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**STAFF CONSULTATION PAPER NO. 2015-01**  
***THE AUDITOR'S USE OF THE WORK OF SPECIALISTS***  
**MAY 28, 2015**

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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](mailto:comments@pcaobus.org) or through the PCAOB's website at: [www.pcaobus.org](http://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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## 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."<sup>1</sup> 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.<sup>2</sup>
- 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

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<sup>1</sup> See paragraph .01 of AU section ("AU sec.") 336, *Using the Work of a Specialist*.

<sup>2</sup> 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.<sup>3</sup> 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

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<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> For example, companies use actuaries to determine employee benefit obligations,

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<sup>4</sup> 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* (8<sup>th</sup> 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.").

<sup>5</sup> 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).

<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup>

PCAOB inspections data indicate that the largest accounting firms extensively use the work of specialists. The staff analyzed a sample of audits<sup>9</sup> 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 audits<sup>10</sup> 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.

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<sup>7</sup> 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.").

<sup>8</sup> 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 ....").

<sup>9</sup> The staff analyzed data from a sample of 50 audits, performed by large global accounting firms, that were inspected by the PCAOB in 2014.

<sup>10</sup> 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.

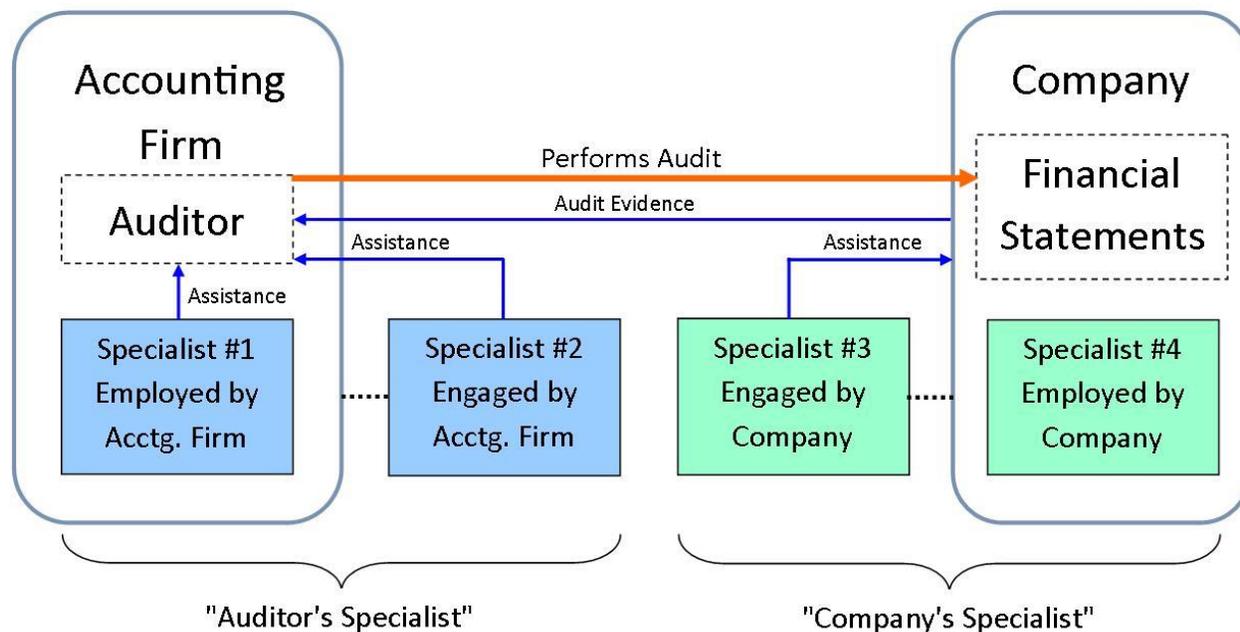
**Figure 1: Examples of Activities that Involve the Work of Specialists**

<b>Activities</b>	<b>Types of Specialists</b>
<b>Valuation</b>	
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
<b>Evaluation of physical and other characteristics</b>	
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
<b>Interpretation of laws, regulations, or contracts</b>	
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.<sup>11</sup>

<sup>11</sup> 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,<sup>12</sup> 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."<sup>13</sup> 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.<sup>14</sup>

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;<sup>15</sup> and
- c. Review the work of engagement team members to evaluate whether:
  - The work was performed and documented;

(footnote continued)

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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).

<sup>12</sup> 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.

<sup>13</sup> See Statement on Auditing Procedure No. 33, *Auditing Standards and Procedures*, AICPA, Committee on Auditing Procedure (1963), at 18.

<sup>14</sup> AU sec. 311 was superseded by the risk assessment standards.

