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CONCEPT RELEASE ON POSSIBLE REVISIONS TO THE PCAOB'S STANDARD ON AUDIT CONFIRMATIONS	<ul><li>PCAOB Release No. 2009-00</li><li>April 14, 2009</li></ul>
	<ul><li>) PCAOB Rulemaking</li><li>) Docket Matter No. 028</li></ul>
	)

Summary:

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing a concept release to solicit public comment on the potential direction of a proposed standards-setting project on audit confirmations.

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#### **Public**

Comment:

Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted via email to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 028 in the subject or reference line. Comments should be received by the Board no later than 5:00 PM EDT on May 29, 2009.

# Board Contacts:

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#### I. Introduction

The Board is evaluating the PCAOB's auditing standard on audit confirmations, AU sec. 330, *The Confirmation Process*. The Board is issuing this concept release to seek public comment on the potential direction of a standards-setting project that could result in an amendment to AU sec. 330 or a new auditing standard that would supersede the Board's current standard on audit confirmations. <sup>1</sup>/

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 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.

Confirmations may be an important source of the evidence auditors obtain as part of an audit of a company's financial statements. Confirmation requests, if properly designed by the auditor, may address one or more financial statement assertions,

Audit confirmation is hereafter referred to as "confirmation."

Paragraph .21a of the Board's auditing standard on audit evidence, AU sec. 326, *Evidential Matter*, states that, "[w]hen evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity."

Paragraph .12 of AU sec. 330, *The Confirmation Process*. Assertions are representations by management that are embodied in the financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories: existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure. <u>See</u> AU sec. 326.03 and PCAOB Release 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 11.



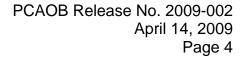
although, confirmations do not address all assertions equally well. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

AU sec. 330 was written over 15 years ago, and there have been significant advances in technology since then. Email, facsimiles, and other electronic communications have become accepted methods of communication in addition to 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 website 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 the need for interaction with an employee of that customer, bank, or other party. Every 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 to no longer dedicate the resources required to handle responses to confirmations and, thus, have hired third parties to respond on their behalf. Academic literature also provides insights into the use of confirmations. A publication that summarizes academic research and U.S. Securities and Exchange Commission enforcement actions states that "[g]enerally, confirmations are relatively

AU sec. 330.12. For example, "[c]onfirmation of goods held on consignment with the consignee would likely be more effective for the existence and the rights-and-obligations assertions than for the valuation assertion. Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions."

<sup>&</sup>lt;sup>5/</sup> AU sec. 330.12.

The auditor may obtain a username and password separate from the client's to gain access to the client's account information. Although an auditor may be able to review electronic records with little or no interaction with client personnel, the auditor may need to interact with the confirming party to ascertain that the direct website link to the confirming party's records is secure and that the link provides the auditor access to the information that is requested.





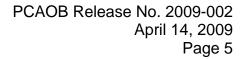
effective in testing the existence assertion for accounts receivable." The authors also noted that "[I]ow response rates, as well as respondent errors and directional bias in detecting errors, are key barriers to confirmation effectiveness." All of these changes in practice have motivated the Board to examine the confirmation standard to determine whether it continues to be appropriate in the current business environment.

There are additional reasons for the Board to review the current standard. Although AU sec. 330 provides direction on designing and using confirmations, the Board wishes to explore whether improvements to such direction and to the confirmation process itself could result in more consistent and effective application of the standard. For example, auditors may use a variety of approaches in the confirmation process. The Board may consider which approaches are most effective in differing situations. Opportunities also may exist to make the confirmation process more meaningful by having auditors confirm, on a routine basis, 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

Paul Caster, Randal J. Elder, and Diane J. Janvrin, "A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness," *Auditing: A Journal of Practice & Theory* (November 2008). The authors had additional findings, including that "[a]necdotal evidence and some research suggest confirmation responses rates are declining," and that "[r]esearch has identified several methods to improve response rates." They also note that "[c]onsiderable evidence exists that electronic confirmations and other forms of electronic database queries (i.e., defined views of supplier and/or customer databases) are becoming more prevalent. Technology offers alternatives to standard paper confirmations that may provide for authentication and improve confirmation effectiveness..."

<sup>&</sup>lt;u>8/</u> Ibid.

See, for example, Public Oversight Board, The Panel on Audit Effectiveness, "Report and Recommendations" (August 31, 2000), paragraph 2.98, which states in part, "The Panel is aware from the focus groups and other input that some auditors believe that confirmation is not a particularly effective audit procedure in many situations." The Panel noted additional examples of differences in the application of the standard as discussed in paragraphs 2.99 through 2.100. See Panel recommendations at http://www.pobauditpanel.org/index.html.



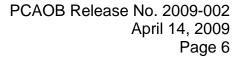


agreements. Expanding the presumption to request confirmation of accounts receivable to also include confirmation of other significant accounts and significant terms in certain transactions and agreements may enhance audit quality and investor protection.

