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### I. Introduction

The Board is proposing a new confirmation standard to supersede the PCAOB's existing confirmation standard, AU section ("sec.") 330, *The Confirmation Process*. On April 14, 2009, the Board issued *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations* (the "Concept Release").<sup>1/</sup> The Board received 24 comment letters<sup>2/</sup> from a variety of commenters on a broad range of topics, including responses to specific questions the Board raised in the Concept Release. In developing the project, the Board considered comments on the Concept Release, input from the PCAOB's Standing Advisory Group ("SAG"),<sup>3/</sup> the Board's inspection activities, academic research,<sup>4/</sup> and the actions of other standard setters.

The Board is proposing a new standard that:

- *Requires confirmation procedures for specific accounts* – The Board is retaining the requirement for the auditor to perform confirmation procedures for receivables because a confirmation response from a confirming party can provide relevant and reliable audit evidence of the existence of receivables, academic research supports the effectiveness of confirmation procedures in testing the existence assertion for receivables, and audit evidence from a third party generally is more reliable than audit evidence generated internally by a company or provided directly by a company. The

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<sup>1/</sup> PCAOB Release No. 2009-002, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations* (April 14, 2009).

<sup>2/</sup> Comments on the Concept Release are available on the Board's Web site at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx>.

<sup>3/</sup> Webcasts of Standing Advisory Group meetings are available on the Board's Web site at <http://pcaobus.org/News/Webcasts/Pages/default.aspx>.

<sup>4/</sup> 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* 27, no.2 (November 2008). Also, see Diane Janvrin, Paul Caster, and Randy Elder, "Enforcement Release Evidence on the Audit Confirmation Process: Implications for Standard Setters," *Research in Accounting Regulation* 22 (April 2010).

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Board also is proposing to expand the requirement to receivables that arise from credit sales, loans, or other transactions, because confirmation procedures can provide audit evidence to address the risk of material misstatement due to fraud. AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to presume there is a risk of material misstatement due to fraud relating to revenue recognition and receivables often are related to revenue recognition.<sup>5/</sup> Confirmation procedures also can provide audit evidence regarding the occurrence assertion for revenue. In addition, a company might have a material receivable from the sale of assets or the sale of a business.

The Board is proposing to require the auditor to perform confirmation procedures for cash and other relationships with financial institutions. The Board is including this requirement because confirmation procedures can provide audit evidence to address the risk of material misstatement due to fraud and because of the importance of cash to a company's liquidity and ongoing operations. The Board also is including this requirement because properly designed confirmation procedures can provide audit evidence regarding other relationships with financial institutions, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees.

- *Incorporates procedures in response to risk of material misstatement* – The proposed confirmation standard incorporates procedures that build upon the Board's Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk (the "proposed risk assessment standards").<sup>6/</sup> The auditor designs and performs audit procedures to address the risks of material misstatement due to error or fraud. The proposed risk assessment standards require the auditor to determine whether any identified and assessed risks of material misstatement are

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<sup>5/</sup> Paragraph .41 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>6/</sup> PCAOB Release 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (December 17, 2009).

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significant risks<sup>7/</sup> and to perform audit procedures in response to significant risks.<sup>8/</sup> The proposed confirmation standard applies this approach to the confirmation process by requiring the auditor to perform confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures. In addition, the proposed standard includes other procedures that address the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating non-responses to confirmation requests.

- *Updates the standard to reflect significant advances in technology –* Significant advances in technology, including increased use of electronic communication methods, have occurred since the existing confirmation standard was written more than 15 years ago. While adding efficiency, some of these electronic methods of communication also have added opportunities for skilled individuals to intercept confirmation requests and change confirmation responses before they reach the auditor. The proposed confirmation standard includes requirements related to addressing the risks that are applicable to confirmation in an electronic environment and includes requirements to assess the reliability of electronic confirmation responses.
- *Defines a confirmation response to include electronic or other medium –* The proposed standard defines a confirmation response as "audit evidence obtained as a direct communication to the auditor from a third party, either in paper form or by electronic or other medium." Revising the definition of a confirmation response to provide for a response by electronic or other medium might make the confirmation process more efficient than paper form, although

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<sup>7/</sup> The term "significant risk" is defined in paragraph A5 of PCAOB Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, as "a risk of material misstatement that requires special audit consideration." The Board intends for that definition to apply to the proposed confirmation standard as well.

<sup>8/</sup> Paragraph 11 of PCAOB Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

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auditors should take into account the risks associated with electronic confirmation responses.

- *Enhances requirements when confirmation responses include disclaimers and restrictive language* – The proposed confirmation standard requires the auditor to evaluate disclaimers and restrictive language included in confirmation responses to determine whether such disclaimers or restrictive language affect the reliability of those responses. The proposed standard further provides that if such language precludes the auditor from treating the response as a confirmation response, the auditor should perform alternative procedures to obtain relevant and reliable audit evidence or assess the implications, if any, for the audit report.

The proposed standard carries forward some of the requirements in AU sec. 330. In addition, for certain matters, the proposed standard adds to the existing requirements by requiring the auditor to perform additional procedures. For example, the proposed standard requires the auditor to perform confirmation procedures in response to significant risks in certain circumstances and to determine the validity of addresses in confirmation requests. Additionally, in drafting the proposed standard the Board considered International Standard on Auditing ("ISA") 505, *External Confirmations*, issued by the International Auditing and Assurance Standards Board ("IAASB") and the Proposed Statement on Auditing Standards, *External Confirmations* (the "ASB's proposed SAS"), of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").<sup>9/</sup>

This release includes three appendices. Appendix 1 to this release contains the text of the proposed standard, *Confirmation*, which has one appendix, *Definitions*. Appendix 2 to this release contains related proposed amendments to existing PCAOB auditing standards to conform them to the requirements in the proposed standard. Appendix 3 provides a comparison of the proposed standard to ISA 505 and the ASB's proposed SAS.

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<sup>9/</sup> See the ASB's Proposed Statement on Auditing Standards, *External Confirmations*, at [http://www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/DownloadableDocuments/20090528a\\_ED\\_External\\_Confirmations.pdf](http://www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/DownloadableDocuments/20090528a_ED_External_Confirmations.pdf).

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### **II. General Areas of Comment on the Concept Release**

Commenters were supportive of the Board updating the existing confirmation standard given the significance of the changes in the business environment since the adoption of that standard, particularly with respect to advances in technology. To make the confirmation process more effective in the current business environment, the proposed definition of confirmation response addresses the significant advances in technology since the existing standard was issued.

The Board received some general comments related to its standard-setting process, including the use of a concept release. The Board continuously endeavors to improve its standards, including by using a robust standard-setting process, and is considering these comments as it does so.

Several commenters encouraged the Board to more closely align a revised confirmation standard with ISA 505. A number of commenters also suggested that the Board consider the ASB's proposed SAS. As discussed above, Appendix 3 to the release compares the Board's proposed standard to ISA 505 and the ASB's proposed SAS.

### **III. Overview of the Proposed Standard**

The Board's proposed standard is intended to strengthen the existing requirements for confirmation.<sup>10/</sup> The Board requests comments on the proposed standard and is particularly interested in responses to the specific questions included in this release in the sections below.

The Board's proposed standard establishes the requirement for the auditor to perform confirmation procedures (1) for receivables that arise from credit

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<sup>10/</sup> PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, states that "[t]he 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 the action or procedure is presumptively mandatory, while the action or procedure is not.

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sales, loans, or other transactions; (2) for cash and other relationships with financial institutions; and (3) in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures. The proposed standard also establishes requirements regarding the design and performance of confirmation procedures.

For clarity and ease of understanding, the proposed confirmation standard refers to portions of the Board's proposed risk assessment standards. Consequently, the proposed confirmation standard might need to be revised to reflect any changes that are made to the proposed risk assessment standards. Also, because the proposed risk assessment standards were subject to comment during a separate comment process, the Board is not seeking additional comments on the proposed risk assessment standards through proposal of the confirmation standard.

### A. Definitions

AU sec. 330 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."<sup>11/</sup> That 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.<sup>12/</sup>

The majority of commenters to the Concept Release supported expanding the definition of a confirmation response to allow for responses other than traditional mailed responses. Several of these commenters stated that a proposed standard should not attempt to include all the various ways in which a confirmation response might be obtained, as technology and processes will continue to evolve. In addition, the majority of commenters recommended that an oral response to a confirmation request not be considered a confirmation response.

The proposed standard defines confirmation as "[t]he process of obtaining and evaluating a direct communication from a third party in response to a request, either in paper form or by electronic or other medium, for information

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<sup>11/</sup> Paragraph .04 of AU sec. 330, *The Confirmation Process*.

<sup>12/</sup> AU sec. 330.29.

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about a particular item affecting financial statement assertions." Further, the proposed standard defines a confirmation response as "[a]udit evidence obtained as a direct communication to the auditor from a third party, either in paper form or by electronic or other medium." The proposed standard also states that "[a]n oral response to a confirmation request is audit evidence, but it does not meet the definition of a confirmation response."

Revising the definition to permit a confirmation response by electronic or other medium might make the confirmation process less burdensome for confirming parties and, therefore, improve confirmation response rates. In addition, the Board considered comments on the Concept Release that an oral communication does not constitute a confirmation response.

The proposed standard permits the use of direct access as a confirmation response if certain conditions are met. Direct access is defined in the proposed standard as "[a]n auditor's electronic access into a confirming party's electronic records of transactions or balances with the company." For example, auditors might obtain electronic access (e.g., using a Web site link) into a confirming party's (e.g., the company's customer, bank, or other party) electronic records of transactions or balances with the company. A brokerage firm, for instance, can set up a web portal and grant the auditor a unique ID and password for limited-time access to the company's detailed account statements or information specifically generated for, or made available to, the auditor. The definition further states that "[i]f access codes or information necessary to access data held by a confirming party are provided to the auditor by management of the company and not by the confirming party, evidence obtained by the auditor from access to such information does not meet the definition of a confirmation response. Rather that information constitutes other audit evidence."

The proposed standard provides that, among other things, the auditor should evaluate whether direct access is an appropriate means to confirm the particular information that is the subject of the confirmation request and provides that direct access is not an appropriate confirmation procedure in all cases. For example, direct access might be appropriate for confirming the existence of certain cash and investment accounts. However, when confirming revenue agreements, the auditor should evaluate whether the revenue agreements could include terms and oral modifications that would make direct access an inappropriate mechanism for confirmation.

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The proposed standard also includes definitions of confirmation request, exception, negative confirmation request, non-response, and positive confirmation request.

### Question

1. Are the definitions included in the proposed standard sufficiently clear and appropriate? If not, what changes should the Board make to the definitions?

### **B. Objective**

The Board's existing standard does not include an objective. In the Concept Release, the Board requested comments on a potential objective for a proposed standard and indicated that the objective might 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."

The majority of the commenters supported including an objective in a proposed standard. However, commenters indicated that the objective as stated in the Concept Release might be misunderstood to require confirmation for all relevant identified risks. Other commenters indicated that the objective might imply that confirmation would provide sufficient, competent audit evidence in all cases.

The proposed standard states that "[t]he objective of the auditor in designing and performing confirmation procedures is to obtain relevant and reliable audit evidence." In response to comments received on the Concept Release, the proposed objective focuses the auditor on obtaining relevant and reliable audit evidence from confirmation procedures. It also addresses comments by some commenters to the Concept Release that confirmation responses might not provide sufficient audit evidence in all cases and that there might be a need to supplement the responses with other substantive procedures.

### Questions

2. Is the objective of the proposed standard clear and appropriate? If not, what changes should the Board make to the objective?
3. What other matters, if any, should the objective include?

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### C. Confirmation of Specific Accounts

As described in the Board's proposed risk assessment standards, confirmation procedures frequently are used in relation to account balances and their constituent parts.<sup>13/</sup> Confirmation procedures also are used to confirm terms of the company's agreements or transactions with third parties, or to confirm the absence of certain conditions, such as undisclosed side agreements. The Board is proposing requirements for auditors to confirm receivables and cash and to perform confirmation procedures in response to certain significant risks.

#### Receivables That Arise from Credit Sales, Loans, or Other Transactions

AU sec. 330 includes a presumption that the auditor will request confirmation of accounts receivable during an audit unless one of the following is true:

- Accounts receivable are immaterial to the financial statements.
- The use of confirmations would be ineffective.
- 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. In many situations, both confirmation of accounts receivable and other substantive tests of details are necessary to reduce audit risk to an acceptably low level for the applicable financial statement assertions.<sup>14/</sup>

The existing standard defines accounts receivable as:

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

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<sup>13/</sup> Paragraph 18 of PCAOB Proposed Auditing Standard, *Audit Evidence*.

<sup>14/</sup> AU sec. 330.34.

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- b. A financial institution's loans.<sup>15/</sup>

In the Concept Release, the Board acknowledged the importance of retaining the presumption to request confirmation of accounts receivable. The accounting profession in the United States has required confirmation of accounts receivable since 1939, when the American Institute of Accountants<sup>16/</sup> adopted Statement on Auditing Procedure No. 1 as a direct result of the McKesson & Robbins fraud case.<sup>17/</sup> In that case, the U.S. Securities and Exchange Commission (the "SEC") concluded that if confirmation of receivables had been accepted practice at that time, such a procedure would have revealed the fictitious nature of the McKesson & Robbins receivables.<sup>18/</sup>

Although the Board did not specifically request comment on retaining the presumption that the auditor will request confirmation of accounts receivable, a few commenters indicated that they did not support retaining this requirement. One commenter expressed concern that the presumptive requirement supplants auditor judgment and might result in over-reliance on confirmation procedures.

The Board is retaining the requirement to perform confirmation procedures for receivables in the proposed standard because a confirmation response from a confirming party can provide relevant and reliable audit evidence of the existence of a receivable, academic research supports the effectiveness of such procedures in testing the existence of receivables,<sup>19/</sup> and audit evidence from a third party generally is more reliable than audit evidence generated internally by

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<sup>15/</sup> Ibid.

<sup>16/</sup> The American Institute of Accountants was the predecessor to the American Institute of Certified Public Accountants ("AICPA").

<sup>17/</sup> See United States of America before the Securities and Exchange Commission (the "SEC") in the Matter of McKesson & Robbins, Inc., pursuant to Section 21(a) of the Securities Exchange Act of 1934, *Report on Investigation and Testimony of Expert Witnesses* (December 1940), Section 5, Conclusions.

<sup>18/</sup> Ibid, p. 394.

