



Deloitte & Touche LLP  
Ten Westport Road  
P.O. Box 820  
Wilton, CT 06897-0820  
USA

[www.deloitte.com](http://www.deloitte.com)

September 13, 2010

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

**Re: *Request for Public Comment on Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards (PCAOB Release No. 2010-003, July 13, 2010, Rulemaking Docket Matter No. 028)***

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its *Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards* (PCAOB Release No. 2010-003 (the “Release”), July 13, 2010, Rulemaking Docket Matter No. 028) (the “Proposed Standard”).

*Improving the Effectiveness of the Confirmation Process*

We are supportive of efforts to improve the effectiveness of the confirmation process as we believe that, in appropriate circumstances, confirmation procedures are appropriate and effective in addressing identified risks of material misstatement. We also acknowledge that the extant standard (PCAOB AU 330 *The Confirmation Process*) needs to be updated, in particular to recognize increasing and evolving use of technology in performing confirmations.

We believe, however, that the effectiveness of the confirmation process in its entirety needs to be improved, and revisions to the extant auditing standard are only part of what should be a much broader initiative. For the effectiveness of the confirmation process to be improved, confirming parties (1) should be more accountable for responding promptly, accurately, and completely to confirmation requests and (2) should respond without using unnecessary restrictive language. In recent years, auditors have experienced declining response rates to confirmation requests and increasing use of disclaimer or restrictive language in confirmation responses. We believe that, if adopted, the Proposed Standard, in calling for significantly more confirmation requests, will serve to exacerbate these issues.

We realize that addressing respondents’ obligations and the mechanisms that might be put in place to reinforce their responsibilities is a broad and complex undertaking. However, given the direction of the Proposed Standard, which is calling for significantly more effort on the part of the auditor in the confirmation process, we believe that it is now more imperative than ever that there be a corresponding (if not greater) effort to address the obligations and responsibilities of confirming parties. We believe that it is not in the public interest for an auditing standard addressing the confirmation process to impose significant incremental requirements on auditors without an effort to similarly address the obligations of the parties that will be responding to the increased level of confirmation requests that will result from the Proposed Standard.

To that end, we strongly recommend that prior to the finalization of the Proposed Standard, the PCAOB should take the lead in an effort to improve the effectiveness of the confirmation process, working with the Securities and Exchange Commission, issuers, banking and other regulators, auditors, investors, and others. The objective of

such effort should be to (1) surface and understand the issues related to the confirmation process, including liability concerns that are driving the increasing use of restrictive language, and (2) work collaboratively to develop appropriate solutions. Without such an effort, we are very concerned about the ability of the auditor to be successful in implementing the Proposed Standard, and we believe that it will result in little, if any, improvement in audit quality. Rather, it will create effort without the concomitant benefits.

We also believe the Proposed Standard's requirements are unnecessarily expansive when compared to the extant standard, unduly onerous and too prescriptive. We believe that the requirements in the Proposed Standard will result in an inordinate increase in the number of confirmation requests that the auditor will be required to send, regardless of whether the auditor believes that confirmations are actually likely to be effective in addressing identified risks. The prescriptive direction regarding the use of confirmations in the Proposed Standard is inconsistent with the direction of the Board's recently finalized risk assessment standards, which are premised on the planning and performance of audit procedures that the auditor believes will be most effective in addressing the identified risks.

We do not believe that creating additional requirements to use confirmations will necessarily result in improved audit quality. Prescriptive requirements, by their nature, can never be comprehensive in addressing any and all facts and circumstances of a particular situation. Such requirements detract from the ability of the auditor to exercise professional judgment in determining and performing those procedures that are likely to be most effective in addressing identified risks of misstatement.

Establishing detailed requirements to always obtain confirmations in a wide variety of situations also conveys the notion that confirmations are therefore always more reliable or effective than other forms of audit evidence. Confirmations, however, have limitations and other audit procedures may be more effective in addressing particular risks of misstatements.

#### Consideration of the Work of Other Standard Setters

As we have remarked in previous comment letters on the Board's proposed standards, we support and encourage the Board's ongoing consideration of the work of other standard setters. As such, we support the inclusion of appendices such as 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 [(IAASB)] and the Auditing Standards Board [(ASB)] of the American Institute of Certified Public Accountants*, as an appendix to the Proposed Standard, and as a similar appendix to future exposure drafts and final auditing standards. Appendices such as these provide an opportunity for the Board to clearly describe the rationale for the structure and content of its proposed standards. Providing such information is an important step for the Board in meeting its 2009 – 2013 Strategic Plan objectives for transparency.

The discussion in Appendix 3 compares each PCAOB requirement with the equivalent requirement (if any) in the corresponding International Standard on Auditing (ISAs) of the IAASB and Statement on Auditing Standards (SASs) of the ASB, and provides an opportunity for the Board to explain its rationale in establishing different or incremental requirements. Many of the requirements in the Proposed Standard are incremental to, or more prescriptive than, the requirements in the ISAs or the SASs. We are concerned that the Board has not provided sufficient or compelling rationale as to how these incremental and very prescriptive additional requirements will drive an improvement in overall audit quality that is commensurate with the additional and substantial effort that will be required.

We also note that the comparison in Appendix 3 is misleading because some of the instances identified therein as requirements in the Proposed Standard that are incremental to the ISAs or the SASs are actually encompassed in the standards of the IAASB or the ASB in the form of application material or guidance that is attached to more overarching requirements in those standards. The existence of this application material is not called out in

Appendix 3. By failing to identify the existence of such application material in the ISAs or the SASs, the Appendix incorrectly implies that the ISAs or SASs fail to address the issues that are being covered by the PCAOB requirements identified as incremental. The Appendix does not identify those situations in which the ISAs or SASs are more principles-based and support the exercise of auditor judgment in determining how to address the requirements.