The rationale noted above is based, in part, on advice the Board received from the PCAOB's Standing Advisory Group ("SAG"). At a recent meeting with the Board, SAG members provided their views in the following areas –

- Definition of confirmation, including whether the definition of confirmation contained in AU sec. 330 should be expanded to include direct access to information held by a third party.
- Requirement to confirm, including whether the presumption to request confirmation of accounts receivable should be expanded to request confirmation of terms of unusual agreements or transactions as well as complex or unusual revenue transactions. The SAG also discussed whether the standard should include a requirement that the auditor should consider requesting confirmation of other items, such as cash, investments, credit facilities, and debt agreements.
- Reliability of confirmation responses, including factors the auditor should consider when evaluating the reliability of confirmation responses in paper, electronic, or other forms.
- Management requests not to confirm, including procedures the auditor should perform when management makes such requests.
- Disclaimers and restrictive language, including whether auditors should perform procedures to evaluate the effect of such disclaimers and restrictive language on confirmation responses.

The Board discussed audit confirmations with the Standing Advisory Group ("SAG") on April 2, 2009. <u>See</u> the related agenda item at: <a href="http://www.pcaobus.org/News">http://www.pcaobus.org/News</a> and <a href="http://www.pcaobus.org/News">Events/Events/2009/04-02.aspx</a>. The Board also discussed audit confirmations with the SAG in September 2004. Topics discussed in 2004 included the role confirmations play in the audit process, confirmation of revenue transactions and terms, the presumption to request confirmation of accounts receivable, confirmation of other matters, such as cash and accounts payable, types of confirmation





In addition, the International Auditing and Assurance Standards Board recently updated its auditing standard on confirmations, International Standard on Auditing 505 ("ISA 505"), *External Confirmations*. The Board has considered the information in ISA 505 in developing this concept release. Specifically, the Board considered whether the objective, requirements, and application and other explanatory material of ISA 505 are appropriate for audits of public companies and consistent with the Board's statutory mandate "to oversee the audit of public companies that are subject to the securities laws...in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

As discussed in more detail in the Appendix, there are areas in which the Board may diverge from the requirements in ISA 505 as it considers the changes it might make to AU sec. 330. For example, the Board notes that ISA 505 does not require confirmation of any particular accounts or transactions. ISA 505 describes other procedures, and the Board is considering whether certain of those procedures should be expressly required in a standard of the PCAOB. 13/

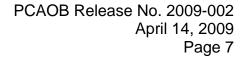
requests, and management requests not to confirm. <u>See</u> the related agenda item at: <a href="http://www.pcaobus.org/News\_and\_Events/Events/2004/09-08-09.aspx">http://www.pcaobus.org/News\_and\_Events/Events/2004/09-08-09.aspx</a>.

International Standard on Auditing 505 ("ISA 505"), *External Confirmations*, can be found at: <a href="http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684&Cart=1234897067200">http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684&Cart=1234897067200</a> <a href="http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684&Cart=1234897067200">http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684&Cart=1234897067200</a> <a href="http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684">http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684&Cart=1234897067200</a> <a href="http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684">http://www.ifac.org/Store/Details.tmpl?SID=1229365477610684</a> <a href="http://www.ifac.org/store/Details.tmpl?SID=122936547761068">http://www.ifac.org/store/Details.tmpl?SID=12

- 12/ Section 101 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7211.
- The Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants has undertaken a project to converge U.S. generally accepted auditing standards ("GAAS") with the ISAs, while avoiding unnecessary conflict with PCAOB auditing standards. <u>See</u> the ASB project, *Clarification and Convergence* (July 2008), at:

http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards/default.htm.

The convergence document states that "[t]he ASB expects that nearly all ISA requirements will also be requirements of U.S. GAAS. However, there may be additional GAAS requirements that address issues specific to the U.S. or the retention of current





In contrast to ISA 505, confirmation of accounts receivable has been a presumptively mandatory procedure in the United States since 1939. Confirmation was first required in response to the McKesson & Robbins case, which involved a fraud that independent auditors failed to detect. The fraud was carried out through collusion among members of top management of the company. Of reported consolidated assets in excess of \$87 million, approximately \$19 million, primarily accounts receivable and inventories, were fictitious. The auditing standard developed in response to that fraud required confirmation of accounts receivable by direct communication with customers in all independent audits of financial statements.<sup>14/</sup>

The Board believes that it is important to retain the presumption to request confirmation of accounts receivable and to consider whether additional, similar presumptions to request confirmation of certain other accounts may be appropriate. In addition, the Board is considering whether and how improvements to the standard on confirmations could enhance the quality of audits. The Board will consider comments received on this concept release as it develops possible changes to the standard on confirmations.

# II. Summary of AU Sec. 330 Requirements

AU sec. 330 includes, among other things, the following –

 A presumption that the auditor will request confirmation of accounts receivable. 15/

practices." In December 2008, "[t]he ASB confirmed its belief (as was decided at the October 2007 ASB meeting) that inclusion of the presumptive requirement to confirm accounts receivable is appropriate." <u>See</u> the ASB meeting summary (December 11-12, 2008), at: <a href="http://www.aicpa.org/download/auditstd/2008\_12\_ASB\_Highlights.pdf">http://www.aicpa.org/download/auditstd/2008\_12\_ASB\_Highlights.pdf</a>.

<sup>&</sup>lt;u>14/</u> <u>See</u> U.S. Securities and Exchange Commission Accounting Series Release No. 19, *In the Matter of McKesson & Robbins, Inc., Summary of Findings and Conclusions* (1940). AU sec. 330, which was written in the early 1990s, superseded the previous auditing standard that addressed confirmations.

<sup>&</sup>lt;sup>15</sup>/ AU secs. 330.34-.35.



