ The auditor's consideration of restrictions, disclaimers, or limitations in a report, or equivalent documentation, provided by an auditor-employed specialist is the same as when such language is contained in a report, or equivalent documentation, provided by an auditor-engaged specialist. See Section IV.B.2 for further discussion of the auditor's consideration of the effect of restrictions, disclaimers, or limitations on the report, or equivalent documentation, provided by the auditor-engaged specialist.

obtained by the auditor, or (3) the auditor's understanding of the company and its environment;

- The specialist lacks a reasonable basis for data or significant assumptions the specialist used; or
- The methods used by the specialist were not appropriate.

These requirements are consistent with existing provisions in paragraphs .06 and .36 of AS 2810, *Evaluating Audit Results*, which provide that, if the auditor concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary (e.g., audit procedures may need to be modified or additional procedures may need to be performed as a result of any changes in the risk assessments). Similarly, if the evidence gathered by the specialist in testing or evaluating data, or evaluating significant assumptions is not adequate, the engagement partner and, as applicable, other engagement team members performing supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

One commenter asserted that auditors may not have sufficient knowledge of the specialist's field of expertise to evaluate a specialist's work and effectively challenge methods, assumptions, and data, particularly in relation to highly complex technical areas. The final amendments recognize that the engagement partner and, as applicable, other engagement team members performing supervisory responsibilities may not have in-depth knowledge of the specialist's field. However, under existing PCAOB standards, the auditor is required to have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the nature, timing, and extent of the auditor's work and the effects on the auditor's report.⁶² Furthermore, the evaluation of the specialist's work under the final amendments is based on matters that are within the capabilities of the auditor (e.g., whether the specialist followed instructions and whether the results of the work support the specialist's conclusions).

Another commenter asked for clarification of the term "reasonable basis" in the context of assessing whether the specialist lacks a reasonable basis for data or significant assumptions the specialist used. In that context, "reasonable basis" refers to whether the specialist's selection of data or significant assumptions was determined arbitrarily or instead based on consideration of relevant information available to the specialist.

⁶² See AS 2101.17.

Comparison with Standards of Other Standard Setters

Paragraph 12 of ISA 620 provides that the 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.

Paragraph 13 of ISA 620 provides that if the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (a) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (b) Perform additional audit procedures appropriate to the circumstances.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

B. Amendments to Existing AS 1210 for Using the Work of an Auditor-Engaged Specialist

This section discusses the final requirements in AS 1210, as amended, for audits in which the auditor uses an auditor-engaged specialist. In such circumstances, the objective of the auditor is to determine whether the work of the auditor-engaged specialist is suitable for the auditor's purposes and supports the auditor's conclusion regarding the relevant assertion.

1. Assessing the Knowledge, Skill, Ability, and Objectivity of the Engaged Specialist

As described in Section III.B of this Appendix, existing AS 1210 requires the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

Similar to the final amendments related to using a company's specialist, the final amendments carry forward the existing requirements with certain modifications described below.

a. Knowledge, Skill, and Ability

See AS 1210.03–.04, as amended

Requirements in existing AS 1210 related to the auditor's evaluation of a specialist's qualifications were described in Section III.B of this Appendix with regard to a company's specialist. These requirements are the same for a company's specialist and an auditor-engaged specialist.

The Proposal substantially carried forward the requirement in existing AS 1210. Unlike the existing standard, however, the Proposal expressly provided that the auditor would obtain an understanding of the professional qualifications of both the specialist and the entity that employs the specialist. The Board is adopting this requirement as proposed.

Two commenters concurred with the proposed approach to assessing knowledge, skill, and ability of the auditor-engaged specialist. One commenter suggested allowing auditors to assess the specialist's knowledge, skill, and ability centrally as part of the firm's system of quality control. Another commenter asserted that the proposed requirement was not well-suited to assessing the knowledge, skill, and ability of the entity that employs the specialist.

Under the final amendments, auditors will continue to be able to use information from, and processes in, the firm's quality control system when assessing the knowledge, skill, and ability of auditor-engaged specialists. The fact that a system of quality control may have a firm-level process for screening engaged specialists does not relieve the engagement partner (with the assistance of appropriate supervisory personnel on the engagement team) of his or her responsibility to assess whether the engaged specialist has the necessary knowledge, skill, and ability for the particular audit engagement. The relevant facts and circumstances, including the nature, scope, and objectives of the specialist's work, should be considered when performing this assessment.

