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

31 July 2015

Re: Staff Consultation Paper: The Auditor's Use of the Work of Specialists

Dear Ms. Brown:

Ernst & Young LLP is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on the *Staff Consultation Paper – The Auditor's Use of the Work of Specialists* (the Consultation Paper). We commend the PCAOB for initiating this potential standard-setting initiative with a staff consultation paper, which we believe is a constructive way to seek stakeholder input earlier in the standard-setting process.

We support the PCAOB's efforts to evaluate whether existing standards on the auditor's use of the work of specialists can and should be improved. We believe efforts to improve PCAOB standards in this area should seek to do all of the following:

- ▶ Provide requirements that are scalable and that recognize the differences between the auditor's specialists and the company's specialists, as well as the types of activities for which auditors and companies use specialists
- ▶ Retain, in general, the objectives of AU sec. 336,¹ while providing enhanced guidance for auditors
- ▶ Align them with the risk assessment standards so that the nature, timing and extent of audit procedures are based on the auditor's risk assessment
- ▶ Align them with any standards resulting from the staff's separate project on auditing accounting estimates and fair value measurements

Our views on the staff's consideration of possible changes to the existing auditing standards are included below in three general sections: (1) using the work of an auditor's specialist, (2) using the work of a company's specialist and (3) other matters.

¹ PCAOB AU section 336, *Using the work of a specialist* (AU sec. 336)

Using the work of an auditor's specialist

Extending the auditor's supervision requirements of AS 10

The Consultation Paper describes an alternative to extend the supervision requirements in AS 10² to all arrangements involving an auditor's engaged specialist.³ We do not support this alternative. When a specialist is employed by an accounting firm, we believe he or she should be considered a member of the audit team and be subject to the same supervision and review requirements as any other audit team member, in accordance with AS 10.

The potential amendment to extend the supervision requirements of AS 10 (which would include ensuring compliance with all PCAOB standards, such as the Quality Control and Ethics and Independence standards) to an engaged specialist would be difficult (if not impossible) to apply. Engaged specialists are not subject to the audit firm's training, independence monitoring or other aspects of the overall system of quality control. The audit firm may not have access to the quality control policies and procedures of the engaged specialist's firm, including the results of ongoing monitoring.

As discussed further below, we would prefer that the Board develop a separate standard (similar to ISA 620⁴ or AICPA AU-C 620⁵) that outlines the requirements for using the work of an auditor's engaged specialist and incorporates the supervision and review principles inherent in those standards.

Development of a separate standard for an auditor's specialist

The Consultation Paper also describes an alternative to develop a separate standard for using the work of an auditor's employed or engaged specialist similar to the approach used by the International Auditing and Assurance Standards Board (IAASB) in ISA 620 and the Auditing Standards Board (ASB) in AICPA AU-C 620.⁶

We support the approach of developing a separate standard that encompasses requirements for employed and engaged specialists. The requirements outlined in ISA 620 and AICPA AU-C 620 represent an appropriate model for using the work of an auditor's specialist as audit evidence. We believe this approach could be beneficial in promoting consistency in how the auditor evaluates the work performed by the specialist. It is generally our understanding that many auditors currently apply the principles of ISA 620 and AICPA AU-C 620 when using the work of employed or engaged specialists.

² PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (AS 10)

³ Consultation Paper, page 28

⁴ International Standard on Auditing (ISA) 620, *Using the work of an auditor's expert* (ISA 620)

⁵ American Institute of Certified Public Accountants (AICPA) Clarified Statement on Auditing Standards (AU-C) Section 620, *Using the work of an auditor's specialist* (AICPA AU-C 620)

⁶ Consultation Paper, page 27

We believe that any potential standard should, at a minimum:

