
PROPOSED AMENDMENTS TO AUDITING
STANDARDS FOR AUDITOR'S USE OF THE
WORK OF SPECIALISTS

) PCAOB Release No. 2017-003
) June 1, 2017
)
) PCAOB Rulemaking
) Docket Matter No. 044
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Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing to amend its auditing standards to strengthen the requirements that apply when auditors use the work of specialists in an audit. The amendments are designed to increase audit attention in areas where a specialist is used and to align the applicable requirements with the PCAOB's risk assessment standards.

Public

Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted via e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 044 in the subject or reference line and should be received by the Board no later than August 30, 2017.

Board

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Major Proposed Amendments:

The Board is proposing for public comment to:

(1) Amend:

- AS 1105, *Audit Evidence*; and
- AS 1201, *Supervision of the Audit Engagement*;

(2) Replace:

- AS 1210, *Using the Work of a Specialist*, and retitle the standard *Using the Work of an Auditor-Engaged Specialist*; and

(3) Rescind:

- AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*; and
- AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*.

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I. Executive Summary

The Board is proposing amendments to its standards for using the work of specialists, under which two existing standards would be amended and a third existing standard would be retitled and replaced with an updated standard. As discussed in more detail below, in the Board's view the proposed amendments would further investor protection by strengthening the requirements for evaluating the work of a company's employed or engaged specialist and applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.

Companies across many industries use specialists¹ to assist in developing accounting estimates in their financial statements. Companies may also use specialists to interpret laws, regulations, and contracts or to evaluate the characteristics of certain physical assets. Those companies may use a variety of specialists, including, among others, actuaries, appraisers, other valuation specialists, legal specialists, environmental engineers, and petroleum engineers. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors might use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

Accounting estimates are also becoming more prevalent and more significant as financial reporting frameworks continue to evolve and require greater use of estimates, including those based on fair value measurements.² As a result, the use of the work of specialists continues to increase in both frequency and significance. If a specialist's work is not properly overseen or evaluated by the auditor, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

Under current PCAOB standards, auditor-employed specialists are subject to supervision under AS 1201, *Supervision of the Audit Engagement*, and auditors' responsibilities with respect to other specialists (employed or engaged by the company or engaged by the auditor) are primarily set forth in AS 1210, *Using the Work of a Specialist*. As a result, requirements that apply to auditor-employed specialists differ

¹ As used in this release, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.

² For purposes of this release, a fair value measurement is a form of accounting estimate.

from the requirements that apply to auditor-engaged specialists, though both serve similar roles in helping auditors obtain and evaluate audit evidence. In addition, AS 1210 imposes the same auditor responsibilities with respect to both a company's specialist and an auditor-engaged specialist, even though those specialists have fundamentally different roles (i.e., the company uses the work of its specialist in the preparation of the financial statements).

Observations from PCAOB oversight activities indicate that there is substantial diversity in practice regarding the use of the work of specialists, such as how auditors use employed or engaged specialists and what procedures auditors perform to evaluate the work of companies' specialists. Moreover, PCAOB inspections staff continues to observe deficiencies related to auditors' use of specialists' work, such as failures to evaluate the assumptions of company specialists in fair value measurements or failures to consider contradictory evidence or issues raised by an auditor's specialist.

The PCAOB has also engaged in outreach to explore the views of market participants and others on the potential for improvements to the auditing standards related to using the work of specialists, through the Board's Standing Advisory Group ("SAG")³ and the issuance of and comments on Staff Consultation Paper, *The Auditor's Use of the Work of Specialists*.⁴

The Board is proposing to amend AS 1105, *Audit Evidence*, to add a new appendix that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. The Board also is proposing to amend AS 1201 to add a new appendix on supervising the work of auditor-employed specialists and to replace AS 1210 with proposed AS 1210, which would set forth requirements for using the work of auditor-engaged specialists. The proposal is intended to strengthen PCAOB auditing standards in the following respects:

³ See SAG meeting briefing papers and webcast archives (Nov. 30-Dec. 1, 2016, Nov. 12-13, 2015, June 18, 2015, Oct.14-15, 2009, and Feb. 9, 2006), available on the Board's website.

⁴ See PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015) ("2015 SCP"). The 2015 SCP was issued to solicit comments on various issues, including the potential need for standard setting and key aspects of potential new standards and related requirements.

- Strengthen requirements for evaluating the work of a company's specialist; and
- Apply a risk-based approach to supervising and evaluating the work of both auditor-employed and auditor-engaged specialists.

The Board is seeking comment on the proposed amendments to its standards, alternatives to those proposed amendments, the economic impacts of the proposal, and data on current practices and potential benefits and costs of the proposal. This release contains questions on discrete aspects of these matters for which the Board seeks comment. Readers are encouraged to answer questions in the release, and to comment on any aspect of the release or the proposed amendments not covered by specific questions. Readers are especially encouraged to provide the reasoning to support their views and any relevant data.

The PCAOB has observed that, in many cases, auditors use the work of a specialist to test or assist in testing the company's process to develop an accounting estimate or in developing an independent expectation of an accounting estimate. In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.⁵ In the Estimates Release, the Board is proposing to retitle and replace AS 2501, *Auditing Accounting Estimates*, and supersede AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Proposed AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

⁵ See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017) ("Estimates Release").

II. Background and Reasons to Improve Standards

Companies across many industries use various types of specialists to assist in developing accounting estimates in their financial statements. Auditors often use the work of these companies' specialists as audit evidence. Additionally, auditors might use the work of auditors' specialists to assist in their evaluation of significant accounts and disclosures, including accounting estimates in those accounts and disclosures.

The use of fair value measurements and other accounting estimates continues to grow in financial reporting with, for example, increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.⁶ If a specialist's work is not properly overseen or evaluated, however, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in accounting estimates.

In May 2015, the PCAOB issued a staff consultation paper to solicit comments on various issues related to the auditor's use of the work of both a company's specialist and an auditor's specialist. The 2015 SCP described information about a potential need for changes to PCAOB standards and discussed possible approaches to such changes. The 2015 SCP solicited comment on these matters, as well as on current practice and economic considerations. The Board's proposal is informed by comments on the 2015

⁶ See, e.g., Jonathan S. Pyzoha, Mark Taylor, and Yi-Jing Wu, *The Effects of Tone-at-the-Top Messaging and Specialists on Auditors' Judgments during Complex Audit Tasks* 4 (Apr. 2016) (working paper, available in Social Science Research Network ("SSRN")) ("To cope with the escalating complexity of business processes and transactions involved with conducting financial statement audits, management and auditors have increasingly relied on the expertise of specialists..."); see also Karin Barac, Elizabeth Gammie, Bryan Howieson, and Marianne van Staden, *The Capability and Competency Requirements of Auditors in Today's Complex Global Business Environment* 6, 83 (Mar. 2016) (report commissioned by Institute of Chartered Accountants of Scotland and The Financial Reporting Council) ("In terms of the current capabilities, the increasing complexity and globalisation of business, combined with the increasing complexity of financial reporting standards and the opportunities/risks afforded by information technology developments, demands increasing specialisation within the audit team...[T]here was recognition that audit teams now include many more experts than in the past, and for some industries, particularly financial services, this was a welcome development.").

SCP and, where relevant to aspects of the proposal, those comments are discussed throughout this release.

This section discusses current requirements under PCAOB auditing standards for auditors' use of the work of specialists in audits, observations regarding current audit practices, and reasons to improve auditing standards in this area.

A. Current Requirements

The primary standard that applies when auditors use the work of auditor-engaged specialists or company specialists is AS 1210. The primary standard that applies when auditors use the work of auditor-employed specialists in an audit is AS 1201. AS 1210 was adopted by the Board in 2003 shortly after the PCAOB's inception.⁷ AS 1201 was one of eight new risk assessment standards adopted by the Board in 2010.⁸

For purposes of AS 1210, a specialist is "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." AS 1210 also states that income taxes and information technology ("IT") are specialized areas of accounting and auditing, and therefore are outside the scope of the standard.⁹ By its

⁷ See *Establishment of Interim Professional Auditing Standards*, PCAOB Release No. 2003-006 (Apr. 18, 2003). Prior to 2003, the American Institute of Certified Public Accountants ("AICPA"): (1) in 1975, issued Statement on Auditing Standards ("SAS") No. 11, *Using the Work of a Specialist*; (2) in 1976, codified it as AU sec. 336; and (3) in 1994, issued a revised standard, SAS No. 73, *Using the Work of a Specialist* (which remained codified as AU sec. 336), that superseded the previous standard. In 2015, the PCAOB reorganized its standards, at which time AU sec. 336 was renumbered AS 1210. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015).

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

⁹ See footnote 1 of AS 1210.

terms, AS 1210 applies when (1) the company engages or employs a specialist and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions or (2) the auditor engages a specialist and uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.¹⁰

AS 1201 establishes requirements for the supervision of the audit engagement, including supervising the work of engagement team members.¹¹ The auditor supervises a specialist employed by the auditor's firm who participates in the audit under AS 1201.¹² AS 1201 also applies in situations in which an income tax specialist or IT specialist participates in the audit, regardless of whether they are employed or engaged by the auditor's firm.¹³

Figure 1 summarizes the primary PCAOB standards that apply to the use of the work of specialists today.

¹⁰ See AS 1201.03.

¹¹ See AS 1201.01. As an employee of the accounting firm, an auditor-employed specialist is a member of the engagement team and is subject to the requirements in PCAOB auditing standards for assigning personnel based on their knowledge, skill, and ability. See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*. In addition, the requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing the independence of auditor-employed specialists. See AS 2101.06b.

¹² See AS 1210.05.

¹³ See footnote 1 of AS 1210.

Figure 1: Primary PCAOB Standards Applicable When Using the Work of Specialists

	#	Nature of Specialist's Involvement	Primary Audit Requirements
Company's Specialist	1	Specialist employed by the company	Auditor performs the procedures required by AS 1210
	2	Specialist engaged by the company	
Auditor's Specialist	3	Auditor-engaged specialist	
	4	Auditor-employed specialist	

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

- Evaluate the professional qualifications of the specialist;¹⁴
- Obtain an understanding of the nature of the specialist's work;¹⁵
- Evaluate the relationship of the specialist to the company, including circumstances that might impair the specialist's objectivity;¹⁶ and
- In using the findings of the specialist:¹⁷
 - Obtain an understanding of the methods and assumptions used by the specialist;

¹⁴ See AS 1210.08.

¹⁵ See AS 1210.09.

¹⁶ See AS 1210.10-.11.

¹⁷ See AS 1210.12.

- Make appropriate tests of data provided to the specialist; and
- Evaluate whether the specialist's findings support the financial statement assertions.

AS 1210 also includes certain provisions that could be considered to limit the auditor's responsibilities related to the work of a specialist, including statements that: (1) the appropriateness and reasonableness of methods and assumptions used, and their application, are the responsibility of the specialist; (2) the auditor ordinarily would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.¹⁸

Using the work of a company's specialist when auditing fair value measurements under AS 2502. In circumstances when a company's specialist develops assumptions used in a fair value measurement and the auditor tests the company's process, the auditor is required to evaluate the reasonableness of those assumptions as if the assumptions were developed by the company, as well as to comply with the requirements of AS 1210.¹⁹

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

- (1) The engagement partner and others who assist the engagement partner in supervising the audit should:
 - Inform engagement team members of their responsibilities;

¹⁸ See AS 1210.12-.13.

¹⁹ Footnote 2 of AS 2502 provides that management's assumptions for developing a fair value measurement include assumptions developed by a specialist engaged or employed by management. The auditor is therefore required to evaluate the reasonableness of assumptions developed by the company's specialist as if they were developed by management.

- Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities; and
 - Review the work of engagement team members to evaluate whether:
 - The work was performed and documented;
 - The objectives of the procedures were achieved; and
 - The results of the work support the conclusions reached.²⁰
- (2) The necessary extent of supervision depends on, for example, the nature of the work performed, the associated risks of material misstatement, and the knowledge, skill, and ability of those being supervised.²¹

B. Current Practice

This section discusses the PCAOB's understanding of current practice based on, among other things, the collective experience of PCAOB staff, observations from oversight activities of the Board, enforcement actions of the Securities and Exchange Commission ("SEC" or "Commission"), comments received on the 2015 SCP,²² and discussions with the SAG, audit firms, and specialist entities. The discussions have included outreach by the PCAOB's staff to audit firms and specialist entities to obtain information on: (1) how auditors evaluate the competence and objectivity of an auditor-engaged specialist and a company's specialist; (2) how auditors evaluate the work performed by an auditor-employed specialist, an auditor-engaged specialist, and a company's specialist; and (3) economic and demographic considerations relating to the

²⁰ See AS 1201.05.

²¹ See AS 1201.06.

²² Most commenters on the 2015 SCP agreed that the information presented therein accurately described current audit practices regarding the use of the work of specialists. Commenters also generally supported the staff's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements.

market for services provided by specialists. The outreach has informed the PCAOB's understanding of current practice at both larger and smaller audit firms.

1. *Overview of Current Practice*

When AS 1210 was originally issued in the early 1970s, the use of the work of specialists was largely confined to pension obligations, insurance reserves, and extractive industry reserves. In recent decades, the use of fair value measurements and other accounting estimates has grown in financial reporting, along with the increasing complexity in business transactions and changes in the financial reporting frameworks. As a result, the use of the work of specialists continues to increase in both frequency and significance.

Currently, companies across many industries use the work of specialists to: (1) assist them in developing accounting estimates, including fair value measurements presented in the companies' financial statements; (2) interpret laws, regulations, and contracts; or (3) evaluate characteristics of physical assets, as shown in Figure 2 below. In those circumstances, the reliability of a company's financial statements may depend in part on the quality of the work of a company's specialist.

Figure 2: Examples of Activities that Involve the Work of Specialists

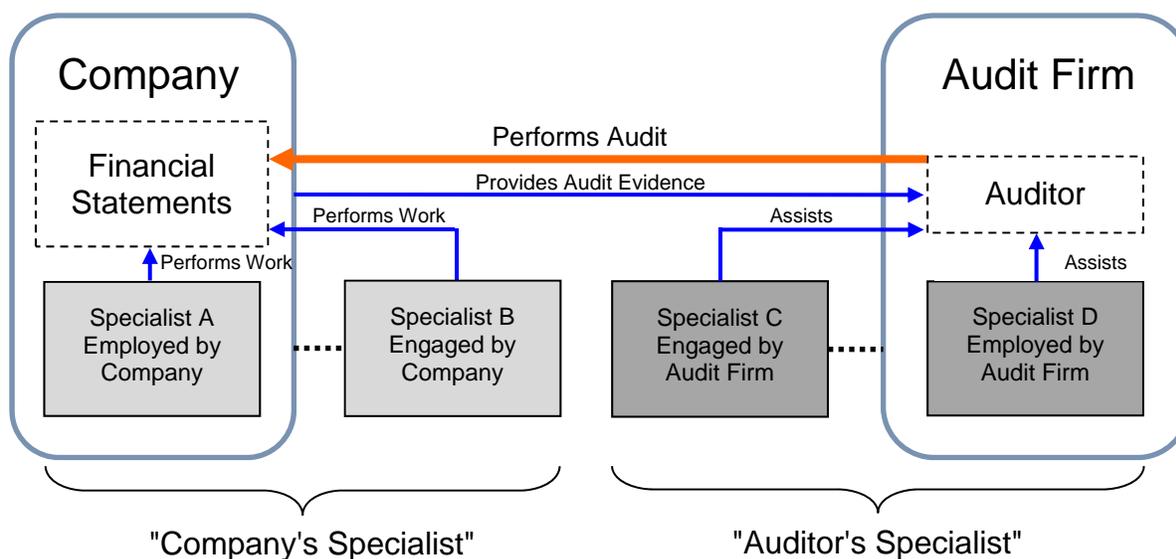
<p>Valuation</p> <ul style="list-style-type: none">Assets acquired and liabilities assumed in business combinationsEnvironmental remediation contingenciesGoodwill impairmentsInsurance reservesIntangible assetsPension and other post-employment obligationsImpairment of real estate or other long-term assetsStock optionsFair values of certain other financial instruments <p>Interpretation of laws, regulations, or contracts</p> <ul style="list-style-type: none">Legal title to property or interpretation of laws, regulations, or contracts <p>Evaluation of physical and other characteristics</p> <ul style="list-style-type: none">Materials stored in stockpilesMineral reserves and conditionOil and gas reservesProperty, plant, and equipment useful lives and salvage values

Auditors also increasingly use the work of specialists in their audits to assist in their evaluation of accounting estimates. Auditors may:

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

Figure 3 illustrates potential ways that auditors use specialists in an audit.

Figure 3: Potential Ways Auditors Use Specialists in an Audit



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

The PCAOB understands that current practices vary among smaller and larger audit firms. For example, smaller audit firms are more likely to use the work of a company's specialist than to employ or engage their own specialist. Larger audit firms

generally require their engagement teams to evaluate the work of the company's specialist, including the specialist's methods and assumptions, and often employ specialists to assist their audit personnel in evaluating that work.²³ In some respects, the current methodologies of these larger firms with respect to using the work of a company's specialist exceed the existing requirements of AS 1210. The following paragraphs discuss audit practices of smaller firms and larger firms that audit issuers, brokers, and dealers in more detail.

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

In circumstances when smaller firms engage specialists, the auditor-engaged specialists may be used in different ways. Some firms perform the procedures specified in AS 1210 described above when using the auditor-engaged specialist. Other firms perform procedures similar to those in AS 1201 for supervising members of the engagement team. For example, some firms merely evaluate whether the specialist's work supports the financial statement assertions, while other firms go further by also evaluating whether (1) the specialist's work was performed and documented, (2) the objectives of the specialist's procedures were achieved, and (3) the results of the specialist's work support the conclusions reached.

Larger firm practices. As discussed above, although not required by AS 1210, some larger audit firms evaluate the methods and significant assumptions used by company specialists when they test the company's process for developing accounting

²³ An analysis by PCAOB staff indicates that smaller firms predominantly use the work of an auditor's specialist in valuation areas, and seldom use the work of an auditor's specialist in other areas, whereas larger firms tend to use the work of an auditor's specialist in a wider range of audit areas, even though they also primarily use the work of specialists in valuation areas.

estimates. Larger firms often employ their own specialists, who serve on engagement teams and assist with the evaluation of the work of company specialists.

Auditor-employed specialists at larger firms are generally involved early in the audit, usually during planning meetings with other members of the engagement team. Also, in audit planning, auditors and auditor-employed specialists generally reach an understanding, in the form of a planning or scoping memorandum, regarding the scope of work to be performed and the respective responsibilities of the auditor and the specialist. The items covered in that memorandum typically include: (1) the nature, scope, and objectives of the specialist's work;²⁴ (2) the role and responsibilities of the auditor and the specialist;²⁵ and (3) the nature, timing, and extent of communication between the auditor and the specialist.²⁶ The auditor communicates with the specialist as the work progresses to become aware of issues as they arise. When the specialist completes his or her work, the auditor reviews the specialist's work, which is typically documented in a separate report or memorandum.

Sometimes, larger firms do not use the work of an auditor's specialist, particularly when the risk of material misstatement is low or the firm does not employ a specialist with expertise in the particular field. In those situations, larger firms may use the work of a company's specialist without involving an auditor's specialist. Alternatively, although infrequent, larger firms may engage a specialist with expertise in the particular field. When larger firms engage specialists, they may use them in different ways. Some firms perform the procedures specified in AS 1210 described above, while other firms perform procedures that are similar to the procedures for supervising the work of auditor-employed specialists under AS 1201.

²⁴ Examples include whether the specialist is testing (or assisting in testing) the company's process for developing an accounting estimate or developing (or assisting in developing) an independent expectation of the estimate.

²⁵ For example, the documentation might identify the respective responsibilities of the auditor and the specialist for evaluating data and significant assumptions used by the company or the company's specialist.

²⁶ Examples include administrative matters, such as the timing, budget, and other staffing-related issues relevant to the specialist's work, or the protocols for discussing and resolving findings or issues identified by the specialist.

2. *Observations from Audit Inspections and Enforcement Cases*

The Board's understanding of current practice has been informed by observations from PCAOB oversight activities and SEC enforcement actions, including (1) audit deficiencies of both larger and smaller firms, and related remedial actions to address the deficiencies and (2) enforcement actions where the work of a specialist was used in the audit.

Inspections observations. Over the past several years, the observations from PCAOB inspections have indicated that auditors, at times, did not fulfill their responsibilities under existing standards when using the work of an auditor's specialist. These observations included instances in which auditors did not, among other things: (1) adequately communicate clear expectations to the specialist regarding the objectives of the specialist's work; (2) reach an understanding with the specialist regarding his or her responsibilities; (3) adequately evaluate the work performed by the specialist; and (4) consider contradictory evidence identified by the specialist or resolve discrepancies or other concerns that the specialist identified. More recently, PCAOB inspection staff have observed a decline in the number of instances by larger firms in which auditors did not perform sufficient procedures related to the work of an auditor's specialist.

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

Over the past several years, the observations from PCAOB inspections have also included instances in which the auditor used the work of a company's specialist without performing the procedures required by AS 1210. These findings were less common than those related to using the work of an auditor's specialist over the same period. More recent findings include instances in which auditors did not, among other things: (1) evaluate the reasonableness of assumptions used by a company's specialist in developing fair value measurements; (2) obtain an understanding of methods or assumptions used by the company's specialist; (3) test the accuracy and completeness of company-provided data used by the company's specialist; and (4) evaluate the professional qualifications of the company's specialist. Unlike the findings related to the auditor's use of the work of an auditor's specialist, inspections staff have not observed a similar change in the frequency of findings related to the auditor's use of the work of a company's specialist.

Enforcement actions. Both the SEC²⁷ and the PCAOB²⁸ have brought enforcement actions involving situations where auditors allegedly failed to comply with current auditing standards when using the work of specialists. For example, such proceedings have involved allegations that auditors failed to (1) perform audit procedures that addressed the risks of material misstatements in a company's financial statements, prepared based on the work of a company's specialist²⁹ and (2) comply with certain requirements of AS 1210 when using the work of a company's specialist (for example, requirements to evaluate the professional qualifications of the specialist, obtain an understanding of the methods and assumptions used by the specialist, evaluate the relationship of the specialist to the company, and apply additional procedures to address a material difference between the specialist's findings and the assertions in the financial statements).³⁰ Several of those proceedings were brought in recent years, suggesting that problems persist in this area.

C. Reasons to Improve Auditing Standards

Financial reporting frameworks are evolving and requiring greater use of accounting estimates, including those based on fair value measurements. Such estimates often require substantial judgment. As a result, the use of the work of

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

²⁸ See, e.g., *KAP Purwantono, Sungkoro & Surja, Roy Iman Wirahardja, and James Randall Leali*, PCAOB Release No. 105-2017-002 (Feb. 9, 2017); *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045 (Dec. 5, 2016); *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007 (Apr. 1, 2015); and *Chisholm, Bierwolf, Nilson & Morrill, LLC, Todd D. Chisholm, CPA, and Troy F. Nilson, CPA*, PCAOB Release No. 105-2011-003 (Apr. 8, 2011).

²⁹ See, e.g., *Gordon Brad Beckstead, CPA*, PCAOB Release No. 105-2015-007.

³⁰ See, e.g., *KAP Purwantono, Sungkoro & Surja*, PCAOB Release No. 105-2017-002; *Arturo Vargas Arellano, CPC*, PCAOB Release No. 105-2016-045; *Chisholm, Bierwolf, Nilson & Morrill, LLC*, PCAOB Release No. 105-2011-003; and *Miller Energy Resources, Inc.*, SEC AAER No. 3673.

specialists, both by companies and auditors, continues to increase in both frequency and significance.

