PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202)862-8430
www.pcaobus.org

STANDING ADVISORY GROUP MEETING

AUDIT CONFIRMATIONS

SEPTEMBER 8-9, 2004

Introduction

The Standing Advisory Group ("SAG") will discuss the confirmation process and whether the American Institute of Certified Public Accountants' ("AICPA") auditing standard adopted by the Public Company Accounting Oversight Board ("PCAOB") as its interim standard should be revised to address current practice issues, as well as recommendations from the AICPA Auditing Standards Board ("ASB") and the Public Oversight Board's ("POB") Panel on Audit Effectiveness ("PAE").

The purpose of the discussion with the SAG is to review: (a) a brief history of the auditing requirement for auditors to confirm accounts receivable in audits of financial statements; (b) the auditor's requirements related to confirmation under existing auditing standards; (c) the practice issues identified by the Commission on Auditors' Responsibilities ("Cohen Commission"), the PAE, and the ASB and their related recommendations; and (d) a recommendation to consider a new standard on audit confirmations.

Brief History of the Auditing Requirement To Confirm Accounts Receivable

The auditor's objective in examining accounts receivable is to form an opinion regarding management's representation that accounts receivable is presented fairly in conformity with generally accepted accounting principles ("GAAP"). One of the most widely used substantive tests for determining the existence and, to a lesser extent, the accuracy of accounts receivable is direct communication by the auditor with the company's customers, commonly referred to as "confirmation." A confirmation typically involves a written request asking a recipient to verify the accuracy of the information included in the request. Confirmation is undertaken to obtain independent verification from third parties about certain financial statement assertions. It is generally presumed that evidence obtained from independent sources outside the entity provides greater assurance of reliability for the purpose of an independent audit than evidence obtained solely within the entity.

Confirmation of accounts receivables was first required in 1939, in response to the McKesson & Robbins case, a fraud that independent auditors failed to detect. The fraud was carried out by collusion in the top management of the company. Of reported consolidated assets in excess of $87 million, approximately $19 million, primarily accounts receivable and inventories, were fictitious.[1/] A new auditing standard mandated confirmation of accounts receivable by direct communication with creditors in all independent audits of financial statements. Today, the requirement to confirm accounts receivable is set forth in Statement on Auditing Standards ("SAS") No. 67, *The Confirmation Process.*

Existing Auditing Standards on the Confirmation Process

SAS No. 67, *The Confirmation Process*

SAS No. 67, *The Confirmation Process* (AU sec. 330),[2/] addresses the following auditor requirements:

- *Requirement to exercise due professional care.* SAS No. 67 requires the auditor to exercise professional skepticism throughout the confirmation process: designing the confirmation request, performing the confirmation procedures, and evaluating the results.

- *Requirement to confirm accounts receivable.* SAS No. 67 requires auditors to confirm accounts receivable with third parties in most financial statement audits. That requirement is based on the premise that audit

---

1/ *Report, Conclusions, and Recommendations*, Commission on Auditors Responsibilities (Cohen Commission), p. 124.

2/ The PCAOB adopted as its interim auditing standards those standards promulgated by the AICPA as of April 16, 2003.

evidence obtained from third parties will provide the auditor with higher quality audit evidence than is typically available from within the entity.

- *Transaction terms.* SAS No. 67 requires the auditor only to obtain an understanding of the substance of arrangements and transactions with third parties and to consider whether to confirm the terms of unusual or complex transactions that present greater risk. SAS No. 67 does not require confirmation of transaction terms.

- *Details of the confirmation process.* SAS No. 67 requires the auditor to follow certain specific procedures when designing and mailing confirmation requests to help ensure that the confirmation responses provide relevant and reliable audit evidence. Specifically the auditor should exercise an appropriate level of professional skepticism throughout the confirmation process and tailor confirmation requests to the specific audit objective by considering the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. The auditor should also maintain control over the confirmation requests and responses and should consider whether to apply procedures to authenticate facsimile responses to confirmations.

- *Performing alternative procedures when responses to confirmation requests are not received.* SAS No. 67 requires the auditor in most circumstances to apply alternative procedures when he or she does not receive responses to positive confirmation requests. However, the auditor may omit performing alternative procedures to the nonresponses in limited circumstances.

- *Evaluating confirmation responses.* SAS No. 67 requires the auditor to assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an acceptably low level. If the auditor concludes that evidence provided by confirmations alone is not sufficient, the auditor should apply additional procedures.