- Procedures for designing the confirmation request, including the requirement that the auditor direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed.<sup>16/</sup>
- Procedures to consider when the auditor does not receive a written confirmation response via return mail, including how the auditor should evaluate the reliability of oral and facsimile responses to written confirmation requests.
- Alternative auditing procedures when the auditor has not received a response to a positive confirmation request.
- Requirements for evaluating the results of confirmation procedures, which include the auditor's consideration of "...(a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, <sup>19/</sup> including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed."

# III. Summary of Possible Changes to AU Sec. 330

The following are summaries of the possible changes to the PCAOB's standard on confirmations that the Board is considering. For additional detail regarding each of

<sup>16/</sup> AU secs. 330.16-.27.

<sup>17/</sup> AU sec. 330.29.

<sup>18/</sup> AU secs. 330.31-.32.

AU sec. 330 does not define an exception. Paragraph 6(e) of ISA 505 defines an exception as "[a] response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party." Changes to the confirmation standard may define an exception that is similar to the definition in ISA 505.

 $<sup>\</sup>frac{20}{}$  AU sec. 330.33.

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these areas, refer to the Appendix. The Board is seeking commenters' views on these matters to assist it in developing possible changes to its standard.

• Definition of confirmation – The Board is considering expanding the definition of confirmation contained in AU sec. 330 to include direct access to information held by a third party.<sup>21/</sup> Under an expanded definition, confirmation could be defined as "the process of obtaining and evaluating a direct communication from a third party or direct access to information held by a third party in response to a request for information about a particular item affecting financial statement assertions." 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.

• Requirement to confirm – AU sec. 330 establishes the presumption "that the auditor will request the confirmation of accounts receivable." The

As discussed previously in this concept release, forms of communication include those via traditional mail, email, facsimile and other electronic communications. As a result of advances in technology, auditors may obtain a direct website link into electronic records of an audit client's customer, bank, or other confirming party. "Direct access to information held by a third party," as used in this concept release, refers to an auditor obtaining a read-only direct website link into electronic records of an audit client held by a third party. It is also referred to elsewhere in this concept release as "direct on-line access." The auditor would have to be given a separate password by the third party to enable the auditor to independently confirm information held by the third party. If the auditor were to use the client's password, it would not serve as a confirmation for the auditor but, rather, would be considered to be an alternative procedure.

AU sec. 330.34. The auditor can overcome the presumption to request confirmation of accounts receivable when, among other reasons, in the auditor's judgment, the use of confirmations would be ineffective based on prior audit experience.



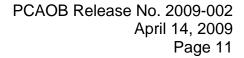
standard further provides that "[t]he auditor should consider requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales, in addition to the amounts." [23] If a Board standard provides that the auditor "should consider" an action or procedure, consideration of an action or procedure is presumptively mandatory, while the action or procedures is not. [24] The Board is considering whether

AU sec. 330.25. Also, other PCAOB standards include confirmation requirements. For example, pursuant to paragraph .06 of AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, "[t]he auditor should request a company's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments." Additionally, paragraph .14 of AU sec. 331, *Inventories*, states that "[i]f inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian." Also, paragraph .10 of AU sec. 334, *Related Parties*, states that "[w]hen necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered" —

- "Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction."
- "Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction."

Changes to the standard on confirmations would not change these requirements or otherwise affect the auditor's responsibilities under AU secs. 331, 334, or 337.

The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, states that the Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors. Under this rule, words like "must," "shall," and "is required" indicate unconditional responsibilities; the word "should" indicates responsibilities that are presumptively mandatory; words such as "may," "might," "could" and other terms and phrases describe actions and procedures that auditors have a responsibility to consider; and "should consider" indicates that





requirements of the standard should be elevated to establish the presumption to request confirmation of the significant terms of complex or unusual agreements or transactions, including complex or unusual revenue transactions. The Board also is considering whether to include a requirement that the auditor should consider confirming other items, such as cash, investments, credit facilities, and debt agreements.

Designing confirmation requests – AU sec. 330 discusses factors to consider in designing confirmation requests, including the form of the confirmation request, the auditor's prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, <sup>26/</sup> including directing a confirmation request to a third party who the auditor believes is knowledgeable about the information being confirmed. <sup>27/</sup> The Board is considering including a requirement to determine whether the confirming party's address directs the confirmation to the intended recipient. <sup>28/</sup> This requirement would apply to traditional communication using mail as well as electronic communication via email,

consideration of an action or procedure is presumptively mandatory, while the action or procedure is not.

AU sec. 330.08 states that, "[u]nusual or complex transactions may be associated with high levels of inherent risk and control risk. If the entity has entered into an unusual or complex transaction and the combined assessed level of inherent and control risk is high, the auditor should consider confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity. For example, if the combined assessed level of inherent and control risk over the occurrence of revenue related to an unusual, year-end sale is high, the auditor should consider confirming the terms of that sale."

- <sup>26</sup>/ AU sec. 330.16.
- 27/ AU sec. 330.26.
- Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent.

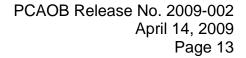


facsimile, use of third-party service providers or direct on-line access to third-party databases.

