

29 May 2009

Our ref: ICAEW Rep 63/09

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THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

cc. Arnold Schilder, Chair, IAASB

By email: *PCAOB Rulemaking Docket Matter No. 028*

Dear Sir

PCAOB RELEASE NO. 2009 - 002: CONCEPT RELEASE ON POSSIBLE REVISIONS TO THE PCAOB'S STANDARD ON AUDIT CONFIRMATIONS

The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the PCAOB's Concept Release on possible revisions to the PCAOB's standard on audit confirmations.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

Our comments have been prepared with the help of our many members working around the world who have detailed knowledge and practical experience of US, EU and other regulatory regimes. We provide main and detailed comments resulting from our discussions as well as answers to the PCAOB's specific questions.

We welcome a revision of the confirmations guidance as it is indeed overdue given changes in technology. In many cases confirmations are still dealt with in the time-honoured manner, by post, but more use is being made of electronic confirmations. They are often a more efficient and reliable method of gathering audit evidence but they do give rise to their own set of risks and they may in some circumstances be vulnerable to greater manipulation and fraud than more traditional methods.

Our overriding concern with the Concept Release is that it should more clearly recognise that each confirmation will give rise to a unique set of risks that the auditor should be required to consider and respond to appropriately, rather than encouraging auditors to hide behind a codified set of rules that are not tailored to address the risks identified.

We welcome the issue of a Concept Release prior to any proposed revisions. This will help ensure that a good level of consensus is built prior to exposure. We also welcome the recognition of the importance of IAASB standards in this area and we urge further efforts at convergence.



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As we noted in our recent response to the PCAOB exposure of its proposed risk assessment standards dated 18 February 2009, convergence is achieved in practice by compromise in order to achieve a greater degree of consensus. While convergence that amounts to 'similarity, with add-ons' is a start, we hope that the PCAOB will seek to narrow differences between its standards and those of the IAASB. Starting with ISA 505 as a basis for the PCAOB standard would be one way to achieve this; ISA 505 covers all of the areas identified in the Concept Release including the issues associated with electronic confirmations.

Our main comments and answers to the PCAOB's detailed questions are set out below.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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Main Comments

Risk, judgement and the mechanics of confirmations

We are particularly encouraged that the PCAOB has addressed the risk assessment standards and we urge a follow-through of the spirit of those proposals in any revisions on confirmations. We note an emphasis on the procedural aspects of confirmations in the Concept Release but we urge more focus on principles, such as the involvement of experienced staff who can exercise proper judgement in planning whether, and how, to conduct confirmations, rather than focusing on their mechanical aspects. As the PCAOB notes in the Concept Release, it is a failure to conduct confirmations at all, and failures to properly control or supervise them, or assess the significance of their outcomes that cause problems. Fine tuning of the process will not compensate for human error in sending confirmation requests out, or the carelessness, or worse, of third party respondents. We therefore urge greater emphasis on the proper use of judgement and professional skepticism in our answers to the detailed questions below. Judgement will become more important as the technology facilitating automated confirmations becomes more accessible.

Rebutting the presumption: when confirmations should not be conducted

A corollary of the risk based approach, and an important aspect of confirmations that the PCAOB has not really addressed, is the *combined* effect of the decline in use of confirmations, low response rates and respondent errors because an increasing number of entities regard them as a low priority, and the widespread increase in the use of restrictive language and disclaimers. The POB comment on Page 4 of the Concept Release to the effect that some auditors believe that confirmation is not a particularly effective audit procedure in many situations, is important. It calls into question the statement on page 5 that expanding the requirements of the standard to other areas may enhance audit quality and investor protection; it may only *appear* to do so. The IAASB has wrestled with the vexed issue of providing guidance to auditors on *when* to conduct confirmations. We do not expect that the PCAOB will withdraw from its presumptively mandatory requirement, particularly given that in some cases, such as bank confirmations, there will only be rare circumstances in which a confirmation is not appropriate. Nevertheless, it may well be prudent to emphasise that confirmations should *not* be conducted for the sake of it, particularly when the risk analysis indicates that it may not be a necessary or efficient method of obtaining audit evidence, such as confirmations of debtors many months after the period-end. A greater discussion of high quality alternative evidence would be helpful here, particularly for those assertions such as existence, for which confirmations, when they *can* be performed, are good.