The final requirement retains the concept in existing AS 1210 that a specialist may be an individual or an entity. Outreach to audit firms suggests that firms have policies and procedures for evaluating the qualifications of specialists, whether individuals or entities. Accordingly, auditors should be familiar with assessing the qualifications of entities that are specialists or employ specialists. Therefore, the final requirement is not expected to result in a significant change in practice.

AS 1210, as amended, does not specify steps to perform or information sources to use in assessing the specialist's knowledge, skill, and ability. Potential sources of relevant information, if available, could include the following:

- Information contained within the audit firm related to the professional qualifications and reputation of the specialist and the entity that employs

the specialist, if applicable, in the relevant field and experience with previous work of the specialist;

- Professional or industry associations and organizations, which may provide information on: (1) qualification requirements, technical performance standards, and continuing professional education requirements that govern their members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against the specialist;
- Information provided by the specialist about matters regarding the specialist's understanding of the financial reporting framework, experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- The specialist's responses to questionnaires about the specialist's professional credentials; and
- Published books or papers written by the specialist.

Requirements applicable to a specialist pursuant to legislation or regulation also could help inform the auditor's assessment of the specialist's knowledge, skill, and ability.

The purpose of the assessment of the auditor-engaged specialist's knowledge, skill, and ability is two-fold: (1) to determine whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform his or her assigned work; and (2) to help determine the necessary extent of the review and evaluation of the specialist's work. AS 1210.04, as amended, emphasizes the importance of engaging a sufficiently qualified auditor's specialist by expressly providing that the auditor should not use the work of an engaged specialist who does not have a sufficient level of knowledge, skill, and ability.

The assessment of the specialist's knowledge, skill, and ability by the engagement partner and, as applicable, other engagement team members performing supervisory activities is also a factor when determining the necessary extent of the review and evaluation of the specialist's work.⁶³ The auditor's evaluation of the work of a specialist may be more extensive if the specialist generally has sufficient knowledge, skill, and ability in the relevant field of expertise, but less experience in the particular

⁶³ See AS 1210.10, as amended.

area of specialty within the field. For example, a valuation specialist may possess sufficient knowledge, skill, and ability in business valuation, but may not be well-versed in the application of business valuation for financial reporting purposes.

b. Objectivity

See AS 1210.05 and .11, as amended

Requirements in existing AS 1210 related to the auditor's evaluation of a specialist's objectivity are described in Section III.B of this Appendix with regard to a company's specialist. Those requirements are the same for a company's specialist and an auditor-engaged specialist.

The Proposal built on the requirements for assessing objectivity in the existing standard and provided that the engagement partner and, as applicable, other engagement team members performing supervisory activities would assess whether the specialist and the entity that employs the specialist have the necessary objectivity, which includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed.

The proposed requirements differed from the existing requirements in two primary respects. First, they articulated the concept of objectivity for purposes of proposed AS 1210, as referring to the specialist's ability "to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit." Second, they expanded the list of matters that the auditor would consider in assessing objectivity to include financial and business relationships with the company and other conflicts of interest.

Some commenters supported the proposed approach. Other commenters expressed concern that the proposed requirement implied that the assessment of whether the specialist had the necessary objectivity was a binary decision. These commenters expressed a preference for describing objectivity as an attribute that exists along a spectrum. Some of these commenters asserted that an auditor should not be precluded from using the work of a less objective specialist, as long as the auditor performed additional procedures in those circumstances.

After considering the comments received, the requirement has been revised to allow auditors to assess the specialist's level of objectivity along a spectrum and use the work of a less objective specialist if the auditor performs additional procedures to evaluate the specialist's work. In revising this requirement, the Board took into account the need for auditors to assess the objectivity of auditor-engaged specialists, while allowing auditors, where appropriate, to engage specialists who have certain relationships with a company that may raise questions as to their level of objectivity.

The final amendments also require the auditor to perform procedures that are commensurate with, among other things, an engaged specialist's degree of objectivity.⁶⁴ Under the final amendments, if the specialist or the entity that employs the specialist has a relationship with the company that affects the specialist's objectivity, the auditor should (1) perform additional procedures to evaluate the data, significant assumptions, and methods that the specialist is responsible for testing, evaluating, or developing consistent with the understanding established with the specialist pursuant to AS 1210.06, as amended, or (2) engage another specialist. The necessary nature and extent of the additional procedures would depend on the degree of objectivity of the specialist. As the degree of objectivity increases, the evidence needed from additional procedures decreases.⁶⁵ If the specialist has a low degree of objectivity,⁶⁶ the auditor should apply the procedures for evaluating the work of a company's specialist.⁶⁷ For example, if the specialist's employer has a significant ownership interest in the company, the specialist's ability to exercise objective and impartial judgment might be low and, therefore, the auditor should evaluate the data, significant assumptions, and methods used by the specialist under the requirements in Appendix A of AS 1105, as amended.