- Maintaining control over confirmation requests and responses AU sec. 330 requires the auditor to maintain control over confirmation requests and responses.<sup>29/</sup> This requirement may need to be updated to address advances in technology that were not anticipated when AU sec. 330 was written, since such technology provides additional opportunities for skilled individuals to intercept and revise confirmation responses.
- Reliability of confirmation responses The Board is considering whether
  additional direction may be needed beyond that which is currently
  contained in AU sec. 330 requiring the auditor to evaluate the reliability of
  confirmation responses. Similar to the discussion in the section,
  "Maintaining control over confirmation requests and responses,"
  technological developments may create concerns about the reliability of
  confirmation responses that were not foreseen when the current standard
  was drafted, and changes to the standard may need to address such
  reliability issues.
- Exceptions and non-responses The Board is considering whether the standard should eliminate the ability for the auditor to omit performing alternative procedures for non-responses to positive confirmation requests<sup>30/</sup> and explicitly require the auditor to investigate exceptions in confirmation responses to determine whether or not they are indicative of

Positive confirmations provide audit evidence only when responses are received from the recipients. See AU sec. 330.18. AU sec. 330.31 permits the omission of alternative procedures "...(a) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (b) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated."

<sup>29/</sup> AU sec. 330.28.





misstatements. Performing alternative procedures for non-responses and investigating exceptions to confirmation requests may result in the identification of previously unidentified risks of material misstatements, including previously unidentified fraud risk factors that require evaluation.

- Management requests not to confirm AU sec. 330 does not specifically address what actions the auditor should consider when management requests that the auditor not confirm selected accounts, transactions, agreements, or other items. However, although such a situation is not specifically addressed in the standard, depending on the circumstances, it could be a scope limitation, which is addressed in the auditor's reporting standard. As a result of discussions with SAG members, the Board is considering whether the standard should include requirements to evaluate circumstances in which management requests the auditor not to confirm certain accounts, transactions, agreements, or other items.
- Disclaimers and restrictive language Some respondents to confirmation requests include disclaimers or restrictive language in their responses. Such disclaimers sometimes indicate, among other things, that the respondent takes no responsibility for the accuracy of the response. Restrictive language may indicate the response is not appropriate for use in the audit of financial statements. As a result of discussions with SAG members, the Board is considering whether the standard should require auditors to evaluate disclaimers and restrictive language and determine whether alternative procedures are necessary to obtain sufficient, competent audit evidence.

Paragraphs .22-.34 of AU sec. 508, *Reports on Audited Financial Statements*.

AU sec. 326 refers to sufficient, competent evidential matter. *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 and indicates that "[t]he objective of the auditor is to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report."



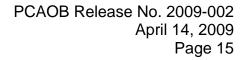
Negative confirmations – The Board is considering whether the confirmation standard should continue to allow the use of negative confirmations. If the use of negative confirmations is allowed, the Board is considering whether the auditor should be required to perform other substantive procedures to supplement the use of negative confirmations.

# IV. Opportunity for Public Comment

The Board is interested in the views of commenters on the potential direction of the proposed standards-setting project and whether there are other approaches that the Board should consider. While the Appendix includes a number of specific questions for which the Board would like to obtain feedback, the Board welcomes comments on any concerns commenters may have related to these issues. The questions posed in the Appendix are applicable to both an integrated audit and an audit of financial statements only.

The Board will seek comment on this concept release for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to <a href="mailto:comments@pcaobus.org">comments@pcaobus.org</a> or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 028 in the subject or reference line and should be received by the Board no later than 5:00 PM EDT on May 29, 2009.

According to AU sec. 330.20, auditors are permitted, in certain circumstances, to use "negative" confirmations, in which the respondent is asked to respond only if he or she disagrees with the information provided on the confirmation request. AU sec. 330.22 indicates that returned negative confirmations may provide evidence about financial statement assertions. "However, unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct."





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On the 14<sup>th</sup> day of April, in the year 2009, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour Secretary

April 14, 2009

Appendix – Additional Background and Discussion on Possible Changes to AU Sec. 330



# Appendix – Additional Background and Discussion on Possible Changes to AU Sec. 330

AU sec. 330, *The Confirmation Process*, provides direction on the use of confirmations and the confirmation process. The following discussion provides a description of the existing standard and describes possible changes the Board is considering making to that standard.

The Proposed Auditing Standard, *Audit Evidence*, indicates that "in general, evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources." AU sec. 330, states that "[c]onfirmation requests, if properly designed by the auditor, may address any one or more of those [financial statement] assertions. However, confirmations do not address all assertions equally well." For example, "[c]onfirmation of goods held on consignment with the consignee would likely be more effective for the existence and the rights-and-obligations assertions than for the valuation assertion. Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions. Thus, when obtaining evidence for assertions not adequately addressed by confirmations, auditors should consider other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures."

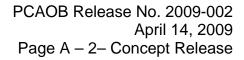
Consistent with other proposed PCAOB standards, the Board is considering including in the standard the objective of the auditor when using confirmations. Preliminarily, such an objective may focus on designing and performing confirmation

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. Paragraph .21a of AU sec. 326, *Evidential Matter*, indicates that "[w]hen evidential matter can be obtained from independent sources outside an entity, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the entity."

<sup>&</sup>lt;sup>2</sup> Paragraph .12 of AU sec. 330, *The Confirmation Process*.

 $<sup>\</sup>frac{3}{}$  Ibid.

PCAOB Release No. 2008-006, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (October 21, 2008).





procedures to obtain sufficient, competent audit evidence from knowledgeable third parties outside the company in response to identified risks. The Board would be interested in comments on a potential objective for the confirmation standard.