The Board's existing standards, however, do not clearly reflect the difference between the roles of a company's specialist and an auditor's specialist. AS 1210 imposes the same responsibilities on auditors with respect to both a company's specialist and an auditor-engaged specialist, even though those two types of specialists have fundamentally different roles. In addition, the requirements for auditor-employed specialists in AS 1201 differ from the requirements for auditor-engaged specialists in AS 1210, even though they have similar roles in assisting the auditor in obtaining and evaluating audit evidence. As discussed, an auditor-engaged or auditor-employed specialist performs work to assist the auditor in obtaining and evaluating audit evidence, while the company's specialist performs work used by the company in the preparation of its financial statements.

If a specialist's work is not properly overseen or evaluated, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.³¹ When an auditor uses the work of a company's specialist, current requirements in AS 1210 allow the auditor to plan and perform audit procedures, as described earlier, that may not be commensurate with the risk of material misstatement inherent in the work of the specialist. When an auditor uses an auditor-employed specialist, current requirements in AS 1201, while risk-based and designed to be scalable for companies of varying size and complexity, do not specifically address how to apply the required supervisory procedures to promote effective coordination between an auditor and a specialist. In the case of auditor-engaged specialists, the current requirements in AS 1210 are not risk-based, are identical to the requirements regarding the use of work of a company's specialist, and do not specifically address informing the specialist of matters that could affect the specialist's work or coordination of the work between the auditor and the specialist.

The factors described above suggest that enhancements to PCAOB standards for using the work of specialists are needed. Specifically, investor protection could be improved by increasing audit attention to the work of specialists with respect to significant accounts and disclosures. Enhancing the auditing standards, through further

³¹ For example, one commenter on the 2015 SCP emphasized that "[m]ore rigorous testing of the work of company specialists will reduce the risk of material misstatements." See Letter from American Federation of Labor and Congress of Industrial Organizations (July 29, 2015), at 2.

integration with the risk assessment standards and requirements tailored to the specialists' differing roles, could (1) lead auditors to devote the appropriate audit attention to the work of a company's specialist and (2) prompt more effective coordination between the auditor and an auditor's specialist in obtaining sufficient appropriate audit evidence, as well as the proper evaluation of the evidence obtained.

1. *Results of Outreach on Reasons to Improve Standards*

The reasons to improve auditing standards were informed by the results of outreach, including the 2015 SCP and discussions at various SAG meetings.

Staff Consultation Paper. Of those commenters on the 2015 SCP that provided relevant comments, most supported the staff's assessment that the use and importance of specialists has increased due to increasing complexity in business transactions and financial reporting requirements, while auditing standards related to the use of the work of specialists have not substantively changed since 1994. Many commenters also supported improving or enhancing auditing standards related to using the work of specialists. Some suggested that improvements to the Board's standards on using the work of specialists could result in enhanced audit quality and reduced risk of material misstatement in financial statements, which could provide greater confidence to users of financial statements. A number of commenters also noted that greater specificity and clarity of requirements related to the use of the work of specialists could result in more consistent application of requirements by auditors. Some commenters suggested making targeted improvements to increase the scalability of AS 1210 through principles-based requirements that align with the Board's risk assessment standards. Several commenters suggested the Board should consider aligning any new standards with the standards of the International Auditing and Assurance Standards Board ("IAASB").³²

In comparison, other commenters asserted that the changing business environment and potential needs identified in the 2015 SCP did not warrant changes to current standards. Some of these commenters argued that the inspection findings and enforcement cases cited in the 2015 SCP did not justify changes to current standards. Certain commenters preferred retaining existing requirements and enhancing the Board's oversight or enforcement activities to improve compliance. The Board's consideration of these and other suggested alternatives to standard setting is discussed in Section IV.D.1.

³² See IAASB's International Standard on Auditing ("ISA") 620, *Using the Work of an Auditor's Expert*, and ISA 500, *Audit Evidence*.

Discussions at Standing Advisory Group meetings. The SAG has discussed specialist-related issues at several meetings, including as recently as November 2016.³³ During these meetings, some SAG members have expressed concerns about the adequacy of current PCAOB standards regarding specialists. Many SAG members have expressed support for requiring: (1) better communication between auditors and their specialists; (2) auditors to have similar responsibilities for using the work of an auditor-employed and an auditor-engaged specialist; and (3) greater responsibility for evaluating the work performed by a company's specialist.

Other SAG members have expressed concerns that auditors may not always have the necessary level of expertise to evaluate the work of some specialists and, as a result, may have to rely on the work of specialists. Some other SAG members have argued in response that auditors should have a sufficient understanding of the specialist's area of expertise to be able to evaluate how the specialist's work relates to other audit work, based on the auditor's own knowledge and experience. These SAG members agree that the auditor should not be required to have the same subject-matter expertise as the specialist, but assert that the auditor should nevertheless be sufficiently knowledgeable about the specialist's work in order to opine on the fair presentation of the financial statements.

2. *Areas of Potential Improvement*

Taking into account observations from oversight activities, SAG member input, comment letters in response to the 2015 SCP, activities of other standard setters, and outreach with audit firms and specialist entities, the Board has identified the following areas needing improvement in the current standards relating to the use of the work of specialists:

- *Strengthening the requirements for evaluating the work of a company's specialist.* Strengthening the requirements for evaluating the work of a company's specialist on significant accounts and disclosures could improve the auditor's ability to detect material misstatements in the financial statements and enhance investor protection. This approach would build on improvements adopted in practices of some firms and set forth a uniform, risk-based approach among all audit firms when using the

³³ See SAG meeting briefing papers and webcast archives (Nov. 30-Dec. 1, 2016, Nov. 12-13, 2015, June 18, 2015, Oct. 14-15, 2009, and Feb. 9, 2006), available on the Board's website.

work of a company's specialist as audit evidence. The improvements include (1) strengthening requirements for the auditor's testing and evaluation of data used by the company's specialist and (2) requiring auditor evaluation of significant assumptions and methods used by the company's specialist. These requirements would be aligned with the risk assessment standards and the Board's separate proposal on auditing accounting estimates, including fair value measurements.³⁴

- *Applying a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists.* Enhancing the requirements for applying a risk-based supervisory approach to auditor-employed specialists, and extending those requirements to auditor-engaged specialists could promote an improved, more uniform approach to supervision of an auditor's specialists, reflecting their similar roles and relationships to the auditor. The extent of such supervision would be based on existing supervisory principles in AS 1201 and thus depend upon: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist.

These improvements are intended to direct auditors to devote more attention to the work of a company's specialist and enhance the coordination between an auditor and the auditor's specialist—employed or engaged. The proposed requirements would also align more closely with the Board's risk assessment standards and acknowledge more clearly the differing roles of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist.

Question:

1. Does the description of existing audit practice accurately depict the state of practice? Does the discussion of the reasons to improve auditing standards sufficiently describe the nature of concerns arising from the use of the work of specialists that the Board should address? Are there additional concerns that the Board should seek to address?

³⁴ Estimates Release, PCAOB Release No. 2017-002. Commenters on the 2015 SCP supported aligning any new standards on using the work of specialists with any new standards related to auditing accounting estimates, including fair value measurements.

III. Discussion of Proposal

This proposal is intended to enhance existing requirements in current standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist. Specifically, the proposal would: (1) add an appendix to AS 1105 with supplemental requirements for using the work of a company's specialist as audit evidence; (2) add an appendix to AS 1201 with supplemental requirements for supervising an auditor-employed specialist; and (3) replace current AS 1210 with a proposed standard for using the work of an auditor-engaged specialist. Key aspects of the proposal are discussed in this section. The ways in which the proposal would address the need for change from an economic perspective are discussed below in Section IV.B. In addition, Appendix 3 of this release describes the proposed amendments in more detail, drawing upon comments on the 2015 SCP when relevant to the discussion of specific aspects of the proposal.

In brief, the Board's proposal would make the following changes to PCAOB auditing standards:³⁵

- *Amend AS 1105.*
 - Add a new Appendix B to AS 1105 that would supplement the requirements in AS 1105 for circumstances when the auditor uses the work of the company's specialist as audit evidence, related to:
 - (1) Obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls;

³⁵ The proposed amendments would apply to audits of issuers as defined in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7201(a)(7), and to audits of brokers and dealers, as defined in Sections 110(3)–(4) of Sarbanes-Oxley, 15 U.S.C. 7220(3)–(4). As discussed further in this release, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies (see Section V below) and any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits (see Section VI below).

- (2) Obtaining an understanding of and assessing the specialist's knowledge, skill, and ability, as well as the specialist's relationship to the company; and
 - (3) Performing procedures to test and evaluate the work of a company's specialist, including: (i) testing and evaluating data used by the specialist and evaluating whether the data was appropriately used by the specialist, (ii) evaluating the appropriateness of methods and reasonableness of significant assumptions used by the specialist, and (iii) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.
- Align the proposed requirements for using the work of a company's specialist with the risk assessment standards and the Board's separate proposal on auditing accounting estimates, including fair value measurements.³⁶
 - Provide factors for determining the necessary evidence to support the auditor's conclusion regarding a relevant assertion when using the work of a company's specialist.
 - Direct the auditor to the respective standard for auditing accounting estimates to determine the procedures to be applied to test and evaluate data and evaluate methods and significant assumptions used by a company's specialist when auditing accounting estimates, including fair value measurements.
 - Remove requirements for using the work of a company's specialist as audit evidence from the scope of AS 1210.
- *Amend AS 1201.*
 - Add a new Appendix C to AS 1201 that would supplement the requirements for applying the supervisory principles in AS 1201.05-.06 when using the work of an auditor-employed specialist to assist

³⁶ Estimates Release, PCAOB Release No. 2017-002.

the auditor in obtaining or evaluating audit evidence, including proposed requirements related to:

- (1) Determining the necessary extent of the auditor's review of the work of the specialist;
 - (2) Informing the specialist of the work to be performed; and
 - (3) Reviewing and evaluating whether the work of the specialist provides sufficient appropriate audit evidence. Evaluating the work of the specialist includes evaluating whether the work is in accordance with the auditor's understanding with the specialist and that the specialist's findings and conclusions are consistent with, among other things, the results of the work performed by the specialist.
- Provide factors for determining the necessary extent of supervision of the work of the auditor-employed specialist.
 - Leverage the requirements in other PCAOB standards for assigning competent staff and determining compliance with independence and ethics requirements, reflecting the fact that auditor-employed specialists are members of the engagement team, and reference applicable independence and ethics requirements.
 - *Replace existing AS 1210.*
 - Replace existing AS 1210 with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, which would establish requirements for using the work of an auditor-engaged specialist to assist the auditor in obtaining or evaluating audit evidence.
 - Include proposed requirements for reaching an understanding with the specialist and reviewing and evaluating the specialist's work that parallel the proposed amendments to AS 1201 for auditor-employed specialists.
 - Provide factors for determining the necessary extent of review of the work of the auditor-engaged specialist.

- Amend requirements related to assessing the knowledge, skill, ability, and objectivity³⁷ of the specialist.
- Describe objectivity as the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and expand the list of matters that the auditor would consider when assessing whether the specialist has the necessary objectivity.

The proposed requirements are aligned with the Board's risk assessment standards, so that the necessary audit effort is commensurate with, among other things, the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and the associated risk. The approach has been informed by, among other things: (1) observations from PCAOB oversight activities and SEC enforcement actions; (2) analysis of comment letters on the 2015 SCP; (3) the IAASB's and the AICPA's Auditing Standards Board's ("ASB") auditing standards and IAASB's post-implementation review;³⁸ (4) outreach to audit firms and specialist entities; (5) views expressed by members of the SAG; and (6) academic research.

The proposed approach for an auditor's specialist has some similarities with the approach in ISA 620, but more directly reflects the different relationships of an auditor-employed specialist and an auditor-engaged specialist to the auditor. Specifically, similar to ISA 620, the proposed requirements recognize the common role served by auditor-engaged and auditor-employed specialists. Unlike ISA 620, however, the proposal sets forth in separate standards the auditor's responsibilities with respect to auditor-engaged and auditor-employed specialists. This approach recognizes that certain proposed requirements can be applied similarly to both types of specialists (e.g., reaching an understanding and evaluating work to be performed), while others should differ (e.g., requiring an assessment of objectivity for auditor-engaged specialists, while recognizing that auditor-employed specialists are required to be independent under SEC and PCAOB rules).

³⁷ In the proposal, the term "objectivity" is reserved for the auditor-engaged specialist and not used to describe the relationship to the company of (1) a company's specialist or (2) an auditor-employed specialist. See Section IV.D.3 below and Section IV.B.1 of Appendix 3 for further discussion of objectivity.

³⁸ See IAASB, *Clarified International Standards on Auditing – Findings from the Post-Implementation Review* 44-45 (July 2013).

The proposal also sets forth requirements for the auditor to evaluate the methods and significant assumptions of a company's specialist when the auditor uses that work as audit evidence. This evaluation is not explicitly required under the Board's existing standards, other than under AS 2502 with respect to the significant assumptions of a company's specialist regarding fair value measurements and disclosures.

In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.³⁹ In the Estimates Release, the Board is proposing to retitle and replace AS 2501 and supersede AS 2502 and AS 2503. Proposed AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

Questions:

2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?
3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

IV. Economic Considerations

The Board is mindful of the economic impacts of its standard setting. The economic analysis describes the baseline for evaluating the economic impacts of the proposal, analyzes the need for the proposal, and discusses potential economic impacts

³⁹ Estimates Release, PCAOB Release No. 2017-002.

of the proposed requirements, including the potential benefits, costs, and unintended consequences. The analysis also discusses alternatives considered. Because there are limited data and research findings available to estimate quantitatively the economic impacts of discrete changes to auditing standards, the Board's economic discussion is qualitative in nature.

A. Baseline

Sections II.A-B above discuss current PCAOB requirements for using the work of specialists and current experience in the application of those requirements. This section addresses from an economic perspective: (1) the prevalence and significance of audits involving specialists; (2) the current audit requirements that apply to the use of the work of specialists; and (3) the quality of audits that involve specialists, based on observations from regulatory oversight and academic literature.

1. Prevalence and Significance of Audits Involving Specialists

Staff analysis of PCAOB inspections data for audits of issuers indicates that larger audit firms extensively use the work of specialists, in particular auditor-employed specialists. This conclusion is based on a staff analysis of the 274 issuer audits⁴⁰ by U.S. audit firms affiliated with global networks that were selected for inspection in 2015. This analysis found that auditors used the work of at least one auditor-employed specialist in about 85 percent of those audits. For the 85 percent of those audits that involved the use of auditor-employed specialists, an average of four to five individual specialists performed some work on each audit, and specialists performed work in an average of one to two fields of expertise on each audit.

The data used in this analysis does not indicate how frequently the auditor used the work of an auditor-engaged specialist. As discussed in Section II.B.1, however, anecdotal evidence suggests that some larger audit firms use the work of auditor-engaged specialists infrequently.

Larger audit firms generally require their engagement teams to evaluate the work of a company's specialist, including the specialist's methods and significant assumptions, and often employ specialists to assist their audit personnel in evaluating

⁴⁰ The analysis was performed on engagement-level data obtained through PCAOB inspections. The audits inspected by the PCAOB are most often selected based on risk rather than selected randomly, and these numbers may not represent the use of the work of specialists across a broader population of companies.

that work. Furthermore, the academic literature suggests that, when the company uses a company's specialist, some larger audit firms also tend to use the work of an auditor's specialist, at least in the context of audits involving challenging fair value measurements.⁴¹

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

These results suggest that, when smaller firms use the work of a company's specialist, they often use that work without concurrently using an auditor's specialist to assist the auditor. That is, among the 66 audits (i.e., the sum of categories (1) and (3) above) in which the auditor used the work of a company's specialist, the auditor concurrently used the work of an auditor's specialist in 30 audits (i.e., about 45% of such audits). The results above also suggest that the smaller firms are more likely to use the work of auditor-engaged specialists than auditor-employed specialists.⁴² Among the 54 audits (i.e., the sum of categories (2) and (3) above) in which the auditor used the work of an auditor's specialist, the specialist was an auditor-engaged specialist in 39

⁴¹ See, e.g., Nathan H. Cannon and Jean C. Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, *The Accounting Review*, in-press 3 (2016) (study using an experiential questionnaire involving audit partners and managers of Big 4 firms in audits involving challenging fair value measurements).

⁴² The predominant use of the work of specialists by both larger and smaller audit firms is in the valuation area. See *supra* text accompanying note 23.

audits (i.e., 72% of such audits, or 11% of the audits that were analyzed). This may suggest that many smaller firms do not maintain their own specialists on staff.⁴³

The academic literature also suggests that the use of valuation specialists is prevalent for at least some audits. One recent study of audits by the four largest firms that involved challenging fair value measurements found that, among the audits studied, about 85% of audit teams used auditor-employed specialists, while about 5% of audit teams used auditor-engaged specialists.⁴⁴ In addition, 60% of the companies in this study used their own specialists, who were primarily engaged rather than employed specialists.⁴⁵ The audits that were included in this study may not be representative of all audit engagements, because they were selected in order to study engagements that involved material, highly challenging fair value measurements. However, the results suggest that the use of an auditor's specialist is at least prevalent among audits performed by the four largest U.S. firms where a company's specialist is used to assist in the development of highly challenging and material fair value measurements, which may also be audit areas with a high risk of material misstatement and thus a need for greater audit attention.⁴⁶

⁴³ The fact that the auditor did not use the work of an auditor's specialist does not imply that the auditor should have used the work of an auditor's specialist.

⁴⁴ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, at 22. The percentages stated may include audit engagements in which an auditor used both auditor-employed and auditor-engaged specialists concurrently. The tabulated results in the paper do not provide information about instances where only auditor-employed or only auditor-engaged specialists were used. In another study of how auditors use valuation specialists, auditors from seven larger U.S. audit firms who were interviewed stated that, on average, 61% of their engagements in the past year involved a valuation specialist. See Emily E. Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 13 (July 2016) (working paper, available in SSRN).

⁴⁵ See Cannon and Bedard, *Auditing Challenging Fair Value Measurements: Evidence From the Field*, at 22.

⁴⁶ Another recent qualitative study conducted through interviewing audit partners, managers, and seniors also observes that auditors in the six larger audit firms consider factors such as the "client's regulatory environment and other risk factors," "lack of subject matter expertise within the audit team," and "complexity of the engagement"

Furthermore, the academic literature also corroborates the characterizations discussed in Section II.B regarding the current practice of audit firms when using specialists. Academic studies suggest that, at least among the audits that were studied where specialists were used, larger firms were more likely to use the work of auditor-employed specialists than auditor-engaged specialists in their engagements,⁴⁷ while smaller firms, relative to larger firms, used the work of auditor-engaged specialists more frequently.⁴⁸

A possible explanation for the tendency of larger firms to use the work of auditor-employed specialists (instead of auditor-engaged specialists) is that larger firms, due to the greater number of their audit engagements or due to a broadening of their non-

when determining whether to use a specialist. See J. Efrim Boritz, Natalia Kochetova-Kozloski, Linda A. Robinson, and Christopher Wong, *Auditors' and Specialists' Views About the Use of Specialists During an Audit* 14-15 (Apr. 2015) (working paper, available in SSRN).

⁴⁷ See, e.g., Steven M. Glover, Mark H. Taylor, and Yi-Jing Wu, *Current Practices and Challenges in Auditing Fair Value Measurements and Complex Estimates: Implications for Auditing Standards and the Academy*, 36 *Auditing: A Journal of Practice & Theory* 63, 75 (2017) ("[R]esults indicate that approximately two-thirds (one-third) of our participants reported that they use in-house (third-party) valuation specialists to support the audit work performed for *financial* FVMs [i.e., fair value measurements]. Moreover, approximately 87 percent (13 percent) of the audit partners indicated that they use in-house (third-party) valuation specialists to support the audit work for *nonfinancial* FVMs."); see also Emily E. Griffith, Jacqueline S. Hammersley, and Kathryn Kadous, *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice*, 32 *Contemporary Accounting Research* 833, 836 (2015) ("[A]uditors [from six larger audit firms that were the subject of the study] typically enlist audit-firm specialists in auditing estimates because they do not have valuation expertise...").

⁴⁸ See Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 58. In this study, all participating auditors from Big 4 audit firms indicated that they used internal valuation specialists (i.e., auditor-employed valuation specialists) and did not use any external valuation specialists (i.e., auditor-engaged valuation specialists). In contrast, only 40% of the auditors from the other audit firms that participated in the study indicated that they exclusively used internal valuation specialists.

auditing practices, have sufficient demand for the services of specialists to warrant hiring specialists who work for them full-time. In contrast, smaller firms may currently use the services of an auditor's specialist fairly infrequently,⁴⁹ so that engaging an auditor's specialist as needed may be economically more advantageous. In addition, the tendency of smaller firms to look to the work of a company's specialist without using the work of an auditor's specialist may reflect the fact that AS 1210 enables the auditor to use the work of a company's specialist in a wide range of situations, without imposing obligations on the auditor that might require the retention of an auditor's specialist. Since smaller firms tend not to employ their own specialists, the use of an auditor-engaged specialist could represent a significant incremental cost for those firms, which they may have an incentive to avoid. In contrast, for larger firms, which tend to employ specialists, using a specialist who already works for the firm on an additional audit engagement may entail a lower incremental cost.

2. PCAOB Auditing Standards Regarding Use of the Work of Specialists

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

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

⁴⁹ However, auditors at smaller firms that primarily audit companies in certain industries for which the involvement of specialists is typically necessary may frequently use specialists, and thus also may have repeated experience supervising an auditor's specialists and evaluating the work of specialists. In such cases, the auditor's capability to supervise an auditor's specialist and evaluate the work of a specialist may improve due to the frequent and repeated experience.

biases (e.g., pressure to conform to management bias), requirements would ideally differentiate between the two types of specialists, but current requirements do not do so.

In contrast, PCAOB requirements for using the work of an auditor-employed specialist, who is subject to supervision under AS 1201, differ from the requirements that apply to using the work of an auditor-engaged specialist. Auditor-employed and auditor-engaged specialists may differ in their economic dependency on the auditor and, by extension, could face different incentives to, for example, acquiesce to auditor decisions to downplay or suppress unfavorable information in order to accommodate a conclusion sought by the auditor.⁵⁰ In the context of a company's specialist, the academic literature provides anecdotal evidence suggesting that employed and engaged specialists may face different incentives when conducting their work.⁵¹ It is difficult to generalize, however, as to whether an auditor-employed specialist has a greater economic dependency on the auditor than an auditor-engaged specialist.⁵² Moreover, any potential bias by auditor-employed and auditor-engaged specialists arising from economic dependency on the auditor may be mitigated by the responsibility

⁵⁰ See, e.g., Griffith, *Auditors, Specialists, and Professional Jurisdiction in Audits of Fair Values* 33 ("Auditors and specialists described several defensive behaviors by auditors that restrict specialists' access to information...Restricting specialists' access to information can influence how specialists do their work, what work they do, and what conclusions they reach.") and 32 ("[A]udit teams delete extraneous information in specialists' memos when that information contradicts what the audit team has documented in other audit work papers...").

⁵¹ See, e.g., J. Richard Dietrich, Mary S. Harris, and Karl A. Muller III, *The Reliability of Investment Property Fair Value Estimates*, 30 *Journal of Accounting and Economics* 125, 155 (2001) ("[O]ur investigation reveals that the reliability of fair value estimates varies according to the relation between the appraiser and the [company] (internal versus external appraiser)...We find evidence that appraisals conducted by external appraisers result in relatively more reliable fair value accounting estimates (i.e., lower conservative bias, greater accuracy and lower managerial manipulation).").

⁵² The extent of economic dependency of an auditor-employed specialist on the auditor will depend on how much of the specialist's work is related to audits (as opposed to non-audit services), which may vary for different auditor-employed specialists. Similarly, the extent of economic dependency of an auditor-engaged specialist on the auditor will depend on how much of the specialist's overall work is connected to the particular audit firm, which may vary for different auditor-engaged specialists.

imposed directly on the engagement partner under AS 1201 for supervision of the work of engagement team members and compliance with PCAOB standards, including those regarding using the work of specialists. In addition, AS 1220, *Engagement Quality Review*, requires the engagement quality reviewer to "evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report." Such significant judgments may include areas where auditors used the work of an auditor-employed or auditor-engaged specialist.