We understand that the Board may conclude that it is appropriate for its standards to contain incremental requirements, or to elevate guidance from the ISAs or the SASs to requirements. However, in order to improve the transparency of its standard-setting process, and the usefulness of Appendix 3, we believe that the Board should clearly highlight those instances in which the subject matter of a particular requirement is addressed as application material or guidance in the ISAs or the SASs, instead of only stating that those standards “do not include similar requirements.”

In addition to the overarching concerns discussed above, we have more specific concerns regarding the Proposed Standard. These concerns are presented in two sections in the attachment to this letter. The first section, entitled Overall Comments, sets forth those comments that are pervasive in nature (and in some cases those comments expand upon the points addressed in this cover letter), while the second section, entitled Detailed Comments and Other Observations, sets forth paragraph-specific comments and other observations.

We welcome an opportunity to further discuss these matters with the Board and the staff. Dialogue with commenters as the Proposed Standard is evaluated and changes are considered will facilitate a more complete understanding of the comments, full consideration of the related implications, and, we believe, will ultimately improve the final standard and the auditor’s ability to implement it effectively and with the desired effect of improving audit quality.

If you have any questions or would like to discuss these matters further, please do not hesitate to contact John Fogarty at (203) 761-3227 or Megan Zietsman at (203) 761-3142. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: Daniel L. Goelzer, Acting PCAOB Chairman  
Bill Gradison, PCAOB Member  
Steven B. Harris, PCAOB Member  
Charles D. Niemeier, PCAOB Member  
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman  
Luis A. Aguilar, SEC Commissioner  
Kathleen L. Casey, SEC Commissioner  
Troy A. Paredes, SEC Commissioner  
Elisse B. Walter, SEC Commissioner  
James L. Kroeker, SEC Chief Accountant  
Brian T. Croteau, SEC Deputy Chief Accountant

## I. Overall Comments

Our overall comments are organized as follows:

- A. Expanded Scope of Required Confirmations
- B. Prescriptive Nature of the Proposed Standard and Implementation Challenges
- C. Inconsistencies with Other PCAOB Auditing Standards
- D. Drafting Conventions
  - 1. Use of Present Tense
  - 2. Requirements Embedded in Examples
  - 3. "Requirements" Presented Outside of the Proposed Standard

### A. Expanded Scope of Required Confirmations

#### *Overall Observations*

The Proposed Standard significantly expands the scope of required confirmation procedures and now includes confirmation (a) of receivables that arise from credit sales, loans, or other transactions, (b) of cash and other relationships with financial institutions, and (c) in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures. The expanded requirements appear premised on the belief that confirmation procedures "can provide audit evidence to address the risk of material misstatement due to fraud."<sup>1</sup> However, alleged audit failures and enforcement actions seem to have been more often linked to fraudulent or unreliable confirmations than to auditor failure to request a confirmation or to perform alternative procedures.

As noted in our cover letter, the expanded requirements in the Proposed Standard addressing when confirmations are required to be performed give the investing public, other interested parties, and auditors the impression that confirmations are a superior form of audit evidence and the most appropriate procedure to perform in all instances. We do not believe that this is supported by the academic studies cited on page 2 of the Release which provide evidence of challenges in the confirmation process that affect the reliability of the audit evidence that confirmation responses might provide. Specifically, one of the studies involved reviewing Security and Exchange Commission Accounting and Auditing Enforcement Releases (AAERs) to highlight weaknesses in current audit practice. The number of enforcement actions supporting the observations regarding the issue of evaluating reliability of evidence from confirmations was overwhelming.<sup>2</sup> For example, a table in the study summarizing confirmation problems reported in AAERs shows that the greatest problem area in current audit practice is evaluating the reliability of confirmations. Of the 30 reported cases, 25 involved collusion between the audited party and a third party to deceive the auditor. The other academic study cited in the Release<sup>3</sup> specifically stated that "academic studies have questioned the reliability of confirmations" and that "a review of AAERs found a

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<sup>1</sup> Page 3 of PCAOB Release No. 2010-003.

<sup>2</sup> 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>3</sup> See 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).

significant number of cases involving collusion and also forged and false confirmations, suggesting that confirmation evidence may not be as persuasive as it is generally perceived.”

It is not clear to us why, despite the questions surrounding the reliability of evidence provided by confirmations and the lack of compelling evidence linking alleged or actual audit failures to an auditor’s decision to not perform confirmation procedures, the Board, through the Release and the Proposed Standard, is placing such significant importance on this type of evidence and requiring significantly more confirmation procedures.

The Board’s recently finalized risk assessment standards provide an appropriate framework to guide the auditor’s judgment regarding the nature, timing, and extent of audit procedures necessary to obtain sufficient appropriate audit evidence. It is therefore not necessary for the Board to establish prescriptive requirements in the Proposed Standard as to the types of procedures that auditors should perform. The establishment of such requirements is inconsistent with the risk assessment standards which call for the planning and performance of procedures that are most responsive to identified risks. Instead of imposing prescriptive requirements for confirmations, the PCAOB should consider adding guidance that illustrates how the auditor can use confirmations to address the risk of material misstatement in areas other than accounts receivable. This would enhance the Proposed Standard and demonstrate how the framework in the risk assessment standards is intended to be applied to the confirmation process.

We also encourage the Board to more specifically acknowledge in the Proposed Standard that the effectiveness of confirmations may be compromised by management override, collusion or by other factors, and that responses may not, therefore, be reliable.

#### *Requirement to Confirm Receivables*

The requirement to confirm accounts receivable in the Proposed Standard represents a significant scope expansion from what is included in the PCAOB’s extant standard. The extant standard contains a rebuttable presumption that auditors confirm only certain receivables (including the entity’s claims against customers that have arisen from the sale of goods or services in the normal course of business, and a financial institution’s loans). However, it allows auditors to apply professional judgment in evaluating whether there is a basis to overcome that presumption, including making a determination as to whether the use of confirmations would be effective in a particular situation.

We are concerned with the expansion of the nature and scope of the requirement to confirm accounts receivable to now include all receivables. Combined with the absence of the ability to appropriately exercise judgment regarding when confirmation procedures are not likely to be effective, this expansion will place the auditor in the position of needing to send confirmation requests even when the auditor knows that the confirmation requests are unlikely to be effective in addressing the identified risks of material misstatement.

