



Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

Phoebe W. Brown, Secretary
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

30 August 2017

Re: Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists, PCAOB Rulemaking Docket Matter No. 044

Dear Ms. Brown:

Ernst & Young LLP (EY) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its proposed amendments relating to the auditor's use of the work of specialists (the Proposal). We support the Board's efforts to strengthen the requirements that apply when auditors use the work of specialists in an audit, and we believe that many of the proposed changes would improve the quality of auditing in this area.

Overall observations

We recognize and appreciate the Board's efforts to streamline the audit standards for the use of the work of specialists in an audit. We agree that providing separate guidance for each of the three categories of specialists (company specialists, auditor-employed specialists and auditor-engaged specialists) is an improvement over existing standards, and we support the structure of the Proposal. However, we have concerns about the proposed guidance on the extent to which an auditor may need to test and evaluate the work of a company's specialist.

We believe that management's use of a specialist generally results in a better application of the relevant financial reporting framework and a decrease in risk of material misstatement in the financial statements. Accordingly, the new standard and the nature and extent of the audit procedures required should acknowledge the potential decrease to audit risk.

We also believe that while the auditor's education and experience enable him or her to be knowledgeable about business matters in general, the auditor should not be expected to have the expertise of a person trained or qualified to engage in the practice of another profession or occupation. Thus, we have concerns about certain elements of the Proposal which could be interpreted as requiring auditors to perform procedures related to aspects of a company's specialists' work that may not be possible or practical. In our view, as more fully described below, without further clarification, these aspects of the proposal could significantly increase the cost of the audit without a commensurate improvement to audit quality.

In addition, we have concerns regarding the proposal to rescind Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210 (AI 11)*, which we believe provides important prescriptive guidance and examples to help the auditor assess the level of assurance obtained from legal opinions.

Testing and evaluating the work of a company's specialist

We are concerned that certain aspects of the Proposal could be interpreted to require auditors to inspect company specialists' models and re-perform their work. For example, paragraph .B8 of the proposal for AS 1105, *Audit Evidence, Appendix B – Using the Work of a Company's Specialist as Audit Evidence* (Proposed Appendix B to AS 1105), states that the auditor "should ... (3) evaluate whether the data was appropriately used by the specialist." It is not clear what "appropriately used" means in this context.

We are also concerned about the note to paragraph .B8. That note indicates that if the specialist is involved with an estimate, the auditor should also comply with Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (Proposed AS 2501). The note to paragraph .10 of that proposal would require the auditor to evaluate whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework. Similar to our concerns about what "appropriately used" means, it is not clear to us what "appropriately applied" means in this context.

If the Board's intent is to require auditors to inspect company specialists' models and re-perform their work, we would have several concerns. First, the auditor may not have sufficient expertise in the specialist's field to perform these procedures. For example, in the oil and gas industry, companies use reports prepared by geologists to value their oil reserves. We agree with the Board that auditors should be required to test the company-produced data used by the specialist and evaluate the (1) relevance and reliability of data obtained from external sources, (2) reasonableness of the significant assumptions and (3) appropriateness of the methods used by the geologist.

However, we do not believe that auditors should also be required to inspect the geologist's models and re-perform the geologist's work if the auditor has determined that the geologist has a high level of knowledge, skill and ability and has a sufficient level of objectivity. Requiring inspection and re-performance of a specialist's work would likely require the auditor to hire another geologist to perform this procedure. Given the highly specialized nature of the work, hiring an additional specialist may not be practical or possible in all cases.

Another issue is that auditors do not always have access to the proprietary models the company specialist uses. If this is the case, a specialist engaged by or employed by an auditor would not be able to test the company's process used to develop the accounting estimate pursuant to paragraphs .09–.18 of Proposed AS 2501. As a result, the auditor's specialist would need to develop an independent expectation of the estimate pursuant to paragraphs .21–.26 of Proposed AS 2501, and that would be impracticable for many estimates such as oil reserve valuations and pension liabilities.

For example, companies often engage third-party actuaries who use proprietary software to estimate pension liabilities. While auditors often employ or engage their own actuaries to evaluate these estimates, it would be impracticable for the auditor's actuaries to be required to develop an independent expectation of these estimates given the time and effort required for initial setup and ongoing maintenance of such an independent model.

We believe that the proposed requirement for auditors to apply the same auditing procedures to accounting estimates regardless of whether management uses an external specialist could have unintended consequences. For example, if the auditor cannot rely on a specialist's work, a company might decide not to engage a specialist to develop an independent estimate, even though using a specialist would likely result in a better application of the relevant financial reporting framework and would likely decrease the risk of misstatement in the financial statements. We believe the Board should acknowledge the decreased risk of misstatement when a company engages a sufficiently competent and objective specialist and should require less testing of the company specialist's work in these cases.

The proposed standard seems to contemplate allowing auditors to scale testing of the company specialist's work based on the auditor's risk assessment. Proposed paragraph .B7 of Appendix B to AS 1105 indicates that the persuasiveness of the evidence the auditor would be required to obtain through testing and evaluating the specialist's work can vary based on a number of factors.