Furthermore, auditor-employed and auditor-engaged specialists serve similar roles in helping auditors obtain and evaluate audit evidence. Given the similar relationships of the auditor with auditor-employed and auditor-engaged specialists, it seems appropriate that the auditor would follow similar requirements when using both types of specialists, though current requirements differ for the two types of specialists. A notable difference in the relationship of the auditor with auditor-employed and auditor-engaged specialists, however, relates to the integration of auditor-employed specialists (as compared with auditor-engaged specialists) in an audit firm's quality control systems, which allows the auditor greater visibility into any relationships that might affect the auditor-employed specialist's independence, as well as greater visibility into the auditor-employed specialist's knowledge, skill, and ability. The proposed requirements with respect to evaluating the objectivity, as well as knowledge, skill, and ability, of an auditor-engaged specialist would, therefore, reasonably reflect that difference by providing the auditor with specific requirements to assess whether the auditor-engaged specialist has both the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit and the level of knowledge, skill, and ability to perform the specialist's work related to the audit.

3. *Quality of Audits That Involve Specialists*

As discussed in Section II.B, PCAOB oversight of audit engagements in which auditors used the work of a company's or an auditor's specialist and SEC enforcement actions have identified certain concerns. PCAOB oversight activities have also led to inspection findings in this area. For issuer audit engagements, PCAOB staff have more recently observed a decline in the number of instances in which auditors did not perform sufficient procedures related to the work of an auditor's specialist. There are some preliminary indications that some, but not all, firms with observed deficiencies have undertaken remedial actions in response to such findings, which may have contributed, at least in part, to improvements in audit quality related to the auditor's use of an auditor's specialist.

Relatively few empirical academic studies have explicitly examined the relationship between the use of specialists and investors' perception of audit quality. This may be because it is difficult, especially for investors, to assess the effect of using specialists on audit quality independently from the effects of other relevant factors, such as the quality of the company's financial reporting or internal controls. Available studies have focused on the idea that estimates by issuers in financial statements, which often are provided with the help of a company's specialist, are uncertain, which "allows room for management bias"; such studies have also observed that, "as estimates become less reliable they become less useful to capital market participants," including investors.⁵³ Other studies suggest that some estimates are also more likely to be discounted by investors.⁵⁴ Because investors' perceptions of the credibility of financial statements are influenced by their perceptions of audit quality, the auditor's appropriate use of the work of specialists may increase the credibility of the accounting estimates included in the financial statements.

Question:

4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

⁵³ See Griffith et al., *Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice* 833.

⁵⁴ See, e.g., Chang Joon Song, Wayne B. Thomas, and Han Yi, *Value Relevance of FAS No. 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms*, 85 *The Accounting Review* 1375 (2010). Furthermore, the academic literature notes that auditing estimates with extreme uncertainty can pose significant challenges for auditors. See, e.g., Brant E. Christensen, Steven M. Glover, and David A. Wood, *Extreme Estimation Uncertainty in Fair Value Estimates: Implications for Audit Assurance*, 31 *Auditing: A Journal of Practice & Theory* 127 (2012).

B. Need for the Proposal

From an economic perspective, the primary cause for market failure⁵⁵ that motivates the need for the proposal is the moral hazard⁵⁶ affecting the auditor's decisions on how to implement audit procedures related to the use of the work of a specialist, which increases the risk of lower audit quality from the investor's perspective.

Generally, the moral hazard problem related to the use of the work of a specialist manifests in the auditor not performing appropriate procedures, even though such procedures would improve audit quality by increasing the auditor's attention, because the auditor may not perceive there to be sufficient economic benefit (compared to the corresponding costs⁵⁷ and efforts) from such actions.

⁵⁵ "Market failure" refers to a situation in which markets fail to function well. One can distinguish between complete and partial market failure. Complete market failure occurs when a market simply does not operate at all, because there are either no willing buyers (but willing producers) or no willing producers (but willing buyers). Partial market failure occurs when a market does function but produces either the wrong quantity of a product, or produces a product at the wrong price, or produces products at the wrong level of quality. For example, a market for public company audits which consistently produces some deficient audits would be considered a market experiencing partial market failure. See, e.g., Francis M. Bator, *The Anatomy of Market Failure*, 72 *The Quarterly Journal of Economics* 351 (1958); and Steven G. Medema, *The Hesitant Hand: Mill, Sidgwick, and the Evolution of the Theory of Market Failure*, 39 *History of Political Economy* 331 (2007).

⁵⁶ The moral hazard problem is also referred to as a hidden action, or agency problem, in economics literature. The term "moral hazard" does not refer to a person's morality, but rather to the incentive an agent may have to take actions (such as not working hard enough) that benefit the agent at the expense of harming the principal. To correct moral hazard problems, the principal must change the incentives the agent faces to better align the agent's actions with the principal's interests. Monitoring the agent's behavior can reinforce these incentives. See, e.g., Bengt Holmström, *Moral Hazard and Observability*, 10 *The Bell Journal of Economics* 74 (1979).

⁵⁷ The general effect of cost pressures on audit quality has been studied in academic literature with varying empirical findings. See, e.g., Bernard Pierce and Breda Sweeney, *Cost–Quality Conflict in Audit Firms: An Empirical Investigation*, 13 *European Accounting Review* 415 (2004).

Specifically, when auditors use the work of a company's specialist, moral hazard may take the form of planning and performing audit procedures that may not be commensurate with the risk of material misstatement inherent in the work of the company's specialist. When auditors use the work of an auditor's specialist, moral hazard may, for example, take the form of not performing procedures or performing insufficient procedures to communicate and reach an understanding with the specialist regarding the specialist's responsibilities and the objectives of the specialist's work and sufficiently evaluate that work.⁵⁸

Moral hazard is made possible in this context by the information asymmetry⁵⁹ that exists due to the lack of transparency about the nature of the auditor's work (i.e., between the auditor on the one hand, and investors on the other hand). For instance, investors typically do not know whether an auditor used an auditor's specialist and if so, how the auditor's specialist was used. Because of this information asymmetry, the auditor may face little to no scrutiny from investors regarding his or her audit procedures when using the work of specialists,⁶⁰ and may perceive limited economic benefits (e.g., gains in revenue, gains in professional reputation, a reduction in the risk of facing litigation) in incurring costs to perform additional audit work. Hence, the moral hazard

⁵⁸ Alternatively, it is conceivable that, in some situations, moral hazard may take the form of the auditor either influencing the findings or conclusions that specialists reach or modifying the specialist's work after the fact to support the conclusions sought by the auditor. See *supra* text accompanying note 50.

⁵⁹ Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

⁶⁰ This is true for other aspects of the audit engagement as well and hence the audit can be thought of providing investors with a credence service. Credence services (or goods) are difficult for consumers to value because their benefits are difficult to observe and measure. See Monika Causholli and W. Robert Knechel, *An Examination of the Credence Attributes of an Audit*, 26 Accounting Horizons 631 (2012). See also Alice Belcher, *Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies*, 18 Bond Law Review 1, 5 (2006) (An "audit is a credence service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company.").

problem between the auditor and investors may have a detrimental impact on audit quality.⁶¹

Because market forces (e.g., pressure and demands from investors) may not be effective in making the auditor more responsive to investor interests with respect to the use of the work of specialists, from an economic perspective, the situation absent standards would be characterized as a form of market failure. While current standards regarding the use of the work of an auditor-engaged specialist and a company's specialist are intended to address and mitigate potential auditor moral hazard, they could be aligned more closely with the risk assessment standards, which could enhance audit quality. In addition, while auditor-employed specialists are supervised under a risk-based approach, specifying requirements for applying that approach could promote an improved, more uniform approach to supervision of auditor-employed specialists. Additionally, if the work of an auditor's specialist is not properly overseen or evaluated (or the work of a company's specialist is not properly tested or evaluated), there may be a heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures.⁶²

The auditor does not engage or employ a company's specialist and does not supervise the work of a company's specialist. This makes the auditor's use of the work of a company's specialist different from the auditor's use of an auditor's specialist in several important ways.

First, because of the different relationships the auditor has with a company's specialist and with an auditor's specialist, the auditor's assessment of the qualifications

⁶¹ Additionally, such situations may occur because the auditor made an error in judgment assessing the audit risk involved when using the work of an auditor's specialist or a company's specialist. In situations in which "objectives and the actions needed to achieve them are complex and multifaceted, it is inevitable that different people" will interpret "them in different ways..." See John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 *Academy of Management Review* 98, 107-108 (2002). Whether one assumes that people either are unselfish yet "prone to mak[ing] mistakes" or are self-interested and opportunistic yet unlikely to make mistakes, when choosing their actions in such situations, Hendry argues that the predicted actions (and hence resulting problems) are more or less the same under either assumption. *Id.* at 100.

⁶² See Section II.C, *supra*.

and relationships of a company's specialist requires greater effort by the auditor compared to the auditor's equivalent procedures with respect to an auditor's specialist. Second, the auditor's consideration of significant assumptions and methods used by the company's specialist may also be more challenging, compared to equivalent procedures performed by the auditor when using an auditor's specialist with whom the auditor has an employment or contractual relationship. Third, an auditor is generally more likely to be familiar with an auditor's specialist than with a company's specialist (e.g., with the professional qualifications, reputation, and work), which reduces the costs associated with the ongoing monitoring of the specialist's work.⁶³ Given these differences, the standards would ideally differentiate between the two types of specialists, but AS 1210 currently does not do so.

Accordingly, the potential for moral hazard relating to the auditor's use of the work of a company's specialist is a particular focus of the proposed requirements. Indeed, observations from PCAOB oversight activities described in Section II.B.2 suggest that current standards could be enhanced by providing specific requirements for using the work of a company's specialists that better align with investors' interests.

The need to enhance current standards is further heightened by the fact that it may be particularly challenging for the auditor to supervise an auditor's specialist or to evaluate the work of both an auditor's specialist and a company's specialist. The work of an auditor's or a company's specialist often involves professional judgment, the nature of which the auditor may not fully appreciate when evaluating the work of the specialist. In particular, the specialist's work is highly technical in nature and often is not entirely transparent to the auditor, who may not have complete access to the specialist's work⁶⁴

⁶³ An additional aspect that affects the potential for moral hazard is the possible differences between auditor-engaged and auditor-employed specialists with respect to their business relationships with the auditor. To the extent that one has a stronger business relationship (e.g., repeated business interactions between the specialist and the auditor), the potential for moral hazard, arising in the context of the auditor using such an auditor's specialist, is likely higher.

⁶⁴ As further discussed in Section IV.B.2 of Appendix 3, some commenters on the 2015 SCP expressed concern that the auditor may have limited access to proprietary information used by auditor-engaged specialists (as compared with information used by auditor-employed specialists) and, as a result, would be unable to supervise the auditor-engaged specialist in the same way he or she supervises an auditor-employed specialist. The proposal would not require the auditor to obtain such proprietary

or the same level of knowledge and skill in the specialist's field.⁶⁵ Thus, due to the potential that an auditor would incur relatively higher cost to supervise an auditor's specialist or to test and evaluate the work of a company's specialist, the auditor may have incentives to forego procedures related to the use of the work of specialists that could be beneficial to investors.

The potential negative impact on audit quality of the auditor's incentives to forego procedures is compounded by the possibility that the specialist may, for example, perceive little benefit (compared to the corresponding costs and efforts) in seeking clarification when the auditor and specialist establish the responsibilities of the specialist, including the objectives of the work to be performed; or, the specialist may in some instances believe that he or she faces few negative consequences (such as an increased risk of litigation) when performing low quality work. However, any such concerns are at least partially alleviated to the extent specialists could perceive a risk of reputational damage or are subject to codes of conduct, standards, and disciplinary processes of their own profession.⁶⁶

Accordingly, the Board believes that enhanced performance standards regarding the use of the work of specialists may be beneficial to the quality of the audit and to investors. To address the potential risks discussed above, the proposal would, as discussed in more detail in Section III: (1) strengthen requirements, which are aligned with the risk assessment standards, regarding using the work of a company's specialists as audit evidence; (2) leverage existing supervisory principles to strengthen

information, but rather require the auditor to obtain sufficient information to evaluate the work of that specialist in accordance with the proposed standard.

⁶⁵ See, e.g., Jennifer R. Joe, Yi-Jin Wu, and Aleksandra B. Zimmerman, *Overcoming Communication Challenges: Can Taking the Specialist's Perspective Improve Auditors' Critical Evaluation and Integration of the Specialist's Work?* 7 (Feb. 2017) (working paper, available on SSRN) ("Recent research on auditors' use of specialists focuses on situations where auditors are advice-seekers and lack the knowledge or expertise of the specialists...").

⁶⁶ See, e.g., Letter from American Academy of Actuaries (July 31, 2015), at 18 ("We note that Precept 1 of the actuary's code of conduct mandates performing engagements with integrity: 'An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession.'").

requirements regarding supervision of the work of an auditor-employed specialist; and (3) strengthen requirements when using the work of an auditor-engaged specialist so that those requirements largely parallel the requirements when using an auditor-employed specialist.

Question:

5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.

C. Economic Impacts

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

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

1. Benefits

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

Investors also may benefit from the proposed requirements because the proposed requirements may result in more uniformly rigorous practices among auditors

when using the work of a company's specialist in their audits, as well as a more consistent approach to supervision of auditor-employed and auditor-engaged specialists. The absence of uniformity in the application of practices related to the auditor's use of the work of specialists, combined with a lack of information about such practices, could lead investors to discount the quality of all audits (with the potential effect on the cost of capital of companies) because of investors' inability to distinguish the quality of each audit separately. Conversely, uniformity in such practices could mitigate those concerns. From an investor's perspective, the increase in audit quality that may result if the proposal were adopted by the Board could translate into an increase in the credibility of the information provided in a company's financial statements and a decrease in the cost of capital for that company, especially if relatively less information is available about the company because of its shorter financial reporting history.⁶⁷

From a capital market perspective, an increase in investors' perception of the credibility of information provided in companies' financial statements because of improved audit quality, in the aggregate, can increase the efficiency of capital allocation decisions. In other words, greater reliability of companies' financial statements generally may result in investment decisions by investors that more accurately reflect the financial position and operating results of each company.⁶⁸

⁶⁷ See, e.g., Jeffrey A. Pittman and Steve Fortin, *Auditor Choice and the Cost of Debt Capital for Newly Public Firms*, 37 *Journal of Accounting and Economics* 113, 114 (2004) ("[E]ngaging [an audit firm with] a brand name reputation for supplying higher-quality audit that enhances the credibility of financial statements...enables young [companies] to reduce their borrowing costs...[O]ur research suggests that the economic value of auditor reputation declines with age as [companies] shift toward exploiting their own reputations to reduce information asymmetry.").

⁶⁸ See, e.g., Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 *Review of Finance* 1, 21 (2011) ("[M]arket illiquidity influences the amount of information that is reflected in prices [and] ... reduces investors' average precision and thus raises the cost of capital. Moreover, the degree of information asymmetry in the economy influences the amount of market illiquidity, which also raises the cost of capital."). Professor Leuz is an economic advisor to the PCAOB's Office of Economic and Risk Analysis. This research was published before he joined the PCAOB.

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

The proposal may also contribute to the aggregate benefits of the auditing standards (i.e., enhance auditors' understanding of, and compliance with, other PCAOB auditing standards), in addition to the other improvements in audit quality described above. For example, the proposed requirements to test and evaluate the work of a company's specialist may result in some auditors developing a better understanding of the company's critical accounting estimates related to relevant financial statement accounts and disclosures. In turn, this may also result in improved communications with the audit committee.⁶⁹

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

Question:

6. The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

⁶⁹ See paragraphs .12c and .13c of AS 1301, *Communications with Audit Committees*, for the auditor's communication requirements related to the company's critical accounting estimates.

2. Costs

The Board recognizes that the benefits of the proposal may come at potential additional costs to auditors and the companies they audit.

As with any changes to existing requirements, it is anticipated that there would be one-time costs for auditors associated with updating audit methodologies and tools, preparing new training materials, and conducting training. The proposal could further give rise to recurring costs in the form of additional time and effort spent on any individual audit engagement by specialists and engagement team members.

The most significant impact of the proposal on costs for auditors is expected to result from the proposed requirements to test and evaluate the work of a company's specialist. Compared with the existing requirements,⁷⁰ the auditor will be required in all cases to evaluate the significant assumptions used by the specialist, as currently required by other auditing standards only in certain circumstances,⁷¹ as well as the methods used by the specialist. In practice, these requirements may result in auditors who currently perform limited procedures over the work of a company's specialist engaging or employing an auditor's specialist to assist in performing those procedures. This may lead to significant changes in practice for some firms, particularly smaller firms that currently follow methodologies solely based on AS 1210, even though the proposal does not require the auditor to use the work of an auditor's specialist.

Some of the cost increases for auditors due to the proposal are likely to be offset by the implementation of more efficient, risk-based audit approaches in practice (e.g., more targeted procedures when using the work of specialists). In particular, more efficient, risk-based audit approaches reduce the risk to the auditor of failing to detect material misstatement and thus could lead to a reduction in costs resulting from the risk of litigation, regulatory sanction (including time and effort spent on remediation of deficiencies) or reputational loss faced by auditors.

⁷⁰ See existing AS 1210.12.

⁷¹ In circumstances when an auditor is auditing fair value measurements in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurement.

The proposal's impact on costs for auditors could also vary based on the size and complexity of an audit engagement. Holding all else constant, anticipated costs generally would be higher for larger, more complex audits than for smaller, less complex audits.⁷² The proposal's impact would also likely vary, however, depending on whether any of the proposed requirements have already been incorporated in audit firms' audit methodologies or applied in practice by individual engagement teams. As discussed above, for auditors that have already implemented elements of the proposal, the costs of implementing the proposed requirements may be lower than for firms that currently perform more limited audit procedures. For example, some firms employ procedures to reach and document their understanding with an auditor's specialist about, among other things, the responsibilities of the auditor's specialist and the nature of the work to be performed. Firms that do not already employ such procedures may incur additional costs under the proposal.

Similarly, the proposal's incremental impact on costs incurred by auditors would likely vary depending on, among other things, how many of an audit firm's engagements involve the use of the work of specialists. For audit firms that use the work of specialists in a similar way on their engagements, the anticipated costs would likely be higher for audit firms that perform many audit engagements involving the use of the work of specialists than for audit firms that perform few such audits. For larger audit firms that generally perform a larger number of audit engagements (which may or may not involve the use of the work of specialists), however, the proposal's incremental impact on costs per engagement may be lower than for smaller firms that generally perform a smaller number of audit engagements (which may or may not involve the use of the work of specialists). The reason is that larger firms, due to their existing economies of scale⁷³

⁷² As discussed in Section IV.A.1, a smaller fraction of audits performed by smaller audit firms tend to involve use of the work of specialists, compared with audits performed by larger audit firms. Furthermore, according to the American Academy of Actuaries "smaller audit firms also tend to have clients that require fewer special needs," implying that audit engagements of smaller audit firms tend to also be less complex than audit engagements of larger audit firms. See Letter from American Academy of Actuaries (July 31, 2015), at 18. Hence, it is reasonable to assume that relatively fewer audits of smaller firms will be impacted by the proposal than audits of larger firms.

⁷³ See *Economies of Scale and Scope*, The Economist, Oct. 20, 2008 ("Economies of scale are factors that cause the average cost of producing something to fall as the volume of its output [i.e., number of audit engagements] increases."). In this context, the average cost would likely fall with the number of audit engagements, because certain

and scope,⁷⁴ would tend to be able to distribute the overall cost impact of the proposal over a larger number of audit engagements.

For companies (and, indirectly, investors), the proposal might result in additional costs to the extent that the proposal causes auditors to raise audit fees, which could vary for the same reasons as described above relating to the proposal's potential impact on costs incurred by auditors.⁷⁵ Further, the proposal could give rise to new recurring costs for management to the extent that the proposal results in the need for companies to devote more time and resources to respond to auditor inquiries and requests. For example, when evaluating the work of a company's specialist under the proposal, an auditor may require more of the company's time or more time of the company's specialist.

costs, such as the cost of employing specialists, are not directly related to the number of audit engagements that an auditor assumes; see also Simon Yu Kit Fung, Ferdinand A. Gul, and Jagan Krishnan, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing*, 87 *The Accounting Review* 1281, 1287 (2012) ("For an audit firm, the scale economies can arise from substantial investment in general audit technology (e.g., audit software development or hardware acquisition) and human capital development (e.g., staff training), which are likely to be shared among all of their clients. Once these investments are in place, additional clients can be serviced at a lower marginal cost than the cost of servicing the first few clients.").

⁷⁴ See *Economies of Scale and Scope*, *The Economist*, Oct. 20, 2008. ("[E]conomies of scope [are] factors that make it cheaper to produce a range of products together than to produce each one of them on its own. Such economies can come from businesses sharing centralised functions...").

⁷⁵ It is not clear to what extent the proposed audit performance requirements would result in higher audit fees. The Board is aware of public reports that have analyzed historical and aggregate data on audit fees and which suggest that audit fees generally have remained stable in recent years, notwithstanding the fact that the Board and other auditing standard setters have issued new standards during that period. See, e.g., Audit Analytics, *Audit Fees and Non-Audit Fees: A Fourteen Year Trend* (Nov. 2016). Because amendments to, and adoption of, new Board standards typically involve discrete parts of an audit, which are not accounted for or priced on a standard-by-standard basis, it is difficult to obtain data that isolate the costs of particular new audit standards and that would be comparable between firms.

Question:

7. The Board requests comment generally on the potential costs to auditors and the companies they audit. Are there additional costs the Board should consider?
3. *Unintended Consequences*

In addition to the benefits and costs discussed above, the proposed amendments could have unintended economic impacts. The following discussion describes potential unintended consequences considered by the Board and, where applicable, factors that mitigate the negative consequences, such as steps the Board has taken or the existence of other countervailing forces.

First, the proposal, to the extent that it increases the need of some audit firms to use the work of an auditor's specialist (rather than only use the work of a company's specialist under existing AS 1210), may result in some smaller firms accepting fewer audit engagements that would require the use of an auditor's specialist. Relatedly, the proposal may inhibit some smaller firms from expanding their audit services for the same reasons.

In particular, the proposal may result in an increased need by some auditors at smaller firms to use the work of an auditor's specialist for certain engagements, to the extent that such auditors have less experience evaluating the work of a company's specialist than auditors at larger firms. Potentially, such firms would be unable to take advantage of economies of scale and scope available to larger firms, and would find it economically less attractive to accept such engagements.

As discussed previously, however,⁷⁶ some auditors at smaller firms that primarily audit companies in industries for which the involvement of specialists is typically necessary may have experience evaluating the work of a company's specialist comparable to auditors at larger firms. For these reasons, the impact on auditors at smaller firms may vary. In addition, as previously discussed in Section IV.A.1, smaller firms tend to have fewer audit engagements than larger firms where a company's specialist or an auditor's specialist is involved. This suggests that any increase in the potential need of smaller firms to use the work of an auditor's specialist may be of limited economic impact for some smaller firms.

⁷⁶ See also *supra* footnote 49.