We note that page 13 of the Release currently states, “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.” This statement does not acknowledge that, in many cases, auditors will not be able to meaningfully improve the effectiveness of the confirmation procedures on their own. For example, the auditor cannot control what disclaimers or restrictive language respondents might choose to use in responding to the confirmation requests. Additionally, the auditor has no way of compelling respondents to reply to confirmation requests if they choose not to respond. As explained in our cover letter, we believe the only way to improve the confirmation process is through an undertaking that brings all relevant parties, including regulatory leadership, together with a clear mandate to collectively develop ways to improve the confirmation process. Improvements to the auditing standard are only one part of how this might be accomplished.

In certain industries, response rates are traditionally very low and, therefore, subject to appropriate consideration of the factors in extant PCAOB AU 330 (paragraph 34). Under the extant standard, it is not common practice to send receivables confirmations when they would not be effective. The healthcare industry provides a relevant example of an industry in which accounts receivable confirmations not only are ineffective, but potentially problematic. Due to the complex nature of accounts receivable associated with delivering health care services, for instance, in the hospital setting, the inability to get responses from third party payers and the difficulty patients would have in verifying amounts owed (e.g., the patient may not be aware of the amounts not covered by insurance plans), it is ineffective and inefficient for auditors to send confirmation requests when performing audits of health care providers. Patients may become confused and concerned upon receipt of such requests. Additionally, use of patient information to send the requests and the risk of unauthorized disclosure of that information if the requests are misdelivered raises legal issues under federal and state privacy and security laws. Under the Proposed Standard, the auditor will now be required to send the confirmation requests regardless, follow up with second requests, consider third requests, and then perform alternative procedures. Additionally, the auditor will likely have to devote significant attention to following up on responses that are actually received which likely will contain exceptions because many patients will not understand the basis for the charges reflected on the invoices that comprise the balances being confirmed and will reflect that in their responses. Currently, auditors use other appropriate procedures to obtain more reliable audit evidence supporting the existence of receivables in the healthcare industry while protecting the privacy and security of patient information. It will be ineffective and inefficient, if not legally problematic, for the auditor to use patient information to send confirmation requests for which they may well not receive a response.

Another example of an industry in which confirmation requests are unlikely to be effective is provided by the utilities industry where confirmations for gas, electric and water bills are highly unlikely to be as effective as substantive analytical procedures. We do not believe that all of this incremental audit effort to perform confirmation procedures where they will be ineffective will result in the desired improvement in audit quality.

#### *Requirement to Use Confirmations in Response to Significant Risks*

Paragraph 10 of the Proposed Standard indicates that the “auditor should perform confirmation procedures in response to significant risks that relate to relevant assertions that can be adequately addressed by confirmation procedures.” We are concerned about a requirement that mandates the use of confirmations when they may be adequate, but are not necessarily the best or most effective procedure, to address a risk that the auditor has identified. Moreover, the Proposed Standard does not provide guidance for the auditor to apply in determining whether confirmations can “adequately address” a significant risk. We believe the Proposed Standard fails to make the point that when evidence from a third party is key to addressing a significant risk, the confirmation is likely to be the most effective way for the auditor to address such a risk. There are many significant risks where third party involvement is very limited or not relevant at all. In such circumstances, the use of confirmations would clearly not be appropriate or effective. The Proposed Standard will now drive the need for additional audit documentation as to why confirmations were not used to respond to those significant risks.

#### *Summary*

For the foregoing reasons, we believe that implementation of the expanded requirements to perform confirmation procedures and elimination of the ability to use professional judgment in determining when confirmation requests do not need to be sent, will result in more widespread use of a procedure that:

- Might not provide reliable evidence
- Might not be the most effective procedure
- Might not be practicable in the circumstances.

The expansion of required confirmation procedures, detached from the risk assessment process, may have the effect of creating more of a mechanical process in which the auditor “checks off” the procedures stated in the requirements as opposed to evaluating whether confirmation procedures are, in fact, the most appropriate procedures to perform, given the circumstances. The unintended consequence may be that audits will be less effective because by requiring confirmation procedures, the perception is created by the Proposed Standard that confirmation is, and always will be, sufficient. Consequently auditors will be less inclined to consider whether additional procedures are necessary to supplement the required procedures or whether other procedures may be more effective in addressing identified risks. Additionally, auditors will need to devote time and effort to complying with the Proposed Standard and the documentation requirements that it triggers and will be left with less time to devote to other audit procedures that are more appropriate for addressing the identified risks of material misstatement.

We urge the Board to reconsider the expansion of the requirements to perform confirmations in the Proposed Standard, and instead allow for the auditor to use his or her judgment in determining whether confirmation procedures are appropriate in the circumstances to address the identified risks. If the Board still concludes that these requirements should be retained, we recommend, similar to the extant standard, that the Board establish requirements to perform confirmation procedures as rebuttable presumptions that provide for the auditor to use appropriate professional judgment in determining when confirmation requests will not be sent.

## **B. Prescriptive Nature of the Proposed Standard and Implementation Challenges**

The Proposed Standard also adds a significant number of required procedures making it significantly more prescriptive than the extant standard. Absent a preponderance of evidence demonstrating that a general practice issue exists among registered firms regarding the confirmation process or, as noted above, evidence that an increase in confirmation requests has led to an increase in the detection of fraud, we believe that the expanded scope and prescriptive nature of the requirements in the Proposed Standard are inconsistent with the risk-based approach that the PCAOB adopted in the risk assessment standards, and are not necessarily in the public interest, as they are unlikely to result in a commensurate increase in audit quality.