<sup>19/</sup> P. Caster, et al., "A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness." Also see D. Janvrin, et al., "Enforcement Release Evidence on the Audit Confirmation Process: Implications for Standard Setters."

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a company or provided directly by a company. Also, there is limited evidence regarding the effectiveness of alternative procedures in place of confirmation of receivables.<sup>20/</sup> The proposed standard includes the requirement for the auditor to perform confirmation procedures for receivables that arise from credit sales, loans, or other transactions and states that "[t]hese receivables may be in the form of loans, notes, and other financial instruments and may be originated by the company or purchased from another entity." The proposed standard further states that "[t]he auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, when selecting which receivables to confirm." The proposed standard also eliminates the definition of accounts receivable that was included in AU sec. 330.<sup>21/</sup> The Board is proposing to extend the requirement to perform confirmation procedures to receivables that arise from credit sales, loans, or other transactions. This requirement includes purchased loans, accounts receivable, royalty receivables, lease receivables, notes receivable, and other similar receivables. As discussed above, the Board is proposing this change to the existing standard because confirmation of receivables can provide audit evidence regarding the occurrence assertion for revenue and can potentially address the risk of material misstatement due to fraud relating to revenue recognition.<sup>22/</sup> In addition, a company might have material receivables that arise from the sale of assets or the sale of a business.

The proposed standard does not carry forward the exceptions for not confirming receivables for several reasons. First, AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.<sup>23/</sup>

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<sup>20/</sup> D. Janvrin, et al., "Enforcement Release Evidence on the Audit Confirmation Process: Implications for Standard Setters."

<sup>21/</sup> AU sec. 330.34.

<sup>22/</sup> AU sec. 316.41 states, "[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."

<sup>23/</sup> AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. PCAOB Proposed Auditing Standard, *Consideration of Materiality in Planning*

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Auditors should follow that standard when considering materiality. Second, if auditors consider confirmation procedures to be ineffective, auditors should determine why they are ineffective and look for ways to improve the effectiveness of confirmation procedures. For example, it might be ineffective to confirm a particular accounts receivable balance, but it might be effective to confirm individual transactions that make up that accounts receivable balance. In addition, useful information can be obtained from the confirmation responses. Finally, AU sec. 316 requires the auditor to presume there is a risk of material misstatement due to fraud relating to revenue recognition, and receivables often are related to revenue recognition.<sup>24/</sup>

Under the proposed standard, the auditor may use audit sampling to select receivables to confirm. If the auditor uses audit sampling when selecting receivables to confirm, he or she should follow the requirements in AU sec. 350, *Audit Sampling*.<sup>25/</sup>

AU sec. 330 requires the auditor to document how he or she overcame the presumption to request confirmation of accounts receivable.<sup>26/</sup> PCAOB Auditing Standard No. 3, *Audit Documentation*, requires, among other things, that audit documentation demonstrate that the engagement complied with the standards of the PCAOB.<sup>27/</sup> Accordingly, pursuant to Auditing Standard No. 3, the auditor should document in the audit work papers his or her rationale for not performing confirmation procedures for receivables that arise from credit sales, loans, or other transactions.

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*and Performing an Audit*, would supersede AU sec. 312 after it is adopted by the Board and approved by the SEC.

<sup>24/</sup> AU sec. 316.41.

<sup>25/</sup> AU sec. 350, *Audit Sampling*.

<sup>26/</sup> AU sec. 330.35.

<sup>27/</sup> Paragraph 5.a. of PCAOB Auditing Standard No. 3, *Audit Documentation*.

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### Question

4. Is the description of "receivables that arise from credit sales, loans, or other transactions" sufficiently clear and appropriate? If not, what changes should the Board make?

### **Cash with Financial Institutions**

The proposed standard requires the auditor to perform confirmation procedures for cash with financial institutions, such as banks, brokerage firms, trust companies, and other similar entities. It further requires that confirmation procedures with these financial institutions should include confirming (a) other relationships, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees; and (b) whether, during the process of completing the confirmation response, any additional information about other deposit or loan accounts has come to the attention of the financial institution.

The Board is including these requirements because confirmation procedures can provide audit evidence to address the risk of material misstatement due to fraud and because of the importance of cash to a company's liquidity and ongoing operations. The Board also is including these requirements in the proposed standard because properly designed confirmation requests can provide audit evidence regarding other relationships with financial institutions, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees.

The AICPA *Standard Form to Confirm Account Balance Information with Financial Institutions*<sup>28/</sup> includes a request that the confirming party represent that "[t]he information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted [in the confirmation response]." In the proposed standard's requirement to confirm cash and other relationships with financial institutions, the auditor is required to request a similar representation from the financial institution.

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<sup>28/</sup> The AICPA, the American Bankers Association, and the Bank Administration Institute agreed on a standard form designed specifically to inquire about deposit balances and loans. This standard form is available from the AICPA at <http://www.cpa2biz.com>.

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The proposed standard also requires the auditor to obtain an understanding of the company's cash management and treasury function to determine which cash accounts and other relationships with financial institutions to confirm. In addition, the proposed standard provides that the auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, when selecting which cash accounts and other relationships to confirm. The auditor should not base his or her selection of cash accounts to confirm only on the reported balances of the cash accounts. There might be significant activity in, and risks associated with, a cash account that has an immaterial or zero balance. In addition, there might be other relationships with the financial institution, such as a significant unused line of credit.

The AICPA *Standard Form to Confirm Account Balance Information with Financial Institutions* provides for confirming cash balances and loan account balances only.<sup>29/</sup> In addition, some financial institutions do not have the relationship management systems that provide the ability to confirm cash and other relationships using one confirmation request. Accordingly, confirmation requests for other relationships with the financial institutions might need to be sent separately from cash confirmation requests.

### Question

5. Is the requirement in the proposed standard to confirm cash and other relationships with financial institutions sufficiently clear and appropriate? If not, what changes should the Board make?

### **Significant Risks**

The existing standard states, "[i]f 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."<sup>30/</sup> In addition, the existing standard states, "[t]he auditor should consider

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<sup>29/</sup> See AU sec. 330.14 which states that "the AICPA *Standard Form to Confirm Account Balance Information with Financial Institutions* is designed to substantiate information that is stated on the confirmation request; the form is not designed to provide assurance that information about accounts not listed on the form will be reported."

<sup>30/</sup> AU sec. 330.08.

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requesting confirmation of the terms of unusual agreements or transactions, such as bill and hold sales, in addition to the amounts."<sup>31/</sup>

In the Concept Release, the Board asked whether the presumptively mandatory requirement to request confirmation of accounts receivable should be expanded to include the requirement for the auditor to request confirmation of the significant terms of complex or unusual agreements or transactions, including complex or unusual revenue transactions. Numerous commenters were not supportive of expanding the presumptively mandatory requirement to request confirmation beyond accounts receivable. A number of these commenters recommended that determining whether to use confirmation to obtain audit evidence should be a function of the auditor's risk assessment and judgment regarding the nature and extent of procedures necessary to obtain sufficient appropriate audit evidence. A few commenters indicated that if the Board decides to expand the requirement to request confirmation of significant complex or unusual agreements or transactions, it would be helpful for the Board to include an explanation of what constitutes significant complex or unusual agreements or transactions.

Many commenters also did not support requiring confirmation procedures for other accounts, transactions, or agreements; however, most commenters suggested that a new standard focus on risks. Accordingly, the Board incorporated procedures to address the risk of material misstatement by requiring the auditor to perform confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.<sup>32/</sup> The proposed requirement should enhance the auditor's application of the standard because (1) the proposed risk assessment standards include factors that should be evaluated in determining which risks are significant risks<sup>33/</sup> and (2) the requirement to perform confirmation procedures

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<sup>31/</sup> AU sec. 330.25.

<sup>32/</sup> This requirement is applicable to significant risks associated with accounts other than receivables and cash, which are addressed in paragraphs 8 and 9, respectively, of the proposed standard.

<sup>33/</sup> Paragraph 71 of PCAOB Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement* states, "[f]actors that should be evaluated in determining which risks are significant risks include:

- a. Whether the risk is a fraud risk;

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has been expanded to apply to all significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.

The proposed standard also acknowledges that confirmation procedures might not be specifically responsive to every significant risk. Confirmation procedures might not adequately address the relevant assertions for a particular account, balance, or other item associated with a significant risk. For example, in the audit of a utility or telecommunications company, the auditor might identify additions to property, plant, and equipment ("fixed assets") as a significant risk. However, confirming these fixed asset additions might not be an appropriate substantive procedure to perform. A confirmation response might not provide any evidence as to (1) whether the asset has been placed into service, is still in use, or exists at the balance sheet date; (2) the cost of the asset, since additional costs might have been incurred to get the asset ready for use; or (3) the value of the asset at the balance sheet date, because the asset might have been depreciated or impaired.

AU sec. 330 states that "[t]he auditor also should consider whether there may be oral modifications to agreements, such as unusual payment terms or liberal rights of return. When the auditor believes there is a moderate or high degree of risk that there may be significant oral modifications, he or she should

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Note: A fraud risk is a significant risk.

- b. Whether the risk is related to recent significant economic, accounting, or other developments;
- c. The complexity of transactions;
- d. Whether the risk involves significant transactions with related parties;
- e. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- f. Whether the risk involves significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual due to their timing, size or nature."

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inquire about the existence and details of any such modifications to written agreements. One method of doing so is to confirm both the terms of the agreements and whether any oral modifications exist.<sup>34/</sup> The proposed standard carries forward and enhances the requirements in the existing standard. The proposed standard states that "[f]or example, for significant risks related to agreements or transactions for which confirmation procedures adequately address the relevant assertions, the auditor should confirm the amounts and terms of such agreements or transactions, including whether there are any undisclosed oral or undisclosed written modifications to those agreements, such as undisclosed side agreements."

### Questions

6. Does the proposed standard appropriately address the risk of material misstatement by requiring confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures? If not, what changes should the Board make?
7. Should the proposed standard include additional requirements with regard to sending confirmation requests in response to significant risks? If so, what additional requirements should the Board include?

### **Other Risks**

The proposed standard acknowledges that performing confirmation procedures might be an appropriate response to other risks of material misstatement. The proposed standard states, "[e]ven when a significant risk does not exist for a particular account, balance, transaction, agreement, or other item, the performance of confirmation procedures still might be an appropriate response to obtain audit evidence for certain relevant assertions regarding that particular account, balance, transaction, agreement, or other item." For example, a company might have an accounts payable account that does not represent a significant risk. In this situation, however, confirming account balances might be the most effective procedure to obtain relevant and reliable audit evidence.

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<sup>34/</sup> AU sec. 330.25.

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### Question

8. Is the description in the proposed standard of other risks sufficiently clear and appropriate? If not, what changes should the Board make?

### **D. Confirmation Procedures**

The existing standard states, "[c]onfirmation requests should be tailored to the specific audit objectives. Thus, when designing the confirmation requests, the auditor should consider the assertion(s) being addressed and the factors that are likely to affect the reliability of the confirmations."<sup>35/</sup> The existing standard requires the auditor to maintain control over confirmation requests and responses.<sup>36/</sup> The existing standard also states that "[m]aintaining control means establishing 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."<sup>37/</sup> A footnote in the existing standard adds that "[t]he need to maintain control does not preclude the use of internal auditors in the confirmation process."<sup>38/</sup>

Through the Concept Release, the Board asked whether additional requirements were needed in a confirmation standard with regard to maintaining control over confirmation requests and responses and designing confirmation requests. The Board also asked whether additional requirements were needed to address advances in technology that were not anticipated when AU sec. 330 was written.

Several commenters indicated that the proposed standard should include further explanation regarding maintaining control over confirmation requests, such as selecting the appropriate confirming party and determining that confirmation requests are appropriately addressed. In response to these comments, the proposed standard retains the existing requirements and includes additional requirements regarding maintaining control over the confirmation

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<sup>35/</sup> AU sec. 330.16.

<sup>36/</sup> AU sec 330.28.

<sup>37/</sup> Ibid.

<sup>38/</sup> Footnote 3 to AU sec. 330.28.

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process. For example, the proposed standard includes the requirements for the auditor to request that the confirming parties or intended intermediaries<sup>39/</sup> respond directly to the auditor and that if a confirming party sends a confirmation response to anyone other than the auditor, the auditor should contact the confirming party and request that the confirming party re-send the response directly to the auditor.

The Board is not retaining the reference to the use of internal auditors in the proposed standard because the requirements for considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor are included in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

The requirement in the proposed standard to maintain control over the confirmation process, however, limits the auditor's ability to use internal auditors to perform certain procedures in the confirmation process for the auditor. The proposed standard provides that "[t]he auditor should send the confirmation requests directly to the intended confirming parties or intended intermediaries and should not permit the company or any other party to send the confirmation requests" and "[w]hen performing confirmation procedures, the auditor should request that the confirming parties or intended intermediaries respond directly to the auditor and not to the company or any other party." In addition, the proposed standard provides that "[t]he auditor should evaluate the audit evidence obtained from performing confirmation procedures and should not rely on the company or any other party for this evaluation." Therefore, the auditor cannot use internal auditors to send confirmation requests, receive confirmation responses, or evaluate the audit evidence obtained from performing confirmation procedures. An auditor may use internal auditors to perform procedures for the auditor in other ways, however, provided that the auditor has assessed the internal auditors' competence and objectivity<sup>40/</sup> and that the auditor supervises, reviews, evaluates, and tests the work performed by internal auditors<sup>41/</sup> pursuant to AU sec. 322. Under this framework, for example, internal auditors may assist in

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<sup>39/</sup> An intermediary is an entity used by the intended confirming party and the auditor to facilitate confirmation between the confirming party and the auditor.

<sup>40/</sup> Paragraph .11 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

<sup>41/</sup> AU sec. 322.27.

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testing that confirmation requests are properly addressed and in assembling information necessary for the auditor to resolve exceptions in confirmation responses.

In addition, consistent with AU sec. 322, an auditor may consider work performed by internal auditors in determining the timing and extent of the auditor's procedures,<sup>42/</sup> provided that the auditor has obtained an understanding of the internal audit function and assessed the internal auditors' competence and objectivity.<sup>43/</sup> For example, if the internal auditors, as part of their work, confirm certain receivables, the auditor may consider the internal auditors' work and change the timing of his or her confirmation procedures or the number of receivables to confirm.<sup>44/</sup> AU sec. 322 also states that:

Even though the internal auditors' work may affect the auditor's procedures, the auditor should perform procedures to obtain sufficient, competent, evidential matter to support the auditor's report. The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the auditor uses the work of other independent auditors, this responsibility cannot be shared with the internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the auditor. As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases.<sup>45/</sup>

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<sup>42/</sup> AU sec. 322.17.

