

# Practical matters

for the c-suite

## SEC reminder: management is responsible for the output provided by third-party pricing services

Many companies use third-party pricing services to obtain fair value information for financial reporting. But the SEC reminds management that they cannot “outsource” its responsibility for maintaining internal control over reliable financial reporting of fair value measurements.

### Here's what you need to know:

- ▶ In recent periodic reviews of filings and in numerous speeches, the SEC staff has focused on a company's internal controls over the use of prices and related information obtained from third-party pricing sources and reported in the company's financial statements.
- ▶ The SEC staff has not, as of yet, required any prescriptive actions or remedies for perceived deficiencies, but has been very inquisitive. The very nature of the questioning has prompted some companies to respond that they intend to institute further enhancements to their internal controls.
- ▶ The SEC is focused on prices for instruments for which observable market quotes are available for similar instruments, but not the same instruments, or for which the only observable transactions are not in active markets.
- ▶ When a pricing service is merely accumulating widely reported data for actively traded instruments, there is less concern.
- ▶ All SEC filers, not just those in financial services, are affected by this new focus.

## Remarks from the 2011 AICPA National Conference on Current SEC and PCAOB Developments

The Securities and Exchange Commission (SEC) staff from the Office of the Chief Accountant and the Division of Corporation Finance discussed its increased focus on registrants' use of fair value information obtained from third-party pricing services. The discussion focused specifically on the use of such information to value financial instruments that are not actively traded and are classified in Level 2 of the fair value hierarchy (as described in Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*), for which significant judgment may be needed to estimate fair value. Given the importance of these estimates and related disclosures to investors, the SEC staff reminded registrants of their obligations to:

- ▶ Comply with US generally accepted accounting principles (GAAP), including disclosure requirements
- ▶ Maintain appropriate internal controls to prevent or detect material misstatements
- ▶ Assess the effectiveness of internal control over financial reporting (ICFR)

The SEC staff reminded registrants of their responsibility to sufficiently understand the valuation techniques, assumptions and other inputs used by third-party pricing services to determine the fair value of financial instruments, to evaluate whether the measurement complies with US GAAP and to comply with the relevant disclosure requirements. The SEC staff noted that registrants may need to perform different procedures when evaluating information obtained from third-party pricing services than when evaluating information obtained from other specialists, such as pension actuaries.

The SEC staff also reminded registrants that management is required to maintain a system of ICFR sufficient to provide reasonable assurance that transactions are recorded as necessary

### Management should be well-equipped to ask themselves the following questions before their regulator or auditor does:

- ▶ Is *sufficient information* available about the values provided by pricing sources to know that we're complying with GAAP?
- ▶ Have we adequately considered *judgments* made by third parties and do we find them reasonable?
- ▶ Do we sufficiently understand the *sources of information* and *methodologies* used by third parties to identify risks to reliable financial reporting?
- ▶ Have we properly identified, tested and documented controls to ensure *reliable financial reporting* as it relates to fair value measurements?

to permit the preparation of financial statements in conformity with GAAP and to annually assess the effectiveness of their ICFR. The SEC staff provided examples of controls that registrants have implemented to address these risks, including:

- ▶ Establishing processes to challenge pricing services on valuations that appear unusual or unexpected
- ▶ Obtaining more detailed information on a sample of securities
- ▶ Monitoring pricing services' assumptions
- ▶ Obtaining and reviewing an independent auditor's report on controls at a pricing service

The SEC staff noted that the combination of controls a company designs and implements should reflect the risks of material misstatement of the financial statements resulting from errors in fair value measurement. The SEC staff also noted that the nature and complexity of the securities, the level of market activity for such securities and the availability of market data may be relevant in assessing the risks of material misstatement.

### SEC reminder applies to all companies – not just financial institutions

The SEC reminder is directed to all registrants – not just banks, insurers and investment funds. Companies in sectors such as pharmaceutical, technology, hospitals and agribusiness that have investments, derivatives or inventory with holdings in the Level 2 or 3 fair value hierarchy are included. Non-financial services companies may still hold investments and positions in commodities carried at fair value, derivative instruments (swaps, forwards and options) and various non-public equity investments (common in the pharmaceutical and technology sectors). Such companies may not have the same level of infrastructure, processes and in-house capabilities that might be more common in large financial services companies and have understandably been more dependent on pricing services or other third parties to obtain the prices necessary to close their books.