We agree with this, but it is not clear to us how auditors in practice would adjust the extent of their evaluation of whether the data was appropriately used by the specialist (per paragraph .B8 of Proposed Appendix B to AS 1105) or the extent of their evaluation of whether the data and significant assumptions are appropriately applied under the applicable financial reporting framework (per paragraph .10 of Proposed AS 2501). We recommend that the Board clarify these proposed requirements, including indicating whether there is a base level of evaluation the auditor should perform that could then be adjusted based on the auditor's risk assessment.

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

The proposal, if adopted in its current form, would rescind AI 11. Auditors have long relied on AI 11 when evaluating the use of legal interpretations as evidential matter to support management's assertion that a transfer of financial assets has met the isolation criterion in Accounting Standards Codification 860, *Transfers and Servicing* (ASC 860).

Among other things, AI 11 provides guidance for assessing the qualifications of attorneys involved and the sufficiency of the legal analysis used as audit evidence, including examples of legal opinions that have been widely used and accepted in practice by both auditors and non-auditors.

AI 11 also provides examples of language that attorneys use as a guide when drafting legal opinions that also include permission for the auditor to use the legal opinion. Rescinding AI 11 could lead to more diversity in practice by companies and legal counsel related to the form and content of the legal opinions. This could result in inconsistencies in the level of evidence obtained by auditors when evaluating whether the isolation criterion in ASC 860 has been met.

The effort to create AI 11 was significant. We are concerned that rescinding AI 11 would be a step backwards and introduce unnecessary threats to audit quality. Its removal would potentially re-open the debate about whether "could" (versus "would") language would provide sufficient evidence to evaluate ASC 860's legal requirement, leading to more diversity in practice by companies and legal counsel related to the form and content of the legal opinions. We recommend that the Board not rescind AI 11.

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

The proposal, if adopted in its current form, would rescind AI 28. Auditors rely on AI 28 to determine the nature, timing and extent of audit procedures over the company's application of ASC 740, *Income Taxes*, including its income tax positions and tax disclosures. We note that companies often have concerns about the sensitivity of information included in tax opinions, tax accrual or tax contingency workpapers.

AI 28 provides prescriptive guidance regarding the audit requirements over certain tax working papers. Rescinding AI 28 could lead to more diversity in practice, by both companies and their advisers, with respect to providing the documentation auditors need. While the proposed standard incorporates the basic principles of AI 28, rescinding AI 28 could make it more difficult for auditors to accumulate sufficient appropriate audit evidence to form the basis of their conclusions over a company's income tax accounting and disclosures. We do not believe that the Board should rescind AI 28.

Company specialists – Understanding of internal controls

It is unclear from the proposal whether the auditor would be required to evaluate the design of internal controls and determine whether they have been implemented, even if the auditor is not performing an audit of internal control or planning to rely on controls for the related assertions.

Paragraph .B2 of Proposed Appendix B to AS 1105 states that the auditor "should ... obtain an understanding of the work and report(s) of the company's specialist(s) and related company process and controls ..." Paragraph .20 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*, states that obtaining an understanding of internal control includes evaluating the design of controls that are relevant to the audit and determining whether the controls have been implemented.

The note to paragraph .34 of AS 2110 is less ambiguous. It says: "A broader understanding of control activities is needed for relevant assertions for which the auditor plans to rely on controls. Also, in the audit of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit."

We believe the Board should clarify and better link the requirements of AS 2110 to avoid the misapplication of the requirements of Paragraph .B2 of Proposed Appendix B to AS 1105. Specifically, the Board should indicate whether the auditor may continue to follow Paragraph .34 of AS 2110 in determining the extent to which the auditor understands control activities depending on whether the auditor plans to rely on upon controls. We suggest the following edits to Paragraph .B2:

.B2 The auditor should, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting,² obtain an understanding of the work and report(s) of the company's specialist(s) ~~and related company processes and controls~~, which includes:

- a. The nature and purpose of the specialist's work;
- b. Whether the specialist's work is based on data produced by the company, data obtained from external sources, or both; and

- c. The company's processes and controls³ for ~~selecting and~~ using the work of specialists.

² See paragraphs .28-.32 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

³ See paragraph .34 of AS 2110

Company specialists – Understanding the selection process

Paragraph .B2(c) of Proposed Appendix B to AS 1105 indicates that the auditor should understand the company's process for selecting and using the work of specialists, including when the specialist is employed by the company. It isn't clear to us what is meant by "selecting" in this context. The statement appears to refer to the process of how the company chooses one specialist over another. If that is the case, we do not believe auditors should be required to understand this process, as an evaluation of the selection process would not, in our opinion, provide a significant amount of incremental insight regarding the specialist's competence and objectivity to warrant the additional audit effort in this area. We recommend that the proposal focus on evaluating the specialist selected by management, including management's evaluation of the specialist's qualifications and expertise.

Auditor-employed specialists – Documentation of understanding with specialist

Paragraph .C5 of proposed AS 1201, *Supervision of the Audit Engagement – Proposed Appendix C – Supervision of Auditor-Employed Specialists* (Proposed Appendix C to AS 1201) requires the auditor to establish and document an understanding with the specialist regarding various matters. Appendix 3 of the Proposal indicates that the Board intends for this understanding to be documented in planning memoranda, separate memoranda, audit programs or other related work papers. However, this language isn't included in the proposed standard. We believe the auditor should have the flexibility to determine where to document its understanding with an auditor-employed specialist and this language should be incorporated into the proposed standard.

