

New PCAOB Audit Requirements Using the Work of a Company's Specialists

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Securities and Exchange Commission Release NO. 34-86270; File NO. PCAOB-2019-03 on July 1, 2019 has the order granting approval of amendments to auditing standards for auditor's use of the work of specialists. AS 1105 Appendix A includes the new requirements for using the work of a company's specialist including understanding, assessing the knowledge, skill and ability, and evaluating the work. The new requirements amend AS 1201 and replace AS 1210 the new requirements are intertwined in all phases of the audit. This paper examines the changes and the potential implications for auditors using the work of a company's specialist.

Keywords: auditors, audit report, due care, risk of material misstatement, specialist

LITERATURE REVIEW

Little prior research or analysis has been performed since the audit standard is so recent. Brown, Grenier, Pyzoha and Reffett in 2019 examined the effects of two critical factors auditors consider when auditing complex estimates, the decision to use a specialist and the relative aggressiveness of management's estimate, on jurors' auditor negligence assessments. The authors found that jurors view auditors' acceptance of a more aggressive estimate as more justifiable and are thus less likely to find the auditors negligent when auditors consult with either internal or external specialists. However, these litigation benefits do not extend to audits of less aggressive estimates. They also found that jurors are less likely to find auditors negligent when auditors use an external versus an internal specialist, due to greater perceptions of external specialist independence. The authors concluded that similar litigation benefits result when auditors consulted with both types of specialists, such as initial use of an internal specialist and then engaging an external specialist to review the inputs and analysis used in the complex estimate of the internal specialist. Doing so will lead to lower juror negligence assessments, as using two specialist types indicates the auditors exercised due care during the audit.

Research by Griffith, 2020, interviewed 28 auditors and 14 valuation specialists, found that specialists work tends to conform to auditors views, and auditors use specialists to create comfort but not insight. Power 2010; and Griffith, Hammersley, and Kadous 2015, indicates the inherent risk of auditing complex estimates is increased by auditors lack of understanding the models used in the estimates. Therefore, auditors often use valuation specialists to help them audit complex estimates, Griffith 2018; Cannon and Bedard 2017; PCAOB 2017b. However, despite auditors' use of specialists, recent research and PCAOB inspection reports indicate difficulties in auditors' verifying complex estimates (e.g., PCAOB 2016a; Joe,

Vandervelde, and Wu 2017a) and their use of external specialists per Griffith 2018; PCAOB 2017b. This increases litigation risk for audit firms, Christensen et al. 2012. Bratten, Gaynor, McDaniel, Montague, and Sierra 2013; Cannon and Bedard 2017, found complex estimates in financial statements has become increasingly prevalent.

The Proposed Rules were published for comment in the Federal Register on April 4, 2019. Comment letters were sent from Deloitte & Touche LLP, April 10, 2019 (“Deloitte Letter”); the Council of Institutional Investors, April 18, 2019 (“CII Letter”); PricewaterhouseCoopers LLP, April 25, 2019 (“PwC Letter”); and the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, April 25, 2019 (“CCMC Letter”). Commenters encouraged the SEC to support the PCAOB’s plans to monitor implementation, conduct post implementation review, or monitor advancements in technology that may impact application of the rules.

INTRODUCTION

The new standard requirements for Using the Work of a Company’s Specialist laid out in Releases No. 34-86270; File No. PCAOB-2019-03 on July 1, 2019, affects all the stages of an audit. When the auditor decides if they will accept or continue with a client they need to consider whether they have the expertise on the client’s industry, what if any specialist the client uses internally or externally and how this will impact the procedures the auditor will need to perform to sign an engagement letter with the client. In phase two risk assessment/planning, the auditor will need to consider the new guidelines for working with a company’s specialist to evaluate the risk of working the specialist, the specialist’s knowledge skill and ability in their area, and final the risk associated with their final product. Additionally, any ability the company may have to influence the specialist conclusions or findings. As such, when the auditor does control testing in phase three of the audit, the auditor will need to evaluate the controls of not only the company but those associate with the specialist and even the selection of how the company came to trust this specialist. Then the auditor will need to evaluate the work of the specialist as part of their substantive procedures in phase four of the audit. Finally, the auditor will need to conclude on the specialist work regarding the risk of material misstatement and the significance to issue their report.

Per AS 1105 Appendix A Note a Specialist is defined, “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. This appendix does not apply when the auditor uses the work of a person with specialized skill or knowledge in income taxes or information technology as audit evidence.”

USING THE WORK OF A SPECIALIST IN PHASE 1 OF THE AUDIT, ENGAGEMENT LETTER (ACCEPTANCE OR CONTINUATION)

As auditor’s work through the engagement letters for new client acceptance or continuation, the auditor should consider whether they will need to use the work of a specialist prior to signing the letter. The auditor’s need to ensure they have the necessary skills to complete an audit and whether they may need assistance from an outside specialist. Examples of specialists include but are not limited to: engineer, valuation specialist, actuary or appraisers for land, building, art, jewelry or natural resources. Ultimately the responsibility for the audit report and opinion rests on the audit firm.

