ICAEW REPRESENTATION 89/17

Proposed Auditing Standard – Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

ICAEW welcomes the opportunity to comment on the Proposed Auditing Standard – *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists* published by the PCAOB on 1 June 2017, a copy of which is available from this link

This response of 30 August 2017 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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MAJOR POINTS

1. We welcome these proposals that do much to bring US standards up to date. External and internal inspections show this to be an area in need in improvement and the rationalisation and enhancement of requirements will do much to improve the efficiency as well as the quality of audit. More auditor challenge of specialists and management is needed.

2. We welcome the:

    - enhancement of requirements to deal with the data and assumptions used by company specialists;
    - elevation of the requirement for auditors to 'obtain an understanding' of specialists' methods and significant assumptions, to instead 'evaluate' whether they are appropriate and whether the significant assumptions used are reasonable;
    - alignment of requirements for auditor engaged and employed, and company engaged and employed specialists respectively - we believe this is the right cut;
    - alignment of the standard in certain respects with ISA 620 *Using the work of an auditor's expert*;
    - abandonment of the suggestion in the Staff Discussion Paper (Staff DP) that preceded this Exposure Draft (ED) that information produced by company specialists should be treated as if it was produced by the company itself;
    - acknowledgement that auditors can take account of the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor employed specialists;
    - additional requirements for auditors to 'inform' auditor employed specialists about the work to be performed and to evaluate contrary evidence developed by specialists, both of which arise from inspection findings;
    - requirements to review specialists' work, rather than simply their reports, to focus auditor attention on the detail and discourage reliance on process.

3. We would welcome a higher level view of the broad approaches and levels of competencies the PCAOB expects of auditors, which would help shape investor understanding and expectations. In our June 2017 Audit Quality Forum (AQF) event *Believe me, I'm an expert?* we explored three possibilities, ie, that auditors should be experts in:

    - financial reporting only, and should simply aggregate the opinions of other experts involved in the audit;
    - financial reporting, and in questioning and challenging other experts, in a manner not dissimilar to a judge, in forming their own conclusion on the financial statements on which they report;
    - all of the relevant specialist areas covered by the financial statements as well as financial reporting.

4. We believe that asking auditors to be experts in everything they report on is unrealistic and unnecessary. The second option was discussed by the PCAOB in the Staff Discussion Paper (Staff DP) that preceded this consultation and we suggested that auditors should not simply act as high level project managers as this would serve neither public expectations nor the public interest. It seems fairly clear that auditors should, and are expected to be experts in

questioning and challenging the experts whose work they use. We believe that this is implicit in the PCAOB's proposals but that it would do well to surface this issue in its communications with investors and others involved in the capital markets.

5. We remain concerned about the unintended consequence clearly highlighted by the PCAOB itself that might see smaller companies, in particular, cease engaging or employing their own specialists, and instead challenging auditors to prove management calculations wrong, or effectively relying on the work of the auditor's specialist.

6. We made this point in our response to the Staff DP and while it helps that the PCAOB has dropped proposals for information produced by company specialists to be treated as if it was produced by the company itself, we are not convinced that in a decade's time, inspectors will not be calling on the Board to deal with the fact that companies are poorly motivated to employ or engage specialists, that management performs its own valuations and that they leave it to the auditors to employ a proper valuation expert. This would have auditors dangerously close to taking responsibility for the valuation. This is all the more important in the light of the fact that standard setters note the particular difficulties smaller companies have in preparing compliant financial information, and that some take the view that this is compounded by unnecessarily rigid ethical requirements that prohibit auditor assistance in this area.

7. The PCAOB demands independence of auditors and auditor engaged specialists. It does not demand objectivity of company specialists. One consequence of this is that the PCAOB's requirements for company specialists fall short of those of the IAASB. The IAASB does require objectivity of company specialists. We believe that independence is a means to an end rather than an end in itself, that formal independence it is no guarantee of objectivity and that without objectivity, independence has little value. Objectivity is a fundamental principle of many leading codes of professional ethics and is required by many national and international standard setters for all assurance and related services engagements. We urge the PCAOB to reconsider this issue.

8. We remain concerned about the lack of acknowledgement among standard setters generally of structural barriers and recent developments that make the evaluation of management's process, assumptions and data in developing certain types of estimate difficult. That lack of acknowledgement is short sighted.

