

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

29 May 2009

PCAOB Rulemaking Docket Matter No. 028
Concept release on possible revisions to the PCAOB's standard on audit confirmations

Dear Mr. Seymour:

Ernst & Young LLP (Ernst & Young) is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) concept release on possible revisions to the standard on audit confirmations (the Concept Release). PCAOB interim auditing standard AU section 330, *The Confirmation Process*, was adopted based on the US Auditing Standard that was written and adopted for fiscal periods ending after June 15, 1992. Since that time, advances in technology have expanded and transformed the ways in which businesses communicate and have provided auditors with additional techniques when using audit confirmations to gather audit evidence. These additional techniques present potential for significant benefits but also present circumstances and risks not previously contemplated by the interim auditing standard. For these reasons, we support the Board's objective to revise its existing interim standard with respect to confirmations.

We believe revisions to the existing standard should focus on improving the audit confirmation process and provide for the use confirmations to obtain audit evidence based on the auditor's professional judgment and his or her assessment of risk. Requiring the auditor to use confirmations is inconsistent with the premise that the auditor should use professional judgment and tailor his or her audit procedures to be responsive to the assessed risks. A high quality audit is not a predefined set of steps that are applied