Some commenters on the Proposal suggested the Board should provide additional guidance to specify the steps to be performed by auditors to assess the objectivity of an auditor-engaged specialist, as well as what constitutes sufficient appropriate evidence to support this assessment. One commenter asserted that auditors would face challenges in assessing the objectivity of the entity that employs the specialist, as required under the Proposal, and suggested that auditors may be unable to obtain the policies, procedures, and systems, if any, of the entity employing the specialist. This commenter suggested either omitting the requirement to consider the objectivity of the specialist's employer or limiting the requirement to performing inquiry of the specialist.

⁶⁴ See first note to AS 1210.05, as amended. See *also* AS 1210.10, as amended, for a description of other factors affecting the necessary extent of the auditor's review.

⁶⁵ See AS 1210.11, as amended.

⁶⁶ The concept of a "low degree of objectivity" is used in paragraph .18 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and, therefore, should be familiar to auditors.

⁶⁷ See AS 1210.11, as amended.

After considering these comments, the Board has eliminated the assessment of the objectivity of the entity that employs the specialist as a separate requirement under the final requirements. Instead, the auditor is required to evaluate relationships between the company and both the specialist and the specialist's employer to determine whether either has a relationship with the company that may adversely affect the specialist's objectivity.⁶⁸ This is consistent with existing AS 1210, under which a specialist may be either an individual or an entity. Additionally, outreach to specialist entities and audit firms suggests that audit firms have policies and procedures for evaluating relationships between a specialist entity that they engage and the company. Accordingly, the concept of assessing relationships between a company and an entity that employs specialists should be familiar to auditors.

As under the Proposal, the final amendments do not prescribe the procedures the auditor must perform to obtain information relevant to the auditor's assessment. In response to questions raised by commenters, the Board added a note to clarify that the evidence necessary to assess the specialist's objectivity depends on the significance of the specialist's work and the related risk of material misstatement.⁶⁹ Under this principles-based approach, as the significance of the specialist's work and the risk of material misstatement increase, the persuasiveness of the evidence the auditor should obtain for this assessment also increases.

In addition, the note includes non-exclusive examples of potential sources of information that could be relevant to the auditor's assessment of the relationship to the company of both the specialist and the specialist's employer.⁷⁰ These examples include responses to questionnaires provided to the specialist regarding relationships between the specialist, or the specialist's employer, and the company. As with the auditor's assessment of a specialist's knowledge, skill, and ability, certain sources of information may provide more persuasive evidence than others. In situations where more persuasive evidence is required, it may be appropriate to perform procedures to obtain evidence from multiple sources.

⁶⁸ See AS 1210.05, as amended. For example, the specialist's employer might have an ownership or other financial interest with respect to the company, or other business relationships that might be relevant to the auditor's assessment of the specialist's ability to exercise objective and impartial judgment.

⁶⁹ See second note to AS 1210.05, as amended.

⁷⁰ *Id.* These examples were based on examples set forth in the Proposal, but have been refined to better reflect their application in practice.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that in the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

AU-C Section 620 contains requirements that are similar to those in ISA 620.

2. *Informing the Specialist of the Work to be Performed, Determining the Extent of Review, and Evaluating the Work of the Specialist*

See AS 1210.06–.12, as amended

As is the case with respect to an auditor-employed specialist, the auditor uses an auditor-engaged specialist to assist the auditor in obtaining and evaluating audit evidence. Given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the final requirements for the auditor-engaged specialist are parallel to the requirements for the auditor-employed specialist when determining the extent of the auditor's review, informing the auditor-engaged specialist of the work to be performed, and evaluating the work of the auditor-engaged specialist. Sections IV.A.2, IV.A.4, and IV.A.5 of this Appendix discuss these final requirements in additional detail.

Some commenters on the Proposal commented on the impact of certain proposed changes solely with respect to auditor-engaged specialists. These comments are discussed below.