9. Firstly, as we noted in our response to the Staff DP the PCAOB and other capital market participants should acknowledge the problems caused by assumptions and methods mandated in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date and there are many such assumptions and methods – such as those used for calculating reserves in the extractive industries – that auditors cannot be expected to question. Individual auditors cannot reasonably be expected to effectively critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.

10. Secondly, the increase in the use of fair values and developments in technology generally have made the audit of some highly complex estimates such as expected credit losses, a daunting exercise, even for well-resourced large firms, particularly where there is little accounting or auditing guidance. The PCAOB refers in the ED to academic evidence alluding to the technical challenges such estimates give rise to, and to the financial, educational and other resource constraints of auditors in this respect.

11. Thirdly, the ED dismisses concerns about the increasingly common situations in which the data and assumptions and structure of the proprietary models used by specialists, regardless of who they are employed or engaged by, are simply unavailable at any price. The PCAOB suggests that auditors do not need access to these models and that auditors should evaluate such black

boxes 'in accordance with the proposed standard'. In practice, the only way of dealing with them is by using approximations based on alternative models to assess the reasonableness of output. The PCAOB refers somewhat disparagingly to the use of heuristics (rules of thumb) in this context but auditors have no choice. Changes to auditing standards will not force the owners of those proprietary models to open them up. Even assessing inputs from pricing specialists in pricing can be prohibitively costly for smaller companies.

12. We do not disagree with the PCAOB's requirements for auditors to address such issues but we do believe it needs to go further. ICAEW's thinking on the broader but closely related area of prospective financial information (PFI) is relevant in this context. In our Corporate Finance Faculty's recent *Consultation paper on prospective financial information* we refer to three 'preparation principles' for PFI which we believe apply equally to many estimates for which specialist assistance is required, particularly in complex areas, including those based on proprietary models to which management and auditors may have no access.

13. The three basic preparation principles are the bases of sound *business analysis* which renders PFI reliable, *reasonable disclosure* of the relevant uncertainties and mitigating actions, and *subsequent validation* which renders the PFI comparable, and preparers accountable. Translated into auditing terms, this means that auditors need to challenge management's employed or engaged specialists to explain:

    - how they have obtained comfort that the estimate is actually based on a sound understanding of how the business actually works - to ensure that assumptions built into the model or background data actually reflect the business environment in which the entity operates;

    - how they have obtained comfort that the right business-specific disclosures have been made for the relevant uncertainties and mitigating factors;

    - how reliable previous estimates have turned out to be in practice, including why they were significantly different, where relevant.

14. The important point is for all concerned to acknowledge that it is not enough for management to take a 'take it or leave it' approach when challenged by auditors, and it is not enough for auditors to perform their own rough independent calculations in the hope that output is not too far away from the figures produced on behalf of management by specialists. Management, auditors and specialists need to engage more closely in these difficult areas and auditors need a better sense of management's ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.

15. Dealing with all three of the issues noted above requires the PCAOB and other standard setters to engage with the SEC and others involved the capital markets.

RESPONSES TO SPECIFIC QUESTIONS

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

16. We would welcome a higher level view of the broad approaches and levels of competencies the PCAOB expects of auditors, which would help shape investor understanding and expectations. In our June 2017 Audit Quality Forum (AQF) event *Believe me, I'm an expert?* we explored three possibilities, ie, that auditors should be experts in:

- financial reporting only, and should simply aggregate the opinions of other experts involved in the audit;
- financial reporting, and in questioning and challenging other experts, in a manner not dissimilar to a judge, in forming their own conclusion on the financial statements on which they report;
- all of the relevant specialist areas covered by the financial statements as well as financial reporting.

17. We believe that asking auditors to be experts in everything they report on is unrealistic and unnecessary. The second option was discussed by the PCAOB in the Staff Discussion Paper (Staff DP) that preceded this consultation and we suggested that auditors should not simply act as high level project managers as this would serve neither public expectations nor the public interest. It seems fairly clear that auditors should, and are expected to be experts in questioning and challenging the experts whose work they use. We believe that this is implicit in the PCAOB's proposals but that it would do well to surface this issue in its communications with investors and others involved in the capital markets.