- *Evaluating the combined evidence provided by confirmations and other procedures.* SAS No. 67 requires the auditor to evaluate the combined evidence provided by confirmations and alternative procedures to determine whether he or she has obtained sufficient evidence about all applicable financial statement assertions. If the combined evidence provided by confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other substantive tests.

- *Documentation.* SAS No. 67 requires auditors to document oral confirmation responses. (In addition, as indicated above, SAS No. 67 sets forth a requirement for auditors to confirm accounts receivable in most circumstances. If auditors do not confirm accounts receivable, SAS No. 67 requires the auditor to document how he or she met the exception criteria.)

Confirmation Responsibilities under Other Auditing Standards

In addition to the requirements of SAS No. 67, three other auditing standards address the auditor's responsibility to obtain third party confirmations.

Inventories

SAS No. 1, *Codification of Auditing Standard and Procedures* (AU sec. 331, "Inventories"), states that if inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian. If such inventories represent a significant proportion of current or total assets and warehouse receipts have been pledged as collateral, the auditor should confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

Related Parties

SAS No. 45, *Related Parties* (AU sec. 334), states that the auditor should consider confirmation of related party transactions and terms to obtain evidence of the purpose, nature, and extent of related party transactions. SAS No. 45, however, does not require auditors to confirm the existence of related parties or the terms of related party transactions.

Fraud

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316.54), states that if there is an identified risk of material misstatement due to fraud that involves improper revenue recognition, the auditor also may want to consider confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements. SAS No. 99, however, does not require confirmation of transaction terms.

Practice Issues Related to Confirmation

Cohen Commission Observations

In 1974, the Cohen Commission was charged to develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. The Cohen Commission was tasked to consider whether a gap existed between public expectations and auditor's responsibilities. During its review, the Cohen Commission noted several practice issues involving the confirmation process. Specifically, the Cohen Commission's report noted that "the Commission's review of significant cases involving auditors disclosed several instances in which certain traditional audit steps did not produce the assurances they were intended to provide. For example, direct confirmation with parties outside the company is an important method of substantiation of both financial statement amounts and other management representations. However, in several cases, outsiders either ignored incorrect information that was clearly shown in confirmations or actively cooperated with management in giving incorrect confirmation."[3/]

Public Oversight Board's Panel on Audit Effectiveness

In 1998, at the request of the Securities and Exchange Commission ("SEC"), the POB established the PAE to review and evaluate the way independent audits of financial statements of publicly traded companies are performed and to assess the effects of recent trends in auditing on the quality of audits and on the public interest. The PAE's final *Report and Recommendations* (issued on August 31, 2000) discussed the use of confirmations as an auditing procedure.

The PAE's principal observation on this topic was a tendency for auditors not to confirm material accounts receivable. The PAE also noted a few instances in which engagement teams failed to maintain control of the confirmation process, failed to authenticate facsimile responses to confirmation requests, and failed to appropriately resolve confirmation exceptions.

[3/] *Report, Conclusions, and Recommendations*, Commission on Auditors Responsibilities (Cohen Commission), p. 40.

STANDING ADVISORY GROUP MEETING

AICPA Auditing Standards Board

In November 2003, the chair of the ASB submitted a written recommendation to the PCAOB for revision of SAS No. 67. The ASB's recommendations were based on its review of the PAE's findings and the practice issues related to the use of audit confirmations identified in Practice Alert 2003-1, "Audit Confirmations," issued by the AICPA Professional Issues Task Force.[4/] The practice issues identified in Practice Alert 2003-01 related primarily to the details of the confirmation process, procedures to be applied to confirmation responses, and other financial statement accounts and transactions for which confirmation may be preferable to applying other auditing procedures.

Recommendations for Consideration of a New Standard on Audit Confirmations

A new standard on audit confirmations may help ensure that auditors understand and satisfy their responsibilities related to corroborating an audit client's account balances and transactions directly with third parties.

Existing standards do not address all areas for which direct confirmation with third parties may be preferable to applying other auditing procedures. For example, existing auditing standards do not require an auditor to confirm cash account balances or the terms of significant transactions or agreements. Because audit evidence obtained directly by independent confirmation with third parties is more reliable than evidence obtained solely from information within the entity being audited, an auditing standard on audit confirmations may require auditors to confirm various matters in addition to accounts receivable.

Auditors are interpreting and applying the circumstances in which the auditor may overcome the requirement in SAS No. 67 to confirm accounts receivable too liberally. Therefore, as a result, auditors may fail to confirm accounts receivable when existing auditing standards require them to do so.