<sup>43/</sup> AU secs. 322.04-.11.

<sup>44/</sup> AU sec. 322.17.

<sup>45/</sup> AU secs. 322.18-.20.

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### Questions

9. Are the requirements in the proposed standard for maintaining control over the confirmation process sufficiently clear and appropriate? If not, what changes should the Board make?
10. Is the description with respect to the use of internal auditors in the confirmation process sufficiently clear and appropriate? If not, what changes should the Board make?

### **Designing the Confirmation Requests**

With regard to designing confirmation requests, several commenters stated that they believed that no significant change is needed from what is in the existing standard. Other commenters recommended that the Board consider including factors for the auditor to consider when designing confirmation requests.

The proposed standard requires the auditor to design confirmation requests to obtain relevant and reliable audit evidence. Factors for the auditor to consider when designing confirmation requests include:

- The assertions being addressed, e.g., selecting balances from the accounts payable subsidiary ledger when addressing the existence assertion and selecting vendor accounts from a vendor list when addressing the completeness assertion.
- The specific risks of material misstatement, including the risk of material misstatement due to fraud ("fraud risk"), e.g., the possible existence of undisclosed side agreements.
- The nature of the information to be confirmed, e.g. the components of a complex mortgage calculation instead of the mortgage balance.
- The layout, presentation, and content of the confirmation request. For example, for a receivable confirmation request, a recipient might be more likely to reply, as well as identify discrepancies, if a copy of the customer's account statement is included with the confirmation request.

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- Prior experience on the audit engagement or other similar engagements. For example, based on prior experience on the audit engagement, the auditor might be aware that certain respondents' accounting systems might facilitate confirming single transactions rather than entire account balances.
- The method of communication, whether it is in paper form or by electronic or other medium. For example, a financial institution might not respond to paper confirmation requests and might respond only to confirmation requests submitted electronically via a designated intermediary or that request direct access to the financial institution's electronic records for the information.
- The company's authorization to the confirming parties to respond to the auditor. For example, some confirming parties might be willing to respond only to a confirmation request containing the company's authorization.
- Local customs that might influence confirmation responses, such as a local custom of responding to confirmation requests without verifying the information. For example, if the local custom is that a confirming party confirms the information contained in the confirmation request without verifying that the information is correct in order to maintain a customer relationship, the auditor could address this issue by using a positive confirmation request that does not state the balance or amount (or certain other information) on the confirmation request.

### Question

11. Are the factors for designing confirmation requests in the proposed standard sufficiently clear and appropriate? If not, what changes should the Board make?

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### *Determining the Type of Confirmation Requests to Send*

The existing standard permits the use of negative confirmations<sup>46/</sup> and 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 (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration." It further provides that "[t]he auditor should consider performing other substantive procedures to supplement the use of negative confirmations."<sup>47/</sup>

The Concept Release requested feedback on whether the proposed 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. The majority of commenters responded that negative confirmations should continue to be permitted. However, several of those commenters also indicated that negative confirmations should not be the sole substantive audit procedure, unless certain conditions were present.

In developing the proposed standard, the Board took into account comments that negative confirmation requests may provide audit evidence in limited circumstances. For example, when performing audit procedures for demand deposit accounts in a financial institution audit, it may be appropriate for an auditor to use negative confirmation requests with copies of the customers' regular account statements attached to the confirmation requests when the risk of material misstatement is low, the auditor reasonably expects a low exception rate, and the auditor reasonably believes that recipients of the negative confirmation requests will give such requests consideration. Negative confirmation requests also might provide some evidence of the existence of confirming parties if the requests are not returned with an indication that the addressees are unknown. In addition, negative confirmation requests might be used effectively in conjunction with positive confirmation requests.

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<sup>46/</sup> AU sec. 330.20 defines negative confirmation as a request for the recipient to respond only if he or she disagrees with the information stated on the request.

<sup>47/</sup> Ibid.

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The absence of a response to a negative confirmation request provides significantly less audit evidence than a response to a positive confirmation request. Therefore, unless the auditor receives a response, the auditor does not know whether the intended confirming party received the confirmation request and verified the accuracy of the information contained in the request. Consequently, the proposed standard states, "the auditor should not use negative confirmation requests as the only form of confirmation request to address the assessed risk of material misstatement at the assertion level unless all of the following factors are present:

- The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the design and operating effectiveness of controls relevant to the assertion;<sup>48/</sup>
- The population of items subject to negative confirmation procedures is made up of a large number of small, homogeneous account balances, transactions, or other items;
- The auditor reasonably expects a low exception rate; and
- The auditor reasonably believes that recipients of negative confirmation requests will give such requests consideration.

Because negative confirmation requests provide limited audit evidence, even when all of the factors above are present, the auditor should perform other substantive procedures to supplement the use of negative confirmation requests."

In designing the confirmation requests, the auditor may use positive confirmation requests, negative confirmation requests, or a combination of both. A response to a positive confirmation request can provide audit evidence. There is a risk, however, that a confirming party will reply to the confirmation request without verifying that the information is correct. The auditor might reduce this risk by using a positive confirmation request that does not state the balance or amount (or certain other information) on the confirmation request (a "blank confirmation request") and, instead, asks the confirming party to fill in the amount

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<sup>48/</sup> Also see paragraphs 16-17 of PCAOB Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, for a discussion of tests of controls.

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or furnish the other information. Thus, the use of blank confirmation requests might provide a greater degree of assurance about the information confirmed. However, blank forms might result in lower response rates because additional effort is required of the confirming parties.

### Question

12. Are the requirements in the proposed standard regarding the use of negative confirmation requests sufficiently clear and appropriate? If not, how should the Board change these requirements?

### ***Determining That Confirmation Requests Are Properly Addressed***

The existing standard does not include a requirement for the auditor to perform procedures to determine the validity of addresses on confirmation requests. In the Concept Release, the Board asked whether the auditor should be required to test some or all of the addresses of confirming parties to determine whether confirmation requests are directed to the intended recipients. Some commenters supported including a requirement to test addresses while other commenters thought the standard should include guidance rather than specific requirements.

The proposed standard requires the auditor to perform procedures to determine the validity of addresses on the confirmation requests, including substantive procedures or tests of controls. The proposed standard further states that "[t]he nature and extent of the procedures depend on the associated risks and materiality of the items being confirmed. For example, the auditor should perform substantive procedures to determine the validity of addresses on the confirmation requests for transactions or accounts that involve significant risks or are material to the financial statements."

The proposed standard provides other factors to consider in determining the nature and extent of procedures to perform to validate addresses on confirmation requests, which include the following:

- The company has a new customer base;
- An address is a post office box; or

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- An e-mail address is not consistent with the confirming party's Web site address (e.g., situations in which the e-mail address has a domain name that differs from the domain name of the Web site).

The proposed standard also states that "[i]f the auditor identifies an invalid address, the auditor should perform the following procedures:

- a. Investigate the reasons for the invalid address and attempt to obtain a valid address;
- b. Evaluate the implications of the invalid address on the auditor's planned confirmation procedures and the auditor's assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures; and
- c. Perform other audit procedures designed to obtain relevant and reliable audit evidence with respect to the account, balance, or other item, if a valid address cannot be obtained for the confirmation request."

### Questions

13. Are the procedures the auditor should perform to determine the validity of the addresses on confirmation requests sufficiently clear and appropriate? If not, what changes should the Board make to the proposed procedures?
14. Are the procedures the auditor should perform when he or she determines that a confirmation request does not include a valid address sufficiently clear and appropriate? If not, what changes should the Board make to the proposed procedures?

### **Management Requests Not to Confirm**

AU sec. 508, *Reports on Audited Financial Statements*, provides that restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an

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opinion.<sup>49/</sup> Management requests not to confirm certain accounts, transactions, agreements or other items could be a scope limitation, which is addressed in the auditor's reporting standard.<sup>50/</sup> In the Concept Release, the Board asked whether a proposed confirmation standard should include procedures for the auditor to perform when management requests the auditor not to confirm certain accounts, transactions, agreements, or other items. The majority of commenters believed that a proposed standard should include specific procedures for the auditor to perform when management makes such a request.

In response to comments received on the Concept Release, the proposed standard states that "[i]f management requests the auditor not to confirm certain accounts, balances, or other items, the auditor should:

- a. Obtain an understanding of management's reasons for the request;
- b. Obtain audit evidence as to the appropriateness of management's reasons for the request; and
- c. Determine whether management's request is appropriate."

For example, management might request the auditor not confirm a specific receivable balance because of litigation between the company and the customer. If the auditor agrees to management's request and does not confirm certain accounts, balances, or other items, the proposed standard requires that the auditor perform the following procedures:

- a. Evaluate the implications of management's request on the auditor's assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures;
- b. Perform other audit procedures designed to obtain relevant and reliable audit evidence with respect to the accounts, balances, or other items not being confirmed;

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<sup>49/</sup> Paragraph .22 of AU sec. 508, *Reports on Audited Financial Statements*.

<sup>50/</sup> AU secs. 508.22-.34.

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- c. Communicate management's request to the audit committee, or equivalent;
- d. Include management's reason for the request in the management representation letter; and
- e. Evaluate the implications for the audit report.

The proposed standard further indicates that "[i]f the auditor does not agree to management's request and management refuses to authorize the confirmation request, the auditor should communicate management's refusal to the audit committee, or equivalent, and evaluate the implications for the audit report."

### Question

- 15. Are the procedures the auditor should perform when management requests the auditor not to confirm certain accounts, balances, or other items sufficiently clear and appropriate? If not, what changes should the Board make to the proposed requirements?

## **E. Evaluation**

The proposed standard requires the auditor to evaluate the audit evidence obtained from performing confirmation procedures and not rely on the company or any other party for this evaluation. Such evaluation includes:

- a. Performing appropriate alternative procedures for each non-response;
- b. Investigating each exception in confirmation responses;
- c. Assessing the reliability of confirmation responses, including performing additional procedures for electronic confirmation responses;
- d. Considering the effect of disclaimers and restrictive language; and
- e. Evaluating results to determine whether relevant and reliable audit evidence has been obtained.

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### Non-responses

AU sec. 330 indicates 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."<sup>51/</sup> The proposed standard includes a similar requirement and states that "[w]hen using positive confirmation requests and a response from a confirming party has not been received, the auditor should follow up with a second request and should consider following up with a third request."

AU sec. 330 provides requirements for situations in which the auditor should perform alternative procedures for non-responses to positive confirmation requests, as well as examples of the types of alternative procedures that he or she might perform.<sup>52/</sup> The existing standard also permits the auditor to omit alternative procedures in limited situations.<sup>53/</sup>

In the Concept Release, the Board requested feedback on whether the auditor should be required to perform alternative procedures for non-responses to positive confirmation requests. The majority of commenters agreed that a proposed standard should include such a requirement. However, several commenters suggested that the Board also retain the provisions in AU sec. 330 that permit auditors to omit alternative procedures for certain non-responses.<sup>54/</sup>

The proposed standard requires the auditor to perform appropriate alternative procedures for all non-responses to positive confirmation requests. Such alternative procedures should address the risks for the related assertion(s)

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<sup>51/</sup> AU sec. 330.30.

<sup>52/</sup> AU secs. 330.31-.32.

<sup>53/</sup> AU sec. 330.31 states that "omission of alternative procedures may be acceptable (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>54/</sup> Ibid.

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intended to be addressed by the confirmation request. The Board is including the requirement to perform appropriate alternative procedures because a non-response to a positive confirmation request might indicate a previously unidentified risk of material misstatement, including a fraud risk. In such situations, the auditor might need to revise the assessed risk of material misstatement at the assertion level and modify planned audit procedures. The proposed standard does not provide for omitting alternative procedures for non-responses to positive confirmation requests.

The proposed standard requires that the item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of the alternative audit procedures that the auditor should perform for non-responses. For example, when performing confirmation procedures for the existence assertion for receivables that arise from credit sales, loans, or other transactions, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash receipts (including matching such receipts with the actual invoices being paid), (2) shipping documents, or (3) other supporting documentation. In addition, if the auditor is confirming the account balance for a receivable, and the account balance is made up of numerous invoices, debit memos, credit memos and other adjustments, the auditor's alternative procedures should include (1) testing subsequent cash receipts or other supporting documentation for the invoices, and (2) testing documentation for the debit memos, credit memos, and other adjustments that make up that account balance. When performing confirmation procedures for the completeness assertion for accounts payable, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash disbursements, (2) correspondence from vendors and suppliers, or (3) other documentation or records.

Under the proposed standard, when the auditor performs confirmation procedures for the terms of a transaction or agreement and does not receive a response to such a request, he or she should perform appropriate alternative procedures. The proposed standard also provides examples of such procedures, including inspecting the original signed contract and amendments thereto, comparing contractual terms to industry norms, and confirming or discussing significant information with other parties involved in the transaction or agreement. The proposed standard also indicates that in addition to performing alternative procedures, the auditor should, for significant transactions or agreements, include the terms of the transactions or agreements in the management representation letter and communicate the terms of the transactions or agreements to the audit committee, or equivalent. The auditor also should

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consider inquiring of and obtaining written representation from the company personnel involved with the significant transaction or agreement.

### Questions

16. Are there circumstances in which it would not be necessary for the auditor to perform alternative procedures for non-responses to positive confirmation requests? If so, what are those circumstances?
17. Are the additional procedures that are required when the auditor does not receive a confirmation response for the terms of a significant transaction or agreement appropriate? If not, what changes should the Board make?

### ***When a Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence***

In certain circumstances, a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. AU sec. 326, *Evidential Matter*, states, "[s]ufficient 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."<sup>55/</sup>

The proposed standard includes circumstances that make it necessary for the auditor to receive a response to a positive confirmation request to obtain sufficient appropriate audit evidence. In such circumstances, alternative audit procedures will not provide the audit evidence the auditor requires. The proposed standard lists such circumstances to include the following:

- The information to corroborate management's assertion(s) is available only outside the company.
- Specific fraud risk factors, such as the risk of management override of controls or the risk of collusion, which can involve employee(s),

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<sup>55/</sup> Paragraph .01 of AU sec. 326, *Evidential Matter*. PCAOB Proposed Auditing Standard, *Audit Evidence*, would supersede AU sec. 326 after it is adopted by the Board and approved by the SEC.

