

**MEMO# 28333**

August 22, 2014

# **PCAOB Staff Paper Seeks Comment on Auditing Accounting Estimates and Fair Value Measurements**

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 21-14  
END OF DAY PRICING FORUM No. 2-14 RE: PCAOB STAFF PAPER SEEKS COMMENT ON  
AUDITING ACCOUNTING ESTIMATES AND FAIR VALUE MEASUREMENTS

The Public Company Accounting Oversight Board recently released a staff consultation paper seeking comment on standard-setting activities related to auditing accounting estimates and fair value measurements. [\[1\]](#) The paper was prepared by the Office of the Chief Auditor as part of its outreach efforts to seek input related to possible changes to existing auditing standards or a new auditing standard. [\[2\]](#) The PCAOB announced that its Standing Advisory Group will meet on October 2 to discuss matters related to auditing accounting estimates and fair value measurements.

Comments on the staff consultation paper are due to the PCAOB no later than November 3. If you have any concerns with the staff consultation paper, or otherwise think that ICI should submit a comment letter, please contact me at [smith@ici.org](mailto:smith@ici.org) or (202) 326-5851 no later than September 19.

## **Possible Approach to Standard-Setting**

The paper indicates that the staff is considering developing a single audit standard that would supersede existing standards: Auditing Fair Value Measurements and Disclosures (AU 328), Auditing Accounting Estimates (AU 342), and much of Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (AU 332). The potential new audit standard could be designed to::

- Align with existing audit risk assessment standards,
- Generally retain the approaches to substantive testing from AU 328 and AU 342, but include requirements that apply to both accounting estimates and fair value measurements,
- Establish more specific audit requirements related to the use of third parties in developing accounting estimates and fair value measurements, and
- Create a more comprehensive standard related to auditing accounting estimates and

fair value measurements to promote greater consistency and effectiveness.

The paper notes that existing audit standards prescribe three approaches for auditing accounting estimates and fair values:

- Testing management's process – the auditor generally evaluates significant assumptions used by management for reasonableness and tests the data used, including evaluating whether the data is complete, accurate and relevant. The auditor also evaluates the consistency of assumptions used by management.
- Developing an independent estimate – the auditor can use management's or alternative assumptions to develop an independent estimate or an expectation as to the estimate.
- Reviewing subsequent events or transactions – the auditor can use events or transactions occurring subsequent to the balance sheet date but prior to the date of the auditor's report to provide evidence about the reasonableness of the estimate.

The paper indicates that research and outreach conducted by the staff to date have not lead the staff to conclude that these approaches should be replaced. The staff paper does not specifically address the requirement for auditors of SEC registered investment companies to independently verify all quotations used by the fund at the balance sheet date.

### **Developing an Independent Estimate: Evaluating Evidence from Third-Party Sources**

The paper indicates that the staff is considering how a potential new standard could address audit evidence obtained from third-party sources, such as pricing services and broker-dealers. The staff paper recognizes the nature of evidence obtained from third-party sources varies based on the type of instrument being valued and the source of information used by pricing services. Some pricing services provide consensus prices, while others use their own methodology based on various market data obtained or derived from other sources, including trades of comparable instruments, broker quotes, and historical trade activity to determine a value. The paper indicates the staff is exploring whether a new standard should set forth specific requirements for evaluating information from third-party pricing sources as part of evaluating the relevance and reliability of the evidence pursuant to AS No. 15: Audit Evidence.

Under the approach being considered, the auditor would first evaluate the reliability of the evidence provided by the third-party pricing source, taking into account certain factors. For example, the auditor would consider a) the experience and expertise of the third-party relative to the type of asset being valued, and b) the methods used by the third-party in determining the fair value for the specific company's assets being tested and whether the methodology used is in conformity with the applicable financial reporting framework. The auditor would then evaluate whether the evidence provided by the third-party source is relevant to the fair value measurement by determining:

- Whether fair values are based on trades of the same instrument or active market quotations,
- When the fair values are based on transactions of comparable assets, how those transactions are identified and considered comparable,
- When there are no transactions either for the asset or comparable assets, how the information was developed including whether the inputs developed represent the

assumptions that market participants would use when pricing the asset, or

- When the fair value measurement is based on a broker quote, whether the quote (i) is from a market-maker who transacts in the same type of financial instrument, and (ii) is binding or nonbinding, with more weight placed on quotes based on binding offers.

The staff paper then asks a series of questions relating to the proposed approach, including:

- Would the factors noted above help the auditor in evaluating the reliability and relevance of evidence obtained from third-party pricing sources? Are there other factors that are applicable in determining the reliability or relevance of such evidence?
- Are there other approaches to testing evidence obtained from third-party pricing sources that the staff should consider?
- Would the approach address the various methods used by third-party pricing sources for determining fair value measurements (e.g., use of consensus pricing and proprietary models)?

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#### **endnotes**

[1] The staff consultation paper is available at [http://pcaobus.org/Standards/Documents/SCP\\_Auditing\\_Accounting\\_Estimates\\_Fair\\_Value\\_Measurements.pdf](http://pcaobus.org/Standards/Documents/SCP_Auditing_Accounting_Estimates_Fair_Value_Measurements.pdf).

[2] These outreach efforts include meetings held by the Board's Pricing Sources Task Force during 2011 in which representatives of several ICI member firms participated.