18. The description of existing audit practice is broadly accurate although it omits to acknowledge some important extraneous factors. We note in our main points above our concern about the lack of acknowledgement among standard setters generally of structural barriers and recent developments that make the evaluation of management's process, assumptions and data in developing certain types of estimate difficult in some cases. Dealing with all three of the issues noted below requires the PCAOB (and other standard setters) to engage with the SEC and others involved in the capital markets.

19. Firstly, as we noted in our response to the Staff DP, the PCAOB and other capital market participants should acknowledge the problems caused by assumptions and methods mandated in professional practice. These include the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date and there are many such assumptions and methods – such as those used for calculating reserves in the extractive industries – that auditors cannot be expected to question. Individual auditors cannot reasonably be expected to critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.

20. Secondly, the increase in the use of fair values and developments in technology generally have made the audit of some highly complex estimates such as expected credit losses, a daunting exercise, even for well-resourced large firms, particularly where there is little accounting or auditing guidance. The PCAOB refers in the ED to academic evidence alluding to the technical challenges such estimates give rise to and to the financial, educational and other resource constraints on auditors in this respect.

21. Thirdly, the ED dismisses concerns about the increasingly common situations in which the data and assumptions and structure of the proprietary models used by specialists, regardless of who

they are employed or engaged by, are simply unavailable at any price. The PCAOB suggests that auditors do not need access to these models and that auditors should evaluate such black boxes 'in accordance with the proposed standard'. In practice, the only way of dealing with them is by using approximations based on alternative models to assess the reasonableness of output. The PCAOB refers somewhat disparagingly to the use of heuristics (rules of thumb) in this context but auditors have no choice. Changes to auditing standards will not force the owners of those proprietary models to open them up. Even assessing inputs from pricing specialists in pricing can be prohibitively costly for smaller companies.

22. We do not disagree with the PCAOB's requirements for auditors to address such issues but we do believe it needs to go further. ICAEW's thinking on the broader but closely related area of prospective financial information (PFI) is relevant in this context. PFI is about the future, as are many estimates, including those that require the involvement of specialists. Our Corporate Finance Faculty's recent *Consultation paper on prospective financial information* updates our guidance for UK directors on the subject published in 2003. In that context we refer to three 'preparation principles', for PFI which we believe apply equally to many estimates for which specialist assistance is required, particularly in complex areas including those based on proprietary models to which management and auditors may have no access.

23. The three basic preparation principles are the bases of sound *business analysis* which renders PFI reliable, *reasonable disclosure* of the relevant uncertainties and mitigating actions, and *subsequent validation* which renders the PFI comparable, and preparers accountable. Translated into auditing terms, this means that auditors need to challenge management's employed or engaged specialists to explain:

    - how they have obtained comfort that the estimate is actually based on a sound understanding of how the business actually works - to ensure that assumptions built into the model or background data actually reflect the business environment in which the entity operates;
    - how they have obtained comfort that the right business-specific disclosures have been made for the relevant uncertainties and mitigating factors;
    - how reliable previous estimates have turned out to be in practice, including why they were significantly different where relevant.

24. The important point is for all concerned to acknowledge that it is not enough for management to take a 'take it or leave it' approach when challenged by auditors, and it is not enough for auditors to perform their own rough independent calculations in the hope that output is not too far away from the figures produced by specialists on behalf of management. Management, auditors and specialists need to engage more closely in these difficult areas and auditors need a better sense of management's ability and willingness to be accountable for complex estimates, regardless of how many specialists and/or third parties are involved.

Q 2. Do these proposed amendments to existing standards appropriately address the reasons to improve standards discussed above? Are the reasons for having separate standards for using the work of a company's specialist, an auditor-employed specialist, and an auditor-engaged specialist clear?

25. There is a shortfall to be addressed and the proposed amendments broadly address the reasons to improve standards as set out in the ED. However, we do not believe that the case has been made for having separate standards for auditor employed and auditor engaged specialists. ISA 620 manages to achieve the same objectives as those of the PCAOB using just one standard and we do not believe it is beyond the capabilities of the PCAOB to do the same. Of itself, we see no great mischief in having separate standards other than the potential for inefficiency and confusion arising from a great deal of avoidable repetition.

