

May 28, 2009

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via email to comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 028: Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 028: Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*. We appreciate the opportunity to provide input.

The views expressed in this letter and attachments are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist in developing revisions to the PCAOB's standard on audit confirmations. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

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General Comments

The Committee commends the PCAOB (“the Board”) for addressing the use of confirmations, including electronic confirmations, and confirmations of other accounts and special terms. The following section presents a number of specific comments or suggestions, organized along the lines of the questions posed by the Board in the concept release. These comments are followed by additional comments and observations on the use of confirmations.

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

The Committee believes that the objective of the confirmation standard should be for the auditor to design and perform confirmation procedures to obtain sufficient competent audit evidence from knowledgeable third parties outside the company. We note that other questions in this concept release address the definition of a confirmation. We also note that addressing the knowledge of the third party is challenging, and may not be relevant when the procedures involve direct access to information held by a third party.

We believe all testing should be responsive to risk, and that requirements in the confirmation standard be responsive to risk. Other questions in this concept release address the question of risk and when confirmations are required. However, we believe the wording “in response to identified risks” may suggest that confirmations should only be used when specific risks have been identified.

The primary audit objective for receivable confirmations is existence, which is related to the management assertion of existence, and should be emphasized in any changes to the proposed standard. This emphasis on existence affects how many other issues are viewed, such as confirmation differences and the use of negative confirmations.

2. Should the definition of confirmation allow for response other than traditional mailed responses, such as oral confirmation, facsimile, email, responses provided through third-party service providers, and direct on-line access to information held by a third party? Why or why not?

The Committee believes that these alternative forms of responses should be permitted. However, the auditor should consider the risk of significant misstatement and the need for authentication depending on the identified risk.

The primary objective of confirmations is to obtain evidence directly from a third party. When the interim confirmation standard was developed, many of these alternative forms of communication did not exist. Cost and low response rates suggest that traditional written, mailed confirmations are not very effective.

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The various alternative forms of communication vary in reliability. It may be appropriate to consider the reliability of the various forms of communication in the standard. The evidence in Caster et al. (2008) suggests that mailed responses also have reliability issues, although they are likely more reliable than faxed or emailed responses. It is quite likely that third-party providers and direct on-line access may be more reliable than a mailed response.

Some of the other forms of communication have lower reliability. We believe that oral confirmations should be discouraged, especially for material balances, and that auditors should be encouraged to consider the need for authentication when relying on all other types of responses.

3. What direction should the standard include regarding the use of electronic confirmations and third-party service providers?

Direction regarding these types of confirmations should be addressed in the broader context of the need for authentication of confirmation evidence from any source. Auditors that use third-party service providers should request reports on the controls at the service provider. This is similar to a report on internal controls at a service organization, but sufficiently different that the need for such a report may need to be addressed in any changes to the proposed standard. However, the third-party service provider could also be viewed as merely a communication intermediary like the postal service.

4. What procedures should the auditor be required to perform to address the risk that the information is not from a proper source and risk of the integrity of the data is not compromised?

The need for authentication of responses should be based on risk and materiality for all types of confirmation. As noted above, third-party providers should provide evidence of the effectiveness of controls over the confirmation procedures. For mailed confirmations, this could involve verification of addresses. For fax and email responses, procedures to verify the respondent would be appropriate.

5. Should the Board expand the presumptively mandatory requirement to request confirmation of accounts receivable in AU sec. 330 to include the confirmation of the significant terms of complex or unusual agreements or transactions, including complex or unusual revenue transactions? Why or why not?

The Committee believes that terms of complex or unusual agreements should be confirmed where material. The term “complex or unusual agreements” indicates that these have higher risk. It could be argued that confirming this information is more important than confirmation of receivable balances, since the latter can be readily addressed through alternative procedures.

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6. Should the Board require that the auditor consider confirming other items? If so, which items should be included in this requirement?

We believe that auditors should be required to confirm significant cash balances. We also believe they should be required to consider confirmations for material investments, credit facilities, debt agreements, and compensating balance agreements. Auditors should also be required to consider confirmation of accounts payable and other accounts or agreements when a significant risk has been identified.