- ▶ Recognize the distinction between an auditor’s employed specialist and an engaged specialist, specifically, an auditor’s engaged specialist should not be considered a member of an engagement team
- ▶ Require that the nature, timing and extent of the procedures performed by the auditor using the work of a specialist be based on the auditor’s assessed level of risk, consistent with the Board’s risk assessment standards
- ▶ Retain, in general, the concepts of AU sec. 336 with respect to evaluating the qualifications and work of a specialist, evaluating the relationship of the specialist to the client and using the findings of the auditor’s specialist

We believe that the potential requirements outlined in the Consultation Paper⁷ relating to the areas in AU sec. 336 mentioned above would be appropriate to include in the new standard. We have outlined some proposed recommendations for the staff’s consideration below.

Under this alternative, the Consultation Paper states that the “principles of supervision set forth in Auditing Standard No. 10 (AS 10) would continue to apply when the auditor uses the work of an employed specialist, and the potential new standard would provide specific requirements for how an auditor applies those principles when supervising an auditor’s employed specialist.”⁸ The Consultation Paper also indicates that these requirements would also “apply to the auditor’s use of the work of an engaged specialist.”⁹

We agree that the staff would need to provide specific requirements for an auditor’s engaged specialist that are scalable and acknowledge that there are differences between the auditor’s engaged and employed specialist. We encourage the staff to consider the framework of ISA 620 and AICPA AU-C 620, which do not have a separate section on supervision and review but include the principles of supervision and review inherently achieved through the requirements of the standards. Examples of the requirements in ISA 620 and AICPA AU-C 620 that we believe achieve the principles of AS 10 include the following:

- ▶ AS 10 describes the matters that an auditor should take into account when determining the extent of supervision necessary for the engagement team. One of those matters is the “risks of material misstatement.”¹⁰ ISA 620 and AICPA AU-C 620 have a similar requirement for the auditor to consider the “risks of material misstatement in the matter to which the work of the auditor’s specialist relates”¹¹ when determining the nature, timing and extent of procedures necessary in using the work of a specialist.

⁷ Outlined in the Consultation Paper on pages 36 to 42

⁸ Consultation Paper, page 27

⁹ Ibid

¹⁰ AS 10, paragraph 6

¹¹ ISA 620, paragraph 8 and AICPA AU-C 620, paragraph 8

- ▶ Another matter that AS 10 describes is “the knowledge, skill and ability of each engagement team member.”¹² ISA 620 and AICPA AU-C 620 describe the requirement for the auditor to consider whether the auditor’s specialist has the necessary competence, capabilities and objectivity for the auditor’s purpose.¹³

In the Consultation Paper, the staff indicates that under both proposed alternatives (i.e., develop a separate standard for an auditor’s specialist or extend the supervision requirements of AS 10), it would be necessary to provide potential enhanced requirements for evaluating the knowledge, skill and objectivity of an auditor’s specialist, informing an auditor’s specialist of his or her responsibilities and evaluating the work of an auditor’s specialist. While we support some of the potential requirements described in the Consultation Paper,¹⁴ we have several concerns and recommendations related to them. Our concerns and proposed alternatives for the staff’s consideration are outlined below.

Evaluating the knowledge and skill of an auditor’s specialist

We agree that the auditor should be required to evaluate whether the specialist has the requisite knowledge and skill to perform the assigned tasks. The auditor’s employed specialist is subject to the firm’s overall system of quality control under PCAOB standards, including Quality Control Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC 20). QC 20 includes an evaluation of an employee’s independence, integrity and objectivity, personnel management, engagement performance and monitoring, among other things. We believe that the engagement teams should be able to rely on the firm’s system of quality control.