We are also concerned that a number of the required procedures that the auditor is expected to perform under the Proposed Standard are, in fact, beyond the auditor’s control, or relate to matters that we believe the auditor cannot be reasonably expected to know or to be able to find out. For example:

- Paragraph 16 requires the auditor to consider, when designing confirmation requests, “[l]ocal customs that might influence confirmation responses, such as a local custom of responding to confirmation requests without verifying the information.” Similarly, paragraph 31 requires the auditor, when assessing the reliability of confirmation responses, to take into account whether confirmation responses reflect “[l]ocal customs that may affect the confirmation responses, such as customs that create an environment in which confirmation responses are inherently unreliable.” It is not clear to us what is meant or intended by the use of the term “local customs,” and we question how the auditor might be expected to have this knowledge, or what is expected in terms of making efforts to obtain it. Additionally, to the extent the auditor has knowledge of local customs or practices whereby respondents reply to requests without verifying information or where customs create an environment in which confirmation responses are inherently unreliable, it seems illogical that the auditor would try to perform confirmation procedures. However the Proposed Standard would nevertheless require that confirmations be performed in those circumstances.
- Paragraph 32 requires the auditor to assess any indication that the confirming party is not competent or objective, has questionable motives, or is not free from bias with respect to the company, when evaluating the reliability of the response received. The auditor has limited

interaction with a confirming party; therefore we are not sure how the auditor might be expected to have this knowledge, or what would be expected of the auditor in making efforts to obtain it.

We therefore request the Board to revisit the requirements in the Proposed Standard, particularly those cited above, and specifically challenge their practicability, including whether they are reasonably expected to be matters that the auditor can control, have knowledge about, or make reasonable efforts to obtain such knowledge.

### **C. Inconsistencies with Other PCAOB Auditing Standards**

#### *Use of Internal Auditors*

The Proposed Standard restricts the role that the internal audit function may have in the confirmation process and therefore limits the auditor's ability to use judgment in determining the extent to which the work of others can be used in the confirmation process. Specifically, the auditor is precluded from using the work of internal auditors or others within the company to send confirmation requests, receive confirmation responses or evaluate the evidence obtained from performing confirmation procedures.

We are not aware of widespread support for the notion that the use of internal auditors in performing confirmation procedures has been shown to have contributed to audit failure. There are only two situations referred to in one of the academic studies cited in the Release where it appears that the use of third parties to send confirmations was related to an SEC enforcement action, one involving an internal auditor in 1999 and the other not involving an internal auditor at all, but rather a secretary of a related party in 1987.<sup>4</sup>

We do not believe that the one case involving the use of an internal auditor in the confirmation process alone creates a compelling rationale for this new limitation on the ability to use the work of internal auditors. We are concerned that the new limitation will drive an unnecessary change in current practice without a corresponding improvement in audit quality. We believe that there are times when appropriately objective and competent internal auditors might be used to assist the auditor in the confirmation process, particularly in areas where the risk of material misstatement has not been assessed as high. We also believe that appropriate use of internal auditors may also allow the auditor to focus more effort on areas that are more complex and where the risk of material misstatement is higher.

We therefore believe that the Proposed Standard should emphasize the auditor's responsibility to direct and control the entire confirmation process, and that it be modified to provide for the auditor's ability to use the work of others based on the application of the framework in PCAOB AU 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, and the auditor's risk assessment.

We note that modifying the Proposed Standard along these lines would achieve more consistency with the approach that is included in PCAOB Auditing Standard ("AS") No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements*, and the risk assessment framework in the Board's recently approved risk assessment standards. The framework for the use of internal auditors provided by PCAOB AU 322 is acknowledged in the release to AS No. 5. The effect of a risk-based approach on the auditor's use of internal audit and others in an audit of internal control over financial reporting was discussed on page 14 of the release to AS No. 5<sup>5</sup>. The Board stated that, "[i]n line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others

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<sup>4</sup> 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>5</sup> See PCAOB Release 2007-005A, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements and Related Independence Rule and Conforming Amendments*, June 12, 2007, Rulemaking Docket Matter No. 021.



depends, in part, on the risk associated with the control being tested.” It further stated that “...the final standard allows the auditor to use the work of these sufficiently competent and objective others — not just internal auditors — to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.... The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.”

It is unclear why, despite allowing the auditor to use internal auditors and others in an audit of internal control over financial reporting, the Proposed Standard prohibits such use for confirmation procedures, which are performed as part of a risk-based audit.

We also note that the use of the term “rely” in paragraph 26 of the Proposed Standard is inappropriate because the concept of “shared responsibility” that the word implies is prohibited in paragraph PCAOB AU 322.<sup>6</sup>

## **D. Drafting Conventions**

### *1. Use of Present Tense*

We continue to have concerns about the use of the present tense in PCAOB Proposed Standards. The use of the present tense in the Board’s standards creates ambiguity and confusion as to what is required of the auditor pursuant to such statements. To the extent such statements describe auditor actions, it is not clear where they fit within the framework of Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*.

As we have indicated in prior comment letters to the Board on its Proposed Standards, we believe that the Board should develop and publish guidelines for use of the present tense in the Board’s auditing standards. We believe that the use of present tense should be reserved for providing or describing statements of fact and not for when describing auditor actions. We have concerns that the lack of clarity and transparency as to the Board’s intent when using the present tense to describe auditor actions will lead to inconsistency in the application by auditors of the Board’s standards. In many cases in the Proposed Standard, we believe it would be more appropriate to replace present tense statements that describe auditor actions with conditional statements, for example, “lists of factors that may be considered” instead of statements that “factors to be considered are...”

Examples that support this observation are as follows:

- Paragraph 16: This paragraph includes a present tense statement that “[f]actors to consider when designing confirmation requests include:” which is followed by a list of eight bulleted items. It is not clear whether the auditor needs to consider each and every item (and document the results of such consideration as to each) or whether the auditor might exercise judgment in considering which factors might be relevant to the requirement to “design confirmation requests to obtain relevant and reliable audit evidence,” and include in the audit documentation a more general description as to how the requirement was addressed overall. We recommend revising the lead-in to the bulleted items to be “[f]actors **that the auditor may** consider when designing confirmation requests include:”
- Paragraph 19: The last sentence of the paragraph before the bulleted list includes a present tense statement that “[o]ther factors to consider in determining the nature and extent of procedures to perform to validate addresses on confirmation requests include the following...” Similar to our observations on paragraph 16, it is not clear whether the auditor needs to separately consider each bullet (and document such consideration) or whether a more overall consideration would be acceptable. We recommend revising the

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<sup>6</sup> See paragraph 19 of PCAOB AU 322, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements*.

lead-in to the bullet points to be “...factors *that the auditor may* consider in determining the nature and extent...”