Requiring the performance of specific procedures

We note that in many questions the PCAOB asks whether auditors should be required to perform specific procedures. We urge the PCAOB (and indeed other standard-setters) to consider the effects of this approach. Almost always, requiring the performance of specific procedures

- is out of line with a risk based approach;
- encourages a mechanical approach to auditing standards;

- discourages the use of professional judgement; and
- inhibits the development of judgement in more junior staff.

This is not in the long term interests of the businesses and markets that auditors serve. Requiring the performance of specific procedures is necessary in auditing standards, but it should be the exception, and not the rule.

Answers to PCAOB Questions

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?

Yes, but the objective should be the objective of the auditor, and not of the standard, in line with other PCAOB standards.

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

Yes, but there should be no assumption that 'other' responses are any more inherently reliable than traditional mailed responses. They may be more unreliable, and there may be less high quality documentation to support them, depending on circumstances. This is particularly relevant to direct access where the information recorded is often transient, reflecting the position at a moment in time and where documentation such as a screen shot may be all that is available for the audit files.

Oral confirmations are acceptable, provided that there is contemporaneous documentation of the evidence obtained.

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

The control objectives relevant to electronic confirmations are the same as those relevant to more traditional methods; completeness, existence and accuracy, are sought, for example. The overarching control procedures within the control environment implemented to achieve those objectives are also similar, proper risk assessment, planning, and follow-up for example. The differences exist at a lower level. The focus should be on the higher level controls, as failures in these are where, as we note above, failures in the conduct of confirmations often occur. Direction should deal with the need for auditors to adapt processes to appropriately respond to the different risks that present themselves, and should not be detailed.

Confirmations sent to and received from third party service providers should be subject to the same standards of evidence as confirmations sent to and received from the entity itself. The risk assessment the auditor must perform before deciding to seek confirmations from such third parties needs to take account of the associated risk profile and the controls needed to reduce risk to an acceptably low level.

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

Auditors should not be required to check the authenticity of documents in this area any more than in any others, unless conditions identified during the audit cause the auditor to believe that a document may not be authentic. Professional skepticism does not extend to an assumption that documents lack authenticity. Any revision should make this clear.

Auditing guidance to date has generally either been silent on what to do when auditors' suspicions are aroused regarding the authenticity or integrity of data, or restricted to a requirement for auditors to resolve any uncertainties and inconsistencies, and failing that, to qualify their audit opinion on the basis of a limitation in the scope of the audit. In practice, while auditors may suspect, and in rare cases identify the occurrence of fraud, auditors do not make legal determinations of whether fraud has actually occurred and they can only seek additional or alternative evidence to corroborate their assessments where evidence presented is doubtful. This is a matter that is already dealt with in auditing standards on audit evidence. To require a different standard of evidence here would require consideration for the need for a different standard of evidence in many other areas.

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

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

No (5 and 6). *While confirming terms of revenue contracts, particularly in the software and other high technology industries is common, simply extending the presumptively mandatory requirement for confirmation to them or other items without making any reference to assessed risk, will create additional work for no benefit in the majority of industries in which contractual terms are rarely, if ever, complex or unusual. Unusual or complex transactions are not necessarily associated with heightened risk (as noted on page 11 of the Concept Release) particularly if they are immaterial. The requirement, and the work needed to document its rebuttal, is not without cost and a risk based approach, with guidance (in line with the thinking of some SAG members) rather than a presumptively mandatory requirement might make auditors think harder.*

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?

No. *The auditor should be required to justify evaluation of confirmations as ineffective. Specific procedures are not necessary and are likely to enable auditors to hide behind them rather than justify their decisions.*

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?

No, regardless of whether the PCAOB ultimately decides to include a risk based approach to unusual or complex agreements, or a presumptively mandatory requirement. If the PCAOB considers auditors unable to use their judgement to determine what is unusual or complex without guidance in this area, it implies that the PCAOB has no faith in the ability of auditors to use their judgement at all. If auditors require direction in this area then they have not properly understood the business they are auditing or they have been inadequately trained and it is to these areas that the PCAOB should direct its attention.