We note that Paragraph .06 of proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist* (Proposed AS 1210), includes the same requirement as .C5 of Proposed Appendix C to AS 1201. We believe this requirement is appropriate because the documentation should generally be more formal when an auditor engages an external specialist.

Auditor-employed and auditor-engaged specialists – Approach to work

We suggest clarifying what is meant by specialists' "approach to that work." Proposed paragraphs .C5(b) of Appendix C to AS 1201 and .06(b) of AS 1210 indicate that the engagement partner and other engagement team members who perform supervisory activities should establish and document an understanding with both auditor-employed and auditor-engaged specialists regarding the nature of the work that the specialist will perform and the specialist's approach to that work. However, it is not clear to us what the specialist's "approach to that work" means. We believe the Board should clarify its intent.

Auditor-engaged specialists and company specialists – Objectivity

Paragraph .05 of proposed AS 1210 indicates that the auditor should not use a specialist who lacks the necessary objectivity. Proposed Paragraph .04 indicates that assessing whether the specialist (and the entity that employs the specialist) has the necessary objectivity includes evaluating whether the specialist (or the entity that employs the specialist) has a relationship with the company. Together, these two paragraphs

appear to imply that if any relationship is identified (e.g., employment, financial ownership, another business relationship, contractual rights, family relationships), the auditor should not use the specialist.

Such an interpretation would be inconsistent with Paragraph .11 of extant AS 1210, which generally enables the auditor to consider the nature of the relationship in evaluating the specialist's objectivity. We believe that a specialist's objectivity should be viewed as a continuum that affects the nature, timing and extent of procedures auditors need to perform. We believe the auditor, who is required to be independent under the most restrictive standards, should be allowed to exercise judgment and determine whether additional procedures are necessary to provide sufficient appropriate audit evidence. We recommend that the Board clarify paragraph .05 to better reflect the degree of judgment intended in the evaluation of the specialist's objectivity.

Proposed paragraph .B4 of Appendix B to AS 1105, *Audit Evidence*, would require auditors to assess the relationship to the company of the specialist and the entity that employs the specialist (if the specialist isn't employed by the company). On the other hand, the proposed standard on auditor-engaged specialists (paragraph .04 of proposed AS 1210), would require auditors to assess whether the specialist and the entity that employs the specialist have the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit.

While both standards appear to require the consideration of the same factors, it is not clear to us why the proposal on auditor-engaged specialists uses the term "objectivity" while the proposal on company specialists does not. We also note that extant ISA 500 includes requirements for the auditor to evaluate the objectivity of a specialist and specifies in paragraph .A43 that it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate.

Given the different ways in which the proposal addresses the auditor's consideration of objectivity related to auditor-engaged and company specialists, we believe the Board should clarify the differentiating factors in the nature, timing and extent of testing when evaluating the work of an auditor-engaged versus company-engaged or company-employed specialist.

In addition, proposed paragraph .B5 of Appendix B to AS 1105 indicates that the necessary evidence to assess the level of knowledge, skill and ability of the company's specialist and his or her relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion and (2) the risk of material misstatement. Given that the persuasiveness of the evidence the auditor should obtain for those assessments increases as the significance of the work and risk of material misstatement increases, we believe the Board should clarify whether there is a base level of audit evidence that the auditor should obtain in this assessment and how it should vary based on audit risk or the estimation uncertainty associated with the specialist's work.

Other comments relating to testing and evaluating the work of a company specialist

The proposal would add points (4) and (5) about whether the auditor has doubt about the specialist's knowledge, skill and ability and whether the specialist has a conflict of interest relevant to his or her work to the note to Paragraph .B10 of Proposed Appendix B to AS 1105. These points appear to be misplaced. We believe the Board should move points (4) and (5) to an earlier paragraph in Appendix B under the heading "Assessing the Knowledge, Skill, and Ability of the Company's Specialist and the Specialist's Relationship to the Company."



Applicability

We agree that the proposed amendments could benefit audits of emerging growth companies and brokers and dealers that are required to be conducted in accordance with PCAOB standards. Accordingly, we support making any final standard apply to audits of those entities.

Outreach to preparers

We believe that implementation of the Proposal, particularly in the area of testing and evaluating the work of a specialist and the rescission of AI 11, could also have implications for preparers. We encourage the Board to seek feedback from preparers on how they believe potential changes in the auditing standards could affect their processes (if at all) and consider that input before finalizing the Proposal.

Effective date

We believe that a final standard should be effective at the same time as any new standard and related amendments on auditing accounting estimates, including fair value measurements. As described in this letter, if our understanding of the Proposal is correct and changes to it are not made, we believe that its implementation could be a significant undertaking. As a result, we recommend that the standard be effective for audit periods ending two years after the Securities and Exchange Commission approves the final standard.

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

Very truly yours,

Copy to:

PCAOB

James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

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