Q 3. Are there any other areas of improvement in existing standards relating to audits that involve specialists that the Board should address? Are there related areas of practice for which additional or more specific requirements may be needed?

26. We noted in our response to the Staff DP the fact that the focus appeared to be on process at the expense of substance - on the formal relationships, the categorisation of specialists and on management's process. We also said that very little directly addresses the problem of auditors failing to challenge the substance of the assumptions or methods used by specialists.

27. We remain of the view that a sense of 'challenge' does not really come through in these proposals, and that it should do. The word 'challenge' itself is often used in this context but unless standard-setters have the courage to use it in the standards themselves – and we appreciate the obstacles to this but they should not be insurmountable – standards will remain process driven and prescriptive, seemingly avoiding the need for auditors to stand back and look at the picture as a whole, or exercise judgement except where specifically instructed to do so.

28. We also believe that the PCAOB should acknowledge the problems caused by assumptions and methods mandated in professional practice, such as the actuarial tables used in the pensions industry for many years based on assumed life expectancies that were decades out of date. Individual auditors cannot reasonably be expected to critique established professional practice outside their own professional expertise and we caution against creating expectations, explicit or implicit, that auditors will be in a position to critically evaluate well-established and widely-used methods and assumptions within an industry, still less in more specialised areas.

Q 4. The Board requests comment generally on the baseline for evaluating the potential economic impacts of the proposal. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs
Q 5. The Board requests comment generally on the analysis of the need for the proposal. Are there additional academic studies or data the Board should consider? The Board is interested in any alternative economic approaches to analyzing the issues presented in this release, including references to relevant data, studies, or academic literature.
Q 6 The Board requests comment generally on the potential benefits to investors, auditors, and other capital market participants. Are there additional benefits the Board should consider?

29. We take a keen interest in PCAOB's Economic and Risk Analysis work in support of its standard setting activities. Good quality research to support all stages of auditing standard setting - from the need to develop or revise standards, through impact analyses of proposals to post-implementation review - is critical to the quality of auditing standards, the credibility of standards and confidence in the integrity of the standard setting process. Such research takes time to scope and perform, not least because it takes time for standard setters and researchers to understand and align their respective objectives. It is not cheap, and the results are often less conclusive than desired. But it is still better than an approach based solely on the beliefs of the standard setter about what will improve audit quality. We have challenged standard setters on many occasions to provide support for their belief that a given approach will improve matters. Too few standard setters have devoted resources to such research, instead relying on respondents to consultations to fill the gap.

30. We note elsewhere in this response our belief that the PCAOB should seek to engage with other capital market participants on some of the more complex issues raised by the research described in the ED. These include appropriate responses to the complete inaccessibility of proprietary models increasingly used in the development of financial instruments, including the assumptions made therein and the data on which those assumptions are based. They also

include the impact of limited resources, including the educational level of auditors, when faced with requirements to evaluate such models and the assumptions and data incorporated therein.

31. There are no other additional studies or data of which we are aware that the PCAOB should consider at this time. The potential benefits to investors, auditors and other capital market participants are well-articulated in the ED. There are no additional benefits to which we wish to draw the PCAOB's attention.

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

32. Complexity in accounting standards, business models and financial instruments accounts for much of the complexity in the audit of accounting estimates and for the need to use specialists. Complexity is referred to in the proposals but in a manner that does not reflect the significance of the issue. The proprietary models referred to above and expected credit losses are just two examples. There is little accounting or auditing guidance for auditors facing highly complex technical issues such as these and we believe that at the very least, the PCAOB should acknowledge the magnitude of the cost and other resource implications. It should also acknowledge that simply throwing time and money at the issue is not a solution when there are too few specialists to go around, which is not unusual, particularly outside the US, and particularly in the context of complex financial instruments.

33. There could be better cross-referencing between this proposed standard and the proposed standard on accounting estimates.

34. The costs to companies should not be underestimated, a simple example being the need for companies to provide more support for their choice of discount rate than in the past in some cases. We note in our response to the PCAOB on its proposed standard on accounting estimates our belief that the PCAOB should seek to engage with the SEC and others involved in the capital markets to ensure that companies do in fact provide the required support for their estimates on a timely basis. Asking auditors to put pressure on companies to up their game without applying similar pressure to the companies themselves is effectively asking auditors to regulate companies through the back door, through auditing standards.