Second, the proposal may, in some audit engagements involving specialists, lead auditors to devote more of their attention and resources to the work of a company's specialists (including related training of audit personnel) and to enhancing the coordination with an auditor's specialists, and less time and resources to other tasks that warrant greater attention. The impact on overall audit quality might vary as the re-orientation of attention would occur in different ways for each audit engagement. Any potential adverse impact on overall audit quality is mitigated, however, by the proposal's risk-based approach to using the work of specialists. To the extent that the re-orientation of the auditor's attention leads to more effort in areas with the greatest risk of material misstatement to the financial statements, overall audit quality would be expected to increase. Furthermore, if auditors devote more attention to the work of specialists and enhancing the coordination with their specialists, the proposal may result in some auditors acquiring greater expertise, which could positively affect the quality of audit work performed by such auditors.⁷⁷

Third, the potential exists that auditors might interpret the proposal to suggest that they should use the work of an auditor's specialist in situations where the auditor had already obtained sufficient appropriate audit evidence with respect to a relevant assertion of a significant account or disclosure.⁷⁸ This might occur, for example, if an

⁷⁷ Such auditor specialization could lead some audit firms to seek fewer audit engagements involving specialists, while other firms might seek more such engagements. In addition, it could encourage a stronger degree of differentiation among audit firms, providing some firms with more business opportunities and the ability to take advantage of economies of scale and scope resulting from an increased focus on audit engagements involving specialists. As with any market with differentiated product, the competitive effects of increased differentiation are highly dependent on the circumstances. See, e.g., Fung et al, *City-Level Auditor Industry Specialization, Economies of Scale, and Audit Pricing* 1287 ("[I]ndustry specialization enables auditors to service a larger number of firms within an industry, as they possess similar client characteristics and service needs, thereby reducing audit costs and simultaneously increasing the 'service value' provided to clients.").

⁷⁸ For example, in commenting on the potential unintended consequence of strengthening the requirements regarding the auditor's use of the work of company's specialists in response to the 2015 SCP, one commenter asserted that "[r]equiring auditors to evaluate evidence provided by a company's specialist in a similar way to any other evidence provided by the company's management generally would require the auditor to employ or engage an auditor's specialist to evaluate the company's specialist's work." See Letter from BKD, LLP (July 24, 2015), at 5.

auditor had already tested and evaluated the work of a company's specialist, but decided to employ or engage its own specialist to perform additional procedures (for example, to develop or assist in developing an independent expectation of an estimate) in order to further demonstrate his or her diligence or err on the side of caution. In some instances, it is possible that the auditor might do so even though the auditor believes the costs of using the work of an auditor's specialist will outweigh the expected benefits in terms of audit quality. This risk is mitigated, however, by the fact that the proposed requirements do not require the auditor to use the work of an auditor's specialist. In addition, the proposed requirements regarding the nature, timing, and extent of the testing and evaluation of the work of the company's specialist are designed to be risk-based and scalable to companies of varying size and complexity and thereby avoid unnecessary effort by the auditor and the auditor's specialist.⁷⁹ Accordingly, the instances described above are expected to be relatively rare.

Finally, in audit engagements involving specialists, the proposal could affect the balance between the work of a company's specialist and the work of an auditor's specialist. Although the proposed standards do not change management's responsibility for the financial statements or their obligation to maintain effective internal control over financial reporting, some issuers and some company specialists, anticipating the use of an auditor's specialist for the audit engagement, may decide to use a company's specialist to a lesser extent when preparing financial statements or exhibit a reduced sense of responsibility, respectively.⁸⁰ In such instances, the auditor's specialist may have to perform more work in order to adequately test and evaluate potential audit evidence provided by the issuer (i.e., the work of the company's specialist), or the auditor may decide not to use the work of the company's specialist or use it to a lesser extent. This could reduce audit quality in some instances. The change in the balance

⁷⁹ See Section III.C of Appendix 3 for examples that illustrate the application of the proposed requirements.

⁸⁰ Some of the commenters on the 2015 SCP articulated similar concerns. See, e.g., Letter from Wilary Winn LLC (July 30, 2015), at 6 ("[I]f audit firms are forced to use a specialist to review the work of the company's engaged specialist, fewer companies would retain their own specialists and would instead rely on the auditor's engaged specialist in order to avoid paying for the same work twice."); and Letter from Illinois CPA Society (July 31, 2015), at 6 ("One potential unintended result of revising the level of auditor evaluation of the independent investigators' [i.e., company specialists'] work...may be that companies are discouraged from seeking outside expertise in this important area...").

between the work of a company's specialist and the work of an auditor's specialist, however, would likely be limited, as companies control the work of a company's specialist over information to be used in the financial statements, but lack similar control over an auditor's specialist. Companies generally are likely, therefore, to prefer to continue their use of a company's specialist.

Questions:

8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?
9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

D. Alternatives Considered

The development of the proposal involved considering a number of alternative approaches to address the problems described above. This section explains: (1) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (2) other standard-setting approaches that were considered by the Board; and (3) key policy choices made in determining the details of the proposed standard-setting approach.

1. Why Standard Setting Is Preferable to Other Policy-Making Approaches

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. The Board considered whether providing guidance or increasing inspection or enforcement efforts would be effective corrective mechanisms to address concerns with the testing and evaluation of the work of a company's specialists, the supervision of an auditor's specialists, and the sources of market failure discussed in Section IV.B.

Interpretive guidance, inspections, or enforcement actions alone without amending auditing standards would be unlikely to achieve the Board's objectives, as described in Section II.C.2. Interpretive guidance inherently provides additional

information about existing standards. Inspection and enforcement actions take place after insufficient audit performance (and potential investor harm) has occurred. Devoting additional resources to guidance, inspections, or enforcement activities, without improving the relevant performance requirements for auditors, would at best focus auditors' performance on existing standards and would not provide the benefits associated with improving the standards. The proposed approach reflects the conclusion that standard setting is needed to fully achieve the benefits resulting from improvement in audits involving specialists.

2. *Other Standard-Setting Alternatives Considered*

Several alternative standard-setting approaches were also considered, including: (1) retaining the existing framework but requiring the auditor to disclose when the auditor used the work of specialists in the audit; or (2) targeted amendments to existing requirements.

(a) *Disclosing When the Work of a Specialist is Used*

As an alternative to amending AS 1105 and AS 1201 and replacing AS 1210 in its entirety, the Board considered amending AS 1210 to remove the current prohibition in AS 1210.15 on disclosing that a specialist was involved in the audit. Instead, under this approach, the auditor would be required to disclose this fact. Investors might benefit from such a requirement, since it would inform investors, at a minimum, that the auditor had evaluated the need for specialized skill or knowledge in order to perform an audit in accordance with PCAOB standards. Such disclosures could, in theory, positively affect audit practice, as auditors might face more scrutiny from investors regarding their decisions whether or not to use specialists.

Disclosure alone, however, would be unlikely to achieve the Board's objectives. In a separate rulemaking, the Board is considering adoption of a new auditing standard that would require the auditor to communicate in the auditor's report critical audit matters ("CAMs") arising from the audit that involved especially challenging, subjective, or complex auditor judgment. Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist if the work or findings related to accounts or disclosures that were material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.⁸¹ While it

⁸¹ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

is uncertain how frequently the use of the work of specialists would be disclosed in the auditor's report as part of a CAM, the disclosure requirements would be complemented by amending AS 1105 and AS 1201 and replacing AS 1210 to improve performance requirements over the use of the work of specialists. As discussed in Section IV.B, this would directly mitigate auditor moral hazard and change certain elements of audit practice observed by PCAOB oversight activities, described in Section II.B, that have given rise to concern.

(b) Amending Existing Requirements for Using the Work of an Auditor's Specialists

The Board considered, but is not proposing, two alternative approaches for an auditor's use of the work of an auditor's specialist. The staff sought comment on these approaches in the 2015 SCP. Each approach involved new requirements for: (1) evaluating the knowledge, skill, and objectivity of an auditor's specialist; (2) informing the specialist of his or her responsibilities; and (3) reviewing the specialist's work and conclusions.

The first alternative was to develop a separate standard for using the work of an auditor's specialist. This approach would have created a new auditing standard for using the work of an auditor's specialist, whether employed or engaged by the auditor, similar to the approach in ISA 620 and AU-C Section 620 (and thereby separating the requirements for using the work of an auditor-engaged specialist from those for using the work of a company's specialist). The approach would have applied the supervisory principles set forth in AS 1201 to both auditor-employed and auditor-engaged specialists in a separate standard. This approach also would have required the auditor to continue applying AS 1201 when using the work of an auditor-employed specialist.

The second alternative was to extend the supervisory requirements in AS 1201 to an auditor-engaged specialist. This approach would have amended AS 1210 to remove all references to an auditor-engaged specialist and amended AS 1201 to include all arrangements involving auditor-employed and auditor-engaged specialists. Similar to developing a separate standard, this approach would apply the supervisory principles set forth in AS 1201 to both auditor-employed and auditor-engaged specialists. This approach would be familiar to auditors who employ specialists, since AS 1201 already applies to an auditor-employed specialist.

Many commenters on the 2015 SCP opposed including an auditor-engaged specialist within the scope of AS 1201, and thereby treating such specialist as a member of the engagement team subject to the firm's system of quality control. Many of these commenters asserted that it would not be practical to apply important aspects of an audit firm's system of quality control to an auditor-engaged specialist. Other commenters, however, expressed support for having similar requirements for supervising

an auditor-employed specialist and an auditor-engaged specialist. Some commenters recommended that any new requirements should be principles-based and allow auditors to exercise judgment in overseeing the work of an auditor's specialists. Many of these commenters also supported aligning current requirements with those in ISA 620. A few commenters did not support changing the current requirements for using the work of an auditor's specialist.

The Board determined that, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the auditor's procedures for reaching an understanding with the specialist and evaluating the work to be performed by the specialist should be similar. After considering the comments on certain elements of the two alternatives discussed in the 2015 SCP, the Board determined instead to propose separate, but parallel, requirements for using the work of an auditor-employed specialist and an auditor-engaged specialist related to reaching an understanding and evaluating the work to be performed. The proposed approach acknowledges that, unlike auditor-employed specialists, auditor-engaged specialists are not subject to certain elements of a firm's system of quality control, such as independence, personnel management, and ongoing monitoring.⁸² Requiring the auditor or the auditor-engaged specialist to create and maintain a system of quality control for independence, personnel management, and ongoing monitoring that would apply to the auditor-engaged specialist would pose an undue cost burden on the auditor and auditor-engaged specialist relative to the potential benefits of the two alternatives described above.⁸³ Accordingly, under the proposal, the auditor would perform different procedures when assessing the knowledge, skill, ability, and objectivity of auditor-engaged specialists than when assessing the knowledge, skill, ability, and independence of auditor-employed specialists.

⁸² See, e.g., paragraphs .09-.10 of QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (describing the independence, integrity, and objectivity element of a firm's system of quality control); paragraphs .11-.13 of QC 20 (describing the personnel management element of a firm's system of quality control); paragraph .20 of QC 20 (describing the monitoring element of a firm's system of quality control); and QC 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

⁸³ See also Section IV.D.3 for additional discussion regarding the objectivity of the auditor-engaged specialist.

3. *Key Policy Choices*

Given the preference for creating separate requirements for using a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist, the Board considered different approaches to addressing key policy issues.

(a) *Testing and Evaluating the Work of a Company's Specialist*

The Board is proposing to amend AS 1105 to enhance the requirements for testing and evaluating the work of a company's specialist. Including these requirements in an appendix to the Board's standard on audit evidence underscores that the auditor may use the work of a company's specialist as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure. The proposal is intended to be risk-based and to focus the auditor's attention on information from a company's specialist that pertains to accounts or financial statement disclosures that are significant or have a higher risk of material misstatement, while allowing the auditor to take the knowledge, skill, and ability of the specialist into account in determining the necessary evidence from the auditor's testing and evaluation of the specialist's work.

The Board considered, but is not proposing, an alternative approach discussed in the 2015 SCP for an auditor's use of the work of a company's specialist. This approach suggested the possibility of amending the requirements in AS 1210 to remove certain provisions that might be considered to limit the auditor's responsibilities to evaluate the work of a company's specialist.⁸⁴ While this approach would have required limited changes to existing AS 1210, it does not respond to the risk of material misstatement that may be associated with the financial statement accounts or disclosures with which the work of a company's specialist is involved. In comparison, the Board's proposal, while eliminating the provisions that might be considered to limit the auditor's responsibilities, directs the auditor to focus on areas of greater significance with higher risks of material misstatements.

⁸⁴ For example, this alternative discussed eliminating language in AS 1210.12-.13 that states that: (1) the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist; (2) the auditor would ordinarily use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances; and (3) if the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained.

The Board also considered, as a second alternative, rescinding AS 1210 without issuing new requirements for the auditor's use of the work of a company's specialist. Under this approach, also discussed in the 2015 SCP, information provided by a company's specialist would be evaluated similarly to any other information provided by the company. This approach might respond better to the risks of material misstatement associated with the work of a company's specialist than current requirements, as well as result in increased testing by some auditors who currently "rely" on the work of a company's specialist without performing additional procedures. However, this approach would not specifically acknowledge the role of a company's specialist in performing work that is used by the company in preparing its financial statements and that the auditor may use as audit evidence. It also would fail to direct an auditor to consider the knowledge, skill, and ability of the specialist in determining the necessary evidence from the auditor's testing and evaluation of the specialist's work.

The Board considered the views of commenters on the two alternatives discussed in the 2015 SCP. Some commenters supported amending AS 1210 to remove certain language that could be considered to limit the auditor's responsibility, or retaining the current requirements with, at most, minor enhancements. A few commenters supported rescinding AS 1210 entirely and instead treating the work of a company's specialist the same as other information provided by the company. Other commenters expressed support for amending the existing requirements to align the requirements with the PCAOB's risk assessment standards or ISA 500 the IAASB's standard on audit evidence.

Certain commenters, however, expressed concern that rescinding AS 1210 and elevating the requirements for using the work of a company's specialist would suggest that an auditor is required to have the same level of expertise as a specialist. A few commenters also asserted that such changes would result in the auditor being required to use the work of an auditor-employed or auditor-engaged specialist when evaluating the work of a company's specialist. Some commenters also recommended that the Board distinguish between the work of a company's employed specialists and the work of a company's engaged specialists, as company management may be able to exert greater influence over a specialist employed by the company, while other commenters urged the Board to consider the impact on the nature, timing, and extent of audit procedures related to internal control over financial reporting when a company uses a specialist.

After considering the views expressed by commenters, the Board determined that the proposed approach appropriately recognizes the purpose of the work of a company's specialist and aligns the requirements for using the work of a company's specialist with the risk assessment standards. The proposal would require auditors to focus their attention on information pertaining to financial statement accounts or disclosures that are significant or considered to have a higher risk of material misstatement, as well as the

source of that information. This approach would retain the benefits of a risk-based audit approach, while at the same time providing the auditor with the ability to take the quality of the source of the information into consideration when determining his or her audit approach.

(b) *Objectivity of the Auditor-Engaged Specialist*

The Board's proposal sets forth a framework for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist. The proposed approach directs the auditor to assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. It further assists the auditor in making that assessment by identifying the types of relationships and interests that the auditor should consider, in addition to evaluating whether the specialist has any other conflicts of interest relevant to the work to be performed.

The Board considered, but is not proposing, two approaches for assessing the level of objectivity of the auditor-engaged specialist. The staff sought comment on these approaches in the 2015 SCP. Each would have required a more rigorous evaluation of business, employment, and financial relationships that may impair the objectivity of the specialist than is presently required.

The first approach would extend the PCAOB and SEC auditor independence rules⁸⁵ to auditor-engaged specialists. Under this potential approach, an auditor-engaged specialist could be subject to the independence restrictions that apply to a "covered person in the [accounting] firm" under Rule 2-01 of the Commission's Regulation S-X.⁸⁶ This approach would result in the same independence requirements for auditor-engaged specialists as for auditor-employed specialists, who also assist

⁸⁵ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client," meaning that they must satisfy all independence criteria applicable to an engagement. Under Rule 2-01 of Regulation S-X, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

⁸⁶ See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. 210.2-01(f)(11).

auditors in obtaining and evaluating audit evidence.

Most commenters on the 2015 SCP who addressed this approach opposed applying the requirements of the PCAOB's independence rules to an auditor-engaged specialist.⁸⁷ These commenters, who were accounting firms, associations of accountants, or specialists, generally argued such an approach would be impracticable because the majority of specialists do not currently have the quality control systems needed to monitor compliance with the independence rules. They argued that creating and maintaining the necessary quality control and ongoing monitoring systems would result in significant incremental costs to third-party specialists. These commenters asserted that third-party specialists may not be willing to undertake these additional costs and efforts, which would result in a decreased pool of otherwise qualified specialists available to assist auditors.

The second approach—referred to as an "enhanced objectivity approach" in the 2015 SCP—would incorporate a "reasonable investor" test as an overarching principle in evaluating the objectivity of an auditor-engaged specialist, while also identifying certain relationships and interests that might impair a specialist's objectivity. In addition, this alternative would specify how an auditor should obtain information regarding such relationships and interests from the specialist and the company.

Some commenters on the 2015 SCP supported enhancing the requirements for evaluating the objectivity of an auditor-engaged specialist, including clarifying when the specialist's objectivity may be impaired. They asserted, however, that aspects of the "enhanced objectivity approach," as described, were unduly prescriptive (for example, requiring the auditor to obtain a written description from the specialist regarding, among other things, the process used by the specialist to respond to the auditor's inquiries).

Some commenters on the 2015 SCP also suggested that the Board consider the application and explanatory material in ISA 620 and AU-C Section 620 regarding evaluating the significance of threats to the specialist's objectivity and determining

⁸⁷ Two commenters on the 2015 SCP asserted that the independence requirements should be extended to auditor-engaged specialists. Another commenter, a specialist firm, asserted that this approach would be consistent with its current practices regarding independence and objectivity, while a fourth commenter suggested a different approach whereby all specialists would be required to be independent of both the company and the auditor.

whether there are safeguards to reduce them.⁸⁸ This proposal sets forth a framework, similar to that currently in ISA 620 and AU-C Section 620, for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist. While the proposal would not expressly require an evaluation of safeguards against threats to the specialist's objectivity, it does include a similar assessment of relationships to the company and other conflicts of interest that may affect the specialist's objectivity.

In the Board's view, the proposed approach is preferable to the two more prescriptive approaches described in the 2015 SCP. Specifically, the proposal provides that the auditor should assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. This includes evaluating whether the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed. While an auditor typically would request information from the specialist as part of the auditor's evaluation, the proposal does not specify how the auditor should request information from the specialist or how the specialist should respond to such requests. If the specialist lacks the necessary objectivity, the proposal provides that the auditor would not use that specialist.⁸⁹ This approach is intended to achieve the objective of ensuring that auditors engage specialists who can exercise impartial judgment on all relevant issues related to the audit, without imposing unnecessary costs.

Questions:

10. The Board requests comment generally on the alternative approaches described in this release that the Board considered, but is not proposing. Are any of these approaches, or any other approaches, preferable to the approaches the Board is proposing? What reasons support those approaches over the approaches the Board is proposing?

⁸⁸ See generally ISA 620.A19 and paragraph .A20 of AU-C Section 620, *Using the Work of an Auditor's Specialist*.

⁸⁹ See Section IV.B.1 of Appendix 3 for discussion of the application of this potential requirement and sources of information that the auditor might consider when performing this assessment.

11. Are there additional economic considerations associated with this proposal that the Board should consider? If so, what are those considerations?

V. Special Considerations for Audits of Emerging Growth Companies

The proposed amendments would apply to audits of issuers, as defined in Section 2(a)(7) of Sarbanes-Oxley. As discussed below, the PCAOB is seeking comment on whether the proposed amendments should apply to audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Securities and Exchange Act of 1934 ("Exchange Act").

Pursuant to Section 104 of the Jumpstart Our Business Startups ("JOBS") Act, any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."⁹⁰ As a result of the JOBS Act, the rules and related amendments to PCAOB standards the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

General data on EGCs⁹¹ indicate that, among other things, a majority of EGCs are smaller public companies that are relatively new to the SEC reporting process. As a result, there is less information available to investors regarding such companies relative to the broader population of public companies. Academic research finds that, on average, investors are less informed about companies that are smaller and that these

⁹⁰ See Pub. L. No. 112-106 (Apr. 5, 2012). See Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act. Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The proposed amendments do not fall within either of these two categories.

⁹¹ See *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's website.

companies are followed by fewer analysts.⁹² To the extent that EGCs exhibit one or more of these properties, investors are likely to have less information available about EGCs relative to the broader population of public companies. Accordingly, EGCs are likely to have a greater relative degree of information asymmetry between management and investors, which increases the importance to investors of the external audit to enhance the credibility of management disclosures.⁹³ The proposed requirements relating to the auditor's use of the work of specialists, which are intended to enhance audit quality, could contribute to an increase in the credibility of financial statement disclosures by EGCs.

When confronted with information asymmetry, investors may require a larger risk premium, and thus increase the cost of capital to companies.⁹⁴ Reducing information asymmetry, therefore, can lower the cost of capital to companies, including EGCs, by decreasing the risk premium required by investors.⁹⁵

Compared to the broader population of public companies that use specialists and whose auditors use specialists, there is no evidence that EGCs—a majority of which are smaller companies—are more or less likely to use the work of a company's specialists in preparing their financial statements than non-EGCs of comparable size, though specialists might be used more frequently in some industries than others. Furthermore, there is no evidence that the prevalence and significance of the use of the work of

⁹² See, e.g., V. V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 *Journal of Financial Economics* 101 (1988); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361 (1995).

⁹³ See, e.g., Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185, 189 (2004) ("[Academic studies] provide archival evidence that external assurance from auditors increases disclosure credibility...These archival studies suggest that bankers believe audits enhance the credibility of financial statements...").

⁹⁴ See *supra* footnote 68.

⁹⁵ For a discussion of how increasing reliable public information about a company can reduce risk premium, see David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553 (2004).

specialists in audits of EGCs or the quality of audits of EGCs differs systematically from audits of non-EGCs. Thus, the need for the proposal discussed earlier in Section IV.B and the associated benefits of the proposal are believed to generally apply also to audits of EGCs.

While for small companies (including EGCs), even a small increase in audit fees could negatively affect their profitability and competitiveness, many EGCs are expected to experience minimal to no impact from the proposed requirements. In particular, some EGCs presumably do not use a company's specialist and, for those EGCs that do use a company's specialist, the proposed requirements relating to the auditor's use of the work of such specialists are risk-based and designed to be scalable to companies of varying size and complexity. Furthermore, auditors of EGCs who currently do not use the work of auditor's specialists (because, for example, the use of the work of an auditor's specialist for their engagements is not warranted) are expected to experience no to minimal impact from the proposed requirements for using the work of an auditor's specialist, which are also risk-based and scalable. Also, for firms that have already established practices of using their own specialists, the costs on a per engagement basis of adopting the proposed new requirements also may be low. In instances where the proposed requirements will lead to an increase in auditor effort (related to the use of the work of specialists) in audits of EGCs, the increase in auditor effort is expected to be accompanied by a commensurate increase in the quality of such audits. Accordingly, the discussion of benefits, costs and unintended consequences in Section IV.C is generally applicable to audits of EGCs.

Any new PCAOB standards and amendments to existing standards determined not to apply to the audits of EGCs will require auditors to differentiate requirements between clients and develop different methodologies. In this situation, there would be the potential for confusion, as the current PCAOB standards would remain in effect for EGCs and firms potentially would have to maintain two different methodologies in this area.

Question:

12. The Board requests comment generally on the analysis of the impacts of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

VI. Applicability of the Proposed Requirements to Audits of Brokers and Dealers

The proposed amendments would apply to audits of brokers and dealers, as defined in Sections 110(3)-(4) of Sarbanes-Oxley. The information asymmetry between the management of brokers and dealers and their customers about the brokers' and dealers' financial condition may be significant and of particular interest to customers, as a broker or dealer may have custody of customer assets, which could become inaccessible to the customers in the event of the insolvency of the broker or dealer. In addition, unlike the owners of brokers and dealers, who themselves may be managers and thus be subject to minimal or no information asymmetry, customers of brokers and dealers may, in some instances, be large in number and may not be expert in the management or operation of brokers and dealers. Such information asymmetry between the management and the customers of brokers and dealers makes the role of auditing important to enhance the reliability of financial information.

