**MEMO# 31532**

December 21, 2018

# PCAOB Finalizes Fair Value Measurement Audit Standard

[31532]

December 21, 2018 TO: ICI Members SUBJECTS: Audit and Attest Valuation RE: PCAOB Finalizes Fair Value Measurement Audit Standard

The Public Company Accounting Oversight Board recently adopted a new audit standard on accounting estimates, including fair value measurements.[1] The new standard replaces three existing standards by establishing a single standard that sets forth a uniform risk-based approach to auditing estimates[2] and fair value measurements. *Auditing Accounting Estimates* (AS 2501) will be updated and retitled *Auditing Accounting Estimates, Including Fair Value Measurements*. Two other standards, *Auditing Fair Value Measurements* (AS 2502) and *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AS 2503), will be superseded. Subject to approval by the SEC, the final standard and related conforming amendments to other audit standards will take effect for audits of financial statements for fiscal years ending on or after December 15, 2020.

## New Audit Standard

The three audit standards described above were originally adopted between 1988 and 2003. They include common approaches for substantive testing of accounting estimates and fair value measurements but vary in the level of detail in describing the auditor's responsibilities. The three standards predate the Board's risk assessment standards and do not fully integrate risk assessment requirements that relate to identifying, assessing, and responding to the risk of material misstatement.

The new standard builds on the common approaches in the three existing standards and strengthens audit requirements in the following ways:

- Providing direction to prompt auditors to devote greater attention to addressing potential management bias in accounting estimates, as part of applying professional skepticism;
- Extending certain key requirements in the existing standard on fair value measurements to other accounting estimates in significant accounts and disclosures, reflecting a more uniform approach to substantive testing for estimates;
- More explicitly integrating requirements in the Board's risk assessment audit standards to focus auditors on estimates with greater risk of material misstatement;
- Making other updates to the requirements for auditing accounting estimates to

provide additional clarity and specificity; and
- Providing a special topics appendix to address certain aspects unique to auditing fair values of financial instruments, including the use of pricing information from third parties such as pricing vendors and broker-dealers.

## Special Topics Appendix Addressing Use of Pricing Information from Third Parties

The new audit standard includes a special topics appendix that addresses the identification and assessment of the risks of material misstatement related to the fair value of financial instruments, and the use of pricing information from third parties as audit evidence. The special topics appendix requires the auditor to determine whether pricing information obtained from third parties, such as pricing services and broker-dealers, provides sufficient appropriate evidence by:

- Establishing factors that affect relevance and reliability of pricing information obtained from a pricing service.
- Requiring the auditor to perform additional audit procedures to evaluate the process used by the pricing service when fair values are based on transactions in similar financial instruments;
- Requiring the auditor to perform additional procedures on pricing information obtained from a pricing service when no recent transactions have occurred for either the financial instrument being valued or similar financial instruments;
- Establishing conditions under which less information is needed about particular methods and inputs of individual pricing services in circumstances where prices are obtained from multiple pricing services; and
- Establishing factors that affect the relevance and reliability of quotes from broker-dealers.

Commenters on the Board's proposal questioned certain aspects of the special topics appendix including: 1) the extent to which audit procedures could be performed over groups or classes of financial instruments, rather than individual instruments, and 2) the role played by centralized groups within an audit firm, such as a pricing desk, in performing procedures related to testing the fair value of financial instruments.

As to the first area of comment, the adopting release explains that the Board did not intend that all required procedures in the special topics appendix be applied to individual financial instruments in all cases. Rather, the Board intended that financial instruments with similar characteristics and risks could be grouped for purposes of applying substantive procedures. On the second area of comment, the adopting release explains that the new audit standard does not prescribe the role or responsibilities of centralized pricing groups. Instead, the new standard allows engagement teams to continue seeking assistance from centralized groups when performing required procedures.[3] Additionally, the new standard does not prescribe who is to perform required procedures with respect to pricing services. The determination of whether the due diligence procedures over a pricing service should be performed by an engagement team or by the audit firm's centralized pricing desk is at the discretion of the auditor.

In response to comments by the Institute and others, the special topics appendix includes a note clarifying that the existence of a process by which funds can challenge a pricing service's pricing information does not, by itself, mean that fund management has the ability to directly or indirectly control or significantly influence that pricing service.

The new standard does not affect the requirement for auditors to SEC-registered investment companies to independently verify 100 percent of the fair value measurements used by the fund at the balance sheet date.[4]

## Amendments to Audit Evidence (AS 1105)

The Board's proposal added an appendix to AS 1105 that would have retained and updated certain requirements from AS 2503 for situations in which the valuation of an investment selected for testing is based on the investee's financial condition or operating results. That appendix would have addressed, for example, investments in private placements where the fair value measurement is based on a multiple of revenue or earnings derived from the investee's financial statements. The appendix in the proposal would have required the auditor to obtain and evaluate information about the professional reputation and standing of the investee's auditor and obtain information about the procedures the investee's auditor performed and the related results, or review the audit documentation of the investee's auditor.

In its comments on the proposal the Institute expressed concern that the requirement to obtain information about the procedures the investee's auditor performed and the related results, or to alternatively review the investee auditor's audit documentation was not practical. Where the investor is a fund that invests in many different private placement securities, the proposed requirement would add significantly to the work performed by the investor fund's auditor. ICI also questioned whether the investor fund's auditor would have access to the investee auditor's audit documentation as contemplated by the proposal. We are pleased to report that the Board did not adopt the proposed changes described above. Instead the Board retained the existing requirements from AS 2503 with only limited conforming changes.

The proposed appendix to AS 1105 also addressed investment company investment in other funds. The proposal indicated that, unless the investor fund's auditor has doubt about the investee fund's auditor, the investor fund's auditor may test the investor fund's procedures for understanding and assessing the investee fund's valuation process, rather than obtaining information about the audit of the investee fund or reviewing audit documentation. The Institute's comment letter supported the audit approach described in the proposed appendix and recommended that the Board clarify that it would apply to investments in private funds (and not to investments in SEC-registered mutual funds, because those funds have readily determinable fair values). As noted above the Board did not adopt the proposed appendix to AS 1105 and instead carried over the existing requirements from AS 2503 with limited conforming changes.

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**endnotes**

[1] The audit standard, *Auditing Accounting Estimates, Including Fair Value Measurements* (AS 2501) is available on the PCAOB website at https://pcaobus.org/Rulemaking/Docket043/2018-005-estimates-final-rule.pdf. The PCAOB concurrently adopted amendments to its auditing standards intended to strengthen the

requirements that apply when auditors use the work of specialists in an audit. The amendments relating to the use of specialists are available on the PCAOB website at https://pcaobus.org/Rulemaking/Docket044/2018-006-specialists-final-rule.pdf.

[2] Estimates are broader than fair value measurements and may appear in, for example, revenues from contracts with customers, valuation of certain nonfinancial assets, impairments of long-lived assets, allowances for credit losses, and contingent liabilities.

[3] Centralized groups within the audit firm that assist engagement teams with evaluating the specific methods and assumptions related to a particular instrument, identifying and assessing risks of material misstatement, or evaluating differences between the fund's price and the pricing service's price generally would be subject to the supervision requirements of AS 1201, *Supervision of the Audit Engagement.*

[4] *See* SEC Codification of Financial Reporting Policies Section 404.03, *Accounting, Valuation and Disclosure of Investment Securities,* Accounting Series Release No. 118 (December 23, 1970).

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