#### Question

1. Should the objective of the confirmation standard be for the auditor to design and perform confirmation procedures to obtain sufficient, competent audit evidence from knowledgeable third parties outside the company in response to identified risks?

#### Definition of confirmation

Currently, the PCAOB's standard defines confirmation as "... 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." The standard permits oral confirmations, but requires that they be documented in the auditor's work papers and, if significant, "...the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor."

International Standard on Auditing 505 ("ISA 505"), *External Confirmations*, defines an external confirmation as "[a]udit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium." The Application and Other Explanatory Material to ISA

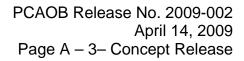
AU sec. 326.01. <u>See</u> Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk, Proposed Auditing Standard, Audit Evidence (October 21, 2008), which would supersede AU sec. 326 and indicates that "[t]he objective of the auditor is to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report."

<sup>&</sup>lt;sup>6</sup>/ AU sec. 330.04.

<sup>&</sup>lt;sup>7/</sup> AU sec. 330.29.

<sup>&</sup>lt;sup>8</sup> International Standard on Auditing ("ISA") 505, *External Confirmations*, paragraph 6(a).

As described in paragraph A59 of ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International





505 states that "an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor."

The Board is considering expanding the definition of confirmation to include direct access to information held by a third party in response to a request for information about a particular item affecting financial statement assertions.  $^{11/}$  Under the revised definition, communications via email and confirmation responses processed through third-party service providers also would be acceptable forms of confirmation.  $^{12/}$  The

Standards on Auditing, Application and Other Explanatory Material does not, in itself, impose a requirement, but is relevant to the proper application of the requirements of an ISA.

- 10/ ISA 505, paragraph A15.
- <u>11</u>/ As discussed previously in this concept release, forms of communication include those via traditional mail, email, facsimile and other electronic communications. As a result of advances in technology, auditors may obtain a direct website link into electronic records of an audit client's customer, bank, or other confirming party. "Direct access to information held by a third party," as used in this concept release, refers to an auditor obtaining a read-only direct website link into electronic records of an audit client held by a third party. It is also referred to elsewhere in this concept release as "direct on-line access." The auditor would have to be given a separate password, by the third party to enable the auditor to independently confirm the information held by the third If the auditor were to use the client's password, it would not serve as a confirmation for the auditor but, rather, would be considered to be an alternative procedure. However, the auditor may need to perform procedures to address the risk that the information is not from a proper source and the risk that the integrity of the data has been compromised. Although an auditor may be able to review electronic records with little or no interaction with client personnel, the auditor may need to interact with the confirming party to ascertain that the direct website link to the confirming party's records is secure and that the link provides the auditor access to the information that is requested.
- The Board discussed audit confirmations with the Standing Advisory Group ("SAG") on April 2, 2009. Certain SAG members expressed the view that oral confirmations should not be used for a number of reasons, including that oral communications are less reliable than written communications. Other SAG members said oral confirmation should be permitted in limited circumstances since, in some audits, there may be legitimate reasons why the auditors will not be able to obtain



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Board is concerned that limiting the definition of confirmation to written responses, as ISA 505 does, may discourage the use of confirmations by auditors. There may be circumstances in which an auditor prefers direct communication from a respondent instead of direct on-line access to information. For example, a direct communication from a respondent provides an opportunity for the respondent to question the information included in a confirmation request or to provide additional information, such as the existence of a side agreement. Direct communication also may be a more effective confirmation procedure in certain situations, such as when an auditor is confirming revenue transactions.

# **Questions**

- 2. 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 online access to information held by a third party? Why or why not?
- 3. What direction should the standard include regarding the use of electronic confirmations and third-party service providers?
- 4. What procedures should the auditor be required to perform to address the risk that the information is not from a proper source and the risk that the integrity of the data has been compromised?

written confirmation responses. In addition, some SAG members supported expanding the definition of a confirmation to include direct access to information held by a third party for various reasons, including that it might improve confirmation response rates. Other SAG members were concerned that the access to the information held by the third party may not be secure and properly controlled. SAG members expressed concern regarding how the auditor knows whether he or she has been given access to the information that is requested. These members also expressed concern with whether the auditor would interpret that information correctly. See the related agenda item at: <a href="http://www.pcaobus.org/News">http://www.pcaobus.org/News</a> and Events/Events/2009/04-02.aspx.



# Requirement to confirm

AU sec. 330 includes "a presumption that the auditor will request the confirmation of accounts receivable during an audit" unless certain criteria are met.  $\frac{13}{}$  Accounts receivable is defined in the standard to mean –

- "The entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and
- A financial institution's loans."

  14/

If confirmation of accounts receivable is not requested, the auditor "should document how he or she overcame this presumption." AU sec. 330 requires the auditor to request confirmation of accounts receivable unless, in the auditor's judgment, the use of confirmations would be ineffective based on prior audit experience. In addition to accounts receivable, AU sec. 330 indicates that "[t]he auditor should

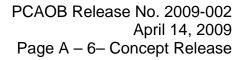
AU sec. 330.34 also indicates the auditor can overcome the presumption to request confirmation of accounts receivable if accounts receivable are immaterial to the financial statements or the auditor's combined assessed level of inherent and control risk is low, and the assessed level, in conjunction 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.