Accordingly, the discussion in Section IV of the need for the proposal, as well as the costs, benefits, alternatives considered and potential unintended consequences to auditors and the companies they audit, also applies to audits of brokers and dealers. In addition, with respect to the impact of the proposal on customers of brokers and dealers, the expected improvements in audit quality described in Section IV.C.1 would benefit such customers, along with investors, capital markets and auditors, while the proposed requirements are not expected to result in any direct costs or unintended consequences to customers of brokers and dealers. The Board is seeking comment on any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits.

Question:

13. Are there any factors specifically related to audits of brokers and dealers that may affect the application of the proposal to those audits?

VII. Effective Date

The Board seeks comment on the amount of time auditors would need before the proposed amendments would become effective, if adopted by the Board and approved by the SEC. Specifically, the Board is considering whether compliance with adopted amendments and a new auditing standard should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if SEC approval occurs in the fourth quarter of a calendar year).

Questions:

14. How much time following SEC approval would audit firms need to implement the proposed requirements?
15. Would requiring compliance for fiscal years beginning after the year of SEC approval provide challenges for auditors? If so, what are those challenges, and how should they be addressed?

VIII. Appendices

This proposal includes this release and its appendices:

- Appendix 1—Proposed Amendments Relating to the Auditor's Use of the Work of Specialists
- Appendix 2—Other Related Proposed Amendments to PCAOB Auditing Standards
- Appendix 3—Additional Discussion of Proposed Amendments

IX. Opportunity for Public Comment

The Board is seeking comments on all aspects of its proposal, as well as specific comments on the proposed amendments and proposed new standard. Among other things, the Board is seeking comment on the economic analysis relating to its proposal, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the proposed amendments and standard.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 044 in the subject or reference line and should be received by the Board no later than August 30, 2017. Written comments on the proposed requirements in the companion release on auditing accounting estimates, including fair value measurements, should refer to PCAOB Rulemaking Docket Matter No. 043 in the subject or reference line.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take

effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

* * *

On the 1st day of June, in the year 2017, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

June 1, 2017

APPENDIX 1

Proposed Amendments Relating to the Auditor's Use of the Work of Specialists

This appendix proposes amendments to AS 1105, *Audit Evidence*, AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of a Specialist*. Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. References to proposed amendments to existing standards presented in the Board's separate companion release on auditing accounting estimates, including fair value measurements, appear in [brackets]. The presentation of the proposed amendments by showing deletions and additions to existing sentences, paragraphs, and footnotes is intended to assist readers in comprehending the proposed changes to the auditing standard. The proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of the auditing standard, as amended by this proposal.¹

¹ Several of the Board's pending rulemaking projects include proposals that would supersede, amend, or delete paragraphs of PCAOB auditing standards for which proposed amendments are included in this appendix. These projects include *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit With Another Accounting Firm*, PCAOB Release No. 2016-002 (Apr. 12, 2016), and *Proposed Auditing Standard—Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017). If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the proposed amendments in this release, the Board may make conforming changes to these proposed amendments.

Auditing Standards Proposed to be Amended²

PCAOB Standard	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
Audit Evidence				
AS 1105, <i>Audit Evidence</i>	.08	Relevance and Reliability	Add a note to paragraph .08	p. A1-4
AS 1105, <i>Audit Evidence</i>	.10	Using Information Produced by the Company	Make conforming amendment	p. A1-5
AS 1105, <i>Audit Evidence</i>	Appendix B	Using the Work of a Company's Specialist as Audit Evidence	Add	p.A1- 10
Supervision of the Audit Engagement				
AS 1201, <i>Supervision of the Audit Engagement</i>	.03	Responsibility of the Engagement Partner for Supervision	Amend	p. A1-14
AS 1201, <i>Supervision of the Audit Engagement</i>	Appendix C	Supervision of the Work of an Auditor-Employed Specialist	Add	p. A1-17
Using the Work of A Specialist				
AS 1210, <i>Using the Work of a Specialist</i>	Title	Using the Work of a Specialist	Amend AS 1210.01-.17 and retitle standard "Using the Work of an Auditor-Engaged Specialist"	p. A1-20

² This table is a reference tool for the proposed amendments that follow. "Add" refers to a new paragraph, appendix, or other text to be added to existing PCAOB standards. "Amend" refers to substantive changes to existing PCAOB standards. "Make conforming amendment" refers to technical changes to existing PCAOB standards, such as changes to cross-references and defined terms.

Auditing Interpretations Proposed to be Rescinded

Auditing Interpretation
AI 11, <i>Using the Work of a Specialist: Auditing Interpretation of AS 1210</i>
AI 28, <i>Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations</i>

AS 1105, *Audit Evidence*

Introduction

.01 This standard explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

.02 Audit evidence is all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.

Objective

.03 The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.¹

¹ AS 2810, *Evaluating Audit Results*, establishes requirements regarding evaluating whether sufficient appropriate evidence has been obtained. AS 1215, *Audit Documentation*, establishes requirements regarding documenting the procedures performed, evidence obtained, and conclusions reached in an audit.

Sufficient Appropriate Audit Evidence

.04 The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion.

.05 Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the following:

- *Risk of material misstatement (in the audit of financial statements) or the risk associated with the control (in the audit of internal control over financial reporting).* As the risk increases, the amount of evidence that the auditor should

obtain also increases. For example, ordinarily more evidence is needed to respond to significant risks.²

- *Quality of the audit evidence obtained.* As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

² Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

.06 Appropriateness is the measure of the quality of audit evidence, i.e., its relevance and reliability. To be appropriate, audit evidence must be both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Relevance and Reliability

.07 *Relevance.* The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The relevance of audit evidence depends on:

- a. The design of the audit procedure used to test the assertion or control, in particular whether it is designed to (1) test the assertion or control directly and (2) test for understatement or overstatement; and
- b. The timing of the audit procedure used to test the assertion or control.

.08 *Reliability.* The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.

Note: See Appendix B, *Using the Work of a Company's Specialist as Audit Evidence*, for requirements related to the evaluation of evidence from a company's specialist.

- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.

- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized, or otherwise converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

.09 The auditor is not expected to be an expert in document authentication. However, if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.

Using Information Produced by the Company

.10 When using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:³

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

³ When using the work of a company's specialist engaged or employed by management, see Appendix B of this standard~~AS 1210, Using the Work of a Specialist~~. When using information produced by a service organization or a service auditor's report as audit evidence, see AS 2601, *Consideration of an Entity's Use of a Service Organization*, and for integrated audits, see AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Financial Statement Assertions

.11 In representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of financial statements and related disclosures. Those assertions can be classified into the following categories:

- *Existence or occurrence*—Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.

- *Completeness*—All transactions and accounts that should be presented in the financial statements are so included.
- *Valuation or allocation*—Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.
- *Rights and obligations*—The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- *Presentation and disclosure*—The components of the financial statements are properly classified, described, and disclosed.

.12 The auditor may base his or her work on financial statement assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement in each significant account and disclosure that has a reasonable possibility⁴ of containing misstatements that would cause the financial statements to be materially misstated, individually or in combination with other misstatements.⁵

⁴ There is a reasonable possibility of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in the FASB Accounting Standards Codification, Contingencies Topic, paragraph 450-20-25-1.

⁵ For an integrated audit, also see AS 2201.28.

Audit Procedures for Obtaining Audit Evidence

.13 Audit procedures can be classified into the following categories:

- a. Risk assessment procedures,⁶ and
- b. Further audit procedures,⁷ which consist of:
 - (1) Tests of controls, and
 - (2) Substantive procedures, including tests of details and substantive analytical procedures.

⁶ AS 2110.

⁷ AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

.14 Paragraphs .15-.21 of this standard describe specific audit procedures. The purpose of an audit procedure determines whether it is a risk assessment procedure, test of controls, or substantive procedure.

Inspection

.15 Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or physically examining an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

Observation

.16 Observation consists of looking at a process or procedure being performed by others, e.g., the auditor's observation of inventory counting by the company's personnel or the performance of control activities. Observation can provide audit evidence about the performance of a process or procedure, but the evidence is limited to the point in time at which the observation takes place and also is limited by the fact that the act of being observed may affect how the process or procedure is performed.⁸

⁸ AS 2510, *Auditing Inventories*, establishes requirements regarding observation of the counting of inventory.

Inquiry

.17 Inquiry consists of seeking information from knowledgeable persons in financial or nonfinancial roles within the company or outside the company. Inquiry may be performed throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.⁹

Note: Inquiry of company personnel, by itself, does not provide sufficient audit evidence to reduce audit risk to an appropriately low level for a relevant assertion or to support a conclusion about the effectiveness of a control.

⁹ AS 2805, *Management Representations*, establishes requirements regarding written management representations, including confirmation of management responses to oral inquiries.

Confirmation

.18 A confirmation response represents a particular form of audit evidence obtained by the auditor from a third party in accordance with PCAOB standards.¹⁰

¹⁰ AS 2310, *The Confirmation Process*.

Recalculation

.19 Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

.20 Reperformance involves the independent execution of procedures or controls that were originally performed by company personnel.

Analytical Procedures

.21 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of significant differences from expected amounts.¹¹

¹¹ AS 2305, *Substantive Analytical Procedures*, establishes requirements on performing analytical procedures as substantive procedures.

Selecting Items for Testing to Obtain Audit Evidence

.22 Designing substantive tests of details and tests of controls includes determining the means of selecting items for testing from among the items included in an account or the occurrences of a control. The auditor should determine the means of selecting items for testing to obtain evidence that, in combination with other relevant evidence, is sufficient to meet the objective of the audit procedure. The alternative means of selecting items for testing are:

- Selecting all items;
- Selecting specific items; and
- Audit sampling.

.23 The particular means or combination of means of selecting items for testing that is appropriate depends on the nature of the audit procedure, the characteristics of the

control or the items in the account being tested, and the evidence necessary to meet the objective of the audit procedure.

Selecting All Items

.24 Selecting all items (100 percent examination) refers to testing the entire population of items in an account or the entire population of occurrences of a control (or an entire stratum within one of those populations). The following are examples of situations in which 100 percent examination might be applied:

- The population constitutes a small number of large value items;
- The audit procedure is designed to respond to a significant risk, and other means of selecting items for testing do not provide sufficient appropriate audit evidence; and
- The audit procedure can be automated effectively and applied to the entire population.

Selecting Specific Items

.25 Selecting specific items refers to testing all of the items in a population that have a specified characteristic, such as:

- *Key items.* The auditor may decide to select specific items within a population because they are important to accomplishing the objective of the audit procedure or exhibit some other characteristic, e.g., items that are suspicious, unusual, or particularly risk-prone or items that have a history of error.
- *All items over a certain amount.* The auditor may decide to examine items whose recorded values exceed a certain amount to verify a large proportion of the total amount of the items included in an account.

.26 The auditor also might select specific items to obtain an understanding about matters such as the nature of the company or the nature of transactions.

.27 The application of audit procedures to items that are selected as described in paragraphs .25-.26 of this standard does not constitute audit sampling, and the results of those audit procedures cannot be projected to the entire population.¹²

¹² If misstatements are identified in the selected items, see AS 2810.12-.13 and AS 2810.17-.19.

Audit Sampling

.28 Audit sampling is the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.¹³

¹³ AS 2315, *Audit Sampling*, establishes requirements regarding audit sampling.

Inconsistency in, or Doubts about the Reliability of, Audit Evidence

.29 If audit evidence obtained from one source is inconsistent with that obtained from another, or if the auditor has doubts about the reliability of information to be used as audit evidence, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.

Appendix A – Reserved

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

.B1 This appendix describes the auditor's responsibilities with respect to the work of a specialist,¹ employed or engaged by the company ("company's specialist"), including procedures to be applied in conjunction with obtaining an understanding of the company's information system relevant to financial reporting (.B2) and procedures to be performed when using the work as audit evidence to support a conclusion regarding a relevant assertion of a significant account or disclosure (.B3-.B10). The requirements in this appendix supplement the requirements of this standard.

¹ For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply when the auditor uses the work of an income tax specialist or information technology specialist as audit evidence.

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

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

- c. The company's process for selecting and using the work of specialists.

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

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

.B3 The auditor should obtain an understanding of the professional qualifications of the company's specialist in the particular field, and the entity that employs the specialist (if other than the company), and assess the level of knowledge, skill, and ability of the specialist in the particular field. Factors that are relevant to the assessment of the specialist's knowledge, skill, and ability include the following:

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

.B4 The auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise).

.B5 The necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company in paragraphs .B3–.B4 depend on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and risk of material misstatement increases, the persuasiveness of the evidence the auditor should obtain for those assessments also increases.

Testing and Evaluating the Work of the Company's Specialist

.B6 Testing and evaluating the work of a company's specialist involves:

- a. Testing and evaluating the data used by the specialist and evaluating whether the data was appropriately used by the specialist;

- b. Evaluating the methods and significant assumptions used by the specialist; and
- c. Evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.

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

.B7 The necessary evidence from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on:

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

Note: The persuasiveness of the evidence the auditor should obtain through testing and evaluation of the specialist's work increases as the significance of the specialist's work, the risk of material misstatement, or the ability of the company to affect the specialist's judgments increases, or as the level of knowledge, skill, and ability possessed by the specialist in the particular field decreases.

.B8 The auditor should (1) test the accuracy and completeness of company-produced data used by the specialist, (2) evaluate the relevance and reliability of data obtained from external sources and used by the specialists, and (3) evaluate whether the data was appropriately used by the specialist. The auditor also should evaluate whether the methods used by the specialist are appropriate and the significant assumptions used by the specialist are reasonable.

Note: If the company's specialist assisted the company in developing an accounting estimate, the auditor should also comply with the requirements in [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB

Release No. 2017-002)] when testing and evaluating data and evaluating methods and significant assumptions.

.B9 The auditor should evaluate the relevance and reliability of the specialist's work and whether the specialist's findings support or contradict the relevant assertion. Factors that affect the relevance and reliability of the specialist's work include:

- a. The results of the auditor's procedures over data, methods, and significant assumptions performed pursuant to paragraph .B8;
- b. The nature of restrictions, disclaimers, or limitations in the specialist's report, if any; and
- c. The consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

.B10 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the auditor should perform additional procedures, as necessary, to address the matter.

Note: Examples of situations in which additional procedures ordinarily are necessary include (1) the specialist's findings and conclusions are inconsistent with (i) other information in the specialist's report, if any, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (2) the specialist's report contains restrictions, disclaimers, or limitations regarding the auditor's use of the report; (3) exceptions were identified in performing the procedures described in paragraph .B8 above to data, methods, or significant assumptions; (4) the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments; or (5) the specialist has a conflict of interest relevant to the specialist's work.

* * *

AS 1201, Supervision of the Audit Engagement

Introduction

.01 This standard establishes requirements regarding supervision of the audit engagement, including supervising the work of engagement team members.

Objective

.02 The objective of the auditor is to supervise the audit engagement, including supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Responsibility of the Engagement Partner for Supervision

.03 The **engagement partner**¹ is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists,² other auditors,³ internal auditors,⁴ and others who are involved in testing controls.⁵ Paragraphs .05-.06 of this standard describe the nature and extent of supervisory activities necessary for proper supervision of engagement team members.⁶

¹ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

² AS 1210, *Using the Work of an Auditor-Engaged Specialist*; Appendix C, *Supervision of the Work of Auditor-Employed Specialists*; and Appendix B of AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, establish requirements for an auditor using the work of an auditor-engaged specialist, auditor-employed specialist, and a company's specialist, respectively, in performing an audit of financial statements.

³ AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

⁴ AS 2605, *Consideration of the Internal Audit Function*.

⁵ Paragraphs .16-.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

⁶ See also paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

.04 The engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her responsibilities pursuant to this standard. Engagement team members who assist the engagement partner with supervision of the work of other engagement team members also should comply with the requirements in this standard with respect to the supervisory responsibilities assigned to them.

Supervision of Engagement Team Members

.05 The engagement partner and, as applicable, other engagement team members performing supervisory activities, should:

- a. Inform engagement team members of their responsibilities,⁷ including:
 - (1) The objectives of the procedures that they are to perform;
 - (2) The nature, timing, and extent of procedures they are to perform; and
 - (3) Matters that could affect the procedures to be performed or the evaluation of the results of those procedures, including relevant aspects of the company, its environment, and its internal control over financial reporting,⁸ and possible accounting and auditing issues;
- b. Direct engagement team members to bring significant accounting and auditing issues arising during the audit to the attention of the engagement partner or other engagement team members performing supervisory activities so they can evaluate those issues and determine that appropriate actions are taken in accordance with PCAOB standards;⁹

Note: In applying due professional care in accordance with AS 1015, each engagement team member has a responsibility to bring to the attention of appropriate persons, disagreements or concerns the engagement team member might have with respect to accounting and auditing issues that he or she believes are of significance to the financial statements or the auditor's report regardless of how those disagreements or concerns may have arisen.

- c. Review the work of engagement team members to evaluate whether:
 - (1) The work was performed and documented;
 - (2) The objectives of the procedures were achieved; and
 - (3) The results of the work support the conclusions reached.¹⁰

⁷ AS 1015.06 and paragraph .05 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establish requirements regarding the appropriate assignment of engagement team members.

⁸ AS 2110, *Identifying and Assessing Risks of Material Misstatement*, describes the auditor's responsibilities for obtaining an understanding of the company, its environment, and its internal control over financial reporting.

⁹ See, e.g., paragraph .15 of AS 2101, *Audit Planning*, AS 2110.74, and paragraphs .20-.23 and .35-.36 of AS 2810, *Evaluating Audit Results*.

¹⁰ AS 2810 describes the auditor's responsibilities for evaluating the results of the audit, and AS 1215, *Audit Documentation*, establishes requirements regarding audit documentation.

.06 To determine the extent of supervision necessary for engagement team members to perform their work as directed and form appropriate conclusions, the engagement partner and other engagement team members performing supervisory activities should take into account:

- a. The nature of the company, including its size and complexity;¹¹
- b. The nature of the assigned work for each engagement team member, including:
 - (1) The procedures to be performed, and
 - (2) The controls or accounts and disclosures to be tested;
- c. The risks of material misstatement; and
- d. The knowledge, skill, and ability of each engagement team member.¹²

Note: In accordance with the requirements of AS 2301.05, the extent of supervision of engagement team members should be commensurate with the risks of material misstatement.¹³

¹¹ AS 2110.10.

¹² See also AS 2301.05a and AS 1015.06.

¹³ AS 2301.05b indicates that the extent of supervision of engagement team members is part of the auditor's overall responses to the risks of material misstatement.

Appendix A – Definition

.A1 For purposes of this standard, the term listed below is defined as follows:

.A2 Engagement partner - The member of the engagement team with primary responsibility for the audit.

Appendix B – Reserved

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

.C1 For engagements in which auditor-employed specialists¹ assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure, this appendix describes supervisory activities to be performed in conjunction with supervising the work of a specialist employed by the auditor's firm ("auditor-employed specialist") in an audit. The requirements in this appendix supplement the requirements in paragraphs .05-.06 of this standard.

¹ For purposes of this standard, a specialist is a person possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this appendix does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. Paragraphs .03-.06 of this standard apply in those situations.

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

Qualifications and Independence of Auditor-Employed Specialists

.C3 The requirements in PCAOB auditing standards for assigning personnel based on their knowledge, skill, and ability are applicable to assigning auditor-employed specialists.²

² See paragraph .05a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

.C4 The requirements in PCAOB auditing standards for determining compliance with independence and ethics requirements also include assessing compliance with the independence requirements applicable to auditor-employed specialists.³

³ See paragraph .06b of AS 2101, *Audit Planning*.

Informing the Auditor-Employed Specialist of Work to be Performed

.C5 The engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the specialist of the work to be performed, which includes establishing and documenting an understanding with the specialist regarding the following:

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

.C6 Pursuant to paragraph .05a(3) of this standard, the engagement partner and, as applicable, other engagement team members performing supervisory activities should inform the auditor-employed specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.⁴

⁴ See AS 1015.07-.09.

.C7 The engagement partner and, as applicable, other engagement team members performing supervisory activities should implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This includes:

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with [paragraphs .21-.26 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)];
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)]; or
- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix B to AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, and, for accounting estimates, [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)].

Evaluating the Work of the Auditor-Employed Specialist

.C8 The engagement partner and, as applicable, other engagement team members performing supervisory activities should review the report, or equivalent documentation, provided by the specialist pursuant to paragraph .C5d above and evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

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

.C9 If the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing

supervisory activities should perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue.

Note: Examples of situations in which additional procedures ordinarily are necessary include (1) the specialist's work was not performed in accordance with the auditor's instructions; (2) the specialist's report contains restrictions, disclaimers, or limitations that affect the auditor's use of the report; (3) the specialist's findings and conclusions are inconsistent with (i) the results of the work performed by the specialist, (ii) other evidence obtained by the auditor, or (iii) the auditor's understanding of the company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

* * *

AS 1210, ~~Using the Work of a Specialist~~ Using the Work of an Auditor-Engaged Specialist

Introduction

.01 This standard establishes requirements regarding the use of a specialist engaged by the auditor's firm ("auditor-engaged specialist") to assist the auditor in obtaining or evaluating audit evidence with respect to a relevant assertion of a significant account or disclosure.¹

¹ For purposes of this standard, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing. Because income taxes and information technology are specialized areas of accounting and auditing, this standard does not apply to situations in which an income tax specialist or information technology specialist participates in the audit. AS 1201, *Supervision of the Audit Engagement*, applies in those situations.

Objective

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

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

.03 The engagement partner and, as applicable, other engagement team members performing supervisory activities should assess the specialist's knowledge, skill, and

ability in the particular field for the type of work under consideration. This includes obtaining an understanding of the following with respect to the specialist and the entity that employs the specialist:

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

Note: The auditor's assessment of the specialist's knowledge, skill, and ability affects the auditor's determination of: (1) whether the auditor-engaged specialist possesses a sufficient level of knowledge, skill, and ability to perform the type of work under consideration (paragraph .05); and (2) the necessary extent of the review and evaluation of the specialist's work (paragraph .10).

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

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

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

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

- a. The responsibilities of the specialist, including the objectives of the work to be performed;
- b. The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop

an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate), and the specialist's approach to that work;

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

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

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

- a. If an auditor's specialist is used to develop (or assist in developing) an independent expectation of an accounting estimate, measures to comply with [paragraphs .21-.26 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)];
- b. If an auditor's specialist is used to test (or assist in testing) the company's process to develop an accounting estimate, measures to comply with

[paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)]; or

- c. If an auditor's specialist is used to evaluate the work of a company's specialist, measures to comply with Appendix B to AS 1105, *Using the Work of a Company's Specialist as Audit Evidence*, and, for accounting estimates, [paragraphs .09-.18 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements* (See PCAOB Release No. 2017-002)].

Evaluating the Work of the Auditor-Engaged Specialist

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

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

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

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

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

company and its environment; (4) the specialist lacks a reasonable basis for data or significant assumptions the specialist used; or (5) the methods used by the specialist were not appropriate.

* * *

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

AI 11, "Using the Work of a Specialist: Auditing Interpretation of AS 1210", as amended, is rescinded.

* * *

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

AI 28, "Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations", as amended, is rescinded.

APPENDIX 2

Other Related Proposed Amendments to PCAOB Auditing Standards

In connection with the proposed amendments to AS 1105, *Audit Evidence*, AS 1201, *Supervision of the Audit Engagement*, and AS 1210, *Using the Work of a Specialist*, the Board is proposing other related amendments, including conforming amendments, to several of its auditing standards ("other proposed amendments").¹

Language that would be deleted by the other proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of the other proposed amendments by showing deletions and additions to existing sentences, paragraphs and footnotes is intended to assist readers in easily comprehending the Board's proposed changes to auditing standards. The Board's other proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of a standard that may be amended.