Existing standards do not address certain practice issues, such as: (a) management requests not to confirm; (b) how related party confirmations differ from

---

[4/] In January 2003, the AICPA's Professional Issues Task Force ("PITF") issued Practice Alert 2003-01, *Audit Confirmations.* The PITF is an AICPA taskforce that considers practice issues that present concerns for accountants and disseminates nonauthoritative advice in the form of Practice Alerts.

confirmations to independent third parties and the circumstances in which related party confirmations should be required, if any; and (c) authenticating confirmation requests received electronically. Addressing practice issues that have arisen regarding the auditor's use of confirmations to obtain audit evidence may help auditors to understand and satisfy their responsibilities relating to substantiating assertions in the financial statements.

Role Confirmations Play in the Audit Process

The objective of an audit of the financial statements is to express an opinion regarding the company's financial statements and to report whether the financial statements are presented fairly in all material respects as they relate to the financial position, results of operation, and the cash flows of the company. To accomplish this objective, the auditor substantiates management's assertions, embodied in the financial statements, regarding the economic actions and events that took place during the period under audit. The specific assertions are as follows:

- Existence or occurrence—whether assets or liabilities of a company exist at a given date and whether recorded transactions have occurred during a given period;

- Completeness—whether all transactions and accounts that should be presented in the financial statements are so included;

- Rights and obligations—whether assets are the rights of the company and liabilities are the obligations of the company at a given date;

- Valuation—whether assets, liabilities, equity, revenue, and expense have been included in the financial statements at appropriate amounts; and

- Presentation and disclosure—whether components of the financial statements are properly classified, described, and disclosed.

Confirmation from independent third parties is one of the procedures auditors may use to assist them in substantiating management assertions, especially the existence assertion and, to a lesser extent, the assertions of completeness and valuation. Confirmation provides auditors with valid audit evidence because, as previously discussed, it is generally presumed that evidence obtained from independent sources outside the company provides greater assurance of reliability for the purpose of an independent audit than evidence obtained solely within the company.

The type of information auditors need to confirm to substantiate a specific financial statement assertion depends on the circumstances of the audit client, including the nature of its business activities and transactions, and the accounting practices unique to the client's industry. SAS No. 67 (AU sec. 330.25) states that the auditor should obtain an understanding of the substance of such arrangements and transactions to determine the appropriate information to include on the confirmation request. For example, based on the auditor's knowledge of the client's business, it may be necessary for the auditor to confirm the terms of transactions, rather than account balances or in addition to account balances, to obtain audit evidence to substantiate specific financial statement assertions.

Discussion Questions –

1. Are confirmations an effective source of evidence for auditors in substantiating management's assertions in the financial statements? If yes, to what extent should confirmations be used during an audit?

2. Are there any pitfalls the auditors should be aware of in using confirmations?

Confirmation of Revenue Transactions and Terms

As previously discussed, the PAE recommended that SAS No. 67 be revised to address circumstances in which confirmation of the terms of revenue transactions should be required. SAS No. 67 indicates that auditors should consider confirming the terms of transactions with the other parties, in addition to examining the documentation held by the audit client, whenever the audit client has entered into an unusual or complex transaction for which the risk of misstatement of the financial statements may be higher. However, SAS No. 67 does not require confirmation in these circumstances.

As noted in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316), material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, SAS No.

99 states that the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

Required confirmation with customers of certain relevant contract terms and the absence of side agreements may be the most effective audit procedure to provide the primary source of evidence that revenue transactions are genuine, that amounts are correct, and that the revenue has been recorded in the appropriate period.

Discussion Questions –

3. Should an auditing standard on audit confirmations require auditors to confirm the terms of revenue transactions? If yes, in what circumstances?

4. Should an auditing standard on audit confirmations require auditors to confirm the absence of side agreements and oral modifications of agreements? If yes, in what circumstances?

Confirmation of Accounts Receivable

SAS No. 67 requires auditors to confirm accounts receivable in financial statement audits unless the following exceptions exist:

a. Accounts receivable are immaterial to the financial statements;

b. The use of confirmations would be ineffective; or

c. The auditor's combined assessed level of inherent and control risk is low and that risk assessment, combined with audit evidence expected to be provided by procedures other than confirmations, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions.

As previously discussed, in some cases, the PAE noted that engagement teams chose not to confirm accounts receivable even though it was not apparent that the auditors had met one of the exception criteria in SAS No. 67.

On the other hand, evidence in practice and audit research is beginning to suggest that routine confirmation of accounts receivable may not be as effective an audit procedure as it has been historically for various reasons, including the difficulty of directing the confirmation request to the appropriate individual who has knowledge of the balance to be confirmed and increasing unwillingness on the part of third parties to respond to confirmation requests.

