AICPA

Agenda Item 2C

Proposed SAS 143 Appendix ~~D~~C

Proposed Appendix to SAS 143, *Auditing Accounting Estimates and Related Disclosures*

.A129 When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions, and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's consideration of the nature, timing, and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class, rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker-indicative quotes for individual securities. ***Appendix D, "Use of Pricing Information from Third Parties as Audit Evidence", provides further guidance on the use of pricing information from third parties as audit evidence.*** SAS No. 142[55] provides guidance with respect to restrictions placed by the external information source on the provision of supporting information. ~~***Appendix D, "Use of Pricing Information from Third Parties as Audit Evidence", provides further guidance on the use of pricing information from third parties as audit evidence.***~~

APPENDIX ~~D~~ C —Use of Pricing Information from Third Parties as Audit Evidence

1. AU-C section 500, *Audit Evidence,* contains requirements and provides guidance about evaluating information to be used as audit evidence, including information from external information sources. This section provides guidance on complying with AU-C section 500 with respect to information to be used as audit evidence relating to accounting estimates, irrespective of the sources of information. This appendix provides additional guidance on meeting the requirements of this section as they relate to the fair value of financial instruments.

[55] Paragraphs 9 and A40 of AU-C section, *Audit Evidence*.

2. Audit procedures to identify and assess risks of material misstatement related to the fair value of financial instruments include obtaining an understanding of the nature of the financial instruments being valued, taking into account the following matters:
   a. The structural, contractual and performance features of the financial instruments, including terms affecting the timing and amount of cash flows, such as:
      - Time to maturity
      - Existence and nature of conversion features
      - Contractual interest rates and whether they are variable
      - Prepayment features
      - Type and quality of collateral.
   b. The extent to which the fair value of the type of financial instruments is based on inputs that are observable directly or indirectly; and
   c. Other factors affecting the valuation of the financial instruments, such as credit or counterparty risk, market risk, and liquidity risk.

Commented [AG1]: Added and moved to be more consistent with paragraph A1 of AS appendix

~~1.~~3. When the auditor uses pricing information from a third party to develop an independent expectation or evaluates pricing information provided by a third party used by the entity, procedures may include evaluating the reliability of information obtained from an external information source and determining whether information can be obtained, or whether the information is sufficiently detailed. The following paragraphs address pricing information from:

a. Organizations that routinely provide uniform pricing information to users, generally on a subscription basis ("pricing services"); and

b. Brokers or dealers.

Using Pricing Information from Pricing Services

~~2.~~4. The reliability of audit evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. The following factors affect the reliability of pricing information provided by a pricing service:

a. The 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;

b. Whether the methodology used by the pricing service in determining fair value of the types of financial instruments being valued is in accordance ~~conformity~~ with the applicable financial reporting framework; and

Commented [SL2]: Recommend revision for consistency with GAAP terms

c. Whether the pricing service has an~~y~~ interest~~s~~ or relationship~~s~~ with the entity by which management has the ability to directly or indirectly control or significantly influence the pricing service.

Commented [SL3]: Recommended edits to more closely align to PCAOB language and how it's written in #3 below

~~3.~~5. The procedures performed under section 550, *Related Parties*, can assist the auditor in determining whether the pricing service has an interest or relationship with the entity by which management has the ability to directly or indirectly control or significantly influence the pricing service. The existence of a process by which subscribers can challenge a pricing service's pricing information does not, by itself, mean that management has the ability to directly or indirectly control or significantly influence that pricing service.

~~4.~~6. If the auditor performs procedures to assess the reliability of pricing information provided by a pricing service at an interim date, the auditor may determine it necessary to evaluate whether the pricing service has changed its valuation process relative to the types of financial instruments being valued, and, if so, the effect of such changes on the pricing information provided at period end.