The uncertainty as to the intent of the Board in using present tense statements is a source for concern as to how they will be interpreted when audit work is subsequently evaluated by the PCAOB (through its inspection process or through enforcement) or addressed by others (e.g., in the context of litigation).

## 2. *Requirements Embedded in Examples*

We are supportive of the inclusion of examples in the Proposed Standard as we believe they are helpful in providing additional guidance and in demonstrating how requirements might be addressed. However, there are a number of instances in the Proposed Standard where requirements (i.e., “should” statements) are embedded within the examples. We do not believe that this practice is appropriate because examples are meant to illustrate the potential application of a requirement to a particular situation and what is described in an example may not be relevant in all instances. The inclusion of requirements in examples will cause the auditor to have to evaluate and document why that requirement does not apply to a particular engagement, and we do not believe this incremental effort will have a commensurate improvement in audit quality.

We therefore recommend replacing all requirements (“should’s”) embedded in the examples with “may’s.” If the Board intends any requirements currently stated in examples to be applicable more broadly, we encourage the Board to draft such requirements as separate paragraphs in the Proposed Standard and not embed them as part of specific examples. Doing so will assist the auditor in being able to better understand the Board’s intent, and will allow the auditor to exercise professional judgment in determining how the requirement might be addressed in situations that are not identical to those described in the example.

Examples that support this observation are as follows:

- Paragraph 14: The “should” embedded in the example in this paragraph might be misconstrued as meaning that sales cutoff testing is the only procedure the auditor needs to perform at year end to update accounts receivable confirmation procedures performed during interim. While sales cutoff testing may be an appropriate test to be performed, it is likely that such testing would need to be combined with other procedures in order to provide sufficient appropriate audit evidence for the existence and completeness assertions. We therefore suggest redrafting the example to indicate that cutoff testing *may* be performed, and that such testing *may* need to be combined with other procedures, as appropriate. We also question whether this is the most appropriate example to use to illustrate the point in the first sentence of paragraph 14 as it appears to be more focused on the auditor’s consideration of evidence obtained as of an interim date as opposed to the use of confirmation procedures.
- Paragraph 19: It is not clear how the apparent requirement embedded in the example and the requirement in the first sentence are intended to be applied, or when the Board believes that tests of controls might be appropriate. The first sentence includes a requirement “to perform procedures to determine the validity of the addresses on the confirmation requests, including substantive procedures or tests of controls.” This requirement therefore allows for the option of using only tests of controls to validate addresses. However, the example in paragraph 19 indicates that “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.” This example therefore seems to eliminate the availability of the option for testing the validity of addresses using tests of controls, in the situations described therein. Furthermore, in referring to “transactions or accounts that involve significant risks or are material to the financial statements,” the example seems to encompass

virtually all situations where confirmations might be used. It is not apparent to us why the auditor would need to perform any procedures, including confirmations, for accounts or transactions that are not material to the financial statements or that do not involve significant risks.

- Paragraph 28: The use of “should” in the examples in the note to this paragraph results in very granular and specific requirements for the auditor’s alternative procedures to address non-responses. The first sentence of the paragraph establishes the requirement to perform alternative procedures for all non-responses to positive confirmation requests and therefore it would be much more appropriate for the examples to be illustrations of the actual alternative procedures the auditor may perform in particular situations. Certain of the procedures included in the examples may not always be appropriate in a particular situation, and the auditor should be allowed to exercise professional judgment in determining the appropriate procedures to address the requirement. We therefore recommend that the detailed examples be redrafted to indicate that they are procedures that the auditor “may” perform, and that they may need to be combined with other procedures, as appropriate.

### 3. *“Requirements” Presented Outside of the Proposed Standard*

We noted that the Release contains sentences describing certain actions of the auditor in terms of “should.” That term is defined in Rule 3101 and is one of the terms used to “describe the degree of responsibility that the standards impose on auditors.” However, the references in the Release do not consistently appear in, or correspond to requirements in the Proposed Standard. Because the actions characterized as requirements in the Release do not appear within the Proposed Standard, they may not be the focus of comment by the investing public and other interested parties. Additionally, the SEC’s approval of the final standard will not extend to those apparent requirements. We believe this will cause significant confusion and uncertainty regarding the requirements of the final standard.

We do not believe that is appropriate to use “should” statements in the Release that do not fully reconcile with an existing requirement in the Board’s standards or proposed requirement within the Proposed Standard. Such use (a) bypasses the approved standard-setting process to establish what some will (presumably) incorrectly believe to be additional requirements, (b) does not serve the public interest, and (c) broadens the expectations gap. We therefore recommend deletion of the “should” statements from the Release unless they are quoting a specific requirement in the Proposed Standard or an existing standard. The following are examples of the problematic use of such terms in the Release:

- “... 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.”<sup>7</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.”<sup>8</sup>

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<sup>7</sup> Page 13 of PCAOB Release No. 2010-003.

<sup>8</sup> Page 39 of PCAOB Release No. 2010-003.

## II. Detailed Comments and Other Observations

### Detailed Comments on PCAOB Proposed Confirmation Standard — By Paragraph

#### Paragraph 4

Paragraph 4 contains requirements that are identical to requirements in PCAOB Auditing Standards (AS) No. 13, *The Auditor's Responses to the Risks of Material Misstatement* and No. 15, *Audit Evidence*. Although these requirements are cross-referenced to the requirements in PCAOB AS No.13 and No. 15, it appears that they are potentially incremental requirements to those within paragraph 4 itself. In order to address this potential confusion, eliminate redundancy, and encourage auditors to read and apply the risk assessment standards in their entirety, we recommend clarifying that these are references to requirements in other standards rather than incremental requirements within paragraph 4.