The Board is requesting comments on all aspects of the proposed amendments.

¹ Several of the Board's pending rulemaking projects include proposals that would supersede, amend, or delete paragraphs of PCAOB auditing standards for which other proposed amendments are included in this appendix. These projects include *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard—Dividing Responsibility for the Audit With Another Accounting Firm*, PCAOB Release No. 2016-002, (Apr. 12, 2016), and *Proposed Auditing Standard—Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017). If, prior to the conclusion of this rulemaking, the Board adopts standards and related amendments that affect the other proposed amendments in this release, the Board may make conforming changes to these other proposed amendments.

Auditing Standards Proposed to be Amended²

PCAOB Standard	Paragraph, Section, or Appendix	Subject Heading of Paragraph(s) or Appendix Affected	Action	Page
AS 2301, <i>The Auditor's Responses to the Risks of Material Misstatement</i>	.07	Overall Responses	Add footnote 5A	p. A2-3
AS 2310, <i>The Confirmation Process</i>	.03	Introduction and Applicability	Make conforming amendment	p. A2-3
AS 2401, <i>Consideration of Fraud in a Financial Statement Audit</i>	.54	Responding to Assessed Fraud Risks: Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting	Make conforming amendment	p. A2-4
AS 2610, <i>Initial Audits—Communications Between Predecessor and Successor Auditors</i>	.16	Audits of Financial Statements That Have Been Previously Audited	Make conforming amendment	p. A2-5

² This table is a reference tool for the proposed amendments that follow. "Add" refers to a new paragraph, appendix, or other text to be added to existing PCAOB standards. "Amend" refers to substantive changes to existing PCAOB standards. "Make conforming amendment" refers to technical changes to existing PCAOB standards, such as changes to cross-references and defined terms.

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

* * *

Overall Responses

* * *

.07 Due professional care requires the auditor to exercise professional skepticism.⁴ Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence.⁵ Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor,^{5A} or examination of documentation from independent sources.

⁴ AS 1015.07-.09.

⁵ AS 2401.13.

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

* * *

AS 2310, *The Confirmation Process*

* * *

Introduction and Applicability

* * *

.03 In addition, this section does not address matters described in ~~AS 1210, *Using the Work of a Specialist*~~, or in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

* * *

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

* * *

Responding to Assessed Fraud Risks

* * *

Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting

* * *

.54

* * *

It also may be appropriate for the auditor to perform additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of a specialist may be helpful in this regard.²² Furthermore, additional testing of count sheets, tags, or other records, or the retention of copies of these records, may be warranted to minimize the risk of subsequent alteration or inappropriate compilation.

* * *

In addressing an identified fraud risk involving accounting estimates, the auditor may want to supplement the audit evidence otherwise obtained (see AS 2501.09 through .14). In certain circumstances (for example, evaluating the reasonableness of management's estimate of the fair value of an intangible asset derivative), it may be appropriate to engage use the work of an auditor-employed specialist or an auditor-engaged specialist or develop an independent estimate for comparison to management's estimate. Information gathered about the entity and its environment may help the auditor evaluate the reasonableness of such management estimates and underlying judgments and assumptions.

* * *

²² Appendix C of AS 1201, *Supervision of the Work of Auditor-Employed Specialists*, and AS 1210, *Using the Work of an Auditor-Engaged Specialist*, ~~AS 1210, *Using the Work of a Specialist*~~, establishes requirements for an auditor who using the work of an auditor-employed specialist and an auditor-engaged the work of a specialist, respectively, in performing an audit of financial statements.

* * *

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

* * *

Audits of Financial Statements That Have Been Previously Audited

* * *

.16 The successor auditor should plan and perform the reaudit in accordance with the standards of the PCAOB. The successor auditor should not assume responsibility for the predecessor auditor's work or issue a report that reflects divided responsibility as described in AS 1205. Furthermore, the predecessor auditor is not an auditor's specialist as defined in AS 1210, *Using the Work of a Specialist*, nor does the predecessor auditor's work constitute the work of others as described in AS 2605, *Consideration of the Internal Audit Function*, or paragraphs .16-.19 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

APPENDIX 3

Additional Discussion of Proposed Amendments

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I. Introduction

This proposal is intended to tailor the requirements for using the work of specialists to the differing roles that specialists have in an audit and thereby improve the quality of audits that involve using the work of specialists employed or engaged by a company ("company's specialist"), employed by the auditor's firm ("auditor-employed specialist"), or engaged by the auditor's firm ("auditor-engaged specialist"). This appendix discusses in more detail amendments to existing auditing standards proposed by the Public Company Accounting Oversight Board ("PCAOB" or "Board") relating to the use of the work of a company's specialist and the use of the work of an auditor-employed specialist, as well as a new standard for using the work of an auditor-engaged specialist that replaces a current Board standard (collectively, the "proposal" or "Board's proposal").

In brief, the Board is proposing to:

- (1) Amend:
 - AS 1105, *Audit Evidence*; and
 - AS 1201, *Supervision of the Audit Engagement*,
- (2) Replace:
 - AS 1210, *Using the Work of a Specialist*, and retitle the standard *Using the Work of an Auditor-Engaged Specialist*, and
- (3) Rescind:
 - AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*; and
 - AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*.

The proposal would add an appendix to AS 1105, *Audit Evidence*, with supplemental requirements, aligned with the Board's risk assessment standards,¹ for using the work of a company's specialist as audit evidence. It would also add an appendix to AS 1201, *Supervision of the Audit Engagement*, with supplemental requirements for applying the supervisory principles in AS 1201 when using the work an auditor-employed specialist (for example, in reaching an understanding with the

¹ See *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, PCAOB Release No. 2010-004 (Aug. 5, 2010).

specialist about the specialist's work and reviewing and evaluating the specialist's work). The proposal would also replace AS 1210, *Using the Work of a Specialist*, with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, which would set forth tailored requirements for assessing the competence and objectivity of an auditor-engaged specialist and requirements that parallel the proposed amendments to AS 1201 for reaching an understanding with the specialist and reviewing and evaluating the specialist's work.

The PCAOB has observed that, in many cases, auditors use the work of a specialist to test or assist in testing the company's process to develop an accounting estimate or in developing an independent expectation of an accounting estimate. In a companion release, the Board is proposing to replace its existing standards on auditing accounting estimates and fair value measurements with a single standard, Proposed AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, that sets forth a uniform, risk-based approach designed to strengthen and enhance the requirements for auditing accounting estimates.² In the Estimates Release, the Board is proposing to retitle and replace AS 2501, *Auditing Accounting Estimates*, and supersede AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Proposed Auditing Standard AS 2501 would also include a special topics appendix that addresses certain matters relevant to auditing the fair value of financial instruments, including the use of pricing information from third parties as audit evidence. Certain provisions of the proposed amendments in this release include references to the proposed auditing standard presented in the Estimates Release in order to illustrate how the proposed requirements in the two releases would work together.

A. Comparison with Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board

This appendix includes a comparison of the proposed requirements with the analogous requirements of the following standards issued by the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA"). The following IAASB and ASB standards are included in the comparison:

IAASB Standards

² See *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*, PCAOB Release No. 2017-002 (June 1, 2017) ("Estimates Release").

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

ASB Standards

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

The comparison included in the appendix may not represent the views of the IAASB or ASB regarding the interpretation of their standards. The information presented in this appendix does not cover the application and explanatory material in the IAASB standards or ASB standards.³

The approach in this proposal has some similarity to the analogous IAASB and ASB standards, such as addressing the auditor's responsibilities for evaluating the work of a company's specialist in the audit evidence standard (ISA 500 and AS 1105, respectively), and separately addressing the auditor's responsibilities with respect to the auditor's specialist. However, there are some important differences. In particular, ISA 620 and AU-C 620 set forth requirements for both an "auditor's internal expert" and an "auditor's external expert" in the same standard, whereas the Board's proposal retains the existing approach for supervision of the auditor-employed specialist under AS 1201, with some additional direction, and sets forth the auditor's responsibilities with respect to auditor-engaged specialists in a separate standard that would replace existing AS 1210. Additionally, the Board's proposal sets forth specific factors for scaling the audit effort in this area.

³ Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement" but "is relevant to the proper application of the requirements of an ISA." Paragraph .A64 of AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that, although application and other explanatory material "does not in itself impose a requirement, it is relevant to the proper application of the requirements of an AU-C section."

B. Requests for Comment

The Board requests comments on the specific questions that are included in this appendix, as well as on the proposal in general.

II. Scope of this Proposal

The scope of this proposal hinges largely on the meaning of the term "specialist." Consistent with AS 1210, this proposal addresses auditors' primary responsibilities with respect to persons or firms with specialized skill or knowledge in a particular field other than accounting or auditing. Furthermore, this proposal retains the principle in existing PCAOB standards that income taxes and information technology ("IT") are specialized areas of accounting and auditing and are therefore outside the scope of the standard.⁴

In its Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists* (May 28, 2015) ("2015 SCP"), the staff solicited comment on a potential definition of the term "specialist" that was consistent with the existing meaning of the term "specialist" in AS 1210 and is consistent with the approach in this proposal. Most commenters who commented on this issue supported retaining the current meaning of the term "specialist," indicating that the term as currently used is adequate. Many of these commenters also asserted that, while income taxes and IT may have increased in complexity over the years, they remain areas of accounting and auditing for which audit firms currently have, and need to maintain, sufficient supervisory processes.

Some commenters, however, suggested changes to the existing meaning of the term "specialist." In particular, two commenters asserted that persons with specialized expertise in certain areas of income taxes and IT, such as foreign income taxes or cybersecurity, should be included within the definition of a "specialist." These commenters argued that the work performed by such persons is often complex and outside the traditional expertise of auditors, and that it would be appropriate to treat persons with such specialized skill or knowledge as specialists. These commenters also asserted that this approach would be more closely aligned with ISA 620, which does not exclude persons with specialized skill or knowledge in income taxes or IT from its definition of an "expert." Other commenters argued that the focus should be on whether the person's field of expertise requires professional accreditation, rather than on whether the skill or knowledge is in a field other than accounting or auditing.

⁴ See footnote 1 of existing AS 1210.

In addition, while not suggesting changes to the existing meaning of the term "specialist," a number of commenters recommended that the Board provide additional guidance as to what constitutes a "specialized area of accounting and auditing," in part to promote greater consistency in practice. A number of commenters also noted that they do not currently view persons with expertise in certain areas (e.g., regulatory compliance) as "specialists" under current AS 1210, and recommended that the Board expressly treat expertise in such areas as a "specialized area of accounting and auditing."

After considering the comments received, this proposal retains the existing meaning of the term "specialist." The term as used today is generally understood by auditors, and observations from PCAOB oversight activities do not indicate that there is significant confusion over the terms "specialist" and "specialized area of accounting and auditing," as currently used in the standards. Further, under this proposal, specialists would continue to include those involved in the activities similar to those shown in Figure 2 of Section II.B of the release. For example, consistent with existing AS 1210.02, specialists would include attorneys engaged by the company as specialists in situations other than to provide services to a client concerning litigation, claims, or assessments⁵ (e.g., attorneys engaged by the company to interpret contractual terms or provide a legal opinion).

Some commenters on the 2015 SCP also suggested that the Board address when a third-party source of pricing information should be considered a "specialist." The Estimates Release addresses the auditor's responsibilities with respect to using pricing information from third parties as audit evidence, including the circumstances in which auditors would look to the requirements of this proposal when using information from a pricing service.⁶ Specifically, the requirements of this proposal on using the work of specialists would apply when a pricing service is engaged by a company or an auditor to individually develop a price for a specific financial instrument not routinely priced for its subscribers.⁷

⁵ AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, applies when attorneys are engaged by the company to provide services concerning litigation, claims, or assessments.

⁶ Estimates Release, PCAOB Release No. 2017-002.

⁷ See paragraph .A3 of Proposed Auditing Standard AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, Estimates Release, PCAOB Release No. 2017-002.

Comparison with Standards of Other Standard Setters

ISA 620 uses the terms "auditor's expert" and "management's expert" in a manner analogous to the term "specialist" in this proposal, although ISA 620 does not provide that income taxes and IT are specialized areas of accounting and auditing.⁸ The meaning of the terms is the same in AU-C Section 620 although that standard uses the word "specialist" instead of "expert."

Questions:

16. Is it appropriate to retain the existing meaning of the term "specialist" in current auditing standards? Do auditors understand the existing meaning of the term and when a person (or firm) is a specialist? If not, what changes are necessary?
17. Are the other terms used in the proposal—"company's specialist," "auditor-employed specialist," and "auditor-engaged specialist"—clear and appropriate for purposes of the Board's proposal? Do these terms align with the role of each of these specialists in the audit?

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

The proposal would add an appendix to AS 1105 with supplemental requirements for using the work of the company's specialist as audit evidence. The proposed requirements would be aligned with the Board's risk assessment standards and the Estimates Release.⁹ The proposed amendments to AS 1105 relate to:

- Obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls;
- Obtaining an understanding of and assessing the specialist's knowledge, skill, and ability, and the specialist's relationship to the company; and
- Performing procedures to assess the work of a company's specialist, including: (1) testing and evaluating the data used by the specialist and

⁸ The term "management's expert" is also defined in ISA 500.

⁹ Estimates Release, PCAOB Release No. 2017-002.

evaluating whether the data was appropriately used by the specialist; (2) evaluating the methods and significant assumptions used by the specialist; and (3) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion.

The proposed appendix would supplement the existing general requirements in AS 1105 for circumstances when the auditor uses the work of a company's specialist as audit evidence. The proposed approach is informed by, among other things, the views of commenters on the 2015 SCP, other outreach activities, and observations from oversight activities.

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

See proposed paragraph .B2 of AS 1105

AS 2110, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of the company's information system, including the related business processes, relevant to financial reporting. This includes, among other things, obtaining information related to: (1) the classes of transactions in the company's operations that are significant to the financial statements; (2) the procedures by which those transactions are initiated, authorized, processed, recorded, and reported; (3) the related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions; (4) how the information system captures events and conditions, other than transactions, that are significant to the financial statements; and (5) the period-end financial reporting process.¹⁰

In addition, existing AS 1210.09 requires that the auditor obtain an understanding of the nature of the work performed or to be performed by the specialist, which includes, among other things: (1) the objectives and scope of the specialist's work; (2) the methods or assumptions used; (3) the appropriateness of using the specialist's work for the intended purpose; and (4) the form and content of the specialist's findings. The existing requirements, however, are not fully aligned with the risk assessment standards. Specifically, they do not require the procedures in AS 1210.09 to be performed in conjunction with obtaining an understanding of the company's information system, nor do they describe the necessary level of audit effort to be devoted to obtaining that understanding.

¹⁰ See AS 2110.28-.32.

The proposed requirement in AS 1105.B2 is more closely aligned with the risk assessment requirements in AS 2110. It specifies that obtaining an understanding of the company's information system relevant to financial reporting encompasses the work and report(s) of the company's specialist(s) and related company processes and controls. This would include obtaining an understanding of: (1) the nature and purpose of the specialist's work; (2) whether the specialist's work is based on data produced by the company, data obtained from external sources, or both; and (3) the company's process for selecting and using the work of specialists. Because the auditor's understanding is linked to understanding the information system relevant to financial reporting, the necessary effort to obtain such understanding would be subject to the general requirements in AS 2110 for obtaining a sufficient understanding of the company's internal control over financial reporting.¹¹ While the proposed requirement likely would not represent a major change in practice, particularly for those firms whose practices already go beyond existing PCAOB standards, it should prompt auditors to appropriately consider the interaction of the specialist's work and the company's processes in assessing and responding to risk in the related accounts and disclosures, especially when the specialist's work is more significant to the auditor's conclusion regarding the relevant assertion and the accounts or disclosures have higher risk.

Comparison with Standards of Other Standard Setters

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

¹¹ See AS 2110.18, which provides that the auditor should obtain a sufficient understanding of each component of internal control over financial reporting to: (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design further audit procedures. See also AS 2110.19, which further provides that the nature, timing, and extent of procedures that are necessary to obtain an understanding of internal control depend on the size and complexity of the company; the auditor's existing knowledge of the company's internal control over financial reporting; the nature of the company's controls, including the company's use of IT; the nature and extent of changes in systems and operations; and the nature of the company's documentation of its internal control over financial reporting.

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

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

See proposed paragraphs .B3–.B5 of AS 1105

AS 1210.08, .10-.11 currently require the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

This proposal sets forth similar requirements, along with additional direction regarding the necessary audit effort in this area. Specifically, proposed AS 1105.B5 provides that the necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist and the specialist's relationship to the company depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. As the significance of the specialist's work and the risk of material misstatement increases, the persuasiveness of the evidence the auditor would obtain for those assessments also increases.

Knowledge, Skill, and Ability

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

Proposed AS 1105.B3 has a similar requirement to that in AS 1210.08 and generally would provide the same factors for the auditor's assessment of the specialist's knowledge, skill, and ability. However, the proposed requirement differs from the current requirement in certain respects. First, the proposed requirement expressly extends the required understanding to include the entity that employs the specialist, if the specialist is not employed by the company. A strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, a poor reputation, or little expertise, of the employer in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted. Second, the requirement in the proposal refers to the level of knowledge, skill, and ability. As with competence under AS 2605, *Consideration of the Internal Audit Function*, this recognizes that knowledge, skill, and ability exist on a spectrum, rather than as a binary attribute. Third, the proposal provides that the

necessary evidence to assess the level of knowledge, skill, and ability of the company's specialist depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion and (2) the risk of material misstatement of the relevant assertion. The persuasiveness of the evidence the auditor would need to obtain increases as the significance of the specialist's work to the auditor's conclusion or the risk of material misstatement of the relevant assertion increases.¹²

Proposed AS 1105.B3 does not prescribe specific steps to perform or information sources to use in assessing the specialist's knowledge, skill, and ability. Potential sources of relevant information could include the following:

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

¹² See Section III.C for illustrative examples on the application of these factors when testing and evaluating the work of a company's specialist.

- Published books or papers written by the specialist.

Under this proposal, the auditor would perform procedures to obtain the necessary evidence for evaluating the specialist's knowledge, skill, and ability, commensurate with the significance of the work and related risk of material misstatement. Some of the sources of information listed above provide more persuasive evidence than others. For example, relevant information from sources not affiliated with the company or specialist and the auditor's experience with previous work of the specialist generally would provide more persuasive evidence than the specialist's representations about his or her professional credentials. Further, in situations where more persuasive evidence is required, it may be necessary to obtain information from multiple sources.

Relationship to the Company

AS 1210.10-.11 currently require the auditor to evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability—through employment, ownership, contractual right, family relationship, or otherwise—to directly or indirectly control or significantly influence the specialist.

AS 1210.11 provides that when a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. When such a relationship is present, the standard requires the auditor to assess the risk that the specialist's objectivity might be impaired; if so, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or engage another specialist for that purpose.

Proposed AS 1105.B4 contains requirements similar to those in existing AS 1210.10. The proposal provides that the auditor should assess the relationship to the company of the specialist and the entity that employs the specialist (if other than the company)—specifically, whether circumstances exist that give the company the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise). This expands the list of matters that the auditor should consider to include financial and business relationships with the company.

Two commenters on the 2015 SCP suggested that the PCAOB consider the requirements to evaluate the objectivity of the company's internal audit function¹³ when developing requirements for evaluating the relationships between the company's specialist and the company. These commenters suggested that using the work of a company's internal audit function is analogous to using the work of a company's specialist. This approach was considered, but is not being proposed, because the work of a company's internal audit function and the work of a company's specialist differ in their nature and objectives. The internal audit function performs an objective evaluation of a subject matter (e.g., the effectiveness of company's controls), whereas a company's specialist assists in developing information that generally serves as source material for one or more financial statement accounts or disclosures.

The proposal did not retain the requirement in AS 1210.11 for performing additional procedures because it is encompassed by other procedures that would be required under the proposal.¹⁴

Proposed AS 1105.B4 also does not prescribe specific steps to perform or information sources to use in assessing the specialist's relationship to the company. Potential sources of information that could be relevant to the auditor's evaluation include:

- Engagement contracts between the company and the company's specialist, or the specialist's employer;
- Requirements related to relationships with clients promulgated by the specialist's profession or by legislation or regulation governing the specialist, if applicable;
- Responses to questionnaires provided to the specialist regarding the relationships between the specialist, or specialist's employer, and the company; and

¹³ AS 2605.10 provides requirements for the auditor to, among other things, obtain or update information from prior years about factors such as (1) the organizational status of the internal auditor responsible for the internal audit function and (2) policies to maintain internal auditors' objectivity about the areas audited.

¹⁴ See proposed AS 1105.B7-.B10.

- Information provided by the employer of a company's specialist regarding relationships with the company.

As with the assessment of knowledge, skill, and ability, some of the sources of information listed above provide more persuasive evidence than others. In situations where more persuasive evidence is required under this proposal, it may be necessary to perform a mix of procedures to obtain evidence from multiple sources.

In assessing whether the company has the ability to significantly affect the specialist's judgments about the work performed, conclusions, or findings for purposes of proposed AS 1105.B4, the auditor might consider a range of relationships, examples of which include, but are not limited to:

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

Notably, the proposal does not use the term "objectivity" in the context of the company's specialist. That term is reserved in this proposal for auditor-engaged specialists, who would be expected to exercise impartial judgment in their work for the auditor. In contrast, the work of a company's specialist, regardless of any relationships between the specialist and the company, generally serves as source material for one or more financial statement accounts or disclosures and thus is different in nature from the work of an auditor's specialist.

The 2015 SCP suggested that any proposed revisions to Board standards should differentiate company-employed and company-engaged specialists. Some commenters agreed that such a distinction would be appropriate because a company-employed specialist could be viewed as inherently less objective and therefore more susceptible to

control or influence than a company-engaged specialist. Some commenters also stated that evaluating the work of a company-employed specialist should require more rigorous testing than the work of a company-engaged specialist. The Board is not proposing to expressly differentiate between company-employed and company-engaged specialists, because the proposed requirement to evaluate the relationship between the company and its specialist inherently takes these considerations into account. For example, under proposed AS 1105.B7d, the necessary evidence needed from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion would, in part, depend on the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Comparison with Standards of Other Standard Setters

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

AU-C Section 500 contains requirements that are substantively the same as those in ISA 500.

C. Testing and Evaluating the Work of a Company's Specialist

See proposed paragraphs .B6–.B10 of AS 1105

AS 1210.12 currently requires the auditor to, among other things: (1) obtain an understanding of the methods and assumptions used by the specialist; (2) make appropriate tests of data provided to the specialist; (3) evaluate whether the specialist's findings support the related assertions in the financial statements; and (4) if the auditor believes the findings are unreasonable, apply additional procedures, which may include obtaining the opinion of another specialist.

