Response to IVSC Financial Instruments Invitation to Comment

25 September 2019
INTRODUCTION

The ICAS Corporate and Financial Reporting Panel welcomes the opportunity to comment on the IVSC’s financial instruments agenda consultation.

Our CA qualification is internationally recognised and respected. We are a professional body of over 22,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK’s and the world’s great companies.

Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Any enquiries should be addressed to David Wood, Senior Policy Director and Interim Secretary to the Corporate and Financial Reporting Panel.

GENERAL COMMENTS

Given the nature of our organisation and the roles in which our members work, we are primarily focused on the importance of financial instruments valuation for the purpose of financial and corporate reporting, and on the extent to which the valuations can be examined and assured by external auditors.

The valuation of financial instruments has been an area of focus immediately after, and since, the 2007-8 financial crisis, particularly in the context of level 3 valuations. Specifically, there seems to have been a lack of confidence in level 3 valuations which has undermined confidence generally in financial reporting, especially in the financial services industry.

Rebuilding confidence in the valuation of financial instruments is therefore a clear goal for us in underpinning the reliability of financial statements, and we are therefore supportive of the proposal to develop a new global standard to ensure consistent and high quality valuation of financial instruments.

We note that the IVSC has a Financial Reporting Working Group, and we are encouraged by the terms of reference which are summarised on page 8 of the Invitation to Comment. As indicated above, it is important that consideration is given to how the financial instruments valuation standard is applied in the context of financial reporting.

SPECIFIC COMMENTS

Scope and Detail

The proposals in this paper seem very ambitious and would seem to intend to provide much more detail than the previous version of IVS 500. At this level of detail, the IVSC needs to be wary about duplicating, or especially contradicting, other existing guidance which is already in place eg in IFRS 13 Fair Value Measurement and its US GAAP equivalent.

Definition of Financial Instruments

We note the IVS 500 definition of ‘financial instruments’ and the intention to use this definition as a basis for the current review. However, we suggest that consideration be given to the definition of financial instruments’ adopted by the International Accounting Standards Board (“IASB”). Our instinctive preference is that these should be consistent, but if there are to be differences in the definitions used by the two bodies the rationale for such differences needs to be clearly explained and documented.

We suggest that the IVSC’s Financial Reporting Working Group considers this matter further and in particular the potential practical implications of any differences between the definitions.
Application of Proposed Valuation Standard

We support the proposed approach of providing a credible industry standard relevant to stakeholders for all types and sizes of entity. We note the intention that the standard should focus on a process for valuation and that it should apply regardless of the measurement objective.

For the purpose of financial reporting, the required valuation is normally that of ‘fair value’. Whilst the proposed standard is intended to apply regardless of measurement objective, we would expect the standard to encapsulate any different considerations which are relevant to the estimation of ‘fair value’ and to other specific measurement objectives. That is, the standard needs to be at a sufficient level of detail to achieve the consistency and quality of valuation which is being sought, for each measurement objective.

In that context, we are pleased to attach the executive summary of a draft report on research which we commissioned in 2016 which considers the environmental and situational factors which might influence the judgements and decision of valuation specialists in a reporting and audit context. We hope this might be useful in highlighting some behavioural aspects relating to financial instrument valuation.

Assurance

We would emphasise the importance of valuation specialists documenting their methods, models, assumptions, data sources, processes and the rationale for the judgements made for the purpose of financial reporting, so that these can be retrospectively assessed by auditors or by independent valuation specialists engaged by them.
Unlocking the Black Box of Fair Value Measurement for Financial Instruments: 
*The Role and Perspectives of Accounting Firm-Employed Specialists*

**Extract from Final Draft Report: Executive Summary**

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Unlocking the Black Box of Fair Value Measurement for Financial Instruments:  
The Role and Perspectives of Accounting Firm-Employed Specialists

Executive Summary

This study examines the preparation and evaluation of fair value measurements (FVMs) for financial instruments (FI) reported in the financial statements, through the lens of valuation specialists (“specialists” hereafter) who play a key role in the production of FVMs. While a growing stream of research provides evidence that auditors’ use of the work of valuation specialists influences auditor judgments related to FVMs (e.g., Cannon and Bedard, 2016; Joe, Vandervelde and Wu, 2017; Brown-Liburd, Mason, and Shelton, 2017; Joe, Wu, and Zimmerman, 2017; Griffith, 2018), little is known about the environmental and situational factors that influence valuation specialists’ fair value judgments and decisions. Using qualitative methods, this study explores the interaction between valuation specialists and their clients (auditors and/or management) to identify: 1) the factors specialists consider most influential in their judgment and decision making when preparing versus evaluating FVMs; 2) the factors that are most influential to the information and communication exchange between specialists and their clients; and 3) whether the “customer” of the valuation service (auditors and/or management) impacts the factors specialists identify as important to their information/communication exchange, and their judgment and decision making process.