35. We observe in many of our responses to standard setters the fact that while clients are willing to pay for the additional work entailed by new accounting standards, they believe that auditors should absorb the costs that new auditing standards entail. We are aware that there is little sympathy for auditors in this regard but standard setters ignore the behavioural implications of this at their peril. Simply expecting auditors to absorb additional costs - and hoping that they will not seek to compensate for this by means of making audit methodologies more efficient elsewhere - is to be wilfully ignorant of a basic fact of human and corporate behaviour. This might be an area of research for the PCAOB's Economic and Risk Analysis.

Q 8. The Board requests comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release appropriate? Are there additional potential unintended consequences that the Board should consider? If so, what responses should be considered?

36. We note above particular concerns about the risk that smaller companies in particular cease engaging or employing their own specialists, and instead challenge auditors to prove management calculations wrong, or effectively rely on the numbers the auditor's specialist produces. If companies are not motivated to employ or engage specialists and management perform its own valuations and leaves it to the auditors to employ a proper valuation expert, auditors are dangerously close to taking responsibility for the valuation.

37. On the other hand, we also note the difficulties articulated by standard setters experienced by smaller companies who find it difficult to prepare compliant financial information, a problem

some believe is compounded by excessively rigid ethical requirements which prohibit auditor assistance.

38. This is a tricky area to navigate and there are structural issues to be addressed that go beyond the PCAOB's standard setting and inspection roles. Once again, we urge the PCAOB to engage with the SEC and others involved in the capital markets on this issue.

39. The PCAOB says that it believes that companies will not cease engaging their own specialists because to do so would take control of valuations out of their hands. While we hope this is correct, hope is no basis for standard setting. We therefore reiterate our belief noted above, that the PCAOB should engage with the SEC and others involved in the capital markets to exert pressure on companies to *ensure* that this does not happen.

Q 9. The Board also requests comment on the potential unintended consequences of the proposal on competition in the market for audit services. How and to what extent could competition be affected by the proposal? Would audit fees be meaningfully affected by the proposal? Would the availability of qualified auditors in the market be meaningfully affected by the proposal?

40. We note the PCAOB's concerns regarding the potential adverse impact of the proposals on competition in the audit market and in particular the ability of smaller firms of auditors that do not enjoy the economies of scale of larger firms to compete with them. This is a self-perpetuating problem and reflects structural issues in the audit market that auditing standards cannot be expected to address.

41. Even so, those smaller firms that do not currently perform work on the assumptions and methods of specialists employed or engaged by companies will need to perform that work going forward. Exempting EGCs from the requirements would simply delay the problem but phasing the requirements might mitigate some of the worst effects. Such firms' clients are the most likely to meaningfully be affected by increases in audit fees. As with all situations in which a firm has only one or two clients in a regulated or complex area, justifying the additional work now required may be difficult and such firms might withdraw from such engagements. All of this clearly has an adverse effect on competition but we do not believe that this is a valid reason, in this case, to exempt EGCs altogether. We also note that these issues are not confined to EGCs.

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

42. One of the PCAOB's standard headings in its exposures is '*Why Standard Setting Is Preferable to Other Policy-Making'*. A much better approach would be to explain *Why Standard Setting is Needed Within the Wider Regulatory Framework.* We strongly believe that standard setting alone, as a sole alternative to other approaches, is rarely, if ever, likely to be effective, simply because auditor behavior is driven to a great extent by the approach taken during audit inspections, regardless of what auditing standards may or may not say.

43. The only other alternative approach on which we comment is with regard to the objectivity of auditor engaged specialists. We agree with the PCAOB's proposed approach which is aligned with the approach taken in ISA 620. Auditors should assess whether the specialist has the necessary objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit. The PCAOB is right not to specify how the relevant information to make the assessment should be obtained. This is preferable to (a) applying the same independence requirements to auditor engaged and employed specialists and (b) to applying a 'reasonable investor test' within an 'enhanced objectivity' approach.

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

44. Other than the cost of ignoring the impact of additional costs on auditor behaviour outlined in our answer to Q 7 above, and the additional costs relating to the unintended consequences referred to in our answer to Q 9 above, there are no other economic considerations related to the proposal to which we wish to draw the PCAOB's attention.