#### Paragraph 5

Paragraph 5 states that “[a]udit evidence in the form of a confirmation response...generally is more reliable than audit evidence generated internally by the company or provided directly by the company.” We believe that there are circumstances in which confirmation responses may not be more reliable than other audit evidence and we therefore believe that this sentence should be revised to read that “[a]udit evidence in the form of confirmation response is **may be** more reliable...”

#### Paragraphs 6 and 7

Paragraphs 6 and 7 make reference to the concept of “confirmation requests” in the first sentences of each paragraph as addressing relevant assertions. The requests themselves do not however provide audit evidence. In the case of positive confirmations, it is not the requests themselves that address the relevant assertions, but rather the procedures or the responses received pursuant to the requests that will actually provide the evidence to address the relevant assertions. In the case of negative confirmations, it is the absence of a response that provides the evidence, not the request itself. We therefore believe that it would be more appropriate to refer to “confirmations” (which is defined in Appendix A, *Definitions*) instead of “confirmation requests.” We also believe that these sentences should not be absolute statements as they are currently drafted, because they may not be true in all cases, particularly if confirmation responses are not received by the auditor. We therefore suggest rewording the introductory phrases of the first sentence of paragraph 6 to read “Confirmations ~~requests~~ **may** address...” and the first sentence of paragraph 7 to read “Confirmations ~~requests~~ **may** not address...”

#### Paragraphs 8 and 9

It is not clear how the risk assessment described in the last sentence of paragraph 8 (“The auditor should assess the risk of material misstatement... when selecting which receivables to confirm”) and the fourth sentence of paragraph 9 (“The auditor also should assess the risk of material misstatement... when selecting which cash accounts and other relationships to confirm”) interact with the requirements in PCAOB AS No. 12, *Identifying and Assessing Risks of Material Misstatement*, paragraph 59, to identify and assess the risks of material misstatement at the financial statement level and assertion level. Additionally these sentences appear contradictory with the first sentences in each paragraph which appear to indicate that confirmation procedures should be performed for all receivables and all cash with financial institutions. We therefore recommend that these paragraphs be redrafted to clarify the references to, and interactions with, the risk assessment process and also the manner in which auditors might appropriately make selections of individual items to confirm.

#### Paragraph 11

We do not believe that paragraph 11 provides useful incremental guidance (i.e., that confirmation procedures might be an appropriate response to obtain audit evidence for certain relevant assertions) as the same might be said for any other audit procedure. The determination of the nature, timing, and extent of further audit procedures to be performed to address identified risks at the relevant assertion level (including confirmation procedures, if appropriate) is comprehensively dealt with in PCAOB AS No. 13. We therefore do not believe that paragraph 11 is necessary and recommend its deletion.

### **Paragraph 12e and Paragraph 22**

Item *e* of paragraph 12 appears to set up paragraph 22 and states that maintaining control over the confirmation process includes “requesting responses directly from the confirming parties.” Paragraph 12e is not currently consistent with paragraph 22. We suggest revising item *e* in paragraph 12 to be consistent (subject to our comment below on paragraph 22) as follows “Requesting ***that the confirming parties*** responses ***directly to the auditor and not to the company or any other party*** ~~from the confirming parties~~”

Paragraph 22 also indicates that the “auditor should request that the confirming parties or intended intermediaries respond directly...” We believe that this is incorrect because the intended intermediary is not responsible for responding; rather it is the confirming party that should respond. The confirming party may respond directly or by using an intended intermediary, but the response is still that of the confirming party. Consequently, we recommend that the phrase “or intended intermediaries” be deleted from the first sentence in paragraph 22.

### **Paragraph 17**

#### *Use of Negative Confirmations*

Paragraph 17 addresses the use of negative confirmations. We agree that positive confirmations provide better audit evidence than negative confirmations; however we acknowledge that there are situations when the auditor might conclude that negative confirmations are sufficient as the only substantive procedure to be performed to address certain risks (e.g., based on the auditor’s assessment of the risk of material misstatement as low and based upon having successfully tested relevant controls that address the identified risks). We are therefore supportive of retaining the framework in the extant standard for the appropriate use of negative confirmations. We note however that paragraph 17 in the proposed standard includes some differences from the extant standard (PCAOB AU 330, *The Confirmation Process*). It is not clear to us why these changes have been made and what changes are expected in terms of auditor performance. In particular:

- The fourth bullet of paragraph 17 indicates that one of the factors that needs to be present if negative confirmations are to be used is that the “auditor reasonably believes that recipients of negative confirmation requests will give such requests consideration.” In the extant standard, paragraph 20 indicates that the use of negative confirmations is appropriate when (among other factors) “the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.” We believe that the requirement in the Proposed Standard will be read as requiring a higher level of performance/evidence than the extant standard. Additionally, the Proposed Standard does not take into account that the auditor will not have a direct relationship with the confirming party. We therefore request that the PCAOB indicate whether this revision is intended to change current practice, and if so, provide a clear description of the nature of the expected change in the auditor’s procedures to address consideration of this factor. If this revision is not intended to change current practice, the language in the Proposed Standard should be revised accordingly to be consistent with the extant standard. If the revision is intended to change current practice, the language in the Proposed Standard should be revised to make the Board’s intent more apparent and a rationale should be provided for the desired change in practice.