This research is important for several reasons. The global market for FIs has expanded significantly, and regulators continually scrutinize the valuations used in financial reporting and valuation practitioners. For example, the Public Company Accounting Oversight Board (PCAOB) and International Forum of Independent Audit Regulators (IFIAR) cite numerous audit deficiencies each year that relate to FVMs such as failure to understand the methods, models and assumptions used by specialists. To address these research questions, this study employs a field survey completed by 62 specialists, and conducts semi-structured interviews with 21 specialists. Accounting firms in North America, Europe, and the Asia-Pacific regions employ these specialist, who serve clients globally. Participants have significant experience (70% of surveyed and interviewed specialists have at least 6 years of valuation experience), and hold senior-level positions such as Director, Managing Director, and Partner. The field survey elicits specialists’ broad perceptions and concerns related to the production of FVMs, whether developing the FVM for management or evaluating a FVM for auditors. The interviews probe deeper into survey responses, help to contextualize the survey findings, and illuminate the human factors that arise in specialists’ interactions with auditors, management, other specialists, and regulators.

Insights from interviews suggest the process used to produce FVMs is the same across geographic regions. Consistently, the interview findings suggest no distinct differences across U.S. and Non-U.S. regions. Interview responses also indicate there are four phases in the production of FVMs—encompassing both specialists’ preparation and evaluation roles—reported in financial statements: 1) project acquisition and planning; 2) scoping, valuation approach, and methodology; 3) estimate preparation and relationship management; and 4) negotiations and final estimate reporting. This report categorizes findings applicable to each of these phases.

1. Project Acquisition and Planning

In the project acquisition and planning phase, specialists report facing tight deadlines and fee pressure from both types of clients—auditors and management. Specialists believe both types of clients generally focus more on the cost rather than the quality of valuation service, and that, often, attempts to avoid the cost of valuation services led to unrealistic deadlines. Prior research suggests that these deadline and fee pressures have negative implications for audit and financial reporting quality because they reduce judgment performance (e.g., McDaniel, 1990) and render professionals likelier to acquiesce to client preferences (e.g. Bennett, Hatfield and Stefaniak, 2015). While prior research takes an outside-in approach to evaluating the role of specialists in the production of FVMs from auditors’ and management’s perspectives, this study differs in that it takes and inside-out approach by examining the process from specialists’ perspective.

2. Scoping, Valuation approach and Methodology

During the scoping, approach and methodology decision phase, specialists suggest that the project budget, management’s valuation knowledge, and availability of model and market data, as well as auditor preference influence their decision making in this phase. For evaluation engagements (performed for auditors), the decision whether to develop an independent measurement versus whether to re-perform or evaluate management’s process is highly dependent on the availability of information on how the estimate was prepared (e.g., whether or not a proprietary model was used and shared with the specialist) and the technical competence of the preparing specialist. Auditors also have significant influence over the scoping and methodological decisions when specialists prepare and evaluate FVMs because specialists seek auditor acceptance of the valuation approach and final measurement, and prefer to minimize tensions with auditors.
These findings suggest that management and auditor preferences have the potential to influence specialists’ valuation decisions. Notably, specialists remark that while FVMs they prepare or evaluate comply with applicable accounting standards, they lack value relevance because they are not an approximation of the market value of the underlying financial instrument(s). Consequently, specialists perceive fair value accounting as an “artificial” concept.

3. Estimate preparation and Relationship Management

In the estimate preparation and relationship management phase, specialists often encounter clients (both auditors and management) who neither understand the complexity of the instruments they hold nor the basic aspects of the estimation task, resulting in a lack of awareness that instruments even require FVM. One notable exception was specialists’ positive perceptions of management in the financial services industry who tend to be sufficiently competent and capable of preparing the FVMs recorded in their financial statements. Specialists contend that valuation is a judgment-intensive process and that even the most competent specialists can develop estimates that differ significantly for the same financial instrument. While specialists believe that managers and auditors who are actively engaged in the preparation and evaluation processes for FVMs facilitate a more effective outcome, specialists report that significant problems are more likely when auditors and managers are inexperienced and/or disengaged. In addition, specialists express concerns about the unintended consequences that can arise from increased regulatory scrutiny. They note that whereas regulatory attention further encourages management to take ownership of, and a more proactive approach to, the production of FVMs, this increased regulatory review emphasizes documentation and creates a counterproductive environment. Specialists suggest that one potentially unintended consequence of regulatory oversight is focus on developing an audit trail that would pass regulatory scrutiny rather than developing a high quality FVM.

