

MEMO# 31937

September 5, 2019

PCAOB Issues Staff Guidance on Auditing the Fair Value of Financial Instruments

[31937]

September 5, 2019 TO: ICI Members SUBJECTS: Audit and Attest
Valuation RE: PCAOB Issues Staff Guidance on Auditing the Fair Value of Financial
Instruments

The PCAOB issued staff guidance for auditors as they begin to plan and perform audits under two recently adopted audit standards, AS 2501 *Auditing Accounting Estimates and Fair Value Measurements*,[\[1\]](#) and AS 1210 *Using the Work of an Auditor Engaged Specialist*. These new audit standards were recently approved by the SEC and are effective for audits of financial statements for fiscal years ending on or after December 15, 2020. The staff guidance describes relevant considerations for auditing the fair value of financial instruments when pricing information from pricing services, broker-dealers, and other third-party sources is used.[\[2\]](#)

The staff guidance describes how the approach to auditing the fair value of financial instruments based on third-party pricing information under AS 2501 consists of identifying and assessing the risks of material misstatement associated with the valuation of financial instruments, and performing procedures to determine whether the pricing information provides sufficient appropriate evidence to respond to those risks. The risks of material misstatement and the specific procedures depend on the nature of the financial instruments and the pricing information.

The guidance indicates that identifying and assessing the risks of material misstatement requires the auditor to obtain an understanding of the nature of the financial instruments, including their terms and characteristics, the extent to which the fair value is based on inputs that are observable directly or indirectly, and other factors affecting fair value such as credit or counterparty risk, market risk, and liquidity risk. Auditors may group or stratify financial instruments by type when assessing the risk of material misstatement.

Once the auditor identifies and assesses the risk of material misstatement associated with the financial instruments, the auditor should design audit procedures to address those risks. This involves performing procedures to determine whether the pricing information provides sufficient appropriate evidence to respond to the risks of material misstatement, including assessing the reliability and relevance of the pricing information. The guidance

indicates that the specific procedures to be performed to determine whether pricing information provides sufficient appropriate evidence depends on the source of the information, namely pricing services, broker-dealers, or other sources.

The reliability of audit evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. According to the guidance, factors affecting the reliability of pricing information from a pricing service may include:

- Experience and expertise of the pricing service relative to the types of financial instruments being valued, including whether the types of financial instruments being valued are routinely priced by the pricing service;
- Whether the methodology used by the pricing service in determining fair value of the types of financial instruments being valued is in conformity with the applicable financial reporting framework; and
- Whether the pricing service has a relationship with the company by which company management has the ability to directly or indirectly control or significantly influence the pricing service.

The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The guidance describes factors affecting the relevance of pricing information from pricing services. For fair values based on transactions in similar financial instruments, factors affecting relevance may include how the transactions are identified and considered comparable to the financial instrument being valued. Examples of additional audit procedures in this circumstance may include evaluating the process used by the pricing service, including how transactions are identified, considered comparable, and used to value the types of financial instruments identified for testing.

The guidance also addresses fair value measurements based on broker quotes. Such quotes provide more relevant and reliable evidence when they are timely, binding quotes, without any restrictions, limitations, or disclaimers from unaffiliated market makers transacting in the same type of financial instrument. If the broker quote does not provide sufficient appropriate evidence, the auditor is required to perform procedures to obtain relevant and reliable pricing information from another source (for example, obtaining a quote from a different broker-dealer, obtaining pricing information from a pricing service, or developing an independent expectation).

Gregory M. Smith
Senior Director, Fund Accounting and Compliance

endnotes

[1] For a summary of AS 2501 see ICI Memorandum No. 31532 (December 21, 2018) available at: https://www.ici.org/my_ici/memorandum/memo31532.

[2] PCAOB Staff Guidance, *Auditing the Fair Value of Financial Instruments* (August 22, 2019) is available at: <https://pcaobus.org/Standards/Documents/Staff-Guidance-Auditing-Fair-Value-Financial-Instruments.pdf>. The PCAOB concurrently issued staff guidance addressing auditing accounting estimates, supervising or using the work of an auditor's specialist, and using the work of a

company's specialist. The staff guidance is available at:
<https://pcaobus.org/Standards/Pages/Guidance.aspx>.

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