Pension plans may present different challenges. Pension plans are among the first recipients of SEC staff comments on the subject, and many pension plans may be dependent on price feeds that their trustees obtain from pricing services. Furthermore, disclosures about securities held by pension plans often appear in the footnotes of the financial statements of their corporate sponsor, and therefore fall under the sponsor's ICFR responsibilities.

## Illustrative comments from the SEC paraphrased from letters received by registrants over the past three months

We note that you use the services of independent pricing services in certain of your fair value estimates. Please address the following in detail:

- ▶ Tell us whether you obtain an independent auditor's report or other documentation from your third party pricing service provider regarding its controls over valuation of financial instruments you classify in Level 2 of the fair value hierarchy to support the completeness and accuracy of the prices received.
- ▶ Describe to us any control deficiencies identified related to the service provider's valuation of Level 2 financial instruments and how you considered the deficiencies in concluding you have complied with GAAP relating to valuation and have effective internal control over financial reporting (ICFR).
- ▶ Explain to us whether any documentation from the third party service provider contains caveats or disclaimers about the pricing information provided. If so, explain the procedures you performed to determine you have complied with GAAP relating to valuation and have effective ICFR.
- ▶ Describe to us the frequency with which you challenge the pricing of any particular Level 2 financial instrument received from the service provider, the results of such challenges, and the impact the challenges had on your assessment of the service provider's internal controls.
- ▶ Tell us whether the third party pricing service providers provide you a list of the observable market data (including similar securities whose price they use or adjust) or model inputs that they use to price each security or class of securities in sufficient detail that you are able to assess whether the pricing methodology complies with ASC 820. If so, explain to us how you validate this data or otherwise confirm its completeness and accuracy.

Please also revise your future filings to expand your disclosures regarding the extent to which you use independent pricing services and how this information is obtained and used in developing your fair value measurements. In this regard, please also disclose the following:

- ▶ Whether, and if so, how and why, you adjust prices obtained from independent pricing services;
- ▶ The extent to which the pricing services are gathering observable market information as opposed to using unobservable inputs and/or proprietary models in making valuation judgments and determinations;
- ▶ The procedures you performed to validate the prices obtained to ensure the fair value determination is consistent with ASC 820, and to ensure that you properly classified your assets and liabilities in the fair value hierarchy; and
- ▶ The internal controls in place over the prices received from pricing services.

## How can management respond to these questions and comments from the SEC staff?

### Reaction

In our interactions with clients, we have noted some frustration with these inquiries from the SEC. Companies have told us that they spend a lot of money to access the valuation "expertise" of their pricing sources precisely so that they would not have to develop or hire in-house valuation expertise. Such companies may think of the pricing services similar to the way they think about other third parties, such as pension actuaries. Financial services companies may have the in-house valuation expertise, but still employ pricing services to handle the sheer volume of pricing activities that might occur daily or for very large portfolios.

Another frequently cited benefit of using pricing services is that prices are developed separately and objectively from the company, free from any temptation of management to bias the valuation outcome. Such companies have reacted with confusion as to the impetus for the regulator's concerns, given that there appears to be no pattern or history of pricing service "busts" that had a material impact on company financial statements.

In contrast, some companies have had fewer concerns, and tell us they have always viewed their pricing service as just one of many sources of information to assist them in reaching a final valuation determination for which management will take full responsibility.

### **What are the historical and environmental forces that might explain the SEC's interest in the topic?**

The intensity of the financial crisis from 2007 to 2009, and particularly the unprecedented inactivity in certain markets, presented valuation challenges and shifted many valuations from more objective (frequent actual trades) to more subjective (less frequent trades, more dependence on comparables instead). The Public Company Accounting Oversight Board (PCAOB) began focusing on how auditors addressed the audit risk posed by hard-to-value Level 2 instruments during their 2010 inspections, and they established a Pricing Sources Task Force.

