

July 30, 2015

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

Re: PCAOB Staff Consultation Paper No. 2015-01

McGladrey LLP appreciates the opportunity to offer our comments on PCAOB Staff Consultation Paper No. 2015-01, *The Auditor's Use of the Work of Specialists*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We are pleased the PCAOB staff has conducted outreach as it considers ways to improve the standards that apply to the auditor's use of the work of specialists. The increasing complexity of information needed to account for transactions in today's business environment has caused our firm and our clients across many industries to use the work of specialists more often than in prior years. Because an auditor does not have the expertise of a person trained for another profession or occupation, it is imperative that auditors continue to be able to use the work of a specialist effectively and efficiently for complex or subjective matters that are potentially material to the financial statements and that require special skill or knowledge to obtain sufficient appropriate evidence.

We believe the proper use of the work of a specialist enhances audit quality in situations requiring specialized knowledge and subject matter expertise the auditor does not possess (i.e., subject matter other than audit and accounting). Furthermore, the audit deficiencies identified in the staff's consultation paper were failures to comply with the existing standard. We therefore believe the foundational elements of AU 336, *Using the Work of a Specialist*, should be retained. Clarifying and enhancing the auditor's responsibilities with respect to the work of specialists will be beneficial for auditors, registrants and investors. We support the staff's objective of improving the standards that apply to the auditor's use of the work of a specialist. However, we believe some of the alternatives proposed in the Staff Consultation Paper may have unintended consequences for non-Big Four firms and the clients they serve.

Our letter explains the use of the work of specialists in our current practice, our views on the potential need for improvement of the standards to address certain operational challenges related to the auditor's use of the work of specialists, and our conclusions regarding possible alternatives discussed in the Staff Consultation Paper.

The use of the work of specialists in our current practice

We use the work of specialists in approximately 80 percent of our audits conducted in accordance with PCAOB standards. Activities for which we most commonly use the work of specialists include the following:

- Valuation specialists for fair value of reporting units in analyzing goodwill impairment
- Valuation specialists for valuation of securities and other complex financial instruments
- Valuation specialists for assets acquired and liabilities assumed in business combinations
- Valuation specialists for intangible asset impairment
- Actuaries for pension and other post-employment obligations

When auditing accounting estimates, auditor's specialists may be used to assist in testing the company's estimation process or in developing an independent estimate. Factors that impact our engagement partners' decisions as to how to use the work of an auditor's specialist in the auditing of an accounting estimate most effectively (i.e., in testing the company's estimation process or developing an independent estimate) include the following, among others:

- The nature of the account for which the estimate is developed.
- The complexity of the estimate. For less complex estimates, it may be efficient and effective to develop an independent expectation of the estimate. For more complex estimates, the development of an independent expectation might be cost prohibitive.
- Whether management has employed or engaged a specialist.
- The level of estimation uncertainty involved in the estimate. Specifically, when there is high estimation uncertainty, the auditor is more likely to test the company's estimation process.
- The depth of knowledge and experience of the engagement team with respect to the estimate.

When we engage a specialist, we usually are not told the number of hours the specialist worked on the audit engagement. However, for audits in which the work of an auditor's engaged specialist is used, we estimate the specialist's hours comprise, on average, less than five percent of the total engagement hours. For audits in which the work of an auditor-employed specialist is used, we estimate the specialist's hours comprise, on average, approximately five percent of the total engagement hours.

Potential need for improvement and alternatives discussed in the Staff Consultation Paper

Evaluating the work of the company's specialist

We believe the core principle of AU 336, when appropriately applied, provides the auditor with a fundamental basis for evaluating the work of a company's specialist. Although certain clarifying enhancements could be made to AU 336 as discussed below, we believe the basic framework of AU 336 should be maintained because it provides the appropriate basis for evaluation of the work of a company's specialist.

Per page 22 of the Staff Consultation Paper, "...the staff is exploring whether the auditor should evaluate the work of a company's specialist in the same manner as other information produced by the company is evaluated." This potential revision would require the auditor to evaluate the appropriateness of the methods and models, test the data used and evaluate the reasonableness of significant assumptions as if the information was produced by the company. Such a requirement would not be practical, and may not even be possible, for the following reasons, among others:

- Because the company's specialist would possess special skills or knowledge in a field other than accounting or auditing, it is probable that the auditor would not have the necessary expertise, and therefore would need to use the work of another specialist to evaluate the work of the company's specialist. This duplication of efforts would result in audit inefficiencies and increased costs to the issuer. Such increased costs could discourage issuers from using specialists, which could have a detrimental effect on the quality of the financial statements.
- In an audit of internal control over financial reporting that is integrated with an audit of financial statements, the auditor would be required to evaluate and test the design effectiveness and operating effectiveness of the internal controls of the company's specialist, the cost of which we believe would outweigh any potential benefit to investors.

When making enhancements to AU 336 for evaluating the work of a company's specialist, consideration should be given to International Standard on Auditing (ISA) 500, *Audit Evidence*, and AU-C 500, *Audit Evidence*, which provide application guidance that is incremental to AU 336 and are sufficient when evaluating the work of the company's specialist. For example, paragraph 8(c) of ISA 500 requires the auditor, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, to evaluate the appropriateness of the expert's work as audit evidence for the relevant assertion. This is supplemented by application guidance in paragraph A48, which states:

"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."