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

45. We note in our answer to Q8 above the difficulties and potential unintended consequences of the proposals for smaller companies, and their auditors. One way of mitigating the risk of (a) smaller companies ceasing to engage or employ their own specialists, and (b) a reduction in competition in the audit market, might be to phase the requirements for EGCs. The impact of the proposals will undoubtedly be most marked for EGCs and their auditors and while both need to step up to the plate, asking them to do so immediately may precipitate or exacerbate the unintended consequences discussed. We also note shortages of specialists in some areas that are likely to impact EGCs most. Again, we note that these issues are not confined to EGCs.

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

46. We do not comment on this question.

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

47. Some larger firms, as the PCAOB notes, are probably doing much of what is proposed already and would not need long to implement the proposals. As we note in our answer to Q12, above, it may be prudent to phase implementation for the audit of EGCs.

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

48. The existing meaning of the term 'specialist' is a person or firm possessing special skill or knowledge in a particular field other than accounting or auditing, except for income taxes and information technology because they are deemed specialised areas of accounting and auditing.

49. We noted in our response to the Staff DP that while the proposed PCAOB description is the same, on the face of it, as that of the IAASB, the IAASB scopes in tax practitioners dealing with complex or unusual issues. We suggested that if the PCAOB must scope out tax specialists, the focus should be not on the nature of the tax (income tax) but on its unusual or complex nature, as in the ISAs. We also note that scoping reflects the fact that by comparison with some other jurisdictions, in the US, firms integrate their tax and IT practitioners in their audit

practices. We remain of the view that in many cases the crossover between tax and IT staff between audit and compliance/advisory practices leads of necessity to them being treated as specialists. IT in particular will continue to develop as an area in which specialist expertise will often be needed in addition to the routine IT skills and competencies needed in all auditors, including auditors who in work exclusively in IT support.

50. The PCAOB notes commentators who refer to cyber security in this context and we would add to that, artificial intelligence and Blockchain technologies. Both are set to play a major role in business development in the coming decades. With the best will in the world, auditors who work exclusively within IT support groups within a practice will struggle to provide the level of insight into and understanding of these technologies that audit will demand in the coming years.

Q 18. Does the proposed approach pose any particular challenges to auditors, such as for particular industries? If so, what are those challenges, and how could the proposed approach be modified to better take them into consideration?

51. We note in our response to Q7 above the fact that there are insufficient numbers of available specialists in some areas, particularly outside the US, and particularly in the context of complex financial instruments. This is a matter that needs to be taken into account in the PCAOB's engagement with the SEC and others involved in the capital markets, but it is also something that PCAOB inspectors need to take account of. Simply ignoring the issue does not make it any less real.

Q 19. Are the proposed requirements scalable as described? If the requirements are not scalable, what changes to the proposals would make them adequately scalable?

52. We note in our responses to the IAASB and the PCAOB on their proposals on estimates the fact that the smallest of companies often engage in complex arrangements. Management may have little awareness of the accounting and auditing implications of such arrangements and therefore struggle to develop, or provide support, for the estimates required by US GAAS.

53. We note in our main points above that standard setters note the difficulties experienced by smaller companies in preparing compliant financial information and that some take the view that this is compounded by excessively rigid ethical requirements which prohibit auditor assistance in this area.

54. We also note in our answer to Q12 above and elsewhere, the difficulties and potential unintended consequences of the proposals more generally for smaller companies and their auditors. We suggest that one way of mitigating the risk of (a) smaller companies ceasing to engage or employ their own specialists, and (b) a reduction in competition in the audit market, might be to phase the requirements for EGCs. The impact of the proposals will undoubtedly be most marked for EGCs and their auditors and while both need to step up to the plate, asking them to do so immediately may precipitate or exacerbate the unintended consequences discussed.

Company specialists

Q 20. How would the proposed requirements for using the work of a company's specialist as audit evidence impact current practice? Describe any changes to current practice you foresee based on the proposed requirements.

Q 21. Are the proposed requirements related to obtaining an understanding of the work and report(s) of the company's specialist(s) and related company processes and controls, in conjunction with obtaining an understanding of the company's information system relevant to financial reporting, clear and appropriate? Do such requirements belong in proposed Appendix B? If not, where should such requirements be included?