Discussion Questions –

5. Confirmation of the terms of significant revenue transactions can provide the auditor with evidence about the existence and amount of any receivable related to the transaction. If a new audit standard on audit confirmations requires auditors to confirm the existence and terms of certain revenue transactions, should the current SAS No. 67 requirement to confirm accounts receivable be eliminated?

6. If the requirement to confirm accounts receivable is retained, should the exceptions to confirm accounts receivable be retained? If so, should they be clarified?

Confirmation of Other Matters

SAS No. 67 does not require the confirmation of cash balances or other arrangements, such as lines of credit, with financial institutions. SAS No. 67 indicates that if the risk related to the existence of cash is low, the auditor may limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.[5/] Recent high profile frauds, such as Parmalat, point out the importance of a properly executed bank confirmation for determining the existence of cash accounts.

The ASB also recommended that independent confirmation of accounts payable balances or transaction terms related to accounts payable balances could substantially contribute to providing audit evidence regarding the existence and completeness of accounts payable. Thus, independent confirmation may be preferable to other auditing procedures in some circumstances, such as:

- Entities that have been party to complex business transactions that create an environment in which unrecorded accounts may exist or that operate in industries for which industry practices may create a higher risk of unrecorded liabilities or inappropriate accounting;

- Entities experiencing cash flow difficulties or that have a history of disputing charges with vendors; or

---

5/ AU sec. 330.10.

- Entities that have deficiencies in internal controls over payables and disbursements, including proper cutoff.

Discussion Questions –

7. Should an auditing standard on audit confirmations require auditors to confirm cash balances? If yes, in what circumstances?

8. Should an auditing standard on audit confirmations require auditors to confirm balances or transaction terms related to accounts payable, such as purchase commitments? If yes, in what circumstances?

9. Should an auditing standard on audit confirmation require auditors to confirm other accounts such as investments and marketable securities?

Types of Confirmation Requests

There are two principal types of accounts receivable confirmations - positive confirmations and negative confirmations. A positive confirmation requests the recipient to respond to the auditor regardless of whether the information being confirmed is correct or incorrect. Auditors expect to receive a response for every positive confirmation mailed, and responses to positive confirmation requests provide audit evidence only when the auditor receives responses. Thus, SAS No. 67 generally requires the auditor to apply alternative procedures for any nonreplies to positive confirmations.

A negative confirmation requests the recipient to respond to the auditor only if he or she disagrees with the information being confirmed. The auditor does not expect to receive a response to a negative confirmation unless the recipient believes that there is an error relating to the account. Because negative confirmations do not require responses for correct information, unreturned negative confirmations provide little direct evidence to substantiate the amount of the receivable being confirmed. Thus, SAS No. 67 limits the circumstances in which negative confirmations may be used.

Although returned negative confirmations may provide evidence about financial statement assertions (that is, they may be returned with evidence indicating misstatements), unreturned negative confirmations do not provide explicit evidence that the intended third parties received the confirmation requests and verified that the information contained in them is correct. Because of the limited evidence provided by negative confirmations, SAS No. 67 recommends that auditors apply other substantive procedures to supplement the use of negative confirmations, but it does not require them to do so.

Discussion Questions –

10. Since negative confirmations rarely provide evidence about the assertions related to accounts receivable, should an auditing standard on audit confirmations preclude auditors from using negative confirmations and require them to use only positive confirmations?

11. If an auditing standard on audit confirmations continues to permit the use of negative confirmations in certain circumstances, should the standard require auditors to apply other substantive procedures to supplement the use of negative confirmations?

<u>Management Requests Not to Confirm</u>

SAS No. 67 does not address the auditor's responsibility when clients request that the auditors refrain from confirming account balances or other information due to a dispute between the client and the customer or for other reasons. Consequently, auditors are unclear whether acquiescing to the client's request constitutes a limitation on the scope of the audit or whether they may consent to the client's request and apply alternative procedures to obtain sufficient evidence about the subject matter of the confirmation. The ASB recommended that SAS No. 67 be revised to provide guidance on the circumstances in which alternative procedures may be appropriate, if any, and the nature of the alternative procedures.

Discussion Question –

12. Should an auditing standard on audit confirmations address the auditor's responsibility when clients request that the auditors refrain from confirming account balances or other information? If yes, how?

STANDING ADVISORY GROUP MEETING

Other Practice Issues

Discussion Question –

13. Are there other practice issues that should be addressed in an auditing standard on audit confirmations?

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.