Developing a separate standard for using the work of an auditor's specialist

To avoid confusion, we agree that it makes sense for the PCAOB to develop a standard for using the work of an auditor's specialist that is separate from the standard for using the work of a company's specialist. The International Auditing and Assurance Standards Board and the Auditing Standards Board both already have developed separate standards:

- ISA 620, *Using the Work of an Auditor's Expert*, and AU-C 620, *Using the Work of an Auditor's Specialist*, which apply to the use of the work of an auditor's employed or engaged specialist
- ISA 500 and AU-C 500, which apply to the evaluation of the sufficiency and appropriateness of evidence prepared using the work of a company's specialist

Requirements in a separate standard for the use of the work of an auditor's specialist should apply to a specialist employed or engaged by the auditor, similar to the approach used in ISA 620 and AU-C 620. The requirements in ISA 620 and AU-620 provide more detailed guidance than those of AU 336 and therefore should be included in a new separate standard. Also, that guidance is already familiar to auditors who perform audits under International Standards on Auditing and U.S. generally accepted auditing standards.

We believe there should continue to be a distinction between an auditor's engaged specialist and an auditor's employed specialist in that an auditor's engaged specialist should not be considered a member of the engagement team. The supervision requirements in PCAOB Auditing Standard (AS) No. 10, *Supervision of the Audit Engagement*, should not be extended to an auditor's engaged specialist because the specialist or the specialist's firm is responsible for their own system of quality control, including supervision and review and it would not be practicable, other than by using an auditor-employed specialist, for the auditor to supervise and review the work of the engaged specialist.

Applying the requirements of SEC Regulation S-X Rule 2-01 to an auditor's engaged specialist

PCAOB Rule 3520, *Auditor Independence*, requires an auditor's employed specialist to be independent of the company. Under PCAOB standards, an accounting firm is required to have quality control policies and procedures to provide reasonable assurance that personnel maintain independence in all required circumstances, perform all professional responsibilities with integrity and maintain objectivity in discharging professional responsibilities.

The staff has included a potential requirement to subject an auditor's engaged specialist to the requirements and restrictions that apply to covered persons in the accounting firm under Rule 2-01 of SEC Regulation S-X. We do not believe this requirement would be practicable because the vast majority of specialists do not have the quality control systems needed to monitor compliance with Rule 2-01 and thus would likely be unable to comply. Such a requirement could reduce the number of specialists who are willing to be engaged by auditors because they may not be willing to implement the required processes and procedures, nor make the necessary disclosure of their personal financial information, to demonstrate compliance with Rule 2-01. This problem would be especially challenging for non-Big Four firms who do not employ the majority of the specialists they use and may not be able to continue to engage specialists due to the lack of availability of specialists and/or the increased cost of engaging the specialists.

Although an auditor's engaged specialist currently is not required to be independent of the company, AU 336.10 already requires the auditor to evaluate the relationship between an auditor's engaged specialist and the company, including circumstances that might impair the specialist's objectivity. We believe an enhanced objectivity alternative should be developed to provide additional specificity about how the auditor would be required to evaluate whether the auditor's engaged specialist has the necessary objectivity for the auditor's purposes. We believe such an evaluation of objectivity should be similar to that in ISA 620 and AU-C 620 and should include:

- Inquiry of the company and the auditor's engaged specialist regarding any known interests or relationships the company has with the auditor's engaged specialist that may create a threat to the objectivity of the auditor's engaged specialist
- Discussion with the auditor's engaged specialist of any applicable safeguards, including any professional requirements applying to that specialist, and evaluate whether the safeguards are adequate to reduce threats to an acceptable level
- A determination, based on the evaluation of that information, whether the objectivity of the auditor's engaged specialist is impaired

Such procedures should be limited to inquiry and other knowledge gained in the audit, and should not extend to procedures to corroborate the inquiries. Also, the auditor's inquiries of the specialist should be sufficient to obtain information about the process used by the auditor's engaged specialist to formulate responses to the auditor's inquiries. Further, interests and relationships that may be relevant should include business, employment and financial relationships between the auditor's engaged specialist and the company. Because the auditor's engaged specialist most likely will not have the necessary quality control policies and procedures in place, financial interests considered only should include the financial interests of the individual specialist(s) who is serving on the audit engagement and those who could influence the outcome of the specialist's work. Consideration should not extend to the financial interests of others in the specialist's firm.

Supervising the auditor's employed specialist

When we use the work of an auditor's employed specialist, such as a valuation specialist, we find that overall there is enough guidance in AS 10 regarding supervising the work of the employed specialist. However, as the specialized skills and knowledge of the auditor's employed specialist become further removed from the fields of accounting and auditing, such as geology and engineering, it becomes more difficult to fully apply the requirements of AS 10. For example, it would be difficult for the engagement partner and, as applicable, other engagement team members performing supervisory activities, to inform such specialists of their responsibilities, including, among others, the nature, timing and extent of procedures they are to perform as required by paragraph 5.a. of AS 10. Also, it would be difficult for the engagement partner and other engagement team members performing supervisory activities to review the work of such a specialist to evaluate whether the objectives of the procedures were achieved as required by paragraph 5.c.2. of AS 10. Therefore, we recommend that interpretive guidance to clarify the supervisory activities related to the use of an auditor's employed specialist be specified in AS 10 and then referenced to the new standard for using the work of an auditor's specialist.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to Sara Lord, National Director of Assurance Services, at 612.376.9572.

Sincerely,

A handwritten signature in cursive script that reads "McGladrey LLP".

McGladrey LLP