The Task Force, comprising investors, preparers, auditors and representatives from pricing services and brokerage firms, looked at the processes that third-party pricing sources use to determine valuations of Level 2 securities, and the SEC staff observed all of these meetings. The staff's interest in how preparers handle their control responsibilities over the pricing sources was piqued by observing these discussions.

Thus far, the SEC's interest has not abated, nor has it demanded any specific actions on the part of registrants. Clearly the focus on how management should take responsibility for the prices and other output from their pricing sources is a developing matter, and the facts and circumstances at each company will be different.

### **What should companies do now?**

#### *First step: Inventory the controls you already have in place and assess their sufficiency*

Many companies have established procedures to evaluate the output provided by the pricing services, sometimes in their accounting groups but perhaps more prominently in their treasury departments, or through intermediate external investment advisors that are acting at the direction of management.

Identifying those procedures and actually refining them into "controls," and then bringing them under the umbrella of the Sarbanes-Oxley-defined internal accounting control structure (if they are not already) is a solid first step.

Examples of the types of procedures that might already be in place include:

- ▶ **Event trigger controls** – Companies may require that review procedures and/ or pricing service inquiries be prompted whenever a security is priced suddenly at zero, is de-listed from its exchange, has *no* price change from the last pricing date (stale price) or has a *severe* price change in either direction, exceeding a pre-established threshold.
- ▶ **Comparison to secondary or alternative pricing sources** – Some companies subscribe to more than one service, with one service designated as the primary service and the second service used as a "check" on the first. When prices between the primary source and the secondary source vary beyond a tolerable

difference threshold, the primary pricing service is "challenged" by management to support the methodology behind their price.

- ▶ **Back-testing** – Based on the theory that the best evidence of fair value is the amount at which an asset or instrument is actually sold, some companies will routinely monitor how accurate the pricing service's value was immediately prior to the sale. Discrepancies are investigated for explanations that might be revelatory for similar assets or instruments still held.

#### *Next step: What additional controls might be needed?*

In 2007, under the Sarbanes-Oxley Act, the SEC issued interpretive guidance on management's evaluation of ICFR. A large aspect of a company's approach to assessing ICFR is identifying and responding to potential risks of material misstatement. In particular, a company's ICFR should be responsive to securities that are more complex and securities that are not actively traded.

To the extent that a company has any of the procedures mentioned above in place, perhaps in Treasury or procurement or in portfolio management, but they are not part of the internal accounting control structure, a company could act to bring them under that internal control umbrella.

Such actions might include formalizing procedures or processes into daily or weekly activities, with review and supervision requirements that include accounting department personnel. In addition, a reporting hierarchy could be established so that the periodic results of such reviews are formally presented to an oversight body, such as an investment committee or audit committee of the board of directors.

A company could institute new controls centered on building an independent capability to oversee and challenge the work done by the pricing service. To achieve this, a company may need to ask for and obtain more supporting information so that it can understand the methods, inputs and assumptions used by third-party pricing services. For Level 2 instruments, that understanding often means tapping into more complex valuation concepts such as "matrix pricing" (interpolating among values for similar, but not identical, instruments arranged in a matrix format). Not every pricing service will interpolate observed values in the same way.

To assist their customers, pricing services publish detailed descriptive manuals of their valuation methodologies by type of security. These manuals can be very helpful to a company in understanding the approach of the pricing service and providing a frame of reference for informed questions and challenges. Ultimately, a company must decide whether the manuals provide sufficient detail related to the company's specific securities.

With this additional information, a company can more ably develop internal controls centered on making targeted price challenges. Price challenges might focus on understanding when the pricing service is exercising a key assumption or judgment that should be approved by management. For example, is the pricing service projecting that a particular bond will be called at the earliest call

date, or is it projecting that the issuer will not call at the first opportunity? Is management, as the actual holder of a bond, closer to the bond issuer's intentions than the pricing service? More importantly, is management ensuring that the pricing service is focused on what market participants are collectively assuming, as ASC 820 requires?