The proposed requirements would enhance the current requirements for testing and evaluating the work of a company's specialist. Among other things, the proposed requirements provide for the auditor to independently test and evaluate the work of a company's specialist that is used as audit evidence. Specifically, proposed AS 1105.B6 provides that testing and evaluating the work of a company's specialist involves: (1) testing and evaluating the data used by the specialist and evaluating whether the data was appropriately used by the specialist; (2) evaluating the methods and significant assumptions used by the specialist; and (3) evaluating the relevance and reliability of the specialist's work and its relationship to the relevant assertion. The proposal also refers the auditor to applicable requirements in other auditing standards (proposed AS 1105.B8), while providing for scalability (i.e., a risk-based approach) in the evidence that

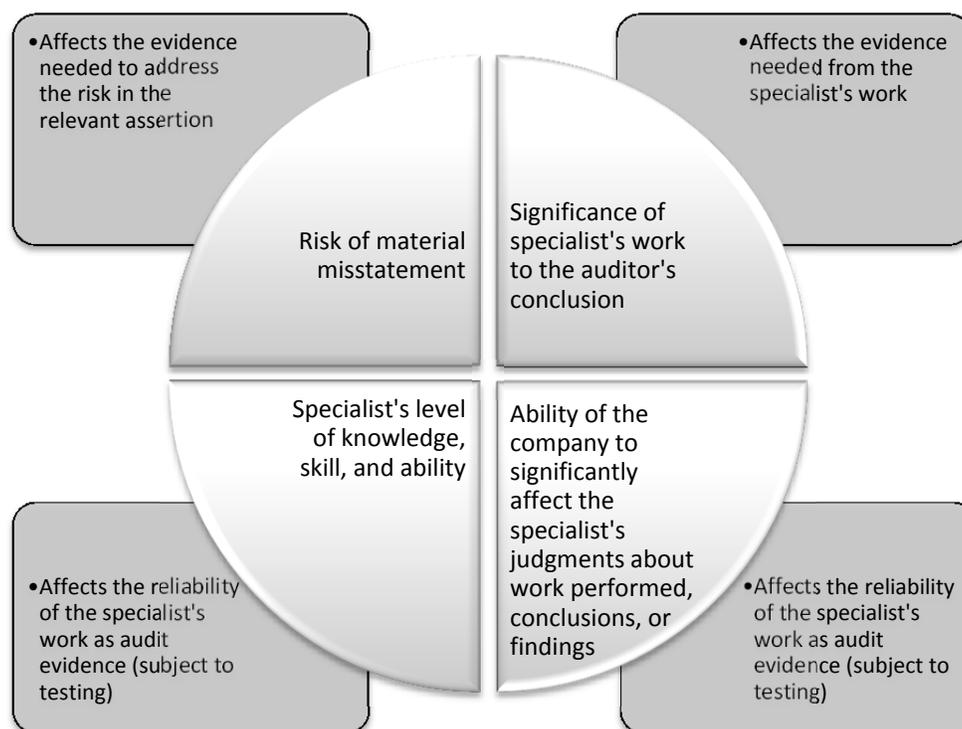
is necessary from the auditor's testing and evaluation of the specialist's work (proposed AS 1105.B7).

In addition, a note to proposed AS 1105.B6 emphasizes that paragraphs .16-.17 of AS 2101, *Audit Planning*, describe the auditor's responsibilities for determining whether specialized knowledge or skill is needed to plan or perform audit procedures or to evaluate audit results.¹⁵ This includes determining whether an auditor's specialist is needed to test and evaluate the work of a company's specialist.

Necessary evidence from the auditor's testing and evaluation of the specialist's work. The current requirements in AS 1210 do not explicitly provide for a scalable approach when the auditor assesses the work of a company's specialist. Proposed AS 1105.B7, however, states that the necessary evidence from the auditor's testing and evaluation of the specialist's work to support a conclusion regarding a relevant assertion depends on the: (1) significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) risk of material misstatement of the relevant assertion; (3) level of knowledge, skill, and ability of the specialist; and (4) the ability of the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings. These factors are illustrated in Figure 1 below.

¹⁵ An auditor also should determine if an auditor's specialist is needed to perform appropriate risk assessments. See AS 2101.16.

**Figure 1: Factors that Affect the Necessary Evidence
From the Auditor's Testing and Evaluation of the Specialist's Work**



Under the proposed amendments, the first two factors, in combination, relate to the persuasiveness of the evidence needed from the work of the company's specialist to support a conclusion on the relevant assertion, and the amount of audit effort necessary to evaluate the last two factors:

- **Risk of Material Misstatement.** Consistent with the risk assessment standards, under the proposed amendments, the risk of material misstatement affects the persuasiveness of the evidence needed to address the risk in the relevant assertion. The higher the risk of material misstatement for an assertion, the more persuasive the evidence needed to support a conclusion about that assertion.¹⁶

¹⁶ See paragraph .09a of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*.

- Significance of the Specialist's Work. The significance of the specialist's work refers to the degree to which the auditor would use the work of the company's specialist to support the auditor's conclusions about the assertion. Generally, the greater the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion, the more persuasive the evidence from the specialist's work needs to be. The significance of the specialist's work stems from:
 - *The extent to which the specialist's work affects significant accounts and disclosures in the financial statements.* In some situations, the specialist's work might be used only as a secondary check for a significant account or disclosure, while in other situations, that work might be a primary determinant in one or more significant accounts and disclosures in the financial statements.
 - *The auditor's approach to testing the relevant assertion.* When a company's accounting estimate is determined principally based on the work of a company's specialist, an auditor testing the company's process for developing the accounting estimate would plan to use the work of the company's specialist for evidence regarding the estimate. On the other hand, if the auditor tests an assertion by developing an independent expectation, the auditor would give less consideration to the work of the company's specialist.

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

Under the proposal, the auditor would need to consider the four factors to determine the necessary audit effort for testing and evaluating the work of the company's specialist. In general, the required audit effort when testing and evaluating the work of a company's specialist would be greatest when the risk of material misstatement is high; the specialist's work is critical to the auditor's conclusion; the specialist has a lower level of knowledge, skill, and ability in the particular field; and the company has the ability to significantly affect the specialist's judgments.

In some situations, if the auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments, the auditor might choose not to use the work of the company's specialist, instead of more rigorously testing the specialist's work. This proposal would not preclude the auditor from pursuing other alternatives to using that specialist's work. Such alternatives might include

developing an independent expectation of the related accounting estimate or seeking to use the work of another company's specialist.

The following examples illustrate various ways in which the factors discussed above can affect the necessary audit effort in testing and evaluating the work of a company's specialist under this proposal. The examples have been provided for illustrative purposes only, and similar situations in practice, accompanied by additional information, could lead to different conclusions. The examples assume that the auditor will test and evaluate, as appropriate, the data used by the specialist, evaluate the methods and the significant assumptions used by the specialist, and evaluate the relevance and reliability of the work of the company's specialist.

Example 1 – An oil and gas production company employs an experienced reserve engineer to assist in developing the estimated proven reserves that are used in multiple financial statement areas, including: (1) the company's impairment analysis; (2) depreciation, depletion and amortization calculations; and (3) related financial statement disclosures. The auditor concludes that the risk of material misstatement of the valuation of oil and gas properties is high, and the reserve engineer's work is significant to that assertion. Thus, the auditor would need to extensively test and evaluate the work of the company's specialist to obtain sufficient appropriate evidence, perhaps with the assistance of an auditor's specialist.¹⁷

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

¹⁷ The proposal would not preclude the auditor (with or without the assistance of an auditor's specialist) from developing an independent expectation instead of testing and evaluating the specialist's work and using that expectation as the primary evidence to support the auditor's conclusion on the assertion. However, for a variety of reasons, that alternative may not be practical in this example or similar situations.

are valued principally based on their collateral than for appraisals inspected in loan file reviews for a portfolio of smaller loans with a low risk of default and a low loan-to-value ratio.

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

Testing and evaluating data and evaluating methods and significant assumptions. AS 1210.12, among other things, currently requires the auditor to make appropriate tests of data provided to the specialist. The proposal expands this requirement to require the auditor to also: (1) test the accuracy and completeness of company-produced data used by the specialist; (2) evaluate the relevance and reliability of data obtained from external sources and used by the specialist; and (3) evaluate whether the data was appropriately used by the specialist.¹⁸ The proposal would also elevate the current obligation of the auditor to "obtain an understanding" of the methods and significant assumptions used by the specialist to "evaluate" whether the methods used by the specialist are appropriate and significant assumptions used by the specialist are reasonable.¹⁹ Accordingly, merely obtaining an understanding of the

¹⁸ See proposed AS 1105.B8.

¹⁹ See *id.* In circumstances when the auditor is auditing fair value measurements in accordance with AS 2502, footnote 2 of that standard provides that management's assumptions include assumptions developed by a specialist engaged or employed by management. Therefore, the auditor is currently required to evaluate the

methods and significant assumptions used by the specialist would not be sufficient. This could represent a significant change in practice for some auditors. As previously discussed in Section IV.B of the release, the change in practice may be most significant for smaller audit firms that use the work of company specialists, as PCAOB staff have observed that, unlike larger audit firms, smaller firms tend to perform only the specified procedures required by AS 1210.²⁰ On the other hand, although not currently required, some larger firms have been observed to evaluate the methods and significant assumptions used by the company's specialist when testing the company's process for developing accounting estimates, often using an auditor's specialist.

The proposed requirements are intended to increase audit attention to the work of a company's specialist, particularly when that work is significant in areas of higher risk, to increase the likelihood that the auditor would detect material misstatements in that area. Some commenters on the 2015 SCP and some SAG members argued that an auditor's responsibility for evaluating the work of a company's specialist should be elevated from current requirements. Others expressed concerns about elevating the requirements to evaluate the work of a company's specialist. As previously discussed in Section IV.D of the release, the proposed approach employs a risk-based approach that takes into account the views expressed by commenters.

Under proposed AS 1105.B8, when the auditor is testing and evaluating data, methods, and significant assumptions used by a company's specialist who assists the company in developing an accounting estimate, the auditor would be required to comply with Proposed Appendix B and Proposed Auditing Standard AS 2501.²¹ The Board's separate proposal on accounting estimates, including fair value measurements, addresses the proposed requirements for testing company-generated data, evaluating data obtained from external sources, and evaluating methods and significant assumptions used to develop the accounting estimate.²² In determining, the nature,

reasonableness of significant assumptions developed by the company's specialist when auditing a fair value measurement.

²⁰ Some accounting firm commenters on the 2015 SCP asserted that some firms "rely" on the work of a company's specialists and that changes to the requirements for using the work of company's specialists would preclude this practice.

²¹ See note to proposed AS 1105.B8 and Estimates Release, PCAOB Release No. 2017-002.

²² Estimates Release, PCAOB Release No. 2017-002. Specifically, the estimates proposal includes requirements, among other things, for: (1) testing the accuracy and

timing, and extent of these procedures, the auditor would take into account the four factors in proposed AS 1105.B7. The approach presented in this proposal would align the requirements for using the work of a company's specialist with those for testing the company's process for developing accounting estimates, avoiding potential redundancy in the requirements and providing direction to auditors in this area.

Evaluating relevance and reliability of the specialist's work. AS 1210.12 currently requires the auditor to evaluate whether the specialist's findings support the related assertions in the financial statements. Proposed AS 1105.B9 would build upon this requirement, with revisions to align the proposed requirement with the risk assessment standards for evaluating the relevance and reliability of audit evidence.

Under the proposal, factors that affect the relevance and reliability of the specialist's work would include: (1) the results of the auditor's procedures over data, methods, and significant assumptions that would be performed pursuant to proposed AS 1105.B8; (2) the nature of restrictions, limitations, or disclaimers in the specialist's report, if any; and (3) the consistency of the specialist's work with other evidence obtained by the auditor and the auditor's understanding of the company and its environment.

AS 1210.12 currently provides that the auditor may perform additional procedures if he or she believes the specialist's findings are unreasonable under the circumstances. It does not specify, however, what might lead an auditor to conclude that he or she should perform additional procedures or obtain the opinion of another specialist. Proposed AS 1105.B10 has a similar requirement to existing AS 1210.12 and an accompanying note providing examples of situations in which additional procedures ordinarily are necessary, including:

- The specialist's findings and conclusions are inconsistent with (1) other information in the specialist's report, if any, (2) other evidence obtained by the auditor, or (3) the auditor's understanding of the company and its environment;
- The specialist's report contains restrictions, disclaimers, or limitations regarding the auditor's use of the report;

completeness of company-provided information; (2) evaluating the relevance and reliability of data from an external source; (3) evaluating whether the data was appropriately used by the company; (4) evaluating the methods used to develop the estimate; and (5) evaluating the reasonableness of significant assumptions.

- Exceptions were identified in performing the procedures described in proposed AS 1105.B8 to data, methods, or significant assumptions;
- The auditor has doubt about the specialist's knowledge, skill, and ability or about the company's effect on the specialist's judgments; or
- The specialist has a conflict of interest relevant to the specialist's work.

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

The proposal does not require the auditor to perform procedures specifically to search for potential conflicts of interest that a company's specialist might have other than those resulting from the specialist's relationship with the company. However, the auditor may become aware of conflicts of interest arising from relationships with parties outside the company, e.g., through obtaining information about the specialist's professional reputation and standing, reading the specialist's report, or performing procedures in other audit areas. For example, in reviewing an appraisal of the collateral for a material loan receivable, the auditor may become aware that the appraiser has a substantial financial interest in the collateral. If the auditor becomes aware of a conflict of interest relevant to the specialist's work, the auditor would need to consider the effect of that conflict on the reliability of the specialist's work, and perform additional procedures if necessary to obtain sufficient appropriate evidence regarding the relevant financial statement assertion.

Comparison with Standards of Other Standard Setters

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

AU-C Section 500 contains requirements that are substantively the same as those in ISA 500.

The IAASB and ASB do not have analogous requirements to test and evaluate data provided to the company's specialist or evaluate methods and significant assumptions used by the company's specialist.

Questions:

18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?
19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?
20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.
21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?
22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?
23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?
24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

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

If the work of an auditor's specialist is not properly overseen or evaluated, there may be heightened risk that the auditor's work will not be sufficient to detect a material misstatement in significant accounts and disclosures, including significant accounting estimates. This proposal sets forth enhanced requirements and additional direction to prompt auditors to more effectively oversee and coordinate with their employed and engaged specialists.

Current PCAOB requirements for using the work of an auditor-engaged specialist differ significantly from the risk-based supervisory requirements that apply when using the work of an auditor-employed specialist, even though, in both situations, the auditor's specialist assists the auditor in obtaining and evaluating audit evidence. Specifically, the use of the work of an auditor-engaged specialist is primarily addressed by the same standard as for the use of the work of a company's specialist, while the auditor-employed specialist is required to be supervised in accordance with AS 1201. This proposal establishes a uniform risk-based approach for determining the scope of the specialist's work and evaluating the specialist's work, while taking into account differences in the auditor's relationship with employed specialists and engaged specialists.

Auditor-employed specialists. Currently, AS 1201 sets forth the general framework for supervision of engagement team members, including the nature and extent of supervisory activities, and this framework applies to the supervision of auditor-employed specialists. This proposal would add an appendix to AS 1201, described in Section IV.A below, that would supplement the existing requirements in AS 1201 and provide more specific direction on applying the general supervisory principles to the supervision of the work of auditor-employed specialists. Additionally, the proposed appendix leverages existing principles in other PCAOB standards for assigning competent staff and determining compliance with independence and ethics requirements.

Auditor-engaged specialists. The proposal would replace current AS 1210, *Using the Work of a Specialist*, with proposed AS 1210, *Using the Work of an Auditor-Engaged Specialist*, described in Section IV.B below, which sets forth requirements for situations in which the auditor uses an auditor-engaged specialist. Proposed AS 1210 includes requirements for assessing the knowledge, skill, ability, and objectivity²³ of the

²³ As noted in Section III.B, this proposal reserves the term "objectivity" for the auditor-engaged specialist.

specialist. It also includes requirements for establishing and documenting an understanding with the specialist and reviewing and evaluating the specialist's work that parallel the proposed amendments to AS 1201 for auditor-employed specialists.

This proposal is informed by observations of oversight activities, other outreach activities, and views of commenters on the 2015 SCP.

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

This section discusses the proposed requirements in Appendix C to AS 1201 for audits in which the auditor uses an auditor-employed specialist who performs work to assist the auditor in obtaining or evaluating audit evidence in accordance with AS 1201, as amended.

1. Determining the Extent of Supervision

See proposed paragraph .C2 of AS 1201

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

Proposed AS 1201.C2 adapts the factors set forth in AS 1201.06 to the relevant circumstances when using the work of an auditor-employed specialist. Specifically, it provides that the necessary extent of supervision would depend on: (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the auditor-employed specialist.

A few commenters on the 2015 SCP suggested that the PCAOB consider the involvement of more experienced specialists who supervise the work of less experienced specialists when the engagement partner is determining the extent of supervision needed over the auditor's specialist. Under the proposal, an assessment of knowledge, skill, and ability is one factor in determining the extent of supervision needed. This assessment of knowledge, skill, and ability may be influenced by the composition of the specialist team involved in the audit, including whether or not more experienced specialists participate in supervising the work of less experienced specialists.

AS 1201.04 currently provides that the engagement partner may seek assistance from appropriate engagement team members in fulfilling his or her supervisory responsibilities, which could include involving a more experienced auditor-employed specialist. However, those responsible for supervising the work of an auditor's specialist should also include the engagement partner and, as applicable, other engagement team members with the necessary knowledge, skill, and ability in accounting and auditing and knowledge of the audit engagement to, among other things, determine whether the specialist's procedures meet the auditor's objectives and evaluate how the specialist's work relates to the auditor's conclusions about the assertions subject to testing.²⁴

Comparison with Standards of Other Standard Setters

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

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

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

²⁴ See AS 2101.17 and AS 1201.05.

2. *Qualifications and Independence of Auditor-Employed Specialists*

See proposed paragraphs .C3–.C4 of AS 1201

Existing PCAOB auditing standards require that personnel be assigned to engagement teams based on their knowledge, skill, and ability,²⁵ and this applies to auditor-employed specialists. Additionally, auditor-employed specialists must be independent of the company.²⁶ The requirements in existing PCAOB auditing standards for determining compliance with independence and ethics requirements apply to auditor-employed specialists.²⁷

Thus, rather than add specific requirements for evaluating the qualifications and independence of auditor-employed specialists, proposed AS 1201.C3-.C4 cites the applicable requirements in existing standards.

Some commenters on the 2015 SCP suggested that any enhancements to requirements for evaluating the knowledge, skill, and ability of an auditor-employed specialist should permit engagement teams to rely on an audit firm's system of quality control. Under the proposal, the auditor would be able to use information from and processes in the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor-employed specialists.

Comparison with Standards of Other Standard Setters

Paragraph 9 of ISA 620 provides that the auditor shall evaluate whether the

²⁵ See AS 2301.05a and paragraph .06 of AS 1015, *Due Professional Care in the Performance of Work*.

²⁶ PCAOB Rule 3520, *Auditor Independence*, requires a registered public accounting firm and its associated persons to be independent of the firm's "audit client," meaning that they must satisfy all independence criteria applicable to an engagement. Under Rule 2-01 of Regulation S-X, any professional employee of the "accounting firm" (as broadly defined in Rule 2-01(f)(2) to include associated entities) who participates in an engagement of an audit client is a member of the "audit engagement team," as that term is defined under Rule 2-01(f)(7)(i). The effect is that an accounting firm is not independent if it uses the work of a specialist employed by the accounting firm who does not meet the independence requirements of Rule 2-01.

²⁷ See AS 2101.06b.

auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes.

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

3. *Informing the Specialist of the Work to be Performed*

See proposed paragraphs .C5–.C7 of AS 1201

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

The proposed requirements in AS 1201.C5-.C7 are intended to prompt the engagement partner and, as applicable, other engagement team members performing supervisory activities to properly supervise the specialist and achieve a proper coordination between the auditor and the specialist in obtaining and evaluating audit evidence.

Proposed AS 1201.C5 includes additional requirements to inform the auditor-employed specialist about the work to be performed, which includes establishing and documenting an understanding with the specialist regarding:

- The responsibilities of the specialist, including the objectives of the work to be performed.
- The nature of the work that the specialist is to perform or assist in performing (for example, testing the company's process used to develop an accounting estimate, including when a company's specialist is involved in developing the estimate, or developing an independent expectation of an estimate), and the specialist's approach to that work.
- The degree of responsibility of the auditor's specialist for:
 - Testing data produced by the company, or evaluating the relevance and reliability of data from external sources;
 - Evaluating the methods used by the company or the company's specialist, or using his or her own methods; and

- Evaluating the significant assumptions used by the company, or the company's specialist, or developing his or her own assumptions.
- The responsibility of the specialist to provide a report, or equivalent documentation, to the engagement partner and, as applicable, other engagement team members performing supervisory activities that describes the work performed, the results of the work, and the findings or conclusions reached by the specialist.

Proposed AS 1201.C6 also provides that, pursuant to AS 1201.05a(3), the engagement partner and, as applicable, other engagement team members performing supervisory activities would inform the auditor-employed specialist about matters that could affect the specialist's work. This includes, as applicable, information about the company and its environment, the company's processes for developing the related accounting estimate, the company's use of specialists in developing the estimate, relevant requirements of the applicable financial reporting framework, possible accounting and auditing issues, and the need to apply professional skepticism.

In addition, proposed AS 1201.C7 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities would implement measures to determine that there is a proper coordination of the work of the specialist with the work of other relevant engagement team members to achieve a proper evaluation of the evidence obtained in reaching a conclusion about the relevant assertion. This proposed requirement emphasizes that the auditor is responsible for complying with relevant auditing standards, including Proposed Auditing Standard AS 2501 and Proposed Appendix B to AS 1105, as applicable.²⁸ This requirement is intended to prompt the auditor to coordinate with the specialist to make sure that the work is performed in accordance with the applicable standards. For example, in auditing an accounting estimate under Proposed Auditing Standard AS 2501, the auditor would either perform, or supervise the auditor's specialist in performing, the required procedures with respect to testing and evaluating the data, and evaluating the methods, and significant assumptions used in developing that estimate.²⁹

The proposed requirements were informed, in part, by observations from the

²⁸ See Proposed AS 1201.C7; Estimates Release, PCAOB Release No. 2017-002; and Proposed Appendix B to AS 1105.

²⁹ See Proposed Auditing Standard AS 2501, Estimates Release, PCAOB Release No. 2017-002.

PCAOB's oversight activities, which indicated that some auditors did not adequately inform specialists of their responsibilities or failed to evaluate contrary evidence developed by specialists.

The 2015 SCP suggested expanding on current requirements by providing specific requirements for the auditor when informing an auditor's employed specialist of his or her responsibilities pursuant to AS 1201.05a. Many commenters on the 2015 SCP agreed that clear communication between the auditor and the specialist regarding relevant responsibilities and terms of the work to be performed is important. One commenter suggested that the agreement include communication of the auditor's risk assessment. Another commenter suggested including the following additional items in the list of required communications: (1) expectations regarding objectivity or independence; (2) the process for resolving findings; and (3) expectations on the content and completeness of the specialist's work for inclusion in audit documentation. Other commenters generally supported requirements for the auditor to communicate the nature, scope, and objectives of an employed specialist's work to the specialist, but asserted that a less detailed list of items to be agreed upon than set forth in the 2015 SCP would be appropriate. Proposed AS 1201.C5-.C7 describes the requirements for establishing an understanding with the specialist in more general terms, as compared to the detailed requirements in the 2015 SCP. While the Board is not proposing to require auditors to communicate all the items that commenters on the 2015 SCP recommended, auditors nevertheless may decide to establish an understanding with their employed specialists regarding such matters, either pursuant to the more general requirements of proposed AS 1201.C5-.C7 or voluntarily.

In addition, some commenters on the 2015 SCP suggested that requirements should address how to evidence the agreement between the auditor and the auditor's specialist. These commenters agreed with a suggestion in the 2015 SCP that evidence of the agreement between the auditor and the auditor's specialist might be included in different work papers prepared by the auditor. Proposed AS 1201.C5 does not include specific requirements for how to document the auditor's understanding with the auditor's specialist. Instead, the Board contemplates that the understanding with the specialist can be documented, at the auditor's discretion, in planning memoranda, separate memoranda, audit programs, or other related work papers. This approach provides auditors with flexibility, while still requiring the documentation of the important aspects of the understanding reached by the auditor and the auditor's specialist.

Based on the PCAOB's observations of current practice and firm methodologies, the proposed requirements would have the greatest impact on smaller audit firms that employ specialists. In general, the larger firms, and some smaller firms, already have processes to: (1) involve specialists in planning meetings; (2) prepare a written agreement or memo describing the specialist's and the audit team's responsibilities; (3) determine that issues and discrepancies are communicated and investigated throughout

the audit; and (4) prepare a summary report or memo in which any remaining issues or concerns are communicated. Firms that do not currently employ similar practices with respect to their employed specialists will likely need to adjust their practices if proposed AS 1201.C5-.C7 were adopted.