- The last sentence of paragraph 17 contains a new requirement that other substantive procedures be performed to supplement negative confirmations in all cases, even when the factors described in the paragraph are present. Paragraph 20 of the extant standard indicates that the “auditor should consider performing other substantive procedures to supplement the use of negative confirmations.” It is not clear to us why the ability of the auditor to apply judgment in selecting the most appropriate procedures or combination of procedures would now be limited in the Proposed Standard through the introduction of the requirement to perform other substantive procedures in combination with negative confirmations in all cases. In some circumstances when negative confirmations have been appropriately used, it may be difficult, if not impossible, for the auditor to develop and perform other substantive procedures at reasonable cost and with a commensurate increase in audit quality. For example, when negative confirmations are used in connection with customer deposits in a financial institution, it is unclear what an appropriate (and cost-effective) additional substantive procedure would be. We question whether the incremental audit effort that might be expended in addressing this new requirement might be better directed towards more risky areas of the audit. We recommend that the Board revise the last sentence of paragraph 17 to make it consistent with the extant standard and to indicate that the auditor “should *consider whether to* perform additional substantive procedures...” It may also be helpful to provide examples of other substantive procedures that might be considered and performed. If the requirement is not changed as we have suggested above, we encourage the PCAOB to provide such examples to assist auditors in complying with the new requirement.

#### Direct Receipt of Confirmation Responses

The second sentence of paragraph 17 indicates that a “positive confirmation request provides audit evidence *only when a* response is received directly by the auditor from the confirming party.” It is not clear to us how this is intended to relate to the factors described in paragraph 31 that should be taken into account by the auditor in assessing the reliability of confirmation responses. Certain factors address situations when the response is received indirectly and the statement in paragraph 17 appears to preclude the auditor from considering such responses as audit evidence. This is not consistent with paragraph 31 where it appears that the auditor has some ability to exercise judgment in evaluating the reliability of the confirmation responses, including consideration of whether additional procedures are necessary. This apparent inconsistency needs to be resolved.

#### **Paragraph 18**

It is not clear to us what incremental procedures with respect to the design of confirmation requests the Board expects the auditor to perform to satisfy this requirement (other than those already expected to address the other requirements in the Proposed Standard). We recommend that additional clarification be provided, including examples of what such procedures might be.

#### **Paragraph 19**

Many companies use post office addresses for certain types of correspondence, including confirmation requests. It is unclear why, absent any indications of impropriety, a post office address is a factor that requires consideration by the auditor when determining the nature and extent of procedures to perform to validate addresses on confirmation requests. We recommend that the Board clarify the risks associated with using a post office address for confirmations with which it is concerned, and revise that bullet to more appropriately describe the circumstances in which such validation is advisable.

#### **Paragraph 21**

We recommend defining the phrase “Intended Intermediary” in Appendix A, *Definitions*, instead of in a footnote.

## Paragraphs 23, 24, and 25

These paragraphs address situations in which management requests the auditor not to confirm certain accounts, balances, or other items. It is not clear from the Proposed Standard how these requirements are to be applied when the confirmation requests relate to accounts that are otherwise required to be subjected to confirmation procedures (e.g., receivables, cash, accounts where significant risks have been identified). For example, it is unclear whether it is acceptable for the auditor to agree to a request from management not to confirm such accounts, if the auditor determines that management's request is appropriate. Additionally, the last part of the note in paragraph 24 implies that there are situations in which the auditor would decide to not perform confirmation procedures ("had the auditor made a decision not to perform confirmation procedures"). The Proposed Standard does not make clear whether an auditor may make such a decision for balances that are required to be confirmed by the Proposed Standard.

## Paragraph 24

As currently drafted paragraph 24 does not make it clear that the basis for the auditor agreeing to management's request should be based on the auditor's determination of whether management's request is appropriate. We recommend that the sentence be revised as follows "If the auditor agrees to management's request, ***based on the auditor's determination that the request is appropriate***, and does not...."

We also do not understand why the note to paragraph 24b requires the auditor to 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." We recommend that the Board clarify its rationale with respect to this note and what is expected of the auditor, including in situations when more persuasive evidence does not exist.

## Paragraph 27

This paragraph requires that the auditor follow up non-responses to initial confirmation requests with second requests and to consider following up with a *third* request. If the auditor decides to not send the third request, he or she will need to document the reason for not doing so, as well as perform *and* document alternative procedures.

It is not clear how a requirement to send second and third requests in all cases is appropriate and likely to enhance audit quality. In those situations when the auditor already expects that response rates will be low, we expect that practice will evolve in these situations such that the auditor will commence immediately with performing alternative procedures. The sending of follow-up requests will be merely a perfunctory exercise, but one that is necessary in order to comply with the requirements of this Standard. We therefore believe that this requirement is overly prescriptive and recommend that it be deleted or replaced with guidance that indicates that the auditor may use professional judgment in determining whether to send follow-up requests or commence directly with performing alternative procedures.

## Paragraphs 27 and 28

Paragraphs 27 and 28 do not address how the auditor might consider an oral response to a confirmation request. The definition of "confirmation response" indicates that an "oral response to a confirmation request is audit evidence, but it does not meet the definition of a confirmation response," and as such an oral response would be a non-response. Paragraph 28 requires the auditor to perform alternative procedures for all non-responses to positive confirmation requests. Paragraph 28 does not discuss how receipt of an oral response affects the nature, timing, and extent of alternative procedures. We suggest that Board provide guidance in paragraph 28 on how an oral response to a confirmation might be considered.

## Paragraph 28

Paragraph 28 requires the auditor to obtain written representations from management regarding the *terms* of significant transactions or agreements in addition to other alternative procedures when confirmation requests are not responded to. We believe that the auditor's working papers will contain documentation/agreements that set forth those terms, and therefore we believe that it may be more appropriate to consider requesting the following representations:

- That the agreement provided to the auditor is the complete agreement and the one currently in effect.
- That there have been no modifications to the terms of the agreement or transaction, or side agreements that have not been communicated to the auditor.

Additionally, it may be appropriate to request representation regarding management's intent and/or interpretation of the more significant and relevant provisions of the agreement. Consistent with our commentary in our overall comments section about the inclusion of requirements in examples, we also recommend that the Board redraft this example such that it provides guidance about the procedures that the auditor may consider, as opposed to establishing a number of incremental requirements in an example that might not be applicable in all circumstances.

## Paragraph 29

Paragraph 29 requires the auditor to consider the implications for the audit and the audit report when (1) there is no response to a positive confirmation request *and* (2) alternative audit procedures will not provide the necessary audit evidence that the auditor requires. We recommend that the requirement be revised to make it clear that the determination as to whether a response to a confirmation request is necessary is a matter of auditor judgment.