 $<sup>\</sup>frac{13}{}$  AU sec. 330.34.

<sup>14/</sup> Ibid.

<sup>15/</sup> AU sec. 330.35.

AU sec. 330.34. Footnote 4 of AU sec. 330.34 indicates that "if, based on prior years' audit experience or on experience with similar engagements, the auditor concludes that response rates to properly designed confirmation requests will be inadequate, or if responses are known or expected to be unreliable, the auditor may determine that the use of confirmations would be ineffective."





consider requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales, in addition to the amounts."  $\frac{17}{2}$ 

ISA 505 does not require confirmation of any specific accounts, terms, or transactions. The Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants is considering revising its standard on confirmations. In its December 2008 meeting, "[t]he ASB confirmed its belief (as was decided at the October 2007 ASB meeting) that inclusion of the presumptive requirement to confirm accounts receivable is appropriate." [19/]

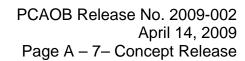
Confirmation procedures may provide auditors with sufficient, competent audit evidence regarding the existence assertion for accounts receivable and also may provide some audit evidence regarding the occurrence assertion for revenue. The Board is considering whether to expand the presumption to request confirmation of accounts receivable, and the related requirement to document how he or she overcame this presumption when omitting such confirmation requests. Expansion of that presumption could establish the presumption to request confirmation of the significant terms of unusual agreements or transactions, including complex or unusual revenue transactions, because of the risk of fraud. The Board also is considering whether the

<sup>17/</sup> AU sec. 330.25.

The International Auditing and Assurance Board took this position because, in part, "there are many circumstances where external confirmation procedures may not be effective" and "a documentation burden would arise if the auditor were to rebut the presumption." <u>See</u> Staff of the International Auditing and Assurance Standards Board, *Basis for Conclusions: ISA 505, External Confirmations* at: <a href="http://web.ifac.org/download/Basis">http://web.ifac.org/download/Basis</a> for Conclusions ISA 505 Revised and Redrafted. <a href="pdf">pdf</a>.

See the Auditing Standards Board meeting summary (December 11 -12, 2008) at: <a href="http://www.aicpa.org/download/auditstd/2008">http://www.aicpa.org/download/auditstd/2008</a> 12 ASB Highlights.pdf.

Paragraph .41 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, states that "[m]aterial misstatements due to fraudulent financial reporting often result from an overstatement of revenues....or an understatement of revenues....Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition."





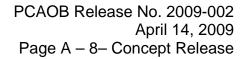
standard should include the requirement that the auditor should consider confirmation of other items when confirmations may provide the auditor sufficient, competent audit evidence for other financial statements assertions.  $\frac{21}{}$  Such items could include cash, investments, credit facilities, and debt agreements.

# Questions

- 5. Should the Board expand the presumptively mandatory requirement to request confirmation of accounts receivable in AU sec. 330 to include confirmation of the significant terms of complex or unusual agreements or transactions, including complex or unusual revenue transactions? Why or why not?
- 6. Should the Board require that the auditor consider confirming other items? If so, which items should be included in this requirement?
- 7. Should the Board require the auditor to perform specific procedures when evaluating whether confirmation of accounts receivable would be ineffective? If so, what should those procedures include?

The Board's Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, states that the Board's auditing and related professional practice standards use certain terms set forth in this rule to describe the degree of responsibility that the standards impose on auditors. Under this rule, words like "must," "shall," and "is required" indicate unconditional responsibilities; the word "should" indicates responsibilities that are presumptively mandatory; words such as "may," "might," "could" and other terms and phrases describe actions and procedures that auditors have a responsibility to consider; and "should consider" indicates that consideration of an action or procedure is presumptively mandatory, while the action or procedure is not.

During the April 2, 2009 SAG meeting, certain SAG members expressed their views that the presumption to request confirmation of accounts receivable should be expanded to certain items, such as investments and cash. Another member indicated the standard should encourage, but not require, confirmations for material revenue transactions near year end because of the risk of fraud. Other members, who were not supportive of expanding the requirement to confirm accounts or other items, indicated that auditors should determine which procedures to perform based on the assessed level of risk for the relevant assertions for each account.





8. Should the Board include direction in the standard on what constitutes "unusual" or "complex" agreements or transactions, including revenue transactions? If so, what should that direction include?

# Designing confirmation requests

The PCAOB's standard requires that "[c]onfirmation requests should be tailored to the specific audit objectives." In addition, the standard provides the following direction in designing confirmation requests –

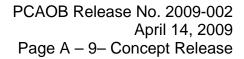
- "[t]he auditor should consider the assertion(s) being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent should affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through confirmation procedures."
- "[t]he auditor should consider the types of information respondents will be readily able to confirm, since the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate."
- "The auditor's understanding of the client's arrangements and transactions with third parties is key to determining the information to be confirmed. The auditor should obtain an understanding of the substance of such arrangements and transactions to determine the appropriate information to include on the confirmation request."

<sup>23/</sup> AU sec. 330.16.

<sup>&</sup>lt;u>24/</u> Ibid.

<sup>25/</sup> AU sec. 330.24.

<sup>&</sup>lt;sup>26</sup>/ AU sec. 330.25.





• "The auditor should direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed." 27/

The PCAOB's standard provides that, "[i]f information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity 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."