Comparison with Standards of Other Standard Setters

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

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

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

4. Evaluating the Work of the Specialist

See proposed paragraphs .C8-.C9 of AS 1201

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

Proposed AS 1201.C8 adapts the requirements in AS 1201.05c for circumstances in which auditor-employed specialists are used. Under the proposed requirements, the engagement partner and, as applicable, other engagement team members performing supervisory activities would review the specialist's report or equivalent documentation describing the work performed, the results of the work, and the findings or conclusions reached by the specialist provided under proposed AS 1201.C5d. The proposed requirement links the scope of the auditor's review to the report or equivalent documentation that the specialist agreed to furnish to the auditor under Proposed AS 1201.C5. The principles in Proposed AS 1201.C2 for the necessary extent of supervision also would apply to reviewing the report or equivalent documentation and evaluating the work of the auditor-employed specialist. Accordingly, the necessary extent of review and evaluation of the auditor-employed specialist's work

depends on (1) the significance of the specialist's work to the auditor's conclusion regarding the relevant assertion; (2) the risk of material misstatement of the relevant assertion; and (3) the knowledge, skill, and ability of the specialist. In performing the review, the auditor also would evaluate whether the specialist's work provides sufficient appropriate evidence, specifically whether:

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

Under this proposal, when the specialist's work relates to testing the company's process to develop an accounting estimate, the auditor's evaluation of the specialist's work would include, for example, evaluating the results of the specialist's testing and evaluation of data and evaluating methods and significant assumptions, as well as any restrictions, limitations, or disclaimers in the specialist's report or equivalent documentation that are not consistent with the auditor's understanding with the specialist.³⁰

The 2015 SCP suggested potential detailed requirements for the auditor to evaluate the work of an auditor's specialist depending on whether the auditor's specialist evaluated management's process or developed an independent expectation of the estimate. Commenters generally agreed with providing requirements or guidance regarding the auditor's review of the specialist's work. Some commenters, however, suggested: (1) taking a more principles-based approach by allowing the auditor to evaluate a specialist's conclusions as opposed to determining whether the specialist's methods and significant assumptions were appropriate (regardless of whether the specialist develops an independent expectation or evaluates the company's process); or (2) issuing staff guidance rather than new standards on evaluating the work of the auditor's specialist. Other commenters recommended that the Board align its requirements with those in ISA 620.

The approach in the Board's proposal provides requirements for reviewing the work of auditor-employed specialists that are less detailed than the potential

³⁰ See Proposed AS 2501.09-.18; Estimates Release, PCAOB Release No. 2017-002.

requirements described in the 2015 SCP. The proposed requirements to evaluate the specialist's findings and conclusions are similar to requirements in ISA 620. ISA 620 specifically provides for the auditor to evaluate significant assumptions, methods, and data used by the auditor's specialist. The Board's proposal would require the auditor to make sure that the specialist's work and report, or equivalent documentation, were in accordance with the auditor's understanding established at the outset. This understanding would include, among other things, responsibilities for testing data produced by the company or evaluating data from external sources used by the specialist and evaluating significant assumptions and methods used by the specialist, the company, or the company's specialist.

Proposed AS 1201.C9 provides that, if the specialist's findings or conclusions appear to contradict the relevant assertion or the specialist's work does not provide sufficient appropriate evidence, the engagement partner and, as applicable, other engagement team members performing supervisory activities would perform additional procedures, or request the specialist to perform additional procedures, as necessary to address the issue. The proposal also provides examples of situations in which additional procedures ordinarily would be considered necessary, including:

- The specialist's work was not performed in accordance with the auditor's instructions;
- The specialist's report contains restrictions, disclaimers, or limitations that affect the auditor's use of the report;
- The specialist's findings and conclusions are inconsistent with (1) the results of the work performed by the specialist, (2) other evidence obtained by the auditor, or (3) the auditor's understanding of the company and its environment;
- The specialist lacks a reasonable basis for data or significant assumptions the specialist used; or
- The methods used by the specialist were not appropriate.

These requirements are consistent with existing provisions in paragraphs .06 and .36 of AS 2810, *Evaluating Audit Results*, which provide that, if the auditor concludes that the evidence gathered is not adequate, he or she should modify his or her audit procedures or perform additional procedures as necessary (e.g., audit procedures may need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments).

Some commenters on the 2015 SCP expressed concern that the potential requirements for evaluating the work of an auditor's specialist could be construed as

requiring the auditor to reperform the work of the specialist. This proposal does not require the auditor to reperform the work of the specialist. The proposal recognizes that the engagement partner and, as applicable, other engagement team members performing supervisory responsibilities may not have sufficient knowledge of the specialist's field to reperform the work of a specialist. However, the auditor should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the nature, timing, and extent of the auditor's work and the effects on the auditor's report.³¹

Comparison with Standards of Other Standard Setters

Paragraph 12 of ISA 620 provides that the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

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

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

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

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

³¹ See AS 2101.17.

Questions:

25. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?
26. Are the proposed factors to consider when determining the necessary extent of supervision clear? Are there other factors that the auditor should be required to consider when making this determination? If so, what are those factors and how should they be considered?
27. Is the extent of supervision in the proposed approach appropriately scalable to the size and complexity of the audit? If not, how can this be made more scalable?
28. Are the proposed requirements for establishing and documenting the understanding with the specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the specialist? If not, how could they be changed?
29. To what extent would the proposed requirement for establishing and documenting the understanding with the specialist represent a change in current practice? If so, what is that change?
30. Are the proposed requirements for evaluating the work, including any report, of the auditor-employed specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?
31. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-employed specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

B. Proposed Amendments to AS 1210 for Using the Work of an Auditor-Engaged Specialist

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

1. *Assessing the Knowledge, Skill, Ability, and Objectivity of the Engaged Specialist*

As described in Section III.B above, AS 1210 currently requires the auditor to evaluate the professional qualifications of a specialist and the relationship of a specialist to the company.

Similar to the proposed requirements related to using a company's specialist, the proposal carries forward the current requirements with certain modifications described below.

Knowledge, Skill, and Ability

See proposed paragraphs .03 and .05 of AS 1210

Current requirements related to the auditor's evaluation of a specialist's qualifications were described in Section III.B above. These requirements are the same for a company's specialist and an auditor-engaged specialist.

Proposed AS 1210.03 substantially retains the requirement in existing AS 1210.08. Unlike the current requirements, the proposal expressly provides that the auditor would obtain an understanding of the professional qualifications of the specialist and the entity that employs the specialist. A strong reputation and standing of the specialist's employer in the specialized field can be a signal that the employer maintains qualified staff. On the other hand, a poor reputation, or little expertise, of the employer in the specialized field can indicate that more scrutiny of the qualifications of the individual specialist is warranted.

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

- Information contained within the auditor's firm related to the professional qualifications and reputation of the specialist in the relevant field and experience with previous work of the specialist;
- Professional or industry associations and organizations, which may provide information regarding: (1) qualification requirements, technical performance standards, and continuing professional education requirements standards that govern its members; (2) the specialist's education and experience, certification, and license to practice; and (3) recognition of, or disciplinary actions taken against the specialist;

- Information provided by the specialist about matters regarding the specialist's understanding of the financial reporting framework, experience in performing similar work, and the methods and assumptions used in the specialist's work the auditor plans to evaluate;
- Responses to questionnaires provided to the specialist regarding the specialist's professional credentials; and
- Published books or papers written by the specialist.

The proposed requirement for assessing the knowledge, skill, and ability of the auditor-engaged specialist is generally consistent with the suggested approach in the 2015 SCP. The approach in the 2015 SCP largely retained the current requirement in AS 1210. Most commenters on the 2015 SCP who provided relevant comments agreed with the potential requirements for evaluating the knowledge, skill, and ability of an auditor-engaged specialist. Two of these commenters, however, expressed concerns about using the word "determine" to describe the auditor's role in considering the specialist's knowledge, skill, and ability. These commenters suggested that the staff consider the word "assess" or "evaluate" to better describe the auditor's responsibility. In addition, while largely supporting the suggested approach in the 2015 SCP, some commenters recommended revising existing provisions based on requirements in ISA 620. Other commenters emphasized the importance of considering the qualifications and credentials of a specialist when assessing his or her competence.

Taking these comments into account, the proposal would require the auditor to "assess," rather than "determine," the knowledge, skill, and ability of the auditor-engaged specialist. The proposed requirement also provides that the auditor would obtain an understanding of the qualifications and professional credentials of a specialist when performing this assessment.

The purpose of the assessment of the auditor-engaged specialist's knowledge, skill, and ability is two-fold: (1) to determine whether the specialist possesses a sufficient level of knowledge, skill, and ability to perform his or her assigned work; and (2) to help determine the necessary extent of the review and evaluation of the specialist's work. Proposed AS 1210.05 emphasizes the importance of engaging a sufficiently qualified auditor's specialist by expressly providing that the auditor would not engage a specialist who does not have a sufficient level of knowledge, skill, and ability. Additionally, the assessment of the specialist's knowledge, skill, and ability by the engagement partner and, as applicable, other engagement team members performing supervisory activities is a factor when determining the necessary extent of the review

and evaluation of the specialist's work.³² For example, a valuation specialist may possess sufficient knowledge, skill, and ability in business valuation, but may not be well-versed in the application of his or her work to financial reporting. Similarly, the auditor's evaluation of the work of a specialist may be more extensive if the specialist has sufficient knowledge, skill, and ability, in the field but less experience in the particular area of specialty within the field.

Objectivity

See proposed paragraphs .04–.05 of AS 1210

Current requirements in PCAOB standards related to the auditor's evaluation of a specialist's objectivity were described in Section III.B above. Those requirements are the same for a company's specialist and an auditor-engaged specialist.

With respect to objectivity, the auditor's primary interest regarding a specialist that the auditor may potentially engage is whether the specialist can be sufficiently objective to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Proposed AS 1210.05 provides that the auditor would not use a specialist who lacks the necessary objectivity.

Building on the current requirements for assessing objectivity in existing AS 1210.10-.11, proposed AS 1210.04 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities would assess whether the specialist and the entity that employs the specialist has the necessary objectivity, which includes evaluating whether the specialist or the entity that employs the specialist has a relationship to the company (e.g., through employment, financial, ownership, or other business relationships, contractual rights, family relationships, or otherwise), or any other conflicts of interest relevant to the work to be performed. Thus, the auditor would be required to evaluate relationships between the company and both the specialist and the specialist's employer to determine whether either has a relationship with the company that may impair the specialist's objectivity.

Proposed AS 1210.04 differs from the existing requirements in two respects. First, it articulates the concept of objectivity for purposes of proposed AS 1210: objectivity refers to the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. Second, it expands the list of matters that the auditor would consider to include financial and business relationships

³² See proposed AS 1210.10.

with the company and other conflicts of interest.

Although the auditor would consider the same types of relationships between the specialist and company, the auditor's assessment of the objectivity of the auditor-engaged specialist differs from the assessment of the relationship between the company and the company's specialist. Under proposed AS 1210, there is an expectation for the auditor-engaged specialist to have the necessary objectivity. Specifically, the auditor would evaluate whether the auditor-engaged specialist or the entity that employs the specialist has relationships or conflicts of interest that would prevent the specialist from exercising impartial judgment on all issues encompassed by the specialist's work; whereas, with the company's specialist, the auditor would assess whether the relationship to the company could enable the company to significantly affect the specialist's judgments about the work performed, conclusions, or findings.

Proposed AS 1210.04 does not prescribe the sources that the auditor would use to evaluate the specialist's relationship to the company. Sources of information that could be relevant to the auditor's evaluation include:

- Engagement contracts between the company and the auditor-engaged specialist, or the specialist's employer;
- Requirements regarding relationships with clients promulgated by the specialist's profession (e.g., a professional code of conduct) or by legislation or regulation governing the specialist, if applicable;
- Responses to questionnaires provided to the specialist regarding the relationships between the specialist, or specialist's employer, and the company;
- Written representations from the specialist concerning its relationships with the company; and
- Information from the specialist's employer regarding relationships with the company.

The proposal further provides that, when evaluating relationships between the auditor-engaged specialist and the company, the auditor should evaluate the relationship between the entity that employs the specialist and the company. Instances could exist in which the specialist performing the work does not have a relationship with the company, but the entity that employs the specialist has a relationship. For example, the specialist's employer might have an ownership or other financial interest with respect to the company, or other business relationships that might be relevant to the auditor's assessment of the specialist's ability to exercise objective and impartial judgment.

The proposal has been informed by comments on the 2015 SCP, in which the staff identified two potential approaches for how the auditor would evaluate the relationship between an auditor-engaged specialist and the company. Both approaches suggested a more rigorous evaluation of business, employment, and financial relationships that may impair the objectivity of the specialist than is presently required.

The first of the two approaches in the 2015 SCP described a potential extension of the PCAOB's independence rules,³³ which currently apply to auditor-employed specialists, to also encompass auditor-engaged specialists. For example, under this approach, an auditor-engaged specialist might be subject to all the independence restrictions that apply to a "covered person in the [accounting] firm" under Rule 2-01 of the Securities and Exchange Commission's Regulation S-X.³⁴ The second approach—referred to as an "enhanced objectivity approach"—described a framework that incorporated a "reasonable investor" test as an overarching principle in evaluating the objectivity of an auditor-engaged specialist. That approach also identified certain relationships and interests that might impair a specialist's objectivity and specified how an auditor would obtain information from the specialist and the company regarding such relationships and interests.

Most commenters on the 2015 SCP who provided comments on this topic were accounting firms, associations of accountants, or specialists. These commenters opposed applying the requirements of the PCAOB's independence rules to an auditor-engaged specialist.³⁵ These commenters generally argued such an approach would: (1) be impracticable; (2) increase costs to third-party specialists; and (3) decrease the pool of specialists available to assist auditors. Many commenters, however, did support enhancing the requirements for evaluating the objectivity of an auditor-engaged specialist. Many of these commenters expressed concern that the "enhanced objectivity approach" as described in the 2015 SCP was too prescriptive. Some of these commenters also did not favor requiring the auditor to obtain a written description from

³³ See PCAOB Rule 3520. See *also* Regulation S-X Rule 2-01, 17 C.F.R. 210.2-01.

³⁴ See Regulation S-X Rule 2-01(f)(11), 17 C.F.R. 210.2-01(f)(11).

³⁵ Two commenters on the 2015 SCP asserted that the independence requirements should be extended to auditor-engaged specialists. Another commenter, a specialist firm, asserted that this approach would be consistent with its current practices regarding independence and objectivity, while a fourth commenter suggested a different approach whereby all specialists would be required to be independent of both the company and the auditor.

the specialist regarding its process to respond to the auditor's request for information bearing on the specialist's objectivity. The views of many of these commenters were also expressed by several members of the SAG.

The proposed approach in AS 1210.04 takes into account the comments on the two potential approaches described in the 2015 SCP and the approaches suggested by commenters.³⁶ It sets forth a framework, similar to that currently in ISA 620, for the auditor's evaluation of relationships that might affect the objectivity of an auditor-engaged specialist, while still identifying the types of relationships and interests that the auditor would consider and which might impair the specialist's ability to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit.

Comparison with Standards of Other Standard Setters

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

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

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

See proposed paragraphs .06–.11 of AS 1210

As is the case with respect to an auditor-employed specialist, the auditor uses an auditor-engaged specialist to assist the auditor in obtaining and evaluating audit evidence. As described in Section IV.D of the release, given the similar role of an auditor-employed and an auditor-engaged specialist in the audit, the proposed requirements for the auditor-engaged specialist are parallel to the requirements for the auditor-employed specialist when determining the extent of the auditor's review, informing the auditor-engaged specialist of the work to be performed, and evaluating the work of the auditor-engaged specialist. Sections IV.A.1, IV.A.3, and IV.A.4 of this Appendix discuss these proposed requirements in additional detail.

Some commenters on the 2015 SCP expressed concern that the auditor may have limited access to proprietary information, such as models, used by auditor-engaged specialists and, as a result, would be unable to supervise the auditor-engaged

³⁶ See Section IV.D.3(b) of the release for further discussion of these approaches.

specialist in the same way he or she supervises an auditor-employed specialist. As described in Section IV.A.4, the auditor should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the auditor's work and audit report. The proposal does not require the auditor to have full access to a specialist's proprietary model or reperform the work of the specialist, but instead to evaluate the work of that specialist in accordance with the proposed standard.

One commenter raised a concern related to the auditor's ability to exercise supervisory responsibilities over an auditor-engaged specialist or his or her work.³⁷ This commenter noted that a specialist entity may not wish to relinquish control of its employees to an audit firm, while retaining the legal risk associated with those employees. The commenter suggested this concern could be mitigated if the auditor includes a requirement in the engagement letter that the engaged specialist provide the audit firm with copies of work papers and access to the preparers as appropriate. The proposal includes a proposed requirement similar to this commenter's suggestion. Specifically, proposed AS 1210.06 provides that the engagement partner and, as applicable, other engagement team members performing supervisory activities should establish and document an understanding with the auditor-engaged specialist as to the work to be performed and documentation to be provided by the specialist.³⁸

Comparison with Standards of Other Standard Setters

Sections IV.A.1, IV.A.3, and IV.A.4 of this Appendix discuss the comparative requirements of the IAASB and the ASB.

Questions:

32. Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?
33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any

³⁷ See Letter from American Academy of Actuaries (July 31, 2015), at 3.

³⁸ See *also* Section IV.A.3 for a discussion of the similar requirement under proposed AS 1201.C5.

additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.

34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?
35. Does the proposed requirement to assess the objectivity of the auditor-engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?
36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?
37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?
38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?
39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits? Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

V. Other Considerations

This proposal, if adopted, would rescind AI 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*, and AI 28, *Evidential Matter Relating to Income Tax*

*Accruals: Auditing Interpretations.*³⁹ These interpretations were originally adopted by the Board in 2003 with its interim auditing standards, but are no longer considered necessary for the reasons discussed below.

A. Proposal to Rescind Auditing Interpretation 11, *Using the Work of a Specialist: Auditing Interpretation of AS 1210*

AI 11 provides guidance for auditing transactions involving transfers of financial assets, such as in securitizations, that are accounted for under Statement of Financial Accounting Standard No. 140.⁴⁰ The interpretation addresses an auditor's use of a legal opinion obtained from a company's legal counsel on matters that may involve the U.S. Bankruptcy Code, rules of the Federal Deposit Insurance Corporation ("FDIC"),⁴¹ and other federal, state, or foreign law to determine whether "transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership," which affects the accounting for the transaction under FAS No. 140. AI 11 also reiterates requirements in generally accepted accounting principles ("GAAP") and PCAOB auditing standards. The interpretation also includes illustrative examples of legal isolation letters based on FAS No. 140 and certain provisions of the FDIC's original rule, both of which were subsequently amended.

The Board is proposing to rescind AI 11 because the interpretation is based on outdated accounting requirements and banking regulations, and the proposed amendments set forth the necessary requirements for evaluating the work of legal

³⁹ Auditing interpretations provide guidance the auditor should be aware of and consider related to specific areas of the audit. See paragraph .11 of AS 1001, *Responsibilities and Functions of the Independent Auditor*. As with other PCAOB guidance, auditing interpretations are not rules or standards of the Board.

⁴⁰ See Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Standards ("FAS") No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This standard was subsequently amended by FAS No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and codified into FASB Accounting Standards Codification ("ASC"), Topic 860, *Transfers and Servicing*.

⁴¹ Subsequent to the Board's adoption of AI 11, the FDIC rule regarding the treatment of financial assets transferred by an institution in connection with a securitization or participation was amended in 2010.

specialists when auditing financial asset transfers. For example, under this proposal, the auditor would continue to use the work of legal specialists when necessary to evaluate the accounting for these transactions. Additionally, the proposed amendments establish requirements for matters covered in AI 11, such as evaluating the knowledge, skill, and ability of a company's specialist and evaluating the effects of restrictions, disclaimers, or limitations in the specialist's report. Additionally, the requirement in the proposed amendments for the auditor to evaluate the relevance of the work of the company's specialist would apply when considering the need for updates to the specialist's report.

While two commenters on the 2015 SCP recommended that the Board consider updating the interpretation, the Board has not identified any relevant guidance in AI 11 that would warrant retaining it. Accordingly, the Board is proposing to rescind AI 11 and is seeking comment on the implications of such change to the auditing interpretation.

Question:

40. Is rescinding AI 11 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

B. Proposal to Rescind Auditing Interpretation 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations*

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

The Board is proposing to rescind AI 28 because the proposed amendments and other existing PCAOB standards already set forth the necessary requirements with respect to auditing income tax accounts and documenting that work. For example:

- AS 1105 requires the auditor to plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion, and both AS 2810, *Evaluating Audit Results*, and AS 3101, *Reports on Audited Financial Statements*, require the auditor to qualify or disclaim an opinion on the financial statements if the auditor is

unable to obtain sufficient appropriate evidence.⁴² These requirements would apply to situations in which the company restricts the auditor's access to the company's books and records related to its income tax calculation.

- AS 1215, *Audit Documentation*, establishes requirements for the nature and extent of the auditor's documentation, including the auditor's responsibility to document the procedures performed, evidence obtained, and conclusions reached for each relevant assertion.⁴³ These documentation requirements apply when auditing income tax accounts.

The proposed amendments retain the concept under existing AS 1210 that income tax is a specialized area of accounting and auditing, so the requirements in the proposed amendments to AS 1210 would not apply to the opinions of legal counsel or tax advisors on income tax matters.⁴⁴ As under existing standards, if the auditor planned to use a tax opinion as audit evidence, the auditor would need to evaluate the analysis underlying the tax opinion to determine whether it provided relevant and reliable evidence, taking into account the requirements of the applicable financial reporting framework.⁴⁵

Question:

41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?

C. Certain Existing Requirements of AS 1210—Discussion of Remaining Requirements Not Specifically Addressed in the Proposed Amendments

Decision to use a specialist. Currently, AS 1210.06 states that an auditor may encounter complex or subjective matters potentially material to the financial statements. It further provides that such matters, examples of which are provided in AS 1210.07,

⁴² See AS 2810.35 and AS 3101.24.

⁴³ See AS 1215.04-.13.

⁴⁴ See existing AS 1210.01. See also AI 28.17-.23.

⁴⁵ See generally AS 1105, AS 2301, and AS 2810.

may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate evidential matter. The proposed new requirements do not retain these paragraphs, as this issue is already addressed in AS 2101. Specifically, AS 2101.16 requires the auditor to determine whether specialized skill or knowledge is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results.

Reporting requirements. Currently, AS 1210.15-.16 prohibit auditors from making reference to the work or findings of a specialist in the auditor's report, unless such reference will facilitate an understanding of the reason for an explanatory paragraph or a departure from an unqualified opinion. AS 1210.15 states that such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

The proposal does not retain this prohibition, as a separate rulemaking would require the auditor to communicate in the auditor's report critical audit matters ("CAMs") arising from the audit that involved especially challenging, subjective, or complex auditor judgment.⁴⁶ Depending on the circumstances, the description of such CAMs might include a discussion of the work or findings of a specialist if the work related to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment.

VI. Additional Questions Regarding Certain Aspects of the Proposal

Appendix 2 contains additional amendments that the Board is proposing to conform its standards to the proposed amendments to AS 1105 and AS 1201, and the proposed replacement of AS 1210. The proposed conforming amendments to AS 2301, AS 2310, AS 2401, and AS 2610 are not intended to change the meaning of existing requirements. The Board invites comments on the amendments in Appendix 2. The following are specific questions on the proposed amendments included in Appendix 2 and more general questions on the overall proposal:

⁴⁶ See *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*, PCAOB Release No. 2017-001 (June 1, 2017).

Questions:

42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?
43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210?