

**MEMO# 30798**

July 25, 2017

## **PCAOB Issues Proposal on Auditing Accounting Estimates**

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TO: Accounting/Treasurers Committee  
Security Valuation Operations Committee RE: PCAOB Issues Proposal on Auditing Accounting Estimates

The Public Company Accounting Oversight Board recently issued for public comment a proposal to amend its audit standards relating to auditing accounting estimates and fair value measurements.<sup>[1]</sup> The Estimates Proposal seeks to focus the auditor's attention on the most significant estimates in the financial statements and the potential for management bias in those estimates.<sup>[2]</sup> The Estimates Proposal reflects input from the Board's Pricing Sources Task Force and comments on the PCAOB staff consultation paper, *Auditing Accounting Estimates and Fair Value Measurements*.<sup>[3]</sup> Comments on the Estimates Proposal are due to the PCAOB by August 30, 2017.

**The Institute is considering whether to file a comment letter on the Estimates Proposal. If you have specific comments or concerns, please contact the undersigned (202-326-5851 or [smith@ici.org](mailto:smith@ici.org)) by August 4.**

### **Estimates Proposal**

Currently there are three PCAOB auditing standards that address auditing accounting estimates, including fair value measurements: *Auditing Accounting Estimates* (AS 2501), *Auditing Fair Value Measurements and Disclosures* (AS 2502), and *Auditing Derivative Instruments, Hedging Activities and Investment Securities* (AS 2503). These standards include common approaches for substantively testing accounting estimates, including fair value measurements. The standards vary, however, in their level of detail in describing those approaches. The PCAOB is proposing to replace the three standards with a single standard, *Auditing Accounting Estimates, Including Fair Value Measurements*, and to amend the risk assessment standards to more specifically address certain aspects of auditing accounting estimates.

The Estimates Proposal retains the three basic approaches currently in existing standards to substantively test an accounting estimate: i) testing management's process, ii) developing an independent estimate, and iii) reviewing subsequent events or transactions.<sup>[4]</sup> The Estimates Proposal indicates that where an auditor develops an

independent expectation of the fair value of a financial instrument using pricing information from a third party, the auditor should evaluate whether the pricing information provides sufficient appropriate audit evidence to respond to the risks of material misstatement. The Estimates Proposal includes, as part of the proposed single standard, a special topics appendix to guide the auditor in determining whether pricing information from pricing services and broker dealers provides sufficient appropriate audit evidence.

### **Special Topics Appendix - Fair Value of Financial Instruments**

The special topics appendix recognizes that fair values of financial instruments based on trades of the same instruments in an active market generally have a lower risk of material misstatement than the fair values of instruments based on similar instruments or unobservable inputs. The special topics appendix describes factors that affect the reliability of pricing information provided by a pricing service including: i) the experience and expertise of the pricing service relative to the types of financial instruments being valued, including whether the financial instruments being valued are routinely priced by the pricing service, ii) whether the methodology used by the pricing service in determining fair value of the financial instrument is in conformity with the applicable financial reporting framework, and iii) 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 special topics appendix recognizes that many financial instruments are not traded actively and that the available audit evidence consists of market data for trades of similar financial instruments or trades for the identical instrument in an inactive market. How a pricing service identifies transactions comparable to the financial instrument being valued affects the relevance of the pricing information provided as audit evidence. The auditor would be required to perform additional audit procedures to evaluate the process used by the pricing service when fair values are based on transactions in similar instruments. The appendix recognizes that the procedures performed by the auditor may vary depending on the process used by the pricing service and could include, for example, evaluating how comparable transactions are selected and monitored or how matrix pricing is developed.

Broker quotes are sometimes used by companies as a basis for the fair value measurement of a financial instrument. The special topics appendix includes factors that address the relevance and reliability of a broker quote including: i) the broker is free of relationships with the company by which company management can directly or indirectly control or significantly influence the broker, ii) the broker making the quote is a market maker that transacts in the same type of financial instrument, iii) the broker quote reflects market conditions at the financial statement date, iv) the broker quote is binding, and v) there are restrictions, limitations, or disclaimers on the quote and their nature. If the broker quote does not provide sufficient appropriate evidence, the auditor would be required to perform procedures to obtain relevant and reliable pricing information from another source.

### **Audit Evidence**

The Estimates Proposal would also make changes to *Audit Evidence* (AS 1105). Those changes address situations in which the fair value measurement of a financial instrument is based on the investee's financial condition or operating results (e.g., a private placement security). The changes emphasize that the persuasiveness of the evidence needed by the auditor increases as the significance of the investee's financial condition and operating results to the valuation of the investment and the risk of material misstatement increase. If the investee's audited financial statements are significant to the valuation of the fund's

investment, the auditor should determine whether the audit of the investee provides sufficient appropriate audit evidence by i) evaluating information about the professional reputation of the investee's auditor, ii) considering information about the procedures the investee's auditor performed.

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#### endnotes

[1] The proposal, *Proposed Auditing Standard - Auditing Accounting Estimates, Including Fair Value Measurements*, PCAOB Release No. 2017-02 [June 1, 2017] (the Estimates Proposal) is available on the PCAOB website at <https://pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf>. At the same time the PCAOB issued for public comment a proposal to amend its audit standards relating to the auditor's use of the work of specialists. The proposal, *Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists*, PCAOB Release No. 2017-03 [June 1, 2017] is available on the PCAOB website at <https://pcaobus.org/Rulemaking/Docket044/2017-003-specialists-proposed-rule.pdf>.

[2] Accounting estimates for this purpose include certain valuations of financial and non-financial assets, impairments of long-lived assets, allowances for credit losses, contingent liabilities, and revenues from contracts with customers. A fair value measurement is considered a form of accounting estimate because it generally shares many of the same characteristics, including subjective assumptions and measurement uncertainty.

[3] See [ICI Memorandum No. 28503](https://www.ici.org/my_ici/memorandum/memo28503), dated November 3, 2014. Available at [https://www.ici.org/my\\_ici/memorandum/memo28503](https://www.ici.org/my_ici/memorandum/memo28503).

[4] Auditors to SEC registered funds typically employ the second of these three approaches. SEC Codification of Financial Reporting Policies, section 404.03c requires the auditor to independently verify all the quotations used by the company at the balance sheet date.