Alternatively, in instances where the auditor uses the work of an engaged specialist, the auditor should still be required to evaluate the specialist’s knowledge, skill and objectivity. We agree with the Consultation Paper that information regarding the engaged specialist’s knowledge and skill can be obtained from a variety of sources, for example, the firm’s prior experience with the work of the specialist, discussions with the specialist and others who have used the specialist and published papers or books written by the specialist. In addition, the auditor should consider the following when evaluating the specialist’s knowledge and skill (mostly consistent with ISA 620 and AICPA AU-C 620):

- ▶ The engaged specialist’s qualifications, including whether he or she is subject to certification and renewal (including education, experience and examination requirements)
- ▶ Whether the engaged specialist’s work is subject to technical performance standards or other professional or industry requirements
- ▶ The engaged specialist’s experience and reputation in the field in which the firm is seeking evidence

¹² AS 10, paragraph 6

¹³ ISA 620, paragraph 9 and AICPA AU-C 620, paragraph 9

¹⁴ Outlined in the Consultation Paper on pages 36 to 42 and 46 to 51

- ▶ The engaged specialist's knowledge of and experience in the entity's industry
- ▶ The relevance of the engaged specialist's competence to the matter for which his or her work will be used, including any areas of specialty within the specialist's field
- ▶ The specialist's competence with respect to relevant accounting and auditing requirements
- ▶ The engaged specialist's relationship to the entity, if any

Informing an auditor's specialist of his or her responsibilities

We support the potential requirement for the auditor to reach an agreement in writing with the auditor's specialist on certain matters that are the specialist's responsibility. However, the staff's language within the Consultation Paper, which does not appear to be included in a potential requirement, suggests that "evidence of the agreement between the auditor and the auditor's specialist might be in the planning memorandum, separate memorandum, audit programs or other related workpapers."¹⁵ We believe this footnote provides appropriate flexibility to the auditor and should be incorporated in a potential requirement.

We also have a concern about potentially requiring the auditor to be responsible for advising the specialist about "matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment, and its internal control over financial reporting, and possible accounting and auditing issues related to areas in which the auditor uses the work of the specialist."¹⁶ We recommend that the potential requirement be narrower and limited to matters that could affect the work the specialist is to perform or the evaluation of that work, including relevant aspects of the company, its environment and its internal control over financial reporting. This would limit the auditor's responsibility to communicate matters specific to the company of which the specialist may not be aware (as opposed to general industry considerations of which a qualified specialist would understand).

Evaluating the work of an auditor's specialist

The Consultation Paper discusses potential requirements for evaluating the work of an auditor's specialist depending on whether the specialist performs work related to either (1) developing an independent estimate or (2) testing the methods and significant assumptions used by the company.

We believe that the nature and extent of the audit procedures to be performed to evaluate the work of the auditor's specialist should reflect the auditor's risk assessment. Fundamentally, the use of specialists is necessary when the auditor does not have the requisite knowledge of the subject matter and there are limitations to the auditor's knowledge about appropriate methods and assumptions.

¹⁵ Consultation Paper, page 38, footnote 74

¹⁶ Consultation Paper, page 37

We are concerned about the potential requirement to evaluate the work of an auditor's specialist differently (i.e., "determine whether"¹⁷ versus "evaluate the conclusions"¹⁸) depending on whether the specialist (1) develops an independent estimate or (2) tests the methods and significant assumptions used by the company. This could be interpreted as requiring the auditor to reperform the specialist's work by developing an independent conclusion on the estimate, despite the fact that the auditor does not possess the necessary expertise and therefore engages a specialist. If the auditor has concluded that a specialist is competent and objective and has an understanding of his or her responsibilities, the auditor should be able to rely on the execution of the procedures by the specialist and evaluate the reasonableness of the specialist's conclusions.

Auditors are not expected to possess the expertise of another profession and may use the work of specialists in certain circumstances to provide the auditor with evidential matter about a particular audit matter, consistent with the core principle of AU sec. 336. By requiring a level of effort that goes beyond evaluating the specialist's conclusions, the alternative would mandate a level of expertise that auditors do not possess. We believe that the requirements for the auditor in both situations should necessarily be more limited to requiring an evaluation of the appropriateness and reasonableness of the specialist's conclusions and findings, consistent with the objectives of AU sec. 336. The guidance in paragraph 12 of AU sec. 336 could also be considered.