<sup>15</sup> 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.<sup>16</sup>

## **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.<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup> Although reasonable assurance is not absolute assurance, it is a high level of assurance.<sup>20</sup>

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.<sup>21</sup>

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.<sup>22</sup> 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.<sup>23</sup> 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.<sup>24</sup>

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<sup>16</sup> See paragraph 5 of Auditing Standard No. 10.

<sup>17</sup> See, e.g., paragraph 4 of ISA 500, *Audit Evidence*.

<sup>18</sup> See paragraph 4 of Auditing Standard No. 15, *Audit Evidence*.

<sup>19</sup> See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

<sup>20</sup> See paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

<sup>21</sup> See paragraph 2 of Auditing Standard No. 15.

<sup>22</sup> See paragraph 7 of Auditing Standard No. 13, *The Auditor's Response to the Risks of Material Misstatement*. See also AU sec. 230.07.

<sup>23</sup> See AU sec. 230.07 – .09.

<sup>24</sup> 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.<sup>25</sup> 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.<sup>26</sup>
- 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.

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<sup>25</sup> See paragraph 16 of Auditing Standard No. 9, which applies to a person with specialized knowledge or skill, including a specialist.

<sup>26</sup> 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.<sup>27</sup>

PCAOB standards also require that the engagement partner:

- Be knowledgeable about the client;<sup>28</sup> 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.<sup>29</sup>

***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.<sup>30</sup>

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;

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<sup>27</sup> 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.

<sup>28</sup> See AU sec. 230.06.

<sup>29</sup> 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*.

<sup>30</sup> 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.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup>

### **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,<sup>34</sup> the auditor is required to evaluate the reasonableness of those assumptions.

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<sup>31</sup> See AU sec. 336.12.

<sup>32</sup> See AU sec. 336.13.

<sup>33</sup> See AU sec. 336.11.

<sup>34</sup> 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<sup>35</sup> and consider them members of the engagement team.<sup>36</sup> These firms may involve their employed specialists early in the audit, usually during planning.<sup>37</sup> 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,<sup>38</sup> 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

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<sup>35</sup> 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.

<sup>36</sup> 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.

<sup>37</sup> 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.").

<sup>38</sup> 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.<sup>39</sup>

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."<sup>40</sup>

**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.<sup>41</sup> Those standards also contain requirements that are generally consistent with the elements of

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<sup>39</sup> 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 ....").

<sup>40</sup> 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.").

<sup>41</sup> 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.<sup>42</sup>

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."<sup>43</sup>

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*.<sup>44</sup> 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?

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<sup>42</sup> See paragraph 12 of ISA 620 and paragraph .12 of AU-C Section 620.

<sup>43</sup> See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review* 44 – 45 (July 2013).

<sup>44</sup> 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.<sup>45</sup> 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.**<sup>46</sup> 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.

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<sup>45</sup> 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 (8<sup>th</sup> ed. 2006).

<sup>46</sup> 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.<sup>47</sup> 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.<sup>48</sup>

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.<sup>49</sup> 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,<sup>50</sup> 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

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<sup>47</sup> See AU sec. 336.12.

<sup>48</sup> See AU sec. 336.13.

<sup>49</sup> 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.").

<sup>50</sup> 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.<sup>51</sup>

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.<sup>52</sup> 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.

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<sup>51</sup> See AU secs. 336.10 – .11.

<sup>52</sup> 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 instances<sup>53</sup> 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;<sup>54</sup> 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.<sup>55</sup>

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<sup>53</sup> 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.

<sup>54</sup> 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.

<sup>55</sup> 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.<sup>56</sup> 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

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<sup>56</sup> 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.<sup>57</sup> 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;<sup>58</sup>
- 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.<sup>59</sup>

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?

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<sup>57</sup> 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.

<sup>58</sup> 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.

<sup>59</sup> 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 guidance<sup>60</sup> 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

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<sup>60</sup> 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.<sup>61</sup> 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

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<sup>61</sup> 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 assistance<sup>62</sup> to the auditor and persons with specialized knowledge and skill in income tax and information technology ("IT") that are engaged by the auditor.<sup>63</sup> 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.<sup>64</sup> 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.<sup>65</sup>

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<sup>62</sup> See paragraph .27 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

<sup>63</sup> 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").

<sup>64</sup> 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.").

<sup>65</sup> 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.<sup>66</sup> 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

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<sup>66</sup> 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."<sup>67</sup>

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.<sup>68</sup> 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

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<sup>67</sup> See AU secs. 336.12 – .13.

<sup>68</sup> 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;<sup>69</sup> 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.