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management, or outside parties, prevent the auditor from relying on evidence from the company.

If the auditor does not obtain a confirmation response in such circumstances, he or she should determine the implications for the audit and the audit report.

### Question

18. Are there additional circumstances that make it necessary for the auditor to receive a confirmation response to a positive confirmation request to obtain sufficient appropriate audit evidence? If so, what are those circumstances?

### **Exceptions**

The existing standard provides that the auditor should evaluate the combined evidence provided by confirmation procedures and the alternative procedures.<sup>56/</sup> In that evaluation, the auditor considers the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions.<sup>57/</sup> In the Concept Release, the Board requested feedback on whether the auditor should be required to investigate exceptions included in confirmation responses. The majority of commenters agreed that a proposed standard should include such a requirement.

The proposed standard defines an exception as "[a] confirmation response that indicates a difference between the information about a particular item for which a confirmation response is requested and the information provided by the confirming party." The proposed standard includes a new requirement for the auditor to investigate all exceptions in confirmation responses to determine why each exception occurred and whether any exceptions, individually or in the aggregate, are indicative of a misstatement or of a previously unidentified risk of material misstatement. An exception might indicate, among other things, a previously unidentified risk of material misstatement due to error or fraud, or deficiencies in the company's internal control over financial reporting. In addition, the proposed standard indicates that "[t]he item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of

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<sup>56/</sup> AU sec. 330.33.

<sup>57/</sup> Ibid.

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the procedures that the auditor should perform to investigate exceptions in confirmation responses."

### Question

19. Is the requirement in the proposed standard for the auditor to investigate all exceptions in confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make to the requirement?

### **Reliability of Confirmation Responses**

The existing standard includes requirements addressing the reliability of the responses to confirmation requests. However, as mentioned previously, there have been significant advances in technology since the existing standard was written. While adding efficiency, some of these electronic methods of communication have added opportunities for skilled individuals to intercept and change confirmation responses before they reach the auditor.

Any confirmation response carries some risk of interception, alteration, or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. In the Concept Release, the Board requested comments on how best to evaluate the reliability of confirmation responses, including when the auditor uses electronic confirmation, direct access, or an intermediary to coordinate and process responses to confirmation requests. Most commenters indicated that additional explanation would be helpful for evaluating the reliability of electronic confirmation. Some commenters referred the Board to AICPA Practice Alert 03-1, *Audit Confirmations*,<sup>58/</sup> and AU

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<sup>58/</sup> AICPA Practice Alert 03-1, *Audit Confirmations*, includes guidance for auditors on improving confirmation response rates, use of negative versus positive confirmations, non-responses to positive confirmations, responses to positive confirmations indicating exceptions, use of electronic confirmation, confirmations received via facsimile or electronically, management requests not to confirm, alternative procedures, confirmation with respect to specific areas, use of client personnel, and evolving alternatives.

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sec. 9330, *The Confirmation Process: Auditing Interpretations of AU section 330*<sup>59/</sup> that discuss the use of electronic confirmation.

With regard to the auditor's responsibility to evaluate confirmation responses, numerous commenters suggested that the Board consider including requirements when the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request. Those commenters recommended that the proposed standard require the auditor to obtain further audit evidence to resolve doubts about the reliability of confirmation responses, and when a confirmation response is not reliable, to evaluate the implications on the assessment of the relevant risks of material misstatement, including fraud risk, and on the related nature, timing, and extent of other audit procedures.

The requirements in the existing standard to evaluate the reliability of confirmation responses are carried forward in the proposed standard with some modifications. The proposed standard also sets forth factors that the auditor should take into account in assessing the reliability of confirmation responses. These factors include, but are not limited to, whether confirmation responses:

- Are returned to the auditor indirectly because the confirming parties forwarded the confirmation responses to the company.
- Appear not to have come from the original intended confirming parties.
- Contradict other information obtained during the audit.
- Come from addresses other than the addresses to which the auditor sent the confirmation requests.
- Are not the original confirmation requests that were sent to the confirming parties.
- Do not include the signatures of or acknowledgements by the confirming parties.

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<sup>59/</sup> AU sec. 9330, *The Confirmation Process: Auditing Interpretations of AU section 330*, was adopted by the ASB after April 16, 2003; therefore, it is not part of the Board's auditing standards.

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- Reflect local customs that may affect the confirmation responses, such as customs that create an environment in which confirmation responses are inherently unreliable.

When evaluating the reliability of the response received from a confirming party, the proposed standard requires the auditor to assess any indication that the confirming party:

- Is not competent, or knowledgeable.
- Has questionable motives.
- Is not objective or free from bias with respect to the company.

The proposed standard provides that circumstances might indicate the need for additional audit evidence to conclude whether the confirmation request is being sent to or received from a confirming party from whom the auditor can expect the response to provide relevant and reliable audit evidence. Such circumstances could include significant, unusual period-end transactions that have a material effect on the financial statements; when management of the company has significant influence over the confirming party; when the confirming party has significant influence over management of the company; when the confirming party is the custodian and servicer of a material amount of the company's assets; or when a confirmation response is from an affiliated party.

The proposed standard further states that "[i]f conditions indicate that a confirmation response might not be reliable, the auditor should obtain additional audit evidence."

### Question

20. Are the requirements in the proposed standard related to addressing the reliability of confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make to those requirements?

### ***Additional Procedures for Electronic Confirmation Responses***

Confirmation responses involve risks relating to reliability because proof of origin might be difficult to establish, and alterations can be difficult to detect. Confirmation responses received electronically (e.g., by facsimile, e-mail, through

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an intermediary, or direct access) might involve additional risks relating to reliability. An electronic confirmation process that creates a secure confirmation environment might mitigate the risks of interception or alteration.<sup>60/</sup> Consequently, the Board is including requirements with regard to electronic confirmation responses in the proposed standard. These requirements focus the auditor on the basic tenets of maintaining control over the confirmation process and on the reliability of the confirmation responses. In assessing the reliability of the electronic confirmation responses, the proposed standard requires the auditor to take into account risks that:

- The confirmation process might not be secure or might not be properly controlled;
- The information obtained might not be from a proper source; and
- The integrity of the transmission might have been compromised.

The proposed standard requires the auditor to perform procedures to address the risks associated with electronic confirmation responses. Such procedures depend on the form of electronic communication and include the following:

- If information is provided via facsimile response, the auditor should verify the source and contents of the facsimile response by directly contacting the intended confirming party (e.g., by a telephone call to the intended confirming party).
- If information is provided via an e-mail response, the auditor should verify the source and contents of the e-mail response, such as verifying the e-mail address of the intended confirming party or contacting the intended confirming party by telephone.
- If an intermediary is engaged to facilitate confirmation, the auditor should obtain an understanding of the controls over the procedures used by the intermediary to process the confirmation requests and

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<sup>60/</sup> Various means can validate the source and prevent interception or alteration of the electronic information. For example, the use of encryption, electronic digital signatures, and procedures to verify Web site authenticity might improve the security of the electronic confirmation process.

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responses. The auditor should perform procedures to determine whether the auditor can use the intermediary's process. For example, the auditor could perform procedures to determine whether the controls are designed and operating effectively. Risks to consider in performing these procedures and making this determination include (1) the process might not be secure or might not be properly controlled, (2) the information obtained might not be from a proper source, and (3) the integrity of the transmission might have been compromised. In addition, the auditor should determine whether the intermediary is authorized to respond on behalf of the intended confirming party.

- If information is provided via direct access, the auditor should evaluate whether direct access is an appropriate means to confirm information about the particular item that is the subject of the confirmation request. Direct access is not an appropriate confirmation procedure in all cases. For example, when confirming revenue agreements, the auditor should evaluate whether the revenue agreements could include terms and oral modifications that would make direct access an inappropriate mechanism for confirmation.

The proposed standard also notes that direct access to information held by a confirming party constitutes a confirmation response only if (1) the auditor's access is provided by the confirming party rather than the company, and (2) the confirming party represents to the auditor, in writing, that (a) it is aware of the auditor's request for and intended use of the information, and (b) the files to be accessed contain information responsive to the auditor's request.

Direct access might pose additional risks because the information might not be in a form that is readily understandable or the Web site might contain disclaimers or restrictions as to use. Accordingly, more experienced engagement team members might need to review the responses provided through direct access. AU sec. 230, *Due Professional Care in the Performance of Work*, states that "[a]uditors should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining."<sup>61/</sup>

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<sup>61/</sup> Paragraph .06 of AU sec. 230, *Due Professional Care in the Performance of Work*.

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If access codes or information necessary to access data held by a confirming party are provided to the auditor by management of the company and not by the confirming party, evidence obtained by the auditor from access to such information does not meet the definition of a confirmation response. Rather that information constitutes other audit evidence.

Financial institutions often provide account holders with direct access to their accounts on the financial institutions' systems. These account holders frequently use this direct access to verify account balances, pay their obligations, transfer funds to other accounts, and perform similar transactions. Financial institutions are subject to regulatory oversight and they have a fiduciary responsibility to account holders. Similar direct access to account information might not be as commonplace between companies in other industries and their customers, suppliers, and vendors. In addition, other companies do not have the same responsibilities and obligations to their account holders as financial institutions have. Consequently, the Board is considering whether to limit the use of direct access as a confirmation response to responses received from financial institutions, and the Board has posed question 25 to solicit feedback on this topic.

Auditors are reminded of the audit documentation requirements pursuant to Auditing Standard No. 3. That standard provides that the "[a]udit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:

- a. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and
- b. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review."<sup>62/</sup>

Consequently, when using an electronic environment, such as direct access, the auditor should include sufficient detail in the audit documentation to demonstrate that the auditor complied with the requirements of the proposed confirmation standard. This includes documentation of the information the auditor received through direct access, such as copies of reports, account statements, or a print screen of the information on the Web site.

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<sup>62/</sup> Paragraph 6 of Auditing Standard No. 3.

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### Questions

21. Does the proposed standard include adequate requirements regarding electronic confirmation procedures? If not, what additional requirements should the Board include?
22. Are there risks related to the use of an intermediary that the proposed standard has not adequately addressed? If so, what are those risks, and how should the standard address them?
23. The Board is interested in information about the services that an intermediary provides, specifically information about the responsibilities and obligations between the auditor and the intermediary and the intermediary and the confirming party.
24. Are there risks related to the auditor's use of direct access that the proposed standard has not adequately addressed? If so, what are those risks, and how should the standard address them?
25. Should direct access be permitted as a confirmation response only if such response is received from a financial institution? Why or why not?

### **Disclaimers and Restrictive Language**

Under the existing standards, "[s]ufficient 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."<sup>63/</sup> Through the inspection process, the PCAOB has observed instances in which the auditor did not obtain sufficient competent evidential matter from confirmation responses that included disclaimers as to their accuracy and appropriateness for use in the preparation of financial statements.<sup>64/</sup> Examples of disclaimers and restrictive language include statements that:

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<sup>63/</sup> AU sec. 326.01.

<sup>64/</sup> Page 14 of PCAOB Release No. 2008-008, *Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms* (December 5, 2008).

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- Information is obtained from electronic data sources, which might not contain all information in the bank's possession.
- Information is not guaranteed to be accurate nor current and might 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.

In the Concept Release, the Board requested comments on whether a proposed standard should require the auditor to evaluate such disclaimers and restrictive language. Several commenters indicated that the auditor should be required to evaluate disclaimers and restrictive language to determine their effect on audit evidence but that the specific procedures for the auditor to perform should be left to the auditor's judgment. In addition, a number of commenters urged the Board to work with others to address the issue of disclaimers and restrictive language in confirmation responses.

The proposed standard includes a requirement for the auditor to evaluate the effect of disclaimers and restrictive language on the reliability of a confirmation response. The Board agrees with commenters that disclaimers or restrictive language do not invalidate the reliability of the confirmation response as audit evidence in all cases. However, the Board acknowledges that the use of disclaimers and restrictive language has become more prevalent and that it raises issues for auditors regarding their reliance on confirmation responses. Accordingly, the proposed standard also states that "[i]f a disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence." The proposed standard requires that, to the extent that a disclaimer or restrictive language precludes the auditor from treating the response as a confirmation response, the auditor should treat such a response as a non-response and perform appropriate alternative audit procedures to obtain relevant and reliable audit evidence or assess the implications, if any, for the audit report.

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### Question

26. Are the requirements in the proposed standard related to disclaimers and restrictive language in confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make?

### **Evaluating Results**

The existing standard includes requirements for evaluating the results of confirmation procedures, including evaluating the combined evidence provided by the confirmations and the alternative procedures to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions.<sup>65/</sup> The existing standard states, "[i]n performing that evaluation, the auditor should consider (a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures."<sup>66/</sup>

The proposed standard carries forward, with limited changes, the requirements contained in the existing standard. The proposed standard requires the auditor to evaluate whether the results of the confirmation procedures, including alternative procedures, provide the necessary relevant and reliable audit evidence or whether additional audit evidence is necessary. In performing such evaluation, the auditor should take into account:

- The reliability of the audit evidence obtained from confirmation responses and alternative procedures;
- The nature and extent of non-responses to positive confirmation requests, including the implications of those non-responses; and
- The nature and extent of any exceptions, including the implications of those exceptions.

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<sup>65/</sup> AU sec. 330.33.

<sup>66/</sup> Ibid.

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If the confirmation procedures, including alternative procedures, do not provide the necessary relevant and reliable audit evidence, the auditor should send additional confirmation requests or perform additional tests<sup>67/</sup> and evaluate the implications, if any, for the audit report.<sup>68/</sup>

### Question

27. Are the requirements in the proposed standard related to evaluating the results of confirmation procedures sufficiently clear and appropriate? If not, what changes should the Board make?

### **F. Related Amendments to PCAOB Standards**

The Board is proposing to amend the existing standards, AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, AU sec. 331, *Inventories*, and AU sec. 333, *Management Representations*. Appendix 2 presents the proposed amendments to these standards.

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<sup>67/</sup> The evaluation requirements in the PCAOB Proposed Auditing Standard, *Evaluating Audit Results*, also apply in addition to these considerations, which are specific to the confirmation process.

<sup>68/</sup> AU secs. 508.22-.34.

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AU sec. 322 states that:

For certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either test of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of cash, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.<sup>69/</sup>

The Board is proposing to remove the reference to cash in the last sentence because it is inconsistent with the requirement in the proposed confirmation standard that the auditor perform confirmation procedures for cash with financial institutions.