In situations where the auditor believes that the specialist's findings are inconsistent with other audit evidence, the auditor should agree with the specialist on the nature and extent of further work to be performed by the specialist, perform additional audit procedures appropriate for the circumstances or obtain the another specialist's opinion to gain additional audit evidence to support the conclusion, consistent with the principles of AU sec. 336.

Evaluating the objectivity of an auditor's specialist

We believe the auditor should evaluate the relationship between the auditor's engaged specialist and the company, including the circumstances that might impair the specialist's objectivity. As described in AU sec. 336, "when a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability."¹⁹ The alternatives discussed in the Consultation Paper suggest that for the auditor to evaluate the engaged specialist's objectivity, the auditor would be required to obtain information about and evaluate the specialist organization's policies and procedures.

We are concerned that the potential amendments may not be operational given the limitations on the ability of an auditor to have access to this information, including the related monitoring. Further, we believe that any amendments should reflect that the determination about whether the work of the engaged specialist is reasonable should be made by the auditor, who is required to be independent under the most restrictive standards of the PCAOB and Securities and Exchange Commission (SEC).²⁰

¹⁷ Consultation Paper, page 40, item a

¹⁸ Consultation Paper, page 40, item b

¹⁹ AU sec.336, paragraph 11

²⁰ PCAOB Rule 3520 *Auditor Independence* and Rule 2-01 of Regulation S-X adopted by the SEC

We believe that rather than placing specific independence requirements on specialists, the existing requirements in AU sec. 336 could clarify how the auditor evaluates the objectivity of a specialist, as well as how that evaluation would affect the auditor's assessment of the reliability of the evidence obtained from the specialist.

Rule 2-01

We believe that the potential requirement requiring an auditor's engaged specialist to comply with the requirements of Rule 2-01 of Regulation S-X adopted by the SEC (Rule 2-01) may not be the best alternative and could result in unintended consequences.

We believe that requiring the auditor's engaged specialist to comply with the full requirements of Rule 2-01 likely would impose significant limitations on an auditor's ability to engage a specialist willing to implement processes and procedures necessary to demonstrate compliance with Rule 2-01. These proposed changes could result in certain specialists no longer providing certain services to accounting firms, which could diminish the population of available specialists, including those with unique skill sets. Consequently, accounting firms that do not have employed specialists on staff may determine that they are unable to comply with these requirements, which would limit their ability to continue to audit public companies.

As acknowledged in the Consultation Paper, Rule 2-01 was written primarily for accounting firms and not for other organizations, such as specialist entities, that are not structured similarly, and specialist entities and individual specialists may face considerable challenges in complying with this rule.²¹ As a result, we question whether compliance with the potential requirements would be beyond the reasonable reach of accounting firms and unnecessarily expose auditors, the companies they audit and users of the financial statements to unnecessary risk should the specialist not be in compliance with Rule 2-01.

Enhanced objectivity approach

We support identifying certain business, financial and employment relationships that might impair a specialist's objectivity,²² and it is generally our experience that auditors make certain inquiries of engaged specialists and of the entity, review the specialist's credentials, including his or her reputation in the industry, and perform other procedures to assess this.

The PCAOB staff is proposing a "reasonable investor test" as part of the enhanced objectivity approach. We believe such a test would present certain challenges in assessing an engaged specialist's objectivity, particularly regarding the auditor's ability to verify the information required under this approach.

²¹ Consultation Paper, page 47

²² Consultation Paper, page 47

Lacking the context of how the specialist entity is organized, an auditor would not be able to fully evaluate whether the process is effective, which appears to be implicit in this requirement. Further, the processes and procedures that a specialist's organization has in place to maintain independence and objectivity with respect to its work could vary greatly in practice. In addition, while some of these specialist organization's processes may be effective, they may not be formalized and documented in sufficient detail.