We also note that one of the circumstances cited for when alternative audit procedures will not provide the necessary audit evidence is where there is a risk of collusion, which can involve outside parties according to paragraph 29. We believe that any confirmation procedure is potentially subject to this risk and that the inclusion of this circumstance as a bullet in paragraph 29 may therefore lead to the auditor concluding that responses to positive confirmation requests are always necessary, thereby undermining requirements in other parts of the Proposed Standard, such as paragraph 28. We believe the auditor should have the ability to appropriately exercise his or her professional judgment in determining whether alternative procedures might be effective. We therefore recommend that the Board revisit the second bullet of paragraph 29 and clarify how it is intended to be considered and applied by the auditor.

## Paragraph 31

Paragraph 31 includes an overall requirement for the auditor to assess the reliability of confirmation responses and then continues with a detailed requirement that the auditor take into account each of the factors listed in paragraph 31, presumably for *each* confirmation response. We believe this to be overly prescriptive. We also believe that it imposes an unduly burdensome obligation for the auditor to document the consideration of each and every factor on the list for every confirmation received, particularly as the number of confirmation responses increases. We assume that this is not what the Board intends, and therefore believe additional clarification is necessary.

Alternatively if the Board really intends for each and every factor to be specifically and individually considered, then we believe that point should be clarified too. If that is the case, we are concerned that the incremental effort that will be required will not necessarily result in a corresponding increase in audit quality. It is also not clear to us how the auditor might demonstrate how some of the factors have been "taken into account", in the absence of



some indication of a problem. For example, it is unclear how the auditor might demonstrate how he or she has “taken into account” that the response does not appear to have come from the originally intended confirming parties. The evaluation of the reliability of confirmation responses is an area where the auditor needs to exercise professional skepticism and professional judgment.

We recommend redrafting the requirement in paragraph 31 as a list of factors that the auditor *may* consider, in conjunction with the appropriate level of professional skepticism, in assessing the reliability of confirmation responses. This will allow the auditor to perform the procedures that most appropriately address the risk of material misstatement.

We also recommend that the guidance in this paragraph be revised to only require additional audit evidence to be obtained if the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request.

### **Paragraph 32**

The auditor will likely not be in a position to assess the indications set forth in the first two bullets of paragraph 32 (i.e., that the confirming party is not competent or knowledgeable, and/or has questionable motives). We recommend deleting the first two bullets of paragraph 32 and instead, emphasizing the need to exercise professional skepticism when evaluating the reliability of a confirmation response.

In addition to the above the purpose of, and message in, the note to paragraph 32 is unclear. Although it appears in a section that relates to the evaluation of the reliability of audit evidence, the note describes circumstances that may 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.” We have two observations regarding this statement:

1. Performing audit procedures to determine whether a confirmation is being *sent* to a confirming party from whom the auditor can expect the response to provide relevant and reliable audit evidence seems to be a confirmation design issue. Paragraph 32 and the section in which it appears do not discuss the design of confirmations.
2. It is not clear why the auditor needs to proceed with a confirmation request if the additional evidence obtained indicates that the auditor cannot expect the response to provide relevant and reliable audit evidence.

We suggest revising the paragraph to more closely align the guidance with the subject of the section (reliability of confirmation responses) and adding guidance on how to proceed if the additional evidence indicates that the auditor cannot expect the confirmation response to provide relevant and reliable audit evidence.

The Note to paragraph 32 indicates that “when the confirming party is the custodian and servicer of a material amount of the company’s assets” may be a circumstance that indicates the need for additional 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. We believe this may be referring to situations involving custodians and investment advisors. We request that the Board further clarify what is intended by this reference in the Note, and what additional evidence might be appropriate in this circumstance.

### **Other Observations**

#### **Confirmation of the Accounting Support Fee**

Although not mentioned in the Proposed Standard, PCAOB Rule 7103(b) requires auditors to obtain a confirmation from the PCAOB that an issuer has paid its share of the accounting support fee *before* issuing an unqualified audit opinion. This requirement is not addressed in the Proposed Standard. We believe that the Board intended for the requirement to serve as a reliable and cost-effective means of maintaining integrity in the assessment and collection process. However, since adopting the Rule, the PCAOB has developed a mechanism to identify and collect payment from delinquent issuers.<sup>9</sup>

We therefore believe that it is inappropriate for the PCAOB to delegate responsibility for maintaining the integrity of the assessment and collection of the accounting support fees to the registered accounting firms that it is charged with overseeing and for the registered accounting firms to provide collection assistance to the entity responsible for regulating them.

Additionally, we believe it is inappropriate for auditors to have to withhold issuance of an audit report until the required confirmation is obtained from PCAOB. The confirmation that is the subject of Rule 7103 does not constitute audit evidence and the purpose for which it is obtained does not relate to auditing standards or improving audit quality. The Board's standards already address the auditor's consideration of illegal acts such as the one that would result from nonpayment of accounting support fees.<sup>10</sup> Therefore, we believe that the auditing standards provide the appropriate mechanism for addressing accounting support fees in the context of an audit.

Furthermore, issuers have sufficient incentive to pay the support fee in order to avoid late fees and violating SEC rules. Based on the PCAOB's financial statements, the PCAOB's collection rate has been close to 100% every year beginning in 2004 (approximately 99.7% for 2009 and 99.9% for each year prior to 2009).

Based on the above, we recommend that the PCAOB delete Rule 7103(b).

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<sup>9</sup> The PCAOB posts a list on its website of all issuers that have paid the accounting support fee. The list is updated on a weekly basis.

<sup>10</sup> After 90 days of nonpayment, the PCAOB can report the delinquency to the Securities and Exchange Commission, and, according to the Rule, the failure to pay would be deemed a violation of Section 13(b)(2)(C) of the Exchange Act of 1934 and could result in administrative, civil, or criminal sanctions.