One commenter on the Proposal expressed concern that the auditor may have limited access to proprietary models used by auditor-engaged specialists. This commenter recommended that the Board include statements made in the Proposal regarding the auditor's access to such models and the impact on the auditor's performance obligations in the final amendments. Similar to the Proposal, the final amendments do not require the auditor to have full access to a specialist's proprietary model or to reperform the work of the specialist, but instead require the auditor to evaluate the work of that specialist in accordance with the final standard. Under AS 1210.10, as amended, the necessary extent of the evaluation of the specialist's work, including a determination of the necessary access to a specialist's model, depends upon (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist. For example, if the specialist used a proprietary model to develop an independent expectation, the auditor would need to obtain information from the specialist to assess whether the specialist's model was in conformity with the applicable financial reporting framework and to evaluate differences between the independent expectation and the company's recorded estimate.

Another commenter recommended including a requirement to inform auditor-engaged specialists of the need to apply professional skepticism, similar to the requirement for auditor-employed specialists in proposed AS 1201.C6. A different commenter recommended that the requirements for informing the specialist of the work to be performed should include communicating the auditor's need to exercise professional skepticism to the auditor-engaged specialist, so that the specialist is aware that relevant information should be passed on to the auditor.

The Board considered these comments and determined to adopt the requirement to inform the specialist of the work to be performed substantially as proposed. Due professional care in the performance of audit procedures requires the auditor to exercise professional skepticism, including a questioning mind and a critical assessment of audit evidence.⁷¹ The Board did not propose extending the auditing standard on due professional care to auditor-engaged specialists and, therefore, no change has been made to AS 1210, as amended. While there is no requirement for auditors to make the engaged specialist aware of the auditor's responsibility to exercise professional skepticism, auditors nevertheless may decide to communicate the auditor's responsibility to the auditor-engaged specialist.

Some commenters asserted that the discussion of the auditor's assessment of disclaimers, limitations, and restrictions related to the report of a company's specialist was equally applicable to the report of the auditor-engaged specialist and recommended similar guidance be provided when using the report of an auditor-engaged specialist. Under the final amendments, the auditor's evaluation of the specialist's report or equivalent documentation includes considering the effect of any restrictions, limitations, or disclaimers in the specialist's report or equivalent documentation on both (1) the relevance and reliability of the audit evidence the specialist's work provides and (2) how the auditor can use the report of the specialist.⁷² For example, a specialist's report that states "the values in this report are not an indication of the fair value of the underlying assets" generally would not provide sufficient appropriate evidence related to fair value measurements. On the other hand, a specialist's report that indicates that the specialist's calculations were based on information supplied by management may still be appropriate for use by the auditor to support the relevant assertion, since the auditor would be required to test the data that was produced by the company and used in the specialist's calculations

⁷¹ See AS 1015.07.

⁷² See note to AS 1210.12, as amended.

Comparison with Standards of Other Standard Setters

Sections IV.A.2, IV.A.4, and IV.A.5 of this Appendix discuss the comparative requirements of the IAASB and the ASB.

V. Other Considerations

The Board proposed to rescind two auditing interpretations.⁷³ The Board has taken commenters' views into account and determined not to rescind these interpretations at this time. The Board is incorporating key elements of each interpretation, however, in the final amendments. These matters are discussed below, along with certain requirements in existing AS 1210 that are not specifically addressed in the final amendments.

A. Auditing Interpretation AI 11, Using the Work of a Specialist: Auditing Interpretations of AS 1210

The Board proposed to rescind AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*, in the Proposal. AI 11 provides guidance for auditing transactions involving transfers of financial assets, such as in securitizations that are accounted for under Statement of Financial Accounting Standards No. 140.⁷⁴ The interpretation addresses an auditor's use of a legal opinion obtained from a company's legal counsel on matters that may involve the U.S. Bankruptcy Code, rules of the Federal Deposit Insurance Corporation ("FDIC"),⁷⁵ and other federal, state, or foreign law to determine whether "transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in

⁷³ Auditing interpretations provide guidance the auditor should be aware of and consider related to specific areas of the audit. See paragraph .11 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

⁷⁴ See Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("FAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This standard was subsequently amended by FAS No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and codified into FASB Accounting Standards Codification ("ASC"), Topic 860, *Transfers and Servicing*.

⁷⁵ Subsequent to the Board's adoption of AI 11, the FDIC rule regarding the treatment of financial assets transferred by an institution in connection with a securitization or participation was amended in 2010.

bankruptcy or other receivership," which affects the accounting for the transaction under FAS No. 140. AI 11 also reiterates certain requirements in generally accepted accounting principles ("GAAP") and PCAOB auditing standards. In addition, the interpretation includes illustrative examples of legal isolation letters based on FAS No. 140 and certain provisions of the FDIC's original rule, both of which have been subsequently amended.

