
STANDING ADVISORY GROUP MEETING

AUDIT CONFIRMATIONS

APRIL 2, 2009

Introduction

Confirmations are an important source of the evidence auditors may obtain as a part of an audit of a company's financial statements. The Public Company Accounting Oversight Board ("PCAOB" or "the Board") is evaluating its auditing standard on audit confirmations, AU sec. 330, *The Confirmation Process*.^{1/} As part of this evaluation, the Board is reviewing issues related to possible amendments to AU sec. 330 or a new auditing standard on confirmations that would supersede the Board's current standard.

AU sec. 330 was written over 15 years ago, and there have been significant advances in technology since then.^{2/} While adding efficiency, some of these electronic methods of communication also add opportunities, unforeseen by the drafters of AU sec. 330, for skilled individuals to intercept and change responses before they reach the auditor. Also as a result of advances in technology, auditors, in many cases, now may obtain a direct link into the electronic records of an audit client's customer, bank, or other confirming party and directly check the existence and amount of the audit client's balance without

^{1/} References to AU sections ("AU secs.") throughout this paper are to the PCAOB's interim auditing standards, which consist of generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at www.pcaobus.org.

^{2/} Email, facsimiles, and other electronic communications have become accepted methods of communication in addition to traditional mail.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

the need for interaction with an employee of that customer, bank, or other party. Further, due to the expansion in the number and international reach of transactions since the confirmation standard was issued, among other reasons, some banks and other businesses have decided that they no longer can dedicate the resources required to handle responses to confirmations and, thus, have hired third parties to respond on their behalf. All of these changes in practice suggest that it may be appropriate for the Board to examine the confirmation standard to determine whether it continues to be appropriate in the current business environment.

The Board also is considering whether opportunities may exist to make the confirmation process more meaningful by having auditors confirm not only accounts receivable, as required by the current standard, but also other significant accounts and the significant terms of material, complex revenue transactions and unusual agreements on a routine basis. Expanding the presumption to request confirmation of accounts receivable to also include confirmation of other significant accounts and significant terms in certain transactions and agreements may enhance audit quality and investor protection.

At the April 2009 meeting of the Standing Advisory Group ("SAG"), the SAG will be asked to discuss some of these issues. This briefing paper provides SAG members with background information about each discussion topic and the questions that will be presented during the discussion.^{3/}

Background

Confirmation is an audit process by which an auditor obtains and evaluates a direct communication from a knowledgeable third party in response to a request for information regarding account balances, transactions or other

^{3/} The staff discussed confirmations with the Standing Advisory Group ("SAG") in September 2004. At that meeting, SAG members provided their views regarding the role confirmations play in the audit process, including the reliability and effectiveness of confirmations; confirmation of revenue transactions and terms; confirmation of accounts receivable; confirmation of other matters, including whether the standard should require confirmation of other items, such as cash, investments, accounts payable, purchase commitments, guarantees, and loans; types of confirmation requests, including the use of negative confirmations and whether additional procedures should be required to supplement those confirmations; and management requests not to confirm. See the related agenda item at: http://www.pcaobus.org/News/Events/Documents/09082004_SAGMeeting/Confirmations.pdf.

items that comprise a company's financial statements. For example, an auditor might request a company's customers to confirm balances due to the company at the financial statement date, or a company's bank to confirm balances of the company's accounts or loans payable to the bank. AU sec. 326, *Evidential Matter*, indicates that it is generally presumed that evidence obtained from independent sources outside a company is more reliable than evidence obtained solely from within the company.^{4/}

The International Auditing and Assurance Standards Board recently updated its auditing standard on confirmations, International Standard on Auditing 505 ("ISA 505") (Revised and Redrafted), *External Confirmations*,^{5/} and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants is considering revising its standard on confirmations for audits of non-public entities. The staff would consider their efforts, as well as the input from the SAG and others, as part of any standards-setting project.

Discussion Topics

Definition of a confirmation

AU sec. 330 indicates that "[c]onfirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions."^{6/} The Board may consider whether to expand the definition of a confirmation contained in AU sec. 330 to include direct access to information held by a third party. Under an expanded definition, a confirmation could be defined as "a direct communication from a third party or direct access to information held by a third

^{4/} Paragraph .21a of AU sec. 326, *Evidential Matter*. See PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, Proposed Auditing Standard, *Audit Evidence* (October 21, 2008), paragraph 8, which indicates evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources. See proposed standard at http://www.pcaobus.org/Rules/Rulemaking/Docket%20026/2008-10-21_Release_No_2008-006.pdf.

^{5/} International Standard on Auditing 505 ("ISA 505") (Revised and Redrafted), *External Confirmations*, can be found at: <http://www.ifac.org/Store/Details.tml?SID=1229365477610684&Cart=12348970672001520>.

^{6/} AU sec. 330.04.

party in response to a request for information." Also, under this definition, communications via email and confirmation responses processed through third-party service providers would be acceptable forms of confirmation.

Expanding the definition may create more opportunities for auditors to use confirmations and improve response rates. For example, providing direct on-line access to the auditor may take less effort on the part of the confirming party than responding to the confirmation request in written form.

Discussion Question –

1. Should the definition of confirmation allow for responses other than traditional mailed responses, such as oral confirmation, facsimile, email, responses processed through third-party service providers, and direct access to information held by a third party?

Requirement to confirm

AU sec. 330 establishes the presumption that the auditor will request the confirmation of accounts receivable during an audit.^{7/} The standard further provides that the auditor should consider requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales, in addition to the amounts.^{8/} In practice, auditors may confirm other items even though the use of confirmations is not required for those items by the auditing standard.