AU sec. 331 states, "[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."<sup>70/</sup> The proposed amendment to AU sec. 331 states that "[i]f inventories are in the hands of public warehouses or other outside custodians, the auditor should confirm such inventories with the custodians." Because AU sec. 331 requires confirmation of inventories held by public warehouses or other outside custodians, the Board is proposing this amendment to directly state the requirements using terms consistent with PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*. AU sec. 331 continues to require the auditor to perform other, more extensive procedures, if such inventories are a significant portion of current or total assets.

AU sec. 333 provides that the auditor should obtain written representations from management for all financial statements and periods covered by the audit report.<sup>71/</sup> That standard also provides a list of specific

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<sup>69/</sup> AU sec. 322.22.

<sup>70/</sup> Paragraph .14 of AU sec. 331, *Inventories*.

<sup>71/</sup> Paragraph .05 of AU sec. 333, *Management Representations*.

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representations that should be included as written representations from management.<sup>72/</sup> The Board is proposing to amend the list of specific representations to include the following requirements from the proposed confirmation standard:

- If management requests the auditor not to confirm certain accounts, balances, or other items, and the auditor agrees to management's request, the reason for management's request.
- If the auditor does not receive a response to a positive confirmation request when confirming the terms of a significant transaction or agreement, the terms of the transaction or agreement.

AU sec. 333 also provides examples of circumstances when an auditor might want to obtain written representation from other individuals. The Board is proposing to add a requirement that when the auditor performs confirmation procedures for the terms of a significant transaction or agreement and the auditor does not receive a response to the confirmation request, the auditor should consider inquiring of, and obtaining written representation from, the company personnel involved with the transaction or agreement.

### IV. **Effective Date**

The Board anticipates that the proposed standard would be effective, subject to approval by the SEC, for audits for fiscal years ending on or after December 15, 2011.

### V. **Opportunity for Public Comment**

The Board will seek comment on the proposed standard and related amendments for a 60-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, DC 20006-2803. Comments also may be submitted by e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 028 on the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on September 13, 2010.

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<sup>72/</sup> AU sec. 333.06.

**RELEASE**

The Board will consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"), proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act.

On the 13th day of July, in the year 2010, 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

## Proposed Auditing Standard

### *Supersedes AU sec. 330, The Confirmation Process*

#### **Confirmation**

##### **Introduction**

1. This standard establishes requirements for the auditor to perform **confirmation**<sup>1/</sup> procedures with respect to receivables and cash and in response to certain significant risks.<sup>2/</sup> Additionally, this standard establishes requirements regarding the design and performance of confirmation procedures.

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<sup>1/</sup> Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

<sup>2/</sup> Paragraph 71 of PCAOB Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, states, "[f]actors that should be evaluated in determining which risks are significant risks include:

- a. Whether the risk is a fraud risk;

Note: A fraud risk is a significant risk.

- b. Whether the risk is related to recent significant economic, accounting, or other developments;
- c. The complexity of transactions;
- d. Whether the risk involves significant transactions with related parties;
- e. The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- f. Whether the risk involves significant transactions that are outside the normal course of business for the company, or that otherwise appear to be unusual due to their timing, size, or nature."

2. This standard does not address inquiries regarding litigation, claims, and assessments, which are addressed in AU section ("sec.") 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

### **Objective**

3. The objective of the auditor in designing and performing confirmation procedures is to obtain relevant and reliable audit evidence.

### **Relationship of Confirmation to the Auditor's Assessment of Audit Risk**

4. The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion<sup>3/</sup> of each significant account and disclosure.<sup>4/</sup> In designing the audit procedures to be performed, the auditor should obtain more persuasive audit evidence the higher the auditor's assessment of risk.<sup>5/</sup>

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<sup>3/</sup> Paragraph 11 of PCAOB Proposed Auditing Standard, *Audit Evidence*, states "[i]n representing that the financial statements are presented fairly in conformity with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures." Those assertions can be classified into the following categories: existence or occurrence, completeness, valuation or allocation, rights and obligations, and presentation and disclosure. Paragraph 12 of that proposed auditing standard further states, in part, that "[t]he auditor may base his or her work on assertions that differ from those in this standard if the assertions are sufficient for the auditor to identify the types of potential misstatements and to respond appropriately to the risks of material misstatement."

<sup>4/</sup> Paragraph 8 of PCAOB Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>5/</sup> Paragraph 9 of PCAOB Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, includes additional requirements in designing the audit procedures to be performed.

5. The reliability of audit evidence depends on the nature and source of the evidence and the circumstances in which it is obtained.<sup>6/</sup> Audit evidence in the form of a **confirmation response**, because it is received directly by the auditor from a confirming party, generally is more reliable than audit evidence generated internally by the company or provided directly by the company.

### ***Confirmation of Specific Accounts***

6. **Confirmation requests** address one or more of the assertions of specific accounts and disclosures. Confirmation procedures frequently are used in relation to account balances and their constituent parts.<sup>7/</sup> These procedures also might be used to confirm the terms of the company's agreements or transactions, or to confirm the absence of certain conditions, such as undisclosed side agreements.

7. Confirmation requests do not address all assertions equally well. For example, properly designed confirmation requests can provide audit evidence to aid in assessing the existence and completeness of accounts and transactions included in the financial statements. The effectiveness of confirmation requests in addressing the existence and completeness assertions depends, in part, on whether the auditor selects from an appropriate population for testing. Receivable confirmation requests would likely be more effective for the existence assertion than for the completeness and valuation assertions. Confirmation of goods held on consignment with a consignee would likely be more effective for the existence and the rights and obligations assertions than for the valuation assertion. Thus, when obtaining audit evidence for assertions that are not adequately addressed by confirmation requests, auditors should perform other audit procedures instead of, or to complement, confirmation procedures.

### **Receivables That Arise from Credit Sales, Loans, or Other Transactions**

8. The auditor should perform confirmation procedures<sup>8/</sup> for receivables that arise from credit sales, loans, or other transactions. These receivables may be in

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<sup>6/</sup> Paragraph 8 of PCAOB Proposed Auditing Standard, *Audit Evidence*.

<sup>7/</sup> Paragraph 18 of PCAOB Proposed Auditing Standard, *Audit Evidence*.

<sup>8/</sup> Such procedures might include confirming account balances or components of account balances, such as individual invoices, debit memos, or credit memos.

the form of loans, notes, and other financial instruments and may be originated by the company or purchased from another entity. The auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk,<sup>9/</sup> when selecting which receivables to confirm.

### **Cash with Financial Institutions**

9. The auditor should perform confirmation procedures for cash with financial institutions. Confirmation procedures with these financial institutions also should include confirming (a) other relationships, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees, and (b) whether, during the process of completing the confirmation response, any additional information about other deposit or loan accounts has come to the attention of the financial institution. The auditor should obtain an understanding of the company's cash management and treasury function to determine which cash accounts and other relationships with financial institutions to confirm. The auditor also should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk,<sup>10/</sup> when selecting which cash accounts and other relationships to confirm. The auditor should not base his or her selection of cash accounts to confirm only on the reported balances of the cash accounts. There might be significant activity in, and risks associated with, a cash account that has an immaterial or zero balance. In addition, there might be other relationships with the financial institution, such as a significant unused line of credit.

### **Significant Risks**

10. The auditor should perform confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.<sup>11/</sup> For example, for significant risks related to agreements or transactions for which confirmation procedures adequately address the relevant assertions, the auditor should confirm the

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<sup>9/</sup> Paragraph 56.f. of Proposed Auditing Standard, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to "[d]etermine whether any of the identified and assessed risks of material misstatement are significant risks."

<sup>10/</sup> Ibid.

<sup>11/</sup> This requirement is applicable to significant risks associated with accounts other than receivables and cash, which are addressed in paragraphs 8 and 9 of this standard, respectively.

amounts and terms of such agreements or transactions, including whether there are any undisclosed oral or undisclosed written modifications to those agreements, such as undisclosed side agreements.

Note: Confirmation procedures might not be specifically responsive to every significant risk because confirmation procedures might not adequately address the relevant assertions.

### **Other Risks**

11. Even when a significant risk does not exist for a particular account, balance, transaction, agreement, or other item, the performance of confirmation procedures still might be an appropriate response to obtain audit evidence for certain relevant assertions regarding that particular account, balance, transaction, agreement, or other item.

### ***Confirmation Procedures***

12. When using confirmation procedures, the auditor should maintain control over the confirmation process. Maintaining control includes:

- a. Determining the information and selecting the items to include in confirmation requests (paragraphs 13-14);
- b. Selecting the appropriate confirming parties (paragraph 15);
- c. Designing the confirmation requests, including determining the type of confirmation requests to send and determining that confirmation requests are properly addressed (paragraphs 16-20);
- d. Directly sending the confirmation requests, including follow-up requests when applicable, to the confirming parties (paragraph 21); and
- e. Requesting responses directly from the confirming parties (paragraph 22).

### **Determining the Information and Selecting the Items to Include in Confirmation Requests**

13. The auditor should obtain an understanding of the substance of the company's arrangements and transactions with third parties and the nature of the items that make up account balances to determine the appropriate information

and select the items to include in confirmation requests. Even if the company suggests to the auditor what information and items to confirm, the auditor should determine the information and select the items to include in a confirmation request.

14. The auditor should determine the timing of confirmation procedures and whether related audit procedures are properly coordinated to obtain relevant and reliable audit evidence. For example, when an auditor performs confirmation procedures for receivables at an interim date, the auditor should perform sales cutoff testing at the balance sheet date to reduce audit risk to an appropriately low level for the existence and completeness assertions.

### **Selecting the Appropriate Confirming Parties**

15. The auditor should direct the confirmation request to an appropriate confirming party. For example, when confirming a company's oral and written guarantees with a financial institution, the auditor should direct the confirmation request to an official at the financial institution who is responsible for the financial institution's relationship with the company or who is knowledgeable about the transactions or arrangements for which the confirmation response is requested. Even if the company provides the auditor with the name of an appropriate confirming party, the auditor should select the confirming party.

### **Designing the Confirmation Requests**

16. The auditor should design confirmation requests to obtain relevant and reliable audit evidence. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- The specific risks of material misstatement, including the risk of material misstatement due to fraud ("fraud risk").
- The nature of the information to be confirmed.
- The layout, presentation, and content of the confirmation request.
- Prior experience on the audit engagement or other similar engagements.
- The method of communication, whether it is in paper form or by electronic or other medium.

- The company's authorization to the confirming parties to respond to the auditor.
- Local customs that might influence confirmation responses, such as a local custom of responding to confirmation requests without verifying the information.

### **Determining the Type of Confirmation Requests to Send**

17. In designing the confirmation requests, the auditor may use **positive confirmation requests**, **negative confirmation requests**, or a combination of both. A positive confirmation request provides audit evidence only when a response is received directly by the auditor from the confirming party. The absence of a response to a negative confirmation request provides significantly less audit evidence than a response to a positive confirmation request. Unless the auditor receives a response, the auditor does not know whether the intended confirming party received the confirmation request and verified the accuracy of the information contained in the request. Therefore, the auditor should not use negative confirmation requests as the only form of confirmation request to address the assessed risk of material misstatement at the assertion level unless all of the following factors are present:

- The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the design and operating effectiveness of controls relevant to the assertion;<sup>12/</sup>
- The population of items subject to negative confirmation procedures is made up of a large number of small, homogeneous, account balances, transactions, or other items;
- The auditor reasonably expects a low exception rate; and
- The auditor reasonably believes that recipients of negative confirmation requests will give such requests consideration.

Because negative confirmation requests provide limited audit evidence, even when all of the factors above are present, the auditor should perform other substantive procedures to supplement the use of negative confirmation requests.

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<sup>12/</sup> Also see paragraphs 16-17 of PCAOB Proposed Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*, for a discussion of tests of controls.

### **Determining That Confirmation Requests Are Properly Addressed**

18. The auditor should design confirmation requests to establish direct communication between the confirming party and the auditor to minimize the possibility that the audit evidence resulting from the confirmation procedures might not be reliable as a result of interception, alteration, or fraud.

19. The auditor should perform procedures to determine the validity of the addresses on the confirmation requests, including substantive procedures or tests of controls. The nature and extent of the procedures depend on the associated risks and materiality of the items being confirmed. For example, the auditor should perform substantive procedures to determine the validity of addresses on the confirmation requests for transactions or accounts that involve significant risks or are material to the financial statements. Other factors to consider in determining the nature and extent of procedures to perform to validate addresses on confirmation requests include the following:

- The company has a new customer base;
- An address is a post office box; or
- An e-mail address is not consistent with the confirming party's Web site address (e.g., situations in which the e-mail address has a domain name that differs from the domain name of the Web site).

20. If the auditor identifies an invalid address, the auditor should perform the following procedures:

- a. Investigate the reasons for the invalid address and attempt to obtain a valid address;
- b. Evaluate the implications of the invalid address on the auditor's planned confirmation procedures and the auditor's assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures; and
- c. Perform other audit procedures designed to obtain relevant and reliable audit evidence with respect to the account, balance, or other item if a valid address cannot be obtained for the confirmation request.

### **Directly Sending the Confirmation Requests**

21. The auditor should send the confirmation requests directly to the intended confirming parties or intended intermediaries<sup>13/</sup> and should not permit the company or any other party to send the confirmation requests.

### **Requesting Responses Directly from the Confirming Parties**

22. When performing confirmation procedures, the auditor should request that the confirming parties or intended intermediaries respond directly to the auditor and not to the company or any other party. If a confirming party sends a confirmation response to anyone other than the auditor, the auditor should contact the confirming party and request that the confirming party re-send the response directly to the auditor.

### **Management Requests Not to Confirm**

23. If management requests the auditor not to confirm certain accounts, balances, or other items, the auditor should:

- a. Obtain an understanding of management's reasons for the request;
- b. Obtain audit evidence as to the appropriateness of management's reasons for the request; and
- c. Determine whether management's request is appropriate.

24. If the auditor agrees to management's request and does not confirm certain accounts, balances, or other items, the auditor should perform the following procedures:

- a. Evaluate the implications of management's request on the auditor's assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures;
- b. Perform other audit procedures to obtain relevant and reliable audit evidence with respect to the accounts, balances, or other items not being confirmed;

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<sup>13/</sup> An intermediary is an entity used by the intended confirming party and the auditor to facilitate confirmation between the confirming party and the auditor.

Note: The auditor should perform procedures to obtain more persuasive audit evidence than he or she would have obtained had there been no response to a confirmation request or had the auditor made a decision not to perform confirmation procedures.