Furthermore, in many cases complexity is a consequence of the specific GAAP requirements in a particular area. Including such direction would inevitably bring GAAP into auditing standards which should be avoided where possible since PCAOB standards are often followed for audits of IFRS and local GAAP financial statements of foreign registrants filed with the Securities and Exchange Commission.

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

No. We do not believe that there are any procedural problems that need fixing here. If there are such problems, they relate to the strategic audit planning and are not mere technical issues. While standardised confirmation procedures facilitate more consistent (and to that extent reliable) responses in the case of requests to, say, banks, the benefit of such standardisation derive from requestees being a homogenous group subject to regulation. This is simply not the case with, say, recipients of requests for confirmation of accounts receivable.

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?

No, simply on the basis that the proposed approach will not deter those intent on deceiving auditors. 100% testing would be extremely inefficient in the absence of some assessment of risk. Auditors might benefit from guidance suggesting that they consider such procedures as part of their risk assessment. Any presumptively mandatory requirement in this area would be better to require that confirmations are controlled by auditors, and that they should ordinarily be sent, and responses thereto received, by auditors.

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

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

PCAOB reports have not highlighted weaknesses in the conduct of confirmations and any additional direction should be kept to a minimum.

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

Our covering letter indicates the need for focus on the outcome of confirmations (including their reliability) and alternatives to confirmations rather than their mechanics. Auditors should be encouraged to apply professional skepticism in evaluating confirmation requests.

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

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

This is a complex area in its own right and in the context of confirmations, it is a good example of circumstances in which the auditor may take the view that confirmations are not the most efficient approach to obtaining audit evidence and that alternative procedures should be considered. Direct electronic confirmation may be more efficient and reliable than manual transcription of electronic information which is then posted to the auditor but direct access to databases may equally be vulnerable to greater manipulation and fraud than more traditional methods. The databases themselves may be subject to a heightened risk of fraud or error and our answer to Q2 above notes that the information therein is often transient. Given the potentially relatively weak audit evidence provided by such databases, it is essential that the auditor either be satisfied with the controls over information delivered to the third party provider, the controls applied to the data during processing, and the control of information returned to the entity from such third parties.

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

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

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

Yes (16, 17 and 18). *Auditors should be required to perform alternative procedures to deal with non-responses (where positive confirmations are sought) and exceptions to confirmation requests. Non-responses are indicative of potential fraud or error and while alternative procedures may not provide conclusive evidence, auditors should not ignore the non-response or disregard alternative evidence. There may be a number of different reasons for non-response and the evaluation of the non-response will depend on the risk associated with the relevant item. A high number of non-*

responses may indicate that planning has not been performed properly. In all cases though, there is a need to investigate exceptions, consider the reasons for non-responses, and consider the implications for the auditors' risk assessment and audit evidence generally.

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?

Yes. *Where auditors conduct such requests, they should be required to follow them through and alternative procedures should be applied for non-responses. Alternative procedures might include using the work of specialists, extending testing of revenue recognition surrounding contracts, requesting and examining copies of the contracts and amendments thereto and comparing contractual terms to industry norms.*

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

Yes. *In many cases there may be valid reasons for the request not to confirm and auditors must use their judgement in determining whether that is the case. No other procedures are required in addition to the procedures listed on page A-15 of the Concept Release*

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?

No. *To require auditors to effectively discount the evidence provided by confirmation requests circumscribed by disclaimers and restrictive language is to enter into a downward spiral at the end of which lies an inability to rely on any confirmation response. Such disclaimers and restrictive language are increasingly common in the UK in response to bank confirmation requests and the view taken is that of themselves, they do not significantly impair the value of such evidence. Furthermore, the practical effect of a disclaimer or restrictive language is likely to require a legal analysis that is not within the auditor's competence.*

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

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

Yes, *(22 and 23) but only in restricted circumstances. Negative confirmations can be useful where there are large groups of homogenous items subject to similar controls*

and a low risk of misstatement. Additional substantive procedures should be required where such items are or may be material.