~~5.~~7. The relevance of audit evidence refers to its relationship to the assertion or to the objective of the control being tested. The following factors affect the relevance of pricing information provided by a pricing service:

a. Whether the fair values are based on ~~trades or transactable~~ quoted prices~~s~~ in active markets for identical financial instruments~~, where documentation of sufficient trade volume may provide appropriate audit evidence~~;

b. When the fair values are based on models that incorporate observable market inputs based on transactions of similar financial instruments, how those transactions are identified and considered comparable to the financial instruments being valued; and

c. When no recent transactions have occurred for either the financial instrument being valued or similar financial instruments, how the fair value was developed, including whether the inputs used represent the assumptions that market participants would use when pricing the financial instruments; whether the price was developed using a model with one or more significant inputs that were not observable in the marketplace; or whether the price was developed using a non-binding quote from a broker or dealer

~~6.~~8. Fair values of financial instruments based on trades of identical financial instruments in an active market have a lower risk of material misstatement than fair values derived from observable trades of similar financial instruments or unobservable inputs. When the fair values are based on transactions of similar financial instruments, audit procedures to evaluate the process used by the pricing service may include evaluating how transactions are identified, considered comparable, and used to value the types of financial instruments selected for testing.

~~7.~~9. When a pricing service uses the same process to price a group of financial instruments, the audit procedures to evaluate the process ~~can~~ may be performed for those financial instruments as a group, rather than for each instrument individually, if the financial instruments are similar in nature. Considerations for determining the similarity of the financial instruments include ~~, taking into account:~~ the ~~following~~matters described in paragraph 2 of this appendix~~:~~.

Commented [AG4]: Revision to revert to AS language

~~a. The structural, contractual and performance features of the financial instruments, including terms affecting the timing and amount of cash flows, such as:~~

- ~~Time to maturity~~
- ~~Existence and nature of conversion features~~
- ~~Contractual interest rates and whether they are variable~~
- ~~Prepayment features~~
- ~~Type and quality of collateral.~~

~~b.~~a. ~~The extent to which the fair value of the type of financial instruments is based on inputs that are observable directly or indirectly; and~~

~~c.~~a. ~~Other factors affecting the valuation of the financial instruments, such as credit or counterparty risk, market risk, and liquidity risk.~~

~~8.~~10. When no recent transactions have occurred for either the financial instrument being valued or similar financial instruments, audit procedures may include evaluating the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs used by the pricing service.

Using Pricing Information from Multiple Pricing Services

~~9.~~11. When pricing information is obtained from multiple pricing services, less information ~~is~~ may be needed about the particular methods and inputs used by the individual pricing services ~~such as~~ when the following conditions are met:

Commented [SL5]: This could be construed as an "implied requirement" as currently drafted. Suggested edits to more clearly make it guidance.

a. There are recent trades of financial instruments substantially similar in structural, contractual and performance features to the financial instruments being valued;

b. The type of financial instrument being valued is routinely priced by several pricing services;

c. Prices obtained are reasonably consistent across pricing services, taking into account the nature and characteristics of the financial instruments being valued, and market conditions; and

d. The pricing information for the type of financial instrument is generally based on inputs that are observable.

~~10.~~12. When the above conditions are not met, audit procedures may include evaluating the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs for a representative price for the type of financial instrument being valued.

Using Pricing Information from a Broker or Dealer

~~11.~~13. When a fair value measurement is based on a quote from a broker or dealer ("broker quote"), the relevance and reliability of the evidence provided by the broker quote depend on whether:

a. The broker or dealer has an interest or relationship with the entity by which management has the ability to directly or indirectly control or significantly influence the broker or dealer;

b. The broker or dealer making the quote is a market maker that transacts in the same type of financial instrument;

c. The broker quote reflects market conditions as of the ~~financial statement~~ date of the financial statements;

d. The broker quote is binding on the broker or dealer; and

e. There are any restrictions, limitations, or disclaimers in the broker quote and, if so, their nature.

~~12.~~14. Broker quotes generally 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 audit evidence, additional procedures to obtain relevant and reliable pricing information from another pricing source may be necessary.

~~13.~~15. The procedures performed under section 550, *Related Parties*, can assist the auditor in determining whether the broker or dealer has an interest or relationship with the entity by which management has the ability to directly or indirectly control or significantly influence the broker or dealer.

Unobservable Inputs

~~14.~~16. When the valuation of a financial instrument includes unobservable inputs that are significant to the valuation, obtaining an understanding of how unobservable inputs were determined and evaluating the reasonableness of the unobservable inputs may include taking into account the following:

a. Whether modifications made to observable information generally reflect the assumptions that market participants would use when pricing the financial instrument, including assumptions about risk; and

b. How management determined its fair value measurement, including whether it appropriately considered the information available.

Commented [SL6]: Suggested revisions to more closely align to rest of GAAS

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