4. Negotiations and Final estimates

In the final phase of the valuation process, specialists typically document their valuation judgments using narrative reports that include more details when it is an initial FVM prepared for management versus an evaluation of a FVM for auditors. The increased detail in preparation-related reports facilitates justification of management’s point estimate to the external auditor. Specialists report that they rarely share their live models with either auditors or management due to their proprietary nature and concerns over misuse. However, they are more willing to share relevant details about model attributes to facilitate clients’ understanding of the valuation process and to fulfill regulatory documentation requirements. Upon completion of the valuation task, specialists often resolve measurement disagreements directly with clients, especially when in the evaluation role. While specialists report that they resist pressures to acquiesce to the client’s preference, they report that they often feel frustrated in the evaluation role when their own audit team supports the view of or advocates for the client’s position.

Findings and Policy recommendations

Findings from this study offer important implications for regulator and stakeholder consideration in each of the four phases of the valuation process. As specialists coordinate budgets and timing when planning for an evaluation, in Phase 1 – project acquisition and planning – they weigh options to either derive an independent estimate FVM or to review and re-perform management’s process. Prior research suggests there is the potential that specialists could anchor on the client’s value when they re-perform management’s process, which can result in suboptimal judgments such as being unduly influenced by management’s preferences (Earley, Hoffman and Joe, 2008). Accordingly, auditors and regulators should consider the relative advantages versus disadvantages of adopting the independent estimate approach as a best practice for the task of evaluating clients’ FVMs. The acute stress specialists feel from budgetary and deadline constraints is likely to have deleterious effects on their judgment performance (McDaniel, 1990) and to reduce audit quality (Lambert, Jones, Brazel, and Showalter, 2017). Standard-setters should also consider building auditor awareness of the effects of these pressures and encourage an organic and integrated team-based approach to remedial actions by the professional community.

In Phase 2, which describes scoping, valuation approach, and methodology, the study finds that exclusion from the scoping process, and the imposition of budgetary constraints can influence specialists’ approach to the production of FVMs. Findings also suggest that specialists’ ability to apply appropriate professional skepticism to the subjective aspects inherent in FVMs can be impaired when they are excluded from scoping decisions or have been given an inadequate budget. Regulators and standard-setters should consider effective means of promoting more collaboration between auditors and specialists, along with the increased guidance on the exercise of professional skepticism in this phase of the production of FVMs.

During Phase 3, estimate preparation and relationship management, specialists manage client relationships as they execute the valuation methodology to prepare and evaluate the fair value measurement. Specialists indicate that
management’s valuation knowledge is the crucial factor influencing their judgments related to the FVM. The conceptual framework guiding financial reporting standards suggest that management owns the financial statements and related contents. However, standard-setters should consider incorporating an evaluation of management’s competence related to FVMs as a component of the auditors’ risk assessment process.

Finally, during Phase 4, negotiations and final estimate reporting, where the final valuation report is generated, interviews reveal that specialists and auditors are vulnerable to client preferences, the inherent risk of material misstatement associated with the subjective nature of FVM, and the measurement uncertainty that is intrinsic to fair value estimation. Prior research (e.g., Fuller, Luippold and Joe, 2017) finds that when auditors provide detailed reports on critical matters within the audit and the audit committee is strong, management is more forthcoming with information. As a result, standard-setters should consider enhancements to corporate governance by promoting communications about the subjectivity inherent in FVMs among the board and audit committees.

Conclusion

Overall, this study presents the first examination of the role and perspectives of accounting firm-employed valuation specialists. These specialists play a key role in the determination of FVMs for FIIs reported in audited financial statements. Surveys and interviews of these specialists reveal that because they collaborate with management, auditors, and also interact with other valuation specialists they provide a unique perspective on the factors that influence the production of FVMs. These factors contextualize findings of prior research on the FVM process conducted using an auditor’s lens and highlight challenges common across and specific to specialists’ roles. While, this study is not designed to evaluate or determine audit quality, the collective challenges identified have implications not only for environmental and situational factors (e.g., firm guidance, regulatory scrutiny, professional inter-relationship factors) influencing specialists’ work but also for audit and financial reporting quality.