We encourage the staff to consider the application guidance under ISA 620 when identifying potential revisions to the requirements for the auditor to obtain information on the specialist's relationships with the client. ISA 620 requires inquiries of the specialist and the client, and in some circumstances, based on auditor judgment, written representations from the specialist.

Finally, we also believe that objectivity should be viewed as a continuum that affects the nature, timing and extent of audit procedures, based on the auditor's judgment. The auditor should weigh all evidence (both positive and negative) that may affect the objectivity of the engaged specialist and adjust procedures as deemed appropriate. The potential objectivity amendments would effectively remove the ability for the auditor to apply additional procedures and continue to use the work of the specialist when certain relationships are noted. The auditor, who is required to be independent under the most restrictive standards, should be allowed to exercise judgment and ultimately be the one making the determination about whether there are additional procedures that would provide sufficient audit evidence.

Using the work of a company's specialist

Amending the requirements in AU sec. 336

The Consultation Paper discusses the potential alternative to amend the requirements in AU sec. 336 relating to the auditor's use of the work of a company's specialist. We believe that the objectives related to management's use of the work of a specialist in AU sec. 336 represent an appropriate model when using the work of a company's specialist as audit evidence and therefore, support the staff's alternative on amending the requirements in AU sec. 336.

The Staff proposes to eliminate the language in AU sec. 336 that states "the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist."²³ We believe this sentence, when considered in the context of the entire paragraph, was not intended to suggest that the auditor does not have any responsibility for auditing the estimate. We believe that this was intended to highlight the core principle of AU sec. 336 that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.

²³ Consultation Paper, page 30

We encourage the staff to consider ISA 500, *Audit Evidence*, when identifying potential revisions to AU sec. 336. ISA 500 includes the core requirements of AU sec. 336 and also provides additional application guidance for the auditor. We believe that the potential revisions to the requirements in AU sec. 336 should incorporate the following:²⁴

- ▶ The concept that a company's failure to employ or engage specialists when it requires expertise in a field other than accounting or auditing increases the risk of material misstatement.
- ▶ An evaluation of the knowledge and skill of the company's specialist (including the staff's proposal to add additional emphasis to that evaluation) should be required.
- ▶ The clarification that the auditor's evaluation of the appropriateness and reasonableness of methods and significant assumptions could include consideration of the following:
 - ▶ The relevance of the competence of the company's specialist on the matter for which that specialist's work will be used, including any areas of specialty within that specialist's field
 - ▶ The competence of the company's specialist with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework
 - ▶ The use of specialized models
- ▶ The auditor's efforts should focus on the assumptions that are significant to the development of the estimate and consider management controls over the estimation process.

We believe that certain of the staff's potential requirements for evaluating objectivity of the auditor's engaged specialist would also apply to the evaluation of objectivity of a company's engaged specialist including:²⁵

- ▶ Requiring the auditor to "obtain information, from the specialist and the company regarding business, employment or financial relationships between the specialist and the company"
- ▶ Requiring the auditor to "evaluate that information and determine whether any relationships impair the specialist's objectivity"

We also recommend that potential requirements that auditors would follow as a part of their evaluation of the objectivity of a company's specialist include:²⁶

- ▶ Any interests and relationships that create threats to the specialist's objectivity, such as self-interest threats, advocacy threats, familiarity threats, self-review threats, intimidation threats and any applicable safeguards, such as any professional requirements that apply to the specialist, and evaluation of whether such safeguards are adequate