- c. Communicate management's request to the audit committee, or equivalent;
- d. Include management's reason for the request in the management representation letter; and
- e. Evaluate the implications for the audit report.<sup>14/</sup>

25. If the auditor does not agree to management's request and management refuses to authorize the confirmation request, the auditor should communicate management's refusal to the audit committee, or equivalent, and evaluate the implications for the audit report.<sup>15/</sup>

### ***Evaluation***

26. The auditor should evaluate the audit evidence obtained from performing confirmation procedures and should not rely on the company or any other party for this evaluation. Such evaluation includes:

- a. Performing appropriate alternative procedures for each **non-response** (paragraphs 27-29);
- b. Investigating each **exception** in confirmation responses (paragraph 30);
- c. Assessing the reliability of confirmation responses, including performing additional procedures for electronic confirmation responses (paragraphs 31-35);
- d. Considering the effect of disclaimers and restrictive language (paragraphs 36-38); and

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<sup>14/</sup> Management's request might represent a significant client-imposed scope limitation on the audit. See paragraphs .22-.34 of AU sec. 508, *Reports on Audited Financial Statements*.

<sup>15/</sup> AU secs. 508.22-.34.

- e. Evaluating results to determine whether relevant and reliable audit evidence has been obtained (paragraph 39).

### **Non-responses**

27. When using positive confirmation requests and a response from a confirming party has not been received, the auditor should follow up with a second request and should consider following up with a third request.

28. The auditor should perform appropriate alternative procedures for all non-responses to positive confirmation requests. Such alternative procedures should address the risks for the related assertion(s) intended to be addressed by the confirmation requests. For example, when the auditor performs confirmation procedures for the terms of a transaction or agreement and does not receive a response to the confirmation request, he or she should perform alternative procedures, such as inspecting the original signed contract and amendments thereto, comparing contractual terms to industry norms, and confirming or discussing significant information with other parties involved in the transaction or agreement. In addition to performing alternative procedures, the auditor should, for significant transactions or agreements, include the terms of the transactions or agreements in the management representation letter and communicate the terms of the transactions or agreements to the audit committee, or equivalent. The auditor also should consider inquiring of, and obtaining written representation from, the company personnel involved with the significant transaction or agreement.

Note: The item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of the alternative audit procedures that the auditor should perform. For example, when performing confirmation procedures for the existence assertion for receivables that arise from credit sales, loans, or other transactions, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash receipts (including matching such receipts with the actual invoices being paid), (2) shipping documents, or (3) other supporting documentation. In addition, if the auditor is confirming the account balance for a receivable, and the account balance is made up of numerous invoices, debit memos, credit memos and other adjustments, the auditor's alternative procedures should include (1) testing subsequent cash receipts or other supporting documentation for the invoices, and (2) testing documentation for the debit memos, credit memos, and other adjustments that make up that account balance. When performing confirmation procedures

for the completeness assertion for accounts payable, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash disbursements, (2) correspondence from vendors and suppliers, or (3) other documentation or records.

### **When a Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence**

29. When a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. Such circumstances include the following:

- The information to corroborate management's assertion(s) is available only outside the company.
- Specific fraud risk factors, such as the risk of management override of controls or the risk of collusion, which can involve employee(s), management, or outside parties, prevent the auditor from relying on evidence from the company.

If the auditor does not obtain a confirmation response in such circumstances, the auditor should determine the implications for the audit and the audit report.<sup>16/</sup>

### **Exceptions**

30. The auditor should investigate all exceptions in confirmation responses to determine why each exception occurred and whether any exceptions, individually or in the aggregate, are indicative of a misstatement or of a previously unidentified risk of material misstatement.

Note: The item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of the procedures that the auditor should perform to investigate exceptions in confirmation responses.

### **Reliability of Confirmation Responses**

31. The auditor should assess the reliability of confirmation responses. Any confirmation response carries some risk of interception, alteration, or fraud although such risks are mitigated by properly designing confirmation requests

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<sup>16/</sup> Ibid.

and properly performing confirmation procedures. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that the auditor should take into account in assessing the reliability of confirmation responses include, but are not limited to, whether confirmation responses:

- Are returned to the auditor indirectly because the confirming parties forwarded the confirmation responses to the company (paragraph 22).
- Appear not to have come from the originally intended confirming parties.
- Contradict other information obtained during the audit.
- Come from addresses other than the addresses to which the auditor sent the confirmation requests.
- Are not the original confirmation requests that were sent to the confirming parties.
- Do not include the signatures of or acknowledgements by the confirming parties.
- Reflect local customs that may affect the confirmation responses, such as customs that create an environment in which confirmation responses are inherently unreliable.

32. When evaluating the reliability of the response received from a confirming party, the auditor should assess any indication that the confirming party:

- Is not competent, or knowledgeable.
- Has questionable motives.
- Is not objective or free from bias with respect to the company.<sup>17/</sup>

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<sup>17/</sup> Paragraphs .09-.10 of AU sec. 334, *Related Parties*, provide requirements for examining related-party transactions that have been identified by the auditor.

Note: Circumstances might indicate the need for additional audit evidence to conclude whether the confirmation request is being sent to or received from a confirming party from whom the auditor can expect the response to provide relevant and reliable audit evidence. Such circumstances could include significant, unusual period-end transactions that have a material effect on the financial statements; when management of the company has significant influence over the confirming party; when the confirming party has significant influence over management of the company; when the confirming party is the custodian and servicer of a material amount of the company's assets; or when a confirmation response is from an affiliated party.

33. If conditions indicate that a confirmation response might not be reliable, the auditor should obtain additional audit evidence.

### **Additional Procedures for Electronic Confirmation Responses**

34. As indicated in paragraph 31, any confirmation response involves risks relating to reliability because proof of origin might be difficult to establish and alterations can be difficult to detect. Confirmation responses received electronically (e.g., by facsimile, e-mail, through an intermediary, or **direct access**<sup>18/</sup>) might involve additional risks relating to reliability. The auditor should assess the reliability of the information obtained through the electronic confirmation response. In assessing the reliability of the confirmation response, the auditor should take into account risks that:

- The confirmation process might not be secure or might not be properly controlled;

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<sup>18/</sup> Auditors might obtain electronic access (e.g., using a Web site link) into a confirming party's (e.g., the company's customer, bank, or other party) electronic records of transactions or balances with the company. For example, a brokerage firm can set up a web portal and grant the auditor a unique ID and password for limited-time access to the company's detailed account statements or information specifically generated for, or made available to, the auditor.

- The information obtained might not be from a proper source; and
- The integrity of the transmission might have been compromised.

35. The auditor should perform procedures to address the risks that electronic confirmation responses might not be reliable. Such procedures depend on the form of electronic communication and include the following:

- If information is provided via facsimile response, the auditor should verify the source and contents of the facsimile response by directly contacting the intended confirming party (e.g., by a telephone call to the intended confirming party).
- If information is provided via an e-mail response, the auditor should verify the source and contents of the e-mail response, such as verifying the e-mail address of the intended confirming party or contacting the intended confirming party by telephone.
- If an intermediary is used to facilitate confirmation, the auditor should obtain an understanding of the controls over the procedures used by the intermediary to process the confirmation requests and responses. The auditor should perform procedures to determine whether the auditor can use the intermediary's process. Risks to consider in performing these procedures and making this determination include (1) the process might not be secure or might not be properly controlled, (2) the information obtained might not be from a proper source, and (3) the integrity of the transmission might have been compromised. In addition, the auditor should determine whether the intermediary is authorized to respond on behalf of the intended confirming party.
- If information is provided via direct access, the auditor should evaluate whether direct access is an appropriate means to confirm information about the particular item that is the subject of the confirmation request. Direct access is not an appropriate confirmation procedure in all cases. For example, when confirming revenue agreements, the auditor should evaluate whether the revenue agreements could include terms and oral modifications that would make direct access an inappropriate mechanism for confirmation.

Note: Direct access to information held by a confirming party constitutes a confirmation response

only if (1) the auditor's access is provided by the confirming party rather than the company, and (2) the confirming party represents to the auditor, in writing, that (a) it is aware of the auditor's request for and intended use of the information, and (b) the files to be accessed contain information responsive to the auditor's request.

### **Disclaimers and Restrictive Language**

36. A response to a confirmation request might contain disclaimers or restrictive language. For example, a response might include a disclaimer as to its accuracy and appropriateness for use in the preparation of financial statements, which has a negative effect on the reliability of the response as audit evidence.

37. The auditor should evaluate the effect of a disclaimer or restrictive language on the reliability of a confirmation response.<sup>19/</sup> If a disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

38. If disclaimers or restrictive language preclude the auditor from treating the response as a confirmation response, the auditor should treat such a response as a non-response and perform appropriate alternative procedures to obtain relevant and reliable audit evidence.

### **Evaluating Results**

39. The auditor should evaluate whether the results of the confirmation procedures, including alternative procedures, provide the necessary relevant and reliable audit evidence or whether additional audit evidence is necessary. In performing such evaluation, the auditor should take into account:

- The reliability of the audit evidence obtained from confirmation responses and alternative procedures;
- The nature and extent of non-responses to positive confirmation requests, including the implications of those non-responses; and

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<sup>19/</sup> Disclaimers and restrictive language could affect the reliability of a confirmation response whether it is in paper form or by electronic or other medium.

- The nature and extent of any exceptions, including the implications of those exceptions.

If the confirmation procedures, including alternative procedures, do not provide the necessary relevant and reliable audit evidence, the auditor should send additional confirmation requests or perform additional tests<sup>20/</sup> and evaluate the implications, if any, for the audit report.<sup>21/</sup>

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<sup>20/</sup> The evaluation requirements in the PCAOB Proposed Auditing Standard, *Evaluating Audit Results*, also apply in addition to these requirements, which are specific to the confirmation process.

<sup>21/</sup> AU secs. 508.22-.34.

## **APPENDIX A – Definitions**

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Confirmation – The process of obtaining and evaluating a direct communication from a third party in response to a request, either in paper form or by electronic or other medium, for information about a particular item affecting financial statement assertions.

A3. Confirmation request – A request, either in paper form or by electronic or other medium, sent by the auditor to a confirming party requesting information about a particular item affecting financial statement assertions.

A4. Confirmation response – Audit evidence obtained as a direct communication to the auditor from a third party, either in paper form or by electronic or other medium. An oral response to a confirmation request is audit evidence, but it does not meet the definition of a confirmation response.

A5. Direct access – An auditor's electronic access into a confirming party's electronic records of transactions or balances with the company. If access codes or information necessary to access data held by a confirming party are provided to the auditor by management of the company and not by the confirming party, evidence obtained by the auditor from access to such information does not meet the definition of a confirmation response. Rather that information constitutes other audit evidence.

A6. Exception – A confirmation response that indicates a difference between the information about a particular item for which a confirmation response is requested and the information provided by the confirming party.

A7. Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

A8. Non-response – When, after sending a positive confirmation request, a confirmation request is returned undelivered, or the auditor does not receive a full response from the intended confirming party, or direct access to the information. A non-response includes a situation in which the auditor receives correspondence from the intended confirming party indicating that the confirming party is unable or unwilling to respond to the confirmation request. A non-response also includes a situation in which a confirmation response contains a

disclaimer or restrictive language that precludes the auditor from treating the response as a confirmation response.

A9. Positive confirmation request – A request that the confirming party respond directly to the auditor and provide the requested information or indicate whether he or she agrees or disagrees with the information included in the request.

## **APPENDIX 2**

### ***Proposed Amendments to PCAOB Auditing Standards***

#### **AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"**

Statement on Auditing Standards ("SAS") No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements – 1991" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), as amended, is amended as follows:

The last sentence of paragraph .22 is replaced with –

Assertions about the existence of prepaid assets and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

#### **AU sec. 331, "Inventories"**

SAS No. 43, "Omnibus Statement on Auditing Standards – 1982" (AU sec. 331, "Inventories"), as amended, is amended as follows:

The first sentence of paragraph .14 is replaced with –

If inventories are in the hands of public warehouses or other outside custodians, the auditor should confirm such inventories with the custodians.

#### **AU sec. 333, "Management Representations"**

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows:

In paragraph .06:

- Subparagraph s-1. is added under the heading, *Recognition, Measurement, and Disclosure*:

If management requests the auditor not to confirm certain accounts, balances, or other items, and the auditor agrees to management's request, the reason for management's request.

- Footnote 12A is added at the end of subparagraph s-1. and states:

See paragraph 24.d. of Proposed Auditing Standard, *Confirmation*.

- Subparagraph s-2. is added under the heading, *Recognition, Measurement, and Disclosure*:

If the auditor does not receive a response to a positive confirmation request when confirming the terms of a significant transaction or agreement, the terms of the transaction or agreement.

- Footnote 12B is added at the end of subparagraph s-2. and states:

See paragraph 28 of Proposed Auditing Standard, *Confirmation*.

The first sentence of paragraph .11 is replaced with –

When the auditor performs confirmation procedures for the terms of a significant transaction or agreement and does not receive a response to the confirmation request, the auditor should consider inquiring of, and obtaining written representation from, the company personnel involved with the transaction or agreement. In certain other circumstances, the auditor may want to obtain written representation from other individuals.

## RELEASE

### APPENDIX 3

#### ***Comparison of the Objectives and Requirements of the Proposed Auditing Standard and the Analogous Standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the American Institute of Certified Public Accountants***

#### ***Introduction***

This appendix discusses certain significant differences between the requirements of the accompanying proposed standard in this release and the analogous standards of the International Auditing and Assurance Standards Board ("IAASB")<sup>1/</sup> and the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").<sup>2/</sup> The comparable IAASB standard is International Standard on Auditing ("ISA") 505, *External Confirmations*. The comparable ASB standard is Proposed Statement on Auditing Standards, *External Confirmations* (the "ASB's proposed SAS").<sup>3/</sup> This analysis does not cover the application and other explanatory material in ISA 505 or the ASB's proposed SAS.<sup>4/</sup>

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<sup>1/</sup> International Standard on Auditing ("ISA") 505, *External Confirmations* (April 2009).

<sup>2/</sup> Proposed Statement on Auditing Standards, *External Confirmations* (the "ASB's proposed SAS") (May 28, 2009).

<sup>3/</sup> Other proposed or adopted standards of the IAASB and the ASB were considered in this comparison to the extent they include comparable requirements. These include ISA 330, *The Auditor's Responses to Assessed Risks*, and the ASB's Statement on Auditing Standards, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

<sup>4/</sup> Paragraph A59 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, indicates that the application and other explanatory material section of the ISAs "does not in itself impose a requirement," but "is relevant to the proper application of the requirements of an ISA." Paragraph A63 of the ASB's standard, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*, states that although application and other explanatory material "does not in itself impose a

This appendix is provided for informational purposes only. It is not a substitute for the proposed standard itself, which is presented in Appendix 1 of this release.