7. Should the Board require the auditor to perform specific procedures when evaluating whether confirmation of accounts receivable would be ineffective? If so, what should those procedures include?

The Committee believes the existing guidance in AU sec. 330 is appropriate. Auditors should document the reason for not sending confirmations. When confirmations are considered to be ineffective, the auditor should document previous response rates or response rates on similar engagements to support the conclusion that confirmations would be ineffective.

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

The committee believes that this should be left to auditor judgment, as these concepts are difficult to define and it is impractical to address all issues in the standard. The standard could include examples, or the PCAOB could provide implementing guidance.

9. Is additional direction needed with regard to designing confirmation requests and, if so, what direction would be helpful to auditors?

The committee does not believe that additional guidance is needed in the standard. The PCAOB may wish to provide implementing guidance, similar to existing sources such as AICPA Practice Alert 2003-01 (AICPA 2007) and Auditing Procedure Study, *Confirmation of Accounts Receivable* (AICPA 1996). In our additional comments we indicate that the standard should discuss confirmation form and its relation to audit objectives and audit evidence.

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10. Should the standard include the requirement for the auditor to test some or all of the addresses of confirming parties to determine whether confirmation requests are directed to the intended recipients? Why or why not?

This question specifically addresses mailed confirmations, and we believe it is best considered under the broader context of authentication of all responses. We do not believe auditors should be required to test addresses, but believe the auditor should consider testing a sample of addresses based on risk and materiality. Large balances, especially those to unknown parties or to PO boxes are examples of accounts that should be considered for authentication.

11. What additional direction should the standard include with regard to maintaining control over confirmation requests and responses.

The Committee believes existing guidance on maintaining control over confirmations is sufficient.

12. What direction is necessary in the standard regarding maintaining control over electronic confirmations?

Some guidance may be necessary in the standard or implementing guidance for electronic and other types of confirmations. Use of a third-party service provider for electronic confirmations indicates some loss of control, and we have noted that there may be a need for a report on controls at the third-party provider.

13. What changes should be made to the standard regarding the auditor's responsibility for evaluating the reliability of confirmation responses and alternative procedures?

The committee believes guidance similar to that contained in ISA 505 is appropriate. We note that evidence reliability is a general concept that should apply to all evidence, including alternative procedures. We believe that auditors should be encouraged to at least consider authentication of the confirmation source, particularly for highly material amounts or where significant risks exist.

14. When an auditor uses direct on-line access to a third party database or a third-party service provider, what procedures should the auditor be required to perform to assess that the information included in the third-party databases or provided by the third-party service provider is reliable?

We believe that third-party providers should provide evidence of the effectiveness of their controls, similar to a SAS 70 report. If the auditor uses direct on-line access to a third-party database, the auditor should evaluate the reliability and authenticity of the source.

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15. Are there factors other than those mentioned above that the auditor should consider when evaluating the reliability of electronic confirmations? If so, what are they?

The committee did not identify any additional factors to be considered.

16. Should the standard require the auditor to perform alternative procedures for non-responses to positive confirmation requests? Why or why not?

In general, the committee believes that auditors should be required to perform alternative procedures for non-responses to positive confirmation requests to obtain sufficient evidence, particularly to address the existence assertion. The committee does note the use of PONI (positive-out, negative-in) confirmations (Williams and Ziegler 1987). In these circumstances, the auditor increases the total number of positive confirmations sent so that sufficient responses are received; the non-responses are treated as negative confirmations. The committee believes such an approach can be appropriate if the total number of positive confirmations received provides sufficient evidence, and the auditor evaluates whether the non-responses indicate any pattern or provide evidence of risks not previously identified.

17. Should the standard require the auditor to investigate exceptions identified as a result of confirmation responses? Why or why not?

All confirmation differences should be investigated, unless they are clearly immaterial and treated as misstatements in the evaluation of results. If the client is asked to reconcile confirmation differences, the auditor must test the client's reconciliation. Where a difference is treated as an exception, the auditor should evaluate whether the cause of the exceptions indicates a previously unidentified risk.

18. Should there be a requirement for the auditor to consider the possibility of previously unidentified risk of material misstatements including previously unidentified fraud risk factors when performing alternative procedures for non-responses and investigating exceptions on confirmation responses? Why or why not?