The SEC staff has also observed that some respondents reported that they perform detailed reviews on specific securities. We have observed such detailed reviews, often because of "triggers" that might drive a company to make a price challenge, and sometimes as a result of sampling or judgmental selection. In the detailed review, a company would work with the pricing service to understand the details of the application of their methodologies to specific securities. The company likely would want to prioritize which securities to detail review by examining criteria that would identify those securities with higher inherent estimation uncertainty, such as the nature and complexity of the securities (i.e., issuer, term, coupon), the level of market activity (i.e., inactive vs. active) and the availability of market data (timeliness, alternative markets). Over time, prioritizations as to which securities to test will change as the portfolio turns over and market conditions change.

The SEC remarks at the 2011 AICPA Conference suggested that a company might obtain and review an independent auditor's report on controls at a pricing service. We are aware that such auditors' reports exist that cover targeted processes for some pricing

services, but coverage is not all-inclusive at this time. However, we have observed that many pricing services are providing more information to their clients and their auditors than a year ago, and companies should ensure that they are obtaining all of the newly available information.

Companies also may have access to Service Organization Controls reports for banks and trust companies and other service providers that provide custodial or accounting services that include pricing. There also may be an associated independent auditor's report on internal controls for that organization. However, such reports must be read carefully to understand what products they cover and what procedures they address. Prices might have been obtained from a third party, provided on a trust statement or custodial report only as an accommodation to the customer, and the service organization may disavow responsibility for the pricing information.

#### **Be proactive**

Many registrants have not yet received comments from the SEC, but the staff speeches forewarn of inquiries likely to come. Companies with significant Level 2-type exposures in either securities or derivatives should ask themselves whether they feel comfortable with their level of oversight over the pricing services to which they subscribe and whether they are prepared to answer some of the sample questions we have highlighted in this document. If not, an action plan to strengthen internal controls in this area is advisable.

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For a more complete technical discussion about this topic, refer to the following publications available through Ernst & Young's Accounting Link, [www.ey.com/us/accountinglink](http://www.ey.com/us/accountinglink):

- ▶ *Technical Line: More focus needed on fair value information from third-party pricing sources (17 November 2011, SCORE No. BB2215)*
- ▶ *Compendium of significant accounting and reporting issues: 2011 AICPA National Conference on Current SEC and PCAOB Developments (12 December 2011, SCORE No. CCO341)*

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## How Ernst & Young may be able to help

Ernst & Young has devoted a great amount of time and effort to understanding the issues surrounding the increased SEC focus on how companies use pricing information from third parties, and our multidisciplinary team of accounting and valuation resources may be able to help you develop responsive action steps. In the chart below, we outline issues and steps you should consider related to the SEC reminder, and indicate how Ernst & Young may be able to help you.

Issues and steps	How Ernst & Young may be able to help
Gain a general understanding of the issues and concerns	<ul style="list-style-type: none"> <li>▶ Share insights and views of the SEC, PCAOB and other market participants</li> <li>▶ Share insights into the changing marketplace for pricing services and how third party pricing sources are approaching increasing the transparency around pricing sources</li> <li>▶ Advise with portfolio risk assessments and pricing variability analysis</li> <li>▶ Advise with respect to understanding the assumptions, methodologies and availability of supporting documentation from third-party pricing sources</li> <li>▶ Design and deliver training sessions for company personnel</li> <li>▶ Advise on responses to inquiries and comments from directors and regulators</li> </ul>
Benchmark the company against peers and others in the industry	<ul style="list-style-type: none"> <li>▶ Provide observations of how others are approaching understanding the output and information provided by third-party pricing sources, problems they encountered and solutions developed</li> <li>▶ Advise with regard to establishing processes and controls to challenge pricing services on valuations</li> <li>▶ Provide observations of how others are approaching monitoring third party pricing sources</li> <li>▶ Advise in the evaluation of peers, competitors and industry disclosures and expected impact on their financial reporting</li> </ul>
Access processes for data collection and internal controls	<ul style="list-style-type: none"> <li>▶ Provide observations and insights based on leading practices on ways the company could design its business process and internal controls in response to the current concerns and any future requirements that might be directed by the SEC</li> <li>▶ Advise with regard to identifying potential risks of material misstatement and complying with the Sarbanes-Oxley Act</li> </ul>
Update accounting manuals and accounting policies	<ul style="list-style-type: none"> <li>▶ Review and provide input into accounting manuals and policies selected by management regarding oversight of pricing services</li> </ul>

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