USING THE WORK OF A SPECIALIST IN PHASE 2 THE AUDIT, RISK ASSESSMENT/ PLANNING

AS 2101.16-17, *Audit Planning*, describes the auditor’s responsibilities for determining whether specialized knowledge or skill is needed. This includes if an auditor’s specialist is needed to evaluate the work of a company’s specialist. If it is determined that a specialist is needed the new requirements layout specifically what should be done in the planning phase per AS 1105.A2. The standard states “The

requirements in AS 2110, *Identifying and Assessing Risks of Material Misstatement*, for obtaining an understanding of the company's information system relevant to financial reporting, include obtaining an understanding of the work and report(s), or equivalent communication, of the company's specialist(s) and related company processes and controls."

USING THE WORK OF A SPECIALIST IN PHASE 3 OF THE AUDIT OBTAINING EVIDENCE ABOUT INTERNAL CONTROL OPERATING EFFECTIVENESS

According to Appendix A of AS 1105 the auditor is to assess the knowledge, skill and ability of the Company's Specialist and the Specialist's Relationships to the Company. According to AS 1105.A3 and the Staff Guidance on Using the Work of a Company's Specialist, the auditor should understand the specialist qualifications including certification, experience, and reputation in the field they are serving as the specialist in. Additionally, the auditor needs to evaluate the specialist level of independence from the company. In order to accomplish this the auditor will evaluate the specialist relationship per AS 2410, *Related Parties*, circumstances for significant effect on the specialist by the company, reporting chain if internal specialist, financial and any other influence on the work performed per AS 1105.A4. The items previously noted for accessing the specialists' knowledge, skill and ability vary depending on the significance of the work the specialist performs and the associated impact the specialists' work has on the relevant assertions of the audit in regards to the risk of material misstatement. The more significant the work to the auditor's conclusion on the overall opinion, the more impactful the specialists work on the conclusion on the audit the more work the auditor needs to do around the specialist work.

USING THE WORK OF A SPECIALIST IN PHASE 4 OF THE AUDIT SUBSTANTIVE TESTING

As part of the auditors' substantive testing procedures, they will need to evaluate the work of the specialists engaged on the audit. The new guidelines for evaluating the work of the specialist are laid out in AS 1105 Appendix A paragraphs 6-9. In order to evaluate the specialist, the auditor needs to obtain persuasive audit evidence. Consistent with testing of controls and AS 1105.A7, the more impact the specialist work has on the following areas the more substantive procedures the auditor will need to perform. The auditor needs to examine each of the following areas: significance of the work of the specialist on the conclusion for a specific assertion, risk of material misstatement, the knowledge skill and ability of the specialist, and ability of the company to impact the specialist conclusions.

Per AS 1105. A8, "The auditor should: (a) test the accuracy and completeness of company-produced data used by the specialist, and evaluate the relevance and reliability of data from sources external to the company that are used by the specialist; (b) evaluate whether the significant assumptions used by the specialist are reasonable as follows...; (c) evaluate whether the methods used by the specialist are appropriate under the circumstances, taking into account the requirements of the applicable financial reporting framework." As such part of the auditors' substantive testing will be procedures to examine the reasonableness of significant assumptions made by the specialist, the methods used by the specialist, and the work performed by the specialist. In AS 1105.A8b(1-3) and broken down in the Staff Guidance on Using the work of a Company's Specialist, there is specific guidance around significant assumptions made by specialists and steps to take for the auditor to become comfortable with the specialist assumptions. Some items to consider if relevant are as follows: generally accepted standards in a field, market estimates, company's objectives, etc.... The audit procedures performed on the specialist will align with the relevant assertions needed to support the auditor's conclusion on the engagement. After this the auditor will need to evaluate the specialists' findings and compare them to relevant assertions. Ultimately, the goal of the substantive procedures regarding the specialist is like that of other work performed on by the auditors which is to obtain sufficient evidence to support the auditor's conclusion in the opinion.

The new release also amends AS 1201.05-06 and adds an Appendix C for the supervisory principles for working with a company's specialist. Some items of note include communicating the work to be done to the specialist, coordinating with the overall audit teams' work and reviewing and evaluating like what is stated in AS 1105 Appendix A. It also amends the requirements for evaluating the knowledge, skills and ability of specialist. The release of Using the Work of a Company's Specialist also supersedes AS 1210.

USING THE WORK OF A SPECIALIST IN PHASE 5 OF THE AUDIT REPORTING

At the end of the engagement when the auditor decides the type of opinion to issue in regarding the company, the auditor needs to consider the work of the specialist. The auditor needs to understand, evaluate, and conclude on the reliance of the specialist work. The auditor should consider both the risk of material misstatement and the significance of the specialist work. The conclusion on the work on the specialist in conjunction with the work of the audit team throughout the phases of the auditor will result in the final reporting opinion of the auditor.

CONCLUSION

The guidance regarding the use of a company's specialist is explicitly laid out in Appendix A of AS 1105 which replaces the existing AS 1210. The guidance makes it very clear the responsibility auditors have over the user of a Company's Specialist. The effects of the guidance will impact all phases of an audit engagement. The guidance is implemented for audits on or after December 15, 2020.

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