We believe that risks should be reconsidered whenever exceptions are identified in any audit testing. We note that such guidance is contained in proposed standard *Evaluating Audit Results* (PCAOB Release 2008-08, p. A5-6).

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19. Should the standard include alternative procedures the auditor should perform for non-responses when the auditor is confirming the significant terms of unusual or complex agreements or transactions? What should those alternative procedures include?

If the auditor deems it appropriate to confirm significant terms, then it seems appropriate to perform alternative procedures for non-responses such as reading agreements or other documents that address the special terms. However, depending on the materiality of the individual agreements or transactions, it may not be necessary to perform alternative procedures for all non-responses of special terms. The purpose of the alternative procedures in this case is to learn about the nature of the agreements or transactions, whereas alternative procedures for positive confirmations of receivable balances are used to generalize from the sample to the population.

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

The Committee believes that if confirmation is a required audit procedure, management requests that certain confirmations not be sent should be regarded as a scope limitation. However, if management is allowed to request that confirmations not be sent, the procedures listed are appropriate.

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

As noted earlier, we believe that accounts receivable confirmations should primarily be used to address the existence assertion. We do not believe such disclaimers substantially reduce the evidence provided by the confirmation, and would not require the auditor to perform alternative procedures.

22. Should auditors be allowed to use negative confirmations and, if so, in what circumstances?

Negative confirmations do not appear to be widely used, and the existing requirements in AU Sec. 330 that negative confirmations be used when controls are effective and individual balances are small seem appropriate. If confirmations are used primarily to address the existence assertion, the Committee believes use of negative confirmations should be encouraged when the requirements for sending negative confirmations are met, especially when negative confirmations are used in addition to positive confirmations.

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23. *Should the standard include the requirement that the auditor perform additional substantive procedures when using negative confirmations? Why or why not?*

The committee does not believe that additional substantive procedures should be required when negative confirmations are used. We also distinguish situations where negative confirmations are used in addition to positive confirmations, and situations when only negative confirmations are sent. Although we don't believe additional substantive procedures should be required, substantive analytical procedures should be encouraged when only negative confirmations are used.

Additional Considerations

Confirmation Reliability – The Committee believes that confirmations are useful, especially for addressing the existence assertion. However, the AAER evidence in Caster et al. (2008) suggests the collusion involving confirmation respondents is relatively common. The existence of a business relationship between the client and respondent suggests that confirmations may not represent independent evidence. Auditors should consider the need for authentication and/or additional evidence when a significant risk exists, or when there is reason to question the independence of the confirmation respondent.

Confirmation Form – We believe the standard should address confirmation form. The concept release discusses negative confirmations, which appear to be rarely used, and perhaps underused. The concept release also discusses confirmation of unusual transactions and significant terms. However, other issues of confirmation form are not addressed.

Forty years ago, blank forms were probably the predominant form of confirmation; and balance confirmations were the primary confirmation form twenty years ago. Invoice confirmations are the predominant confirmation form today. Krogstad and Romney (1980) encouraged the use of invoice confirmations with larger sample sizes, on the basis of efficiency and improved responses. However, Allen and Elder (2001) do not find improved response rates and also do not find larger sample sizes with invoice confirmations. Williams and Ziegler (1987) suggest the use of PONI confirmations, but standards do not address whether a positive confirmation can be treated as a negative confirmation if no response is received.

Whether electronic forms of confirmation replace traditional mailed confirmations is closely tied to the objectives of confirmations. If confirmations are used primarily to address the existence assertion, then written confirmations, regardless of form, may be more effective than electronic confirmations. We believe that electronic confirmations or alternative procedures are effective, and perhaps more effective than written, mailed confirmations, in addressing the valuation assertion. This suggests that the form of

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confirmation (blank, balance or invoice) is less important, and the confirmation and authentication of the customer, including confirmation of significant terms, should be regarded as the primary purpose of confirmations. The valuation assertion can be addressed through alternative procedures or substantive analytical procedures. This also suggests that negative confirmations can be highly effective where unusual transactions or special terms do not exist.

References

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