



DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

A&A UPDATE

January 3, 2012

Subscribe to receive Dixon Hughes Goodman A&A Updates at: www.dhglp.com/subscribe.
Select DHG Advisory Bulletin in the subscription form.

SEC, PCAOB Place Emphasis on Fair Values and Use of Third-Party Pricing Services

Comments from the staff of the Securities and Exchange Commission and the Public Company Accounting Oversight Board indicate an increased focus in the determination of the fair value of investments. In particular, they are interested in how management supports, and how the auditors audit, the valuation assertion when companies use third-party pricing services to determine the fair value of investments that are not exchange-traded, which are typically classified as Level 2 or Level 3 under the fair value hierarchy in ASC 820.

Examples frequently encountered include debt securities such as bonds issued by U.S. Government Agencies or Government Sponsored Entities (GSEs), mortgage-backed securities (MBSs) issued by Agencies or GSEs, mortgage-backed securities issued by banks, brokerage firms, or others (private label MBSs), collateralized debt obligations (CDOs), collateralized mortgage obligations (CMOs), auction rate securities and obligations of state governments and local municipalities.

The securities in focus trade infrequently after initial issuance, and are often priced by reference to either infrequent trades prior to the valuation date, or by reference to similar securities more recently issued.

Recent SEC Staff Communications

The SEC staff has recently discussed management's responsibility for fair value measurements in meetings and speeches. The staff has emphasized that management retains the responsibility for the fair presentation of the financial statements, to maintain accurate books and records, and to maintain appropriate internal controls to prevent or detect material misstatements of the financial statements and periodically assess those internal controls. As it relates to the use of third-party pricing sources, the staff has stated that in order to meet their responsibilities, management must have a sufficient understanding of the valuation methods, assumptions and inputs used by third-party pricing sources in valuing investment securities.

The SEC Staff has stated management must understand the valuation methods, assumptions and inputs used by third-party pricing sources.

Further, for compliance with Section 404(a) of the Sarbanes Oxley Act relating to internal controls over financial reporting, management should be assessing the risk of material misstatement relating to estimating fair value measurements. Such considerations may include:



- Nature and complexity of securities involved;
- Level of market activity for securities; and
- Availability of market data

More specific guidance on how management might fulfill their responsibilities was included in a [December 5, 2011 speech](#) by Jason Plourde, a Professional Accounting Fellow in the Office of the Chief Accountant, at the AICPA's 2011 National Conference on Current SEC and PCAOB Developments.

Recent PCAOB Activities

The PCAOB has demonstrated its focus on the use of third-party pricing services by comments from inspections and by appointing a Pricing Sources Task Force to consider issues related to auditing the fair value of certain financial instruments. The Pricing Sources Task Force consists of members from pricing services, brokerage firms, investors, issuers, and audit firms. The purpose of the Task Force is to assist the Office of the Chief Auditor to gain insight into current issues related to auditing the fair value of financial instruments, which may be used to develop additional guidance or in standard setting.

In recent inspection reports of annually inspected accounting firms, the PCAOB has cited deficiencies in the firms' testing of fair value measurements and disclosures of financial instruments without readily determinable fair values. Deficiencies cited include:

- Failure to obtain an understanding of the specific methods and/or assumptions underlying certain fair value measurements
- Failure to adequately test the issuer's disclosures of certain hard-to-value investments as Level 2 or Level 3 because the firm failed to obtain an understanding of whether significant inputs were observable or unobservable
- Failure to obtain sufficient audit evidence to support the opinion on the effectiveness of internal control over financial reporting

As a Result

Issuers and their auditors will need to consider their use of third-party pricing sources as part of their evaluation of internal controls over financial reporting. The depth of their understanding of valuation methods and models, inputs, and assumptions depends upon a number of factors, including the significance of and risk of material misstatement relating to investments being valued and the extent of reliance the issuer places on the third-party pricing service.

1.866.625.0017 | dhgllp.com

© 2011 by Dixon Hughes Goodman LLP. All rights reserved. Permission is granted to view, store, print, reproduce and distribute any pages of this Newsletter provided that (a) no page is modified and (b) this page is included with any distribution.

Disclaimer: Any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the Internal Revenue Code or applicable state or local tax law or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.