A few commenters supported the proposed rescission. A number of other commenters, however, expressed concern about the proposed rescission of AI 11, stating that it continues to provide useful guidance to auditors regarding the necessary audit evidence to support management's assertion that a transfer of financial assets has met the isolation criterion of ASC 860-10-40, *Transfers and Servicing*. One commenter asserted that companies would struggle to anchor their accounting conclusions to guidance on the existing auditing standards if AI 11 was rescinded.

After considering comments and the continued use of the interpretation in practice, the Board determined not to rescind AI 11 at this time. The final amendments have been revised to include conforming changes to AI 11 to remove outdated references to existing AS 1210, which has been replaced and retitled.

The amended standards for using the work of a company's specialist also incorporate certain principles from AI 11. As discussed in AI 11, legal opinions are sometimes necessary evidence to support an auditor's conclusion about the proper accounting for transfers of financial assets. Accordingly, the final amendments clarify that Appendix A of AS 1105, as adopted, applies in situations when an auditor uses the work of a company's attorney as audit evidence in other matters relating to legal expertise, such as when a legal interpretation of a contractual provision or a legal opinion regarding isolation of transferred financial assets is necessary to determine appropriate accounting or disclosure under the applicable financial reporting framework.⁷⁶ The provision emphasizes the importance of legal opinions as audit evidence in certain contexts and clarifies the requirements the auditor should be applying in such circumstances.

B. Auditing Interpretation AI 28, Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations

The Board also proposed to rescind AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*, in the Proposal. AI 28 provides guidance about matters related to auditing the income tax accounts in a company's financial statements.

⁷⁶ See second note to AS 1105.A1, as adopted.

Topics covered by the interpretation include restrictions on access to the company's books and records related to its income tax calculation, documentation of evidence obtained in auditing the income tax accounts, and use of tax opinions from company legal counsel and tax advisors. The interpretation also reiterates certain requirements from PCAOB auditing standards.

Most commenters did not express a view regarding the proposed rescission of AI 28. A few commenters supported the proposed rescission. Two commenters asserted that AI 28 provides useful guidance to auditors regarding tax specialists and tax working papers and should be retained. The Board has considered these comments and determined not to rescind AI 28 at this time.

The Board recognizes that written advice or opinions of a company's tax advisor or tax legal counsel on material tax matters are sometimes necessary evidence to support the auditor's conclusions on income tax accounts. Accordingly, the Board revised the final amendments to acknowledge such situations and to clarify that, if an auditor plans to use an opinion of legal counsel or the advice of a tax advisor on specific tax issues as audit evidence, it is not appropriate for the auditor to rely solely on that opinion or advice with respect to those tax issues.⁷⁷ Instead, the auditor needs to evaluate the analysis underlying the tax opinion or tax advice to determine whether it provides relevant and reliable evidence, taking into account the requirements of the applicable financial reporting framework.

C. Certain Requirements of Existing AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Final Amendments

Decision to use a specialist. Existing AS 1210 states that an auditor may encounter complex or subjective matters that are potentially material to the financial statements. It further provides that such matters, examples of which are provided, may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter.⁷⁸ The final amendments do not retain this language, as this issue is already addressed in AS 2101. Specifically, AS 2101.16 requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

⁷⁷ See footnote 1 to AS 1105.A1, as adopted; note to AS 2505.08, as amended.

⁷⁸ See existing AS 1210.06.

Reporting requirements. Existing AS 1210 prohibits auditors from making reference to the work or findings of a specialist in the auditor's report, unless such reference will facilitate an understanding of the reason for an explanatory paragraph, a departure from an unqualified opinion, or a critical audit matter ("CAM"). A CAM is defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.⁷⁹ Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist.

No commenters objected to omitting the prohibition in existing AS 1210 from the proposed amendments. For the reasons discussed above, the Board did not make changes to the final amendments to incorporate these extant requirements.

VI. Other Aspects of the Final Amendments

Appendix 2 contains additional amendments that the Board is adopting to conform its standards to the final requirements in AS 1105, AS 1201, and AS 1210, as amended. Those conforming amendments to AS 1015, AS 2301, AS 2310, AS 2401, AS 2610, AT 601, and AT 701 do not change the meaning of existing requirements.

⁷⁹ See AS 3101.11–.17.