Q 22. Are the proposed requirements for obtaining an understanding of and assessing the company specialist's knowledge, skill, and ability, and relationship to the company, clear and appropriate? Do these proposed requirements represent a change from current practice? If yes, how so?
Q 23. The release provides examples of varying the nature, timing, and extent of audit procedures based on the factors described in the proposed requirements. Are the examples provided in the release clear and helpful? Are there additional examples from practice that the Board should consider?
Q 24. Are the proposed requirements to evaluate the relevance and reliability of the company specialist's work clear and appropriate? Do the proposed requirements complement the requirements to evaluate the relevance and reliability of other audit evidence?

55. The PCAOB does not demand objectivity of company specialists. Paragraphs .B4 and .B5 relate to the assessment of the specialist's relationship to the company and the entity that employs the specialist in terms of employment, financial, ownership business, contractual and familial relationships. They also deal with the necessary evidence relating to this being dependent on the assessed risks associated with the relevant assertion and the significance of the specialist's work to the auditor's conclusion.

56. We acknowledge that the content of these paragraphs represents an enhancement of existing requirements. We also acknowledge that they very broadly cover the same areas as paragraphs 8a, A37, A41 and A43 in ISA 500. The PCAOB states that the term 'objectivity' is restricted to auditor engaged specialists and that the issue is covered by the paragraphs referred to above.

57. The PCAOB demands independence of auditors and auditor engaged specialists but it does not demand objectivity of company specialists. One consequence of this is that the PCAOB's requirements for company specialists fall short of those of the IAASB. The IAASB does require objectivity of company specialists. We believe that independence is a means to an end rather than an end in itself, that formal independence it is no guarantee of objectivity and that without objectivity, independence has little value. Objectivity is a fundamental principle of many leading codes of professional ethics and is required by many national and international standard setters for all assurance and related services engagements. We urge the PCAOB to reconsider this issue.

58. We have concerns about the discussion and approach to specialist reports containing restrictions, disclaimers or limitations regarding the auditor's use of the report. Such caveats vary in nature and their use is widespread. The PCAOB gives a single example of wording that would render the related report unreliable – a statement that *the values in this report are not an indication of the fair value of the underlying assets*. We suspect that that wording such as this is commonplace even where the report has been commissioned specifically for audit purposes and is analogous to specialists refusing to give consent to being named in SEC filings. The wording is included as a risk management exercise and auditors may have little choice but to accept such wording. It would be helpful for the PCAOB to acknowledge these issues and to observe that the significance of caveats generally should be taken in the context of the relevant risk assessment as a whole.

59. We take issue with the PCAOB's assertion on page A3-24 to the effect that the IAASB does not have analogous requirements to test and evaluate data provided to the company's specialist or evaluate their methods and significant assumptions. Paragraph 13(b) of ISA 540 refers in detail to the need for auditors to test how management made the accounting estimate and we refer to paragraph A48 of ISA 500 under the heading *Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c)):*

    A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

 The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

 If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

 If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

60. This may not be a requirement but it is analogous to the PCAOB's proposals and we believe its omission misrepresents IAASB's position. We have drawn attention in previous responses to the PCAOB to what we believe could be much better analyses of the differences between PCAOB proposals and the requirements of other standard setters. We have no doubt that the PCAOB is aware of the paragraph referred to above and we are disappointed that it chose not to refer to it.

61. We support the proposed elevation of the requirement for auditors to 'obtain an understanding' of specialists' methods and significant assumptions, to instead 'evaluate' whether they are appropriate, and whether significant assumptions used by specialists are reasonable.

Auditor employed specialists

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

62. We support the proposals:

- that would enable auditors to use information from and processes in the firm's quality control system in assessing the knowledge, skill, ability, and independence of auditor-employed specialists;

- for additional requirements to 'inform' auditor employed specialists about the work to be performed and to evaluate contrary evidence developed by specialists, both of which arise from inspection findings;

- to require the review of specialist reports, rather than their work. This will focus auditor attention on the detail and discourage reliance on process. We do not believe that this will require auditors to reperform the work of specialists.