This analysis does not represent the views of the IAASB and the ASB regarding the interpretation of their standards.

### ***Objective of the Auditor***

#### *PCAOB*

Under the proposed standard, the objective of the auditor in designing and performing confirmation procedures is to obtain relevant and reliable audit evidence. The Board has proposed that the objective focus the auditor on obtaining relevant and reliable audit evidence from confirmation procedures because confirmation responses might not provide sufficient audit evidence in all cases and might need to be supplemented with other substantive procedures.

#### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS include a similar objective for the auditor to design and perform confirmation procedures to obtain relevant and reliable audit evidence.

### ***Confirmation of Specific Accounts***

#### **Receivables That Arise from Credit Sales, Loans, or Other Transactions**

#### *PCAOB*

The proposed standard requires the auditor to perform confirmation procedures for receivables that arise from credit sales, loans, or other transactions. These receivables may be in the form of loans, notes, and other financial instruments and may be originated by the company or purchased from another entity. The proposed standard indicates that the auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, when selecting which receivables to confirm.

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requirement, it is relevant to the proper application of the requirements of an AU section."

The proposed standard does not use the term "accounts receivable" and instead uses "receivables that arise from credit sales, loans, or other transactions" to broaden the requirement to include notes receivable, accounts receivable, purchased loans, lease receivables, and other similar receivables. The Board is retaining the presumption from the existing standard that the auditor confirm receivables, because (1) audit evidence from a third party generally is more reliable than audit evidence generated internally by a company or provided directly by a company, and (2) academic research supports the effectiveness of confirmation procedures in testing the existence of receivables.<sup>5/</sup> Also, the Board is proposing to broaden the requirement to receivables that arise from credit sales, loans, or other transactions, because confirmation of such receivables can provide audit evidence regarding the occurrence assertion for revenue and potentially address the risk of material misstatement due to fraud relating to revenue recognition.<sup>6/</sup> In addition, a company might have material receivables that arise from the sale of assets or the sale of a business.

The proposed standard does not carry forward the exceptions for not confirming receivables for several reasons. First, AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.<sup>7/</sup> Auditors should follow that standard when considering materiality. Second, if auditors consider confirmation procedures to be ineffective, auditors should determine why they are ineffective and look for ways to improve the effectiveness

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<sup>5/</sup> 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* 27, no.2 (November 2008). Also, see Diane Janvrin, Paul Caster, and Randy Elder, "Enforcement Release Evidence on the Audit Confirmation Process: Implications for Standard Setters," *Research in Accounting Regulation* 22 (April 2010).

<sup>6/</sup> Paragraph .41 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, states, "[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."

<sup>7/</sup> AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*. PCAOB Proposed Auditing Standard, *Consideration of Materiality in Planning and Performing an Audit*, would supersede AU sec. 312 after it is adopted by the Board and approved by the U.S. Securities and Exchange Commission.

of confirmation procedures. For example, it might be ineffective to confirm a particular accounts receivable balance, but it might be effective to confirm individual transactions that make up that accounts receivable balance. In addition, useful information can be obtained from the confirmation responses. Finally, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to presume there is a risk of material misstatement due to fraud relating to revenue recognition and receivables often are related to revenue recognition.<sup>8/</sup>

#### *IAASB and ASB*

ISA 505 does not include similar requirements. However, ISA 330, *The Auditor's Responses to Assessed Risks*, states, "[t]he auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures."<sup>9/</sup> The ASB's proposed SAS includes conforming amendments to Statement on Auditing Standards, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which include similar language.<sup>10/</sup> In addition, the ASB's proposed SAS includes conforming amendments to Statement on Auditing Standards, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which require the auditor to use external confirmation procedures for material accounts receivable, except when one or more of the following is applicable:

- a. External confirmation procedures for accounts receivable would be ineffective.
- b. The auditor's assessed level of risk of material misstatement is low, and the auditor plans to obtain sufficient appropriate audit evidence by performing substantive procedures. In many situations, use of external confirmation procedures for accounts receivable and the performance of other substantive tests are necessary to reduce audit risk to an acceptably low level for the relevant assertions.<sup>11/</sup>

Additionally, the ASB's proposed SAS includes conforming amendments to the ASB's Statement on Auditing Standards, *Performing Audit Procedures in*

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<sup>8/</sup> AU sec. 316.41.

<sup>9/</sup> Paragraph 19 of ISA 330.

<sup>10/</sup> Paragraph A29 of the ASB's proposed SAS.

<sup>11/</sup> Ibid.

*Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which state, "[f]or the purpose of this SAS, *accounts receivable* means

- a. the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and
- b. a financial institution's loans."<sup>12/</sup>

### **Cash with Financial Institutions**

#### *PCAOB*

The Board is including a requirement in the proposed standard for the auditor to perform confirmation procedures for cash with financial institutions. It further requires that confirmation procedures with these financial institutions should include confirming (a) other relationships, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees, and (b) whether, during the process of completing the confirmation response, any additional information about other deposit or loan accounts has come to the attention of the financial institution. The proposed standard requires the auditor to obtain an understanding of the company's cash management and treasury function to determine which cash accounts and other relationships with financial institutions to confirm. The auditor also should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, when selecting which cash accounts and other relationships to confirm. The auditor should not base his or her selection of cash accounts to confirm only on the reported balances of the cash accounts. There might be significant activity in, and risks associated with, a cash account that has an immaterial or zero balance. In addition, there might be other relationships with the financial institution, such as a significant unused line of credit.

The Board is including these requirements because confirmation procedures can provide audit evidence to address the risk of material misstatement due to fraud and because of the importance of cash to a company's liquidity and ongoing operations. The Board also is including these requirements because properly designed confirmation requests can provide audit evidence regarding other relationships with financial institutions, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees.

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<sup>12/</sup> Ibid.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS do not include similar requirements.

**Significant Risks**

*PCAOB*

In response to comments on *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations* (the "Concept Release")<sup>13/</sup> that the use of confirmation procedures should be a function of the auditor's risk assessment, the Board is including procedures that address the risk of material misstatement due to error or fraud. The proposed standard requires the auditor to perform confirmation procedures in response to significant risks that relate to relevant assertions that can be adequately addressed by confirmation procedures. The proposed standard acknowledges that confirmation procedures might not be specifically responsive to every significant risk because confirmation procedures might not adequately address the relevant financial statement assertions.

The Board also revised the existing requirement regarding confirmation of terms and amounts of agreements to make it consistent with the proposed requirement to perform confirmation procedures in response to significant risks. Therefore, the proposed standard requires that for significant risks related to agreements or transactions for which confirmation procedures adequately address the relevant assertions, the auditor should confirm the amounts and terms of such agreements or transactions, including whether there are any undisclosed oral or undisclosed written modifications to those agreements, such as undisclosed side agreements.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS do not include similar requirements.

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<sup>13/</sup> PCAOB Release No. 2009-002, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*. Comments on the concept release are available on the Board's Web site at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket028.aspx>.

## Other Risks

### *PCAOB*

The proposed standard acknowledges that performing confirmation procedures might be an appropriate response to other risks of material misstatement. Even when a significant risk does not exist for a particular account, balance, transaction, agreement, or other item, the performance of confirmation procedures still might be an appropriate response to obtain audit evidence for certain relevant assertions regarding that particular account, balance, transaction, agreement, or other item. The Board is including this to encourage the use of confirmation procedures because audit evidence obtained from a knowledgeable source that is independent of the company generally is more reliable than evidence obtained only from internal company sources.<sup>14/</sup>

### *IAASB and ASB*

ISA 330, *The Auditor's Responses to Assessed Risks*, states, "[t]he auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures."<sup>15/</sup> The ASB's proposed SAS states "[t]he auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures."<sup>16/</sup>

## **Confirmation Procedures**

### *PCAOB*

Consistent with the Board's existing confirmation standard, the proposed standard requires that when using confirmation procedures, the auditor should maintain control over the confirmation process. The proposed standard recognizes that it is important for the auditor to maintain control over the confirmation process, including both confirmation requests and confirmation responses, to minimize the possibility that the results will be biased because of interception and alteration of such confirmation requests or responses. Maintaining control includes:

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<sup>14/</sup> Paragraph 8 of PCAOB Proposed Auditing Standard, *Audit Evidence*

<sup>15/</sup> Paragraph 19 of ISA 330.

<sup>16/</sup> Paragraph A29 of the ASB's proposed SAS.

- a. Determining the information and selecting the items to include in confirmation requests;
- b. Selecting the appropriate confirming parties;
- c. Designing the confirmation requests, including determining the type of confirmation requests to send and determining that confirmation requests are properly addressed;
- d. Directly sending the confirmation requests, including follow-up requests when applicable, to the confirming parties; and
- e. Requesting responses directly from the confirming parties.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS include similar requirements for maintaining control over confirmation requests but not specifically for maintaining control over confirmation responses.

**Determining the Information and Selecting the Items to Include in Confirmation Requests**

*PCAOB*

The proposed standard requires the auditor to obtain an understanding of the substance of the company's arrangements and transactions with third parties and the nature of the items that make up account balances to determine the appropriate information and select the items to include in confirmation requests. In addition, the proposed standard indicates that even if the company suggests to the auditor what information and items to confirm, the auditor should determine the information and select the items to include in a confirmation request. The Board is including the requirement to understand the substance of a company's arrangements and the nature of the items that make up the account balance because they are integral to performing confirmation procedures effectively. The Board also is including the requirement for the auditor to determine the information and items to confirm because it is essential to maintaining control over the confirmation process.

The proposed standard also requires the auditor to determine the timing of confirmation procedures and whether related audit procedures are properly coordinated to obtain relevant and reliable audit evidence. For example, when an auditor performs confirmation procedures for receivables at an interim date, the

auditor should perform sales cutoff testing at the balance sheet date to reduce audit risk to an appropriately low level for the existence and completeness assertions. The Board is including this requirement in the proposed standard because auditors frequently perform confirmation procedures at an interim date. The proposed requirement reminds auditors of the importance of coordinating the timing of audit procedures when confirmation procedures are performed prior to the balance sheet date.

*IAASB and ASB*

ISA 505 provides that the auditor shall maintain control over external confirmation requests, including determining the information to be confirmed or requested. The ASB's proposed SAS provides that the auditor should maintain control over external confirmation requests by determining the information to be confirmed or requested.

ISA 505 and the ASB's proposed SAS do not include similar requirements with regard to coordinating the timing of audit procedures.

**Selecting the Appropriate Confirming Parties**

*PCAOB*

The proposed standard requires the auditor to direct the confirmation request to an appropriate confirming party. In addition, the proposed standard indicates that even if the company provides the auditor with the name of an appropriate confirming party, the auditor should select the confirming party. The Board is including the requirement to direct the confirmation to an appropriate confirming party because it is integral to performing confirmation procedures effectively. The Board also is including the requirement for the auditor to select the confirming party because it is essential to maintaining control over the confirmation process.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS require that the auditor maintain control over external confirmation requests, including selecting the appropriate confirming party.

## **Designing the Confirmation Requests**

### *PCAOB*

The proposed standard requires the auditor to design confirmation requests to obtain relevant and reliable audit evidence. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- The specific risks of material misstatement, including the risk of material misstatement due to fraud ("fraud risk").
- The nature of the information to be confirmed.
- The layout, presentation, and content of the confirmation request.
- Prior experience on the audit engagement or other similar engagements.
- The method of communication, whether it is in paper form or by electronic or other medium.
- The company's authorization to the confirming parties to respond to the auditor.
- Local customs that might influence confirmation responses, such as a local custom of responding to confirmation requests without verifying the information.

### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS require the auditor to maintain control over external confirmation requests, design the confirmation requests, and determine that requests are properly addressed and contain return information for responses to be sent directly to the auditor.

### *Determining the Type of Confirmation Requests to Send*

### *PCAOB*

In designing confirmation requests, the auditor may use positive confirmation requests, negative confirmation requests, or a combination of both.

The proposed standard continues to permit the use of negative confirmation requests, and includes the requirement that the auditor should not use negative confirmation requests as the only form of confirmation request to address the assessed risk of material misstatement at the assertion level unless all of the following factors are present:

- The auditor has assessed the risk of material misstatement as low and the auditor has obtained sufficient appropriate audit evidence regarding the design and operating effectiveness of controls relevant to the assertion;
- The population of items subject to negative confirmation procedures is made up of a large number of small, homogeneous account balances, transactions, or other items;
- The auditor reasonably expects a low exception rate; and
- The auditor reasonably believes that recipients of negative confirmation requests will give such requests consideration.

Because negative confirmation requests provide limited audit evidence, the Board is including the requirement that the auditor should perform other substantive procedures to supplement the use of negative confirmation requests.

The proposed standard continues to permit the use of negative confirmation requests because (1) negative confirmation requests might provide some evidence of the existence of confirming parties if the requests are not returned with an indication that the addressees are unknown, and (2) negative confirmation requests might be used effectively in conjunction with positive confirmation requests.

#### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS permit negative confirmation procedures to be the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level if certain conditions are met. Those conditions are somewhat similar to the factors in the Board's proposed standard. In contrast to the Board's proposed standard, ISA 505 and the ASB's proposed SAS do not require the auditor to perform other substantive procedures to supplement the use of negative confirmation requests.

*Determining That Confirmation Requests Are Properly Addressed*

*PCAOB*

As part of designing confirmation requests, the proposed standard includes the requirement for the auditor to determine the validity of the addresses on the confirmation requests as well as requirements for when a confirmation request does not include a valid address. The proposed standard provides that the auditor should perform procedures to determine the validity of the addresses on the confirmation requests, including substantive procedures or tests of controls. The nature and extent of the procedures depend on the associated risks and materiality of the items being confirmed. For example, the auditor should perform substantive procedures to determine the validity of addresses on the confirmation requests for transactions or accounts that involve significant risks or are material to the financial statements. Other factors to consider in determining the nature and extent of procedures to perform to validate addresses on confirmation requests include the following:

- The company has a new customer base;
- An address is a post office box; or
- An e-mail address is not consistent with the confirming party's Web site address (e.g., situations in which the e-mail address has a domain name that differs from the domain name of the Web site).