28/

The Board is considering including a requirement for the auditor to determine whether the confirming party's address directs the confirmation to the intended recipient. This requirement may address advances in technology that were not anticipated when AU sec. 330 was written since such technology provides additional opportunities for skilled individuals to intercept confirmation requests if they are not directed to the intended recipient. This requirement also would apply to traditional communication using mail in addition to electronic communication via email, facsimile, use of third-party service providers or direct on-line access to third-party databases.

# **Questions**

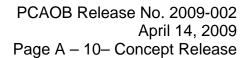
- 9. Is additional direction needed with regard to designing confirmation requests and, if so, what direction would be helpful for auditors?
- 10. Should the standard include the requirement for the auditor to test some or all of the addresses of confirming parties to determine whether confirmation requests are directed to the intended recipients? Why or why not?

Maintaining control over confirmation requests and responses

AU sec. 330 includes the requirement that "the auditor should maintain control over the confirmation requests and responses. Maintaining control means establishing

<sup>&</sup>lt;sup>27</sup> AU sec. 330.26.

<sup>28/</sup> AU sec. 330.27.





direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses." Consideration of fraud risk is an important part of maintaining control. "Fraud also may be concealed through collusion among management, employees, or third parties." The auditor may receive a false confirmation from a third party that is in collusion with management. Maintaining control over the confirmation process may reduce the risk of receiving a fraudulent confirmation response. The standard also states that "[w]hen using confirmation requests other than the negative form, the auditor should generally follow up with a second and sometimes a third request to those parties from whom replies have not been received."

The Board is concerned with the risk that unauthorized individuals will obtain access into the confirmation process. For example, company personnel may be able to intercept the confirmation request to forge a signature or otherwise provide the auditor with false confirmations. The Board is considering whether the standard may need to be updated to address advances in technology that were not anticipated when AU sec. 330 was written since such technology may provide opportunities for skilled individuals to intercept and revise confirmation responses.

#### Questions

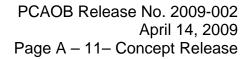
- 11. What additional direction should the standard include with regard to maintaining control over confirmation requests and responses?
- 12. What direction is necessary in the standard regarding maintaining control over confirmations in electronic form?

<sup>&</sup>lt;sup>29/</sup> AU sec. 330.28.

<sup>30/</sup> AU sec. 316.10.

<sup>31/</sup> Ibid.

<sup>32/</sup> AU sec. 330.30.





# 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 to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions. As discussed above in the section "Designing confirmation requests," "[i]f information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity 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."

In a publication that summarizes research and U.S. Securities and Exchange Commission enforcement actions, the authors note that fictitious responses provided by company management were a problem area in enforcement actions involving accounts receivable and cash balance confirmations. "Current auditing standards do not require auditors to authenticate responses."  $\frac{35}{2}$ 

### ISA 505 requires that -

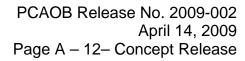
- "If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts." 36/
- "If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of

<sup>33/</sup> AU sec. 330.33.

 $<sup>\</sup>frac{34}{}$  AU sec. 330.27.

Paul Caster, Randal J. Elder, and Diane J. Janvrin, "A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness," *Auditing: A Journal of Practice & Theory* (November 2008).

<sup>36/</sup> ISA 505, paragraph 10.





the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures." 37/

The Board is considering whether more specific requirements may be needed beyond those currently contained in AU sec. 330 by requiring the auditor to evaluate the reliability of confirmations in a manner that is similar to the guidance in ISA 505. As discussed above in the section, "Maintaining control over confirmation requests and responses," technological developments may create concerns about the reliability of confirmation responses 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. Factors that auditors may consider when evaluating the reliability of electronic confirmations include –

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

# **Questions**

- 13. What changes should be made to the standard regarding the auditor's responsibility for evaluating the reliability of confirmation responses and alternative procedures?
- 14. When an auditor uses direct on-line access to a third-party database or a third-party service provider, what procedures should the auditor be



- required to perform to assess that the information included in the third-party database or provided by the third-party service provider is reliable?
- 15. Are there factors other than those mentioned above that the auditor should consider when evaluating the reliability of electronic confirmations? If so, what are they?

# Exceptions and non-responses

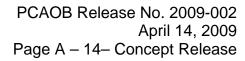
AU sec. 330 does not define explicitly an exception or a non-response.  $\frac{38}{}$  The standard, however, provides direction for situations in which alternative procedures should be performed for non-responses to positive confirmation requests, as well as the types of alternative procedures that may be performed by the auditor.  $\frac{39}{}$  The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, for example, alternative procedures may include examination of subsequent cash receipts, shipping documents, or other company documentation to provide evidence of the existence assertion. The standard permits the auditor to omit alternative procedures in limited situations.

The Board is considering whether changes to the standard should eliminate the ability for the auditor to omit performing alternative procedures for non-responses to positive confirmation requests. The Board also is considering whether the standard should require the auditor to investigate exceptions in confirmation responses to

Paragraph 6(e) of ISA 505 defines an exception as "[a] response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party." Changes to the Board's confirmation standard may define an exception that is similar to the definition in ISA 505.

<sup>39/</sup> AU secs. 330.31-.32.