Other standards-setters have differing views on whether auditors should be required to request confirmation of accounts receivable and other items. For example, ISA 505 does not require confirmation of any specific accounts, terms, or transactions, while the ASB, in its December 2008 meeting, "...confirmed its

^{7/} AU sec. 330.34. The auditor can overcome the presumption to request confirmation of accounts receivable when, in the auditor's judgment, the use of confirmations would be ineffective based on prior audit experience. AU sec. 330.34 also indicates the auditor can overcome the presumption to request confirmation of accounts receivable if accounts receivable are immaterial to the financial statements or the auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

^{8/} AU sec. 330.25.

belief (as was decided at the October 2007 ASB meeting) that inclusion of the presumptive requirement to confirm accounts receivable is appropriate."^{9/}

The Board may consider whether to expand the requirement in AU sec. 330 to include the presumption that the auditor will request confirmation of the terms of unusual agreements or transactions as well as complex or unusual revenue transactions. The Board also may consider whether to include a requirement that the auditor should consider requesting confirmation of other items such as cash, investments,^{10/} credit facilities, and debt agreements.

Discussion Questions –

2. Should the Board expand the presumptively mandatory requirement to request confirmation of accounts receivable in AU sec. 330 to include confirmation of the terms of unusual agreements or transactions and complex or unusual revenue transactions?
3. Should there be a requirement that the auditor should consider requesting confirmation of other items? If so, which items should be included in this requirement?

Reliability of confirmation responses

AU sec. 330 requires the auditor to evaluate the reliability of confirmation responses and alternative procedures as part of the auditor's overall evaluation of the confirmation procedures.^{11/} In addition, if information about the respondent's competence, knowledge, motivation, ability, or willingness to

^{9/} See the Auditing Standards Board ("ASB") meeting summary (December 11 -12, 2008) at: <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/Approved+Highlights+of+ASB+Meetings.htm>.

^{10/} Confirmation of investments may provide audit evidence for existence of those investments. Confirmation of investments other than those that are readily marketable or actively traded may not provide sufficient audit evidence for the valuation of those investments as the auditor may need to perform additional procedures to assess the reasonableness of the assumptions used in the valuation, among other things.

^{11/} AU sec. 330.33.

respond, or about the respondent's objectivity and freedom from bias with respect to the company comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary.^{12/}

AU sec. 330 also indicates that "[t]here may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. For example, facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the *original* confirmation directly to the auditor."^{13/}

Technology creates reliability issues which were not foreseen when the current confirmation standard was drafted. Changes to the standard may include performing procedures to address the reliability of responses when alternative forms of communication are used. For example, the Board might consider requiring auditors to evaluate whether –

- The electronic confirmation process is secure and properly controlled;
- The information is obtained directly by the auditor; and
- The information is obtained from a third party who is the intended recipient.

As discussed previously, banks and other businesses may hire third parties to respond to confirmation requests on their behalf. If a system or process that facilitates confirmation between the auditor and the confirming party is in place, such as a third-party service provider, and if the auditor plans to rely on that system or process, another auditor's report on that system or process may assist the auditor in assessing the design and operating effectiveness of the

^{12/} AU sec. 330.27.

^{13/} AU sec. 330.29.

electronic and manual controls that address the reliability of the information being confirmed.

Discussion Question –

4. What factors should the auditor consider when evaluating the reliability of confirmation responses in paper, electronic, or other forms?

Management requests not to confirm

AU sec. 330 does not specifically address what procedures the auditor should consider when management requests that the auditor not confirm selected accounts. However, such a request could be a scope limitation, which is addressed in the auditor's reporting standard.^{14/}

The Board may consider whether the standard should include procedures for auditors to evaluate situations in which management requests the auditor not to confirm certain accounts. Such procedures could include requiring the auditor to –

- Inquire as to management's reasons for the request and seek audit evidence as to their validity and reasonableness;
- Evaluate the implications of management's request on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing, and extent of other audit procedures; and
- Perform alternative procedures designed to obtain sufficient, appropriate audit evidence.^{15/}

Discussion Question –

5. What procedures should the auditor be required to perform to address situations in which management requests that the auditor not confirm accounts?

^{14/} Paragraphs .22-.34 of AU sec. 508, *Reports on Audited Financial Statements*.

^{15/} ISA 505, paragraph 8, includes similar requirements in situations in which management refuses to allow the auditor to send confirmation requests.

Disclaimers and restrictive language

Some respondents to confirmation requests include disclaimers or restrictive language in their responses. Examples of the types of disclaimers and restrictive language the staff is aware of include the following –

- Information is obtained from electronic data sources, which may not contain all information in the bank's possession.
- Information is not guaranteed to be accurate nor current and may be a matter of opinion.
- The confirming party does not accept any responsibility for errors or omissions.
- Information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability or warranty, express or implied.
- The confirming party has not sought to verify that the information contained in the attached report is true and complete and hereby expressly disclaim any liability.

Certain disclaimers or restrictive language may limit the amount of audit evidence that is provided by a confirmation, such as when a respondent states that he or she has not verified whether the information in the response is accurate or that the information in the response may not be appropriate for use in the preparation of financial statements. AU sec. 330 does not specifically address the use of disclaimers and restrictive language by confirming parties, although AU sec. 326 indicates that, "sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit."^{16/}

^{16/} AU sec. 326.01. PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, Proposed Auditing Standard, *Audit Evidence* (October 21, 2008) would supersede AU sec. 326. That proposed standard indicates that the auditor is to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.

The Board is considering whether the standard explicitly should require auditors to evaluate disclaimers or restrictive language on confirmation responses and determine whether or not such responses provide sufficient competent audit evidence.

Discussion Question –

6. Should the auditor be required to perform procedures to evaluate the effect of disclaimers and restrictive language on confirmation responses? If so, what procedures should an auditor be required to perform in evaluating such disclaimers or restrictive language?

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