²⁴ Consultation Paper, pages 36 and 47 and ISA 500, paragraphs A34 and A40

²⁵ Consultation Paper, page 47

²⁶ ISA 500, paragraphs A41-A43

- ▶ Threats to a specialist's objectivity posed by the employment relationship and whether there is any direct reporting by the specialist to the audit committee or another independent source
- ▶ The terms of the agreement to engage the specialist, including whether, and if so, how, the payment structure is tied to the outcome of the determination of the accounting estimate
- ▶ Whether management has the ability to suggest or require revisions to the specialist's results before those results are finalized
- ▶ The significance of the relationship between the engaged specialist and management (i.e., whether the specialist has an extensive relationship with management, and whether the fees charged by the specialist are material to the specialist)
- ▶ Provision of other services by the engaged specialist to the client

If the auditor believes that the objectivity of the company's specialist might be impaired, the auditor would use knowledge of the risks related to the particular accounting estimate to determine what additional procedures should be performed with respect to some or all of the specialist's assumptions, methods and findings, including whether the auditor should consider engaging an auditor's specialist for that purpose.²⁷ The auditor should perform additional procedures only if, in the professional judgment of the auditor, such procedures are needed as a result of planning risk assessment or as a result of evaluation of audit evidence obtained in order to reach a conclusion in the audit area.

Rescinding the requirements in AU sec. 336

We do not support the staff's alternative on rescinding the requirements of AU sec. 336 and having the auditors follow other applicable PCAOB standards when the work of company's specialist is used. Under this approach, evidence provided by a company's specialist would be evaluated similarly to any other evidence provided by the company to the auditor.²⁸ Consistent with our views expressed in the Staff's Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements*, we have concerns about the unintended consequences of the alternative to rescind AU sec. 336 and the auditor ultimately treating the work of a company's specialist like any other information produced by the entity.

One concern about the suggested requirement to evaluate information provided by a company's specialist in the same manner as information produced by others in the company is that it would discourage the use of specialists by not recognizing the reduction in the resulting risk. The use of a qualified specialist is frequently necessary to develop various accounting estimates and fair value measurements due to the specialized nature of the subject matter.

²⁷ AU sec. 336, paragraph 11

²⁸ Consultation Paper, page 32

We believe that management's decision to use a specialist in these circumstances generally results in a more accurate application of the relevant financial reporting framework and a corresponding decrease in risk of material misstatement in the financial statements. It would then be expected that the nature and extent of the audit procedures to be performed would reflect this decreased risk. ISA 500 recognizes this by including the concept that a company's failure to employ or engage specialists when requiring expertise in a field other than accounting or auditing increases the risk of material misstatement.

We also anticipate substantial application challenges in testing the information provided by external specialists as if it were produced by the company. The models used by specialists frequently are proprietary, which limits the auditor's access to certain information. As a result, auditors would be less able to test management's process for developing the accounting estimate or fair value measurement and would have to develop their own independent estimate. This would be a significant undertaking. As a result, the company would incur both the costs of engaging the specialist to develop the accounting estimate and the auditor's costs to engage or employ a separate specialist to develop an independent estimate, perhaps without a corresponding increase in audit quality. We encourage the staff to perform outreach to issuers to better understand the implications to issuers if AU sec. 336 were rescinded.

Other matters

We support the potential definitions of specialist, auditor's specialist and company's specialist that are included in the Consultation Paper.²⁹ With respect to the definition of specialist, we support the continued recognition of income taxes and information technology as specialized areas of accounting and auditing and the exclusion of these individuals from the definition.

We also agree with the staff's position in the Consultation Paper that the definition of an engaged specialist should exclude third parties that provide information that is routinely and commercially available for a fee. As indicated in our comment letter on the staff's Consultation Paper on *Auditing Accounting Estimates and Fair Value Measurements*, we believe that a definition aimed at excluding certain third parties from the definition of a specialist should focus on those parties that generally provide independent pricing information free from the influence from any one issuer (e.g., the same price is released to all customers without bias). It is this absence of management bias that we believe increases the relevance and reliability of the information and would be considered sufficient appropriate audit evidence.

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²⁹ Consultation Paper, page 34



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

Very truly yours,

Ernst & Young LLP

cc:

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