63. However, we believe that the PCAOB’s assertion that auditors should have sufficient knowledge of the subject matter to evaluate a specialist's work is a moot point, particularly in relation to highly complex technical areas. We note elsewhere in this response the PCAOB’s own observations regarding the ability of auditors, within time, educational and other resource constraints, to effectively challenge models, assumptions and data in highly complex areas and we encourage the PCAOB to engage with the SEC and others involved in the capital markets to consider this issue.

Auditor engaged specialists

Q 32, Does the proposed approach pose any particular challenges to auditors? If so, what are those challenges and how could the proposed approach be modified to better take them into consideration?
Q 33. Does the proposed approach appropriately reflect the relationship between the auditor and an auditor-engaged specialist as compared to the auditor and an auditor-employed specialist? If not, how should the requirements be tailored to reflect that relationship? Are there any additional requirements needed when an auditor engages a specialist that are not contemplated in the proposed approach? Describe specifically any such requirements.
Q 34. Is it clear how the proposed requirement for assessing the knowledge, skill, ability, and objectivity of an auditor-engaged specialist differs from the requirements for assessing the knowledge, skill, and ability of the company's specialist and the relationship of the company's specialist to the company? If not, how can the proposed requirements be changed to improve their clarity?
Q 35. Does the proposed requirement to assess the objectivity of the auditor engaged specialist present any challenges to the auditor? If so, what are those challenges and how could they be addressed?
Q 36. Are the proposed requirements for establishing and documenting the understanding with the auditor-engaged specialist sufficiently clear and appropriate? Would they foster effective two-way communication between the auditor and the auditor-engaged specialist? If not, how could they be changed?
Q 37. To what extent does the proposed requirement for establishing and documenting the understanding with the auditor-engaged specialist represent a change in current practice? What is that change, if any?
Q 38. Are the proposed requirements for evaluating the work, including any report, of the auditor-engaged specialist appropriate and clear? Is the link between the establishment and documentation of the understanding with the specialist and evaluating the specialist's work or report clear?
Q 39. What, if any, additional guidance is needed for auditors to effectively implement and apply the proposed requirements for using the work of auditor-engaged specialists in audits?
Q 40. Should this guidance, if any, be part of the Board's rules or issued separately in the form of staff guidance? Describe specifically what areas need guidance.

64. The PCAOB notes concerns expressed by respondents to the Staff DP about auditors having limited access to proprietary information, such as models, including those used by auditor engaged specialists. It goes on to assert that auditors should have sufficient knowledge of the subject matter to evaluate a specialist's work as it relates to the auditor's work and audit report. Significantly, the PCAOB goes on to say that it does not require auditors to have full access to a specialist's proprietary models or to reperform the work of the specialist, but instead to evaluate the work of that specialist ‘in accordance with the proposed standard’. We urge the PCAOB to include a note to this effect in AS 1210.

65. We note in our answer to Q25-31 above, concerns regarding the capacity of auditors to evaluate a specialist's work in highly complex technical areas. We refer to the PCAOB's own observations regarding the ability of auditors, within the time, educational and other resource constraints to effectively challenge models, assumptions and data in highly complex areas and we encourage the PCAOB to engage with the SEC and others involved in the capital markets to consider this issue.

66. The proposed requirement to specifically require auditors to determine whether a specialist is needed to perform the audit in all cases is aligned with a proposed IAASB requirement in its ED on estimates. We questioned this proposed requirement in our response to the IAASB, and we therefore question the PCAOB's requirement. The use of specialists in smaller audits, remains the exception rather than the rule. We do not believe that a separate specific requirement for auditors to determine whether a specialist is needed is necessary, but that the PCAOB might instead include that consideration as one of issues to be covered during the mandatory team discussion of the risk assessment.

Q 41. Is rescinding AI 28 appropriate, or does the interpretation contain specific guidance necessary to apply PCAOB standards? If so, what is that specific guidance?
Q 42. Are the proposed conforming amendments in Appendix 2 appropriate and clear? Why or why not? What changes to the amendments are necessary?
Q 43. In addition to the proposed conforming amendments in Appendix 2, are other conforming amendments necessary in connection with the proposed changes to AS 1105, AS 1201, and AS 1210? 42-43 – conforming amendments

53. We make no comment on these questions.