The proposed standard states that if the auditor identifies an invalid address, the auditor should perform the following procedures:

- a. Investigate the reasons for the invalid address and attempt to obtain a valid address;
- b. Evaluate the implications of the invalid address on the auditor's planned confirmation procedures and the assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures; and
- c. Perform other audit procedures designed to obtain relevant and reliable audit evidence with respect to the account, balance, or other item if a valid address cannot be obtained for the confirmation request.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS similarly require the auditor to determine whether confirmation requests are properly addressed; however, neither standard includes requirements for when an auditor determines that a confirmation request does not include a valid address.

**Directly Sending the Confirmation Requests**

*PCAOB*

The proposed standard requires the auditor to send the confirmation requests directly to the intended confirming parties or intended intermediaries<sup>17/</sup> and does not permit the company or any other party to send the confirmation requests. The Board is including this requirement because it is essential to maintaining control over confirmation requests.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS require the auditor to send the requests, including follow-up requests when applicable, to the confirming party.

**Requesting Responses Directly from the Confirming Parties**

*PCAOB*

The proposed standard requires the auditor to request that the confirming parties or intended intermediaries respond directly to the auditor and not to the company or any other party. It also states that if a confirming party sends a confirmation response to anyone other than the auditor, the auditor should contact the confirming party and request that the confirming party re-send the response directly to the auditor. The Board is including these requirements because they are essential to maintaining control over confirmation responses.

*IAASB and ASB*

ISA 505 includes the requirement that confirmation requests contain return information for responses to be sent directly to the auditor. The ASB's proposed

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<sup>17/</sup> An intermediary is an entity used by the intended confirming party and the auditor to facilitate confirmation between the confirming party and the auditor.

SAS includes the requirement that confirmation requests provide for being responded to directly to the auditor. However, ISA 505 and the ASB's proposed SAS do not include a requirement when a confirmation request is sent to someone other than the auditor.

### **Management Requests Not to Confirm**

#### *PCAOB*

The Board is including requirements in the proposed standard for when management requests the auditor not to confirm an account, balance, or other item. Consequently, the proposed standard includes the requirement that if management requests that the auditor not confirm certain accounts, balances, or other items, the auditor should:

- a. Obtain an understanding of management's reasons for the request;
- b. Obtain audit evidence as to the appropriateness of management's reasons for the request; and
- c. Determine whether management's request is appropriate.

The proposed standard also requires that if the auditor agrees to management's request and does not confirm certain accounts, balances, or other items, the auditor should perform the following procedures:

- a. Evaluate the implications of management's request on the auditor's assessment of the relevant risks of material misstatement, including fraud risk, and on the nature, timing, and extent of other audit procedures;
- b. Perform other audit procedures designed to obtain relevant and reliable audit evidence with respect to the accounts, balances, or other items not being confirmed;
- c. Communicate management's request to the audit committee, or equivalent;
- d. Include management's reason for the request in the management representation letter; and

- e. Evaluate the implications on the audit report.<sup>18/</sup>

If the auditor does not agree to management's request and management refuses to authorize the confirmation request, the auditor should communicate management's refusal to the audit committee, or equivalent, and evaluate the implications for the audit report.

The Board is including these requirements in the proposed standard in response to comments the Board received on the Concept Release. In addition, management requests to not confirm certain items impose limitations on the audit, and as a consequence the auditor should evaluate the implications on the audit report.

#### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS provide requirements for when management refuses to allow the auditor to send a confirmation request. ISA 505 and the ASB's proposed SAS require the auditor to communicate with those charged with governance only if management's refusal is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative procedures. However, ISA 505 and the ASB's proposed SAS do not include requirements when the auditor agrees to management's request or when the auditor does not agree to management's request and management refuses to sign the confirmation request.

### ***Evaluation***

#### **Non-responses**

##### *PCAOB*

The proposed standard includes a requirement that when using positive confirmation requests and a response from a confirming party has not been received, the auditor should follow up with a second request and should consider following up with a third request.

When the auditor has not received replies to positive confirmation requests, the proposed standard requires the auditor to perform appropriate alternative procedures. Such alternative procedures should be responsive to the

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<sup>18/</sup> Management's request might represent a significant client-imposed scope limitation on the audit. See paragraphs .22-.34 of AU sec. 508, *Reports on Audited Financial Statements*.

risks for the related assertion(s) intended to be addressed by the confirmation request. The proposed standard does not permit omitting alternative procedures for non-responses and requires the auditor to perform alternative procedures for all non-responses.

The proposed standard also provides examples of alternative procedures the auditor should perform for specific situations. For example, when the auditor performs confirmation procedures for the terms of a transaction or agreement and does not receive a response to the confirmation request, he or she should perform alternative procedures, such as inspecting the original signed contract and amendments thereto, comparing contractual terms to industry norms, and confirming or discussing significant information with other parties involved in the transaction or agreement. In addition to performing alternative procedures, the auditor should, for significant transactions or agreements, include the terms of the transactions or agreements in the management representation letter and communicate the terms of the transactions or agreements to the audit committee, or equivalent. The auditor also should consider inquiring of and obtaining written representation from the company personnel involved with the significant transaction or agreement.

The proposed standard requires that the item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of the alternative audit procedures that the auditor should perform. For example, when performing confirmation procedures for the existence assertion for receivables that arise from credit sales, loans, or other transactions, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash receipts (including matching such receipts with the actual invoices being paid), (2) shipping documents, or (3) other supporting documentation. In addition, if the auditor is confirming the account balance for a receivable, and the account balance is made up of numerous invoices, debit memos, credit memos and other adjustments, the auditor's alternative procedures should include (1) testing subsequent cash receipts or other supporting documentation for the invoices, and (2) testing documentation for the debit memos, credit memos, and other adjustments that make up that account balance. When performing confirmation procedures for the completeness assertion for accounts payable, the auditor's alternative procedures should include examining one or more of the following: (1) subsequent cash disbursements, (2) correspondence from vendors and suppliers, or (3) other documentation or records.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS require the auditor to send the requests, including follow-up requests when applicable, to the confirming party. However, sending follow-up requests is not required by these standards.

ISA 505 and the ASB's proposed SAS include a similar requirement for the auditor to perform alternative procedures when the auditor does not receive replies to positive confirmation requests. Similar to the Board's proposed standard, ISA 505 does not permit omitting alternative procedures for non-responses. However, the ASB's proposed SAS indicates that omission of alternative procedures may be acceptable when testing for overstatement of amounts when (a) the non-responses in the aggregate, 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, and (b) the auditor has not identified unusual qualitative factors or systematic characteristics related to the non-responses, such as that all non-responses pertain to year-end transactions.

**Exceptions**

*PCAOB*

The proposed standard requires the auditor to investigate all exceptions in confirmation responses to determine why each exception occurred and whether any exceptions, individually or in the aggregate, are indicative of a misstatement or a previously unidentified risk of material misstatement. The proposed standard also states that the item being confirmed, the account, the assertion in question, and the risk of material misstatement affect the nature of the procedures that the auditor should perform to investigate exceptions in confirmation responses.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS include the requirement for the auditor to investigate exceptions to determine whether or not they are indicative of misstatements.

## **Reliability of Confirmation Responses**

### *PCAOB*

The proposed standard includes the requirement for the auditor to assess the reliability of confirmation responses. The proposed standard also includes factors that the auditor should take into account in assessing the reliability of a response including, but not limited to, whether confirmation responses:

- Are returned to the auditor indirectly because the confirming parties forwarded the confirmation responses to the company.
- Appear not to have come from the originally intended confirming parties.
- Contradict other information obtained during the audit.
- Come from addresses other than the addresses to which the auditor sent the confirmation requests.
- Are not the original confirmation requests that were sent to the confirming parties.
- Do not include the signatures of or acknowledgements by the confirming parties.
- Reflect local customs that may affect the confirmation responses, such as customs that create an environment in which confirmation responses are inherently unreliable.

When evaluating the reliability of the response received from a confirming party, the proposed standard requires the auditor to assess any indication that the confirming party:

- Is not competent, or knowledgeable.
- Has questionable motives.
- Is not objective or free from bias with respect to the company.

The proposed standard also provides that if conditions indicate that a confirmation response might not be reliable, the auditor should obtain additional audit evidence.

The Board is including these requirements in response to comments the Board received on the Concept Release. Numerous commenters recommended that the proposed standard require the auditor to obtain further audit evidence to resolve doubts about the reliability of confirmation responses, and when a confirmation response is not reliable, to evaluate the implications on the assessment of the relevant risks of material misstatement, including fraud risk, and on the related nature, timing, and extent of other audit procedures.

#### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS indicate that if the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor is required to obtain further audit evidence to resolve those doubts. In addition, if the auditor determines that a response to a confirmation request is not reliable, the auditor is required to evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. However, ISA 505 and the ASB's proposed SAS do not include factors about the confirming party that the auditor should assess when evaluating the reliability of a confirmation response.

#### *Additional Procedures for Electronic Confirmation Responses*

#### *PCAOB*

The proposed standard permits confirmation responses received electronically (e.g., by facsimile, e-mail, through an intermediary, or direct access), but it clarifies that such responses, like all confirmation responses, involve risks relating to reliability. The proposed standard requires the auditor to perform additional procedures to address the risks associated with electronic confirmation responses. Such procedures depend on the form of electronic communication and include:

- If information is provided via facsimile response, the auditor should verify the source and contents of the facsimile response by directly contacting the intended confirming party (e.g., by a telephone call to the intended confirming party).

- If information is provided via an e-mail response, the auditor should verify the source and contents of the e-mail response, such as verifying the e-mail address of the intended confirming party or contacting the intended confirming party by telephone.
- If an intermediary is used to facilitate confirmation, the auditor should obtain an understanding of the controls over the procedures used by the intermediary to process the confirmation requests and responses. The auditor should perform procedures to determine whether the auditor can use the intermediary's process. Risks to consider in performing the procedures and making this determination include (1) the process might not be secure or might not be properly controlled, (2) the information obtained might not be from a proper source, and (3) the integrity of the transmission might have been compromised. In addition, the auditor should determine whether the intermediary is authorized to respond on behalf of the intended confirming party.
- If information is provided via direct access, the auditor should evaluate whether direct access is an appropriate means to confirm information about the particular item that is the subject of the confirmation request. Direct access is not an appropriate confirmation procedure in all cases. For example, when confirming revenue agreements, the auditor should evaluate whether the revenue agreements could include terms and oral modifications that would make direct access an inappropriate mechanism for confirmation.

The proposed standard also states that direct access to information held by a confirming party constitutes a confirmation response only if (1) the auditor's access is provided by the confirming party rather than the company, and (2) the confirming party represents to the auditor, in writing, that (a) it is aware of the auditor's request for and intended use of the information, and (b) the files to be accessed contain information responsive to the auditor's request.

The Board is including requirements in the proposed standard relating to electronic confirmation procedures because information received electronically may pose risks relating to reliability because proof of origin might be difficult to establish and alterations can be difficult to detect. Several commenters to the Concept Release also requested additional explanation for evaluating electronic confirmation responses. In addition, the application and other explanatory material of ISA 505 and the ASB's proposed SAS include guidance related to electronic confirmation responses. The Board considered this guidance and,

where appropriate, included it as a requirement in the proposed standard. For example, ISA 505 states that "[i]f a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that: (a) The response may not be from the proper source; (b) A respondent may not be authorized to respond; and (c) The integrity of the transmission may have been compromised."<sup>19/</sup> The Board considers this guidance appropriate and included it as a requirement in the proposed standard.

### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS do not include similar requirements regarding electronic confirmation responses. In addition, neither standard provides requirements as to when direct access meets the definition of a confirmation response. The ASB's proposed SAS defines external confirmation as audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), either in paper form or by electronic or other medium or through the auditor's direct access to information held by a third party.

### **Disclaimers and Restrictive Language**

#### *PCAOB*

Because of deficiencies in auditors' procedures involving disclaimers and restrictive language in confirmation responses, which were noted through the PCAOB's inspection process,<sup>20/</sup> the Board is providing specific requirements in the proposed standard to address such disclaimers and restrictive language. The proposed standard requires the auditor to evaluate the effect of disclaimers or restrictive language on the reliability of a confirmation response. The proposed standard also requires that if a disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate evidence. The proposed standard further states that if disclaimers or restrictive language preclude the auditor from treating the response as a confirmation response, the auditor should treat such a response as a non-response and perform appropriate alternative procedures to obtain relevant and reliable audit evidence.

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<sup>19/</sup> Paragraph A13 of ISA 505.

<sup>20/</sup> Page 14 of PCAOB Release No. 2008-008, *Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected Firms* (December 5, 2008).

The application and other explanatory material of ISA 505 and the ASB's proposed SAS include guidance related to disclaimers and restrictive language in confirmation responses. The Board considered this guidance and, where appropriate, included it as a requirement in the proposed standard. For example, the ASB's proposed SAS states that "[i]f the restrictive language precludes the auditor's use of the information provided therein as audit evidence, the auditor may conclude that it is necessary to treat such a response as a nonresponse."<sup>21/</sup> The Board considers this guidance appropriate and included it as a requirement in the proposed standard.

#### *IAASB and ASB*

ISA 505 and the ASB's proposed SAS do not include similar requirements.

### **Evaluating Results**

#### *PCAOB*

The proposed standard provides that the auditor should evaluate whether the results of the confirmation procedures, including alternative procedures, provide the necessary relevant and reliable audit evidence or whether additional audit evidence is necessary. In performing such evaluation, the auditor should take into account:

- The reliability of the audit evidence obtained from confirmation responses and alternative procedures;
- The nature and extent of non-responses to positive confirmation requests, including the implications of those non-responses; and
- The nature and extent of any exceptions, including the implications of those exceptions.

If the confirmation procedures, including alternative procedures, do not provide the necessary relevant and reliable audit evidence, the auditor should send

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<sup>21/</sup> Paragraph A16 of the ASB's proposed SAS.

additional confirmation requests or perform additional tests<sup>22/</sup> and evaluate the implications, if any, for the audit report.<sup>23/</sup>

The requirements in the Board's existing confirmation standard related to evaluating the results of confirmation procedures were retained, with limited revisions, in the proposed standard because the requirements were considered to be relevant and appropriate.

*IAASB and ASB*

ISA 505 and the ASB's proposed SAS require the auditor to evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

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<sup>22/</sup> The evaluation requirements in the PCAOB Proposed Auditing Standard, *Evaluating Audit Results*, also apply in addition to these requirements, which are specific to the confirmation process.

<sup>23/</sup> AU secs. 508.22-.34.