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<sup>69</sup> 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.<sup>70</sup> Potential definitions are as follows:

**Specialist** – A person<sup>1</sup> with specialized knowledge or skill in a field of expertise other than accounting or auditing.<sup>2</sup>

**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").

<sup>1</sup> As defined by PCAOB Rule 1001 (p)(iv), the term "person" means any natural person or any business, legal or governmental entity or association.

<sup>2</sup> 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.<sup>71</sup>

On the other hand, if an auditor engages a third party to develop fair value

<sup>70</sup> See footnote 1 of AU sec. 336.

<sup>71</sup> 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 objectivity<sup>72</sup> of an auditor's specialist;
- Informing an auditor's specialist of his or her responsibilities; and
- Evaluating the work of an auditor's specialist.

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<sup>72</sup> 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,<sup>73</sup> 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.

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<sup>73</sup> 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;<sup>1</sup> and
- (2) Relevance and reliability of third-party information;<sup>2</sup>
- 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 skepticism<sup>3</sup> in an audit and the need to consider contradictory information.

<sup>1</sup> 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.

<sup>2</sup> Paragraphs 7 and 8 of Auditing Standard No. 15 describe the concepts of relevance and reliability.

<sup>3</sup> 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 writing<sup>74</sup> 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.<sup>75</sup> For example, it

<sup>74</sup> 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.

<sup>75</sup> 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.<sup>76</sup>

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").

<sup>76</sup> 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.<sup>77</sup> 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

<sup>77</sup> 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.<sup>78</sup> This knowledge should inform the auditor's evaluation of the work of the specialist under the potential requirements described above.<sup>79</sup> 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.<sup>80</sup>

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

<sup>78</sup> 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.

<sup>79</sup> 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 ....").

<sup>80</sup> 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.<sup>81</sup> The auditor should evaluate the relationship between an auditor's engaged specialist and the company, including circumstances that might impair the specialist's objectivity.<sup>82</sup> The staff is

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<sup>81</sup> 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).

<sup>82</sup> 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,<sup>83</sup> 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.<sup>84</sup>

If the specialist has a relationship with the company, the auditor should assess the risk that the specialist's objectivity might be impaired.<sup>85</sup> 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.<sup>86</sup>

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.

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<sup>83</sup> 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.

<sup>84</sup> See AU sec. 336.10.

<sup>85</sup> See AU sec. 336.11.

<sup>86</sup> *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"<sup>87</sup> within the meaning of all applicable requirements. For purposes of Regulation S-X Rule 2-01<sup>88</sup> ("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 2-01<sup>89</sup> to include a specialist employed by a registered public "accounting firm" as defined in Rule 2-01 (which includes associated entities).<sup>90</sup> 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:

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<sup>87</sup> 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*.

<sup>88</sup> See Regulation S-X Rule 2-01, *Qualifications of Accountants*, 17 CFR 210.2-01.

<sup>89</sup> See Regulation S-X Rule 2-01(f)(7)(i).

<sup>90</sup> See Regulation S-X Rule 2-01(f)(2).

- Certain financial relationships with the audit client;<sup>91</sup>
- Certain employment relationships with the audit client;<sup>92</sup>
- Certain business relationships with the audit client;<sup>93</sup>
- Providing certain non-audit services to an audit client;<sup>94</sup> and
- Entering into contingent fee arrangements.<sup>95</sup>

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 procedures<sup>96</sup> 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.<sup>97</sup>

### ***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.<sup>98</sup> 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

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<sup>91</sup> See Regulation S-X Rule 2-01(c)(1), *Financial Relationships*.

<sup>92</sup> See Regulation S-X Rule 2-01(c)(2), *Employment Relationships*.

<sup>93</sup> See Regulation S-X Rule 2-01(c)(3), *Business Relationships*.

<sup>94</sup> See Regulation S-X Rule 2-01(c)(4), *Non-Audit Services*.

<sup>95</sup> See Regulation S-X Rule 2-01(c)(5), *Contingent Fees*.

<sup>96</sup> 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*.

<sup>97</sup> See QC sec. 20.09.

<sup>98</sup> 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"<sup>99</sup> 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"<sup>100</sup> 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."<sup>101</sup>

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<sup>99</sup> "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.

<sup>100</sup> "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.

<sup>101</sup> "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.<sup>102</sup>

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,<sup>1</sup> the auditor determines that the specialist is independent regarding the company, then the auditor may consider that specialist to meet the objectivity requirement.

<sup>1</sup> 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

<sup>102</sup> 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 role<sup>103</sup> 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

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<sup>103</sup> 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.<sup>104</sup> 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?

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<sup>104</sup> 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*.