AU sec. 330.31 indicates the auditor may omit alternative procedures "(a) when the auditor has not identified unusual qualitative factors or systematic characteristics related to the nonresponses, such as that all nonresponses pertain to year-end transactions, and (b) when testing for overstatement of amounts, the nonresponses in the aggregate, when projected as 100 percent misstatements to the population and added to the sum of all other unadjusted differences, would not affect the auditor's decision about whether the financial statements are materially misstated."





determine whether or not they are indicative of misstatements. Performing alternative procedures for non-responses and investigating exceptions to confirmation requests may result in the identification of previously unidentified risk of material misstatements, including previously unidentified fraud risk factors that require evaluation.

# **Questions**

- 16. Should the standard require the auditor to perform alternative procedures for non-responses to positive confirmation requests? Why or why not?
- 17. Should the standard require the auditor to investigate exceptions identified as a result of confirmation responses? Why or why not?
- 18. Should there be a requirement for the auditor to consider the possibility of previously unidentified risk of material misstatements including previously unidentified fraud risk factors when performing alternative procedures for non-responses and investigating exceptions on confirmation responses? Why or why not?
- 19. Should the standard include alternative procedures the auditor should perform for non-responses when the auditor is confirming the significant terms of unusual or complex agreements or transactions? What should those alternative procedures include?

# Management requests not to confirm

The PCAOB's standard does not specifically address what actions the auditor should consider when management requests that the auditor not confirm selected accounts, transactions, agreements, or other items. However, such a request could be a scope limitation, which is addressed in the auditor's reporting standard. $\frac{41}{}$ 

The Board is considering including procedures for auditors to perform to evaluate situations in which management requests the auditor not to confirm certain accounts, transactions, agreements, or other items. Such procedures could include requiring the auditor to –

<sup>41/</sup> Paragraphs .22-.34 of AU sec. 508, *Reports on Audited Financial Statements*.



- 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, competent audit evidence. 42/

### Question

20. Should the standard include procedures for the auditor to perform to address situations in which management requests the auditor not confirm certain accounts, transactions, agreements, or other items? If so, are the procedures listed above the appropriate procedures for the auditor to perform? What other procedures should the auditor perform to address situations in which management requests that the auditor not confirm accounts, transactions, agreements, or other items?

### Disclaimers and restrictive language

Through the inspection process, the PCAOB has observed instances in which confirmation responses from third parties or counterparties included disclaimers as to their accuracy and appropriateness for use in the preparation of financial statements. Examples of such disclaimers and restrictive language include statements that –

• Information is obtained from electronic data sources, which may not contain all information in the bank's possession.

ISA 505, paragraph 8, includes similar procedures in situations in which management refuses to allow the auditor to send confirmation requests.

See PCAOB Release No. 2008-008, Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms (December 5, 2008), page 14.



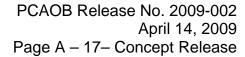
- Information is not guaranteed to be accurate nor current and may be a matter of opinion.
- The confirming party does not accept any responsibility for errors or omissions.
- Information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability or warranty, express 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 disclaims any liability.

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."44/ Depending on the circumstance, a disclaimer or the use of restrictive language may limit the responsibility the respondent is taking for the accuracy and completeness of the information on the confirmation response, which limits the amount of audit evidence that is provided by the confirmation. Examples of such language include a respondent stating 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. 45/ If the auditor concludes that the disclaimer or restrictive language on a confirmation response limits the extent of audit evidence provided by the confirmation, the auditor should perform additional procedures to obtain sufficient, competent audit evidence. For example, in auditing the existence assertion for accounts receivable, alternative procedures may include examining subsequent cash receipts (including matching some receipts with the actual items being paid), shipping documents, or other company documentation.

The Board is considering whether the standard should further clarify the auditor's responsibility to evaluate disclaimers or restrictive language on confirmation responses

<sup>44/</sup> AU sec. 326.01.

PCAOB Release No. 2008-008, Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms (December 5, 2008).





and determine whether or not such responses provide sufficient, competent audit evidence. The Board also is considering, when the audit evidence provided by confirmation responses containing such language appears to be limited, alternative procedures auditors should perform to obtain additional audit evidence.

# Question

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

# Negative confirmations

The PCAOB's standard on confirmations provides for two types of confirmation requests: the positive form and the negative form. Positive confirmations provide audit evidence only when responses are received from the recipients. With a negative confirmation, the recipient is asked to respond only if he or she disagrees with the information stated on the request. The standard states that "...unreturned negative confirmation requests rarely provide significant evidence concerning financial statement assertions other than certain aspects of the existence assertion. For example, negative confirmations may provide some evidence of the existence of third parties if they are not returned with an indication that the addressees are unknown. However, unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained on them is correct."

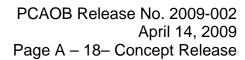
The PCAOB's standard provides that "[n]egative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and

<sup>46/</sup> AU sec. 330.17.

<sup>47/</sup> AU sec. 330.18.

<sup>48/</sup> AU sec. 330.20.

<sup>49/</sup> AU sec. 330.22.





(c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration." The existing standard further states that "the auditor should consider performing other substantive procedures to supplement the use of negative confirmations."  $\frac{51}{2}$ 

The Board is considering whether the standard should continue to permit the use of negative confirmations and, if so, whether to require the auditor to perform other substantive procedures to supplement the use of negative confirmations.

# Questions

- 22. Should auditors be allowed to use negative confirmations and, if so, in what circumstances?
- 23. Should the standard include the requirement that the auditor perform additional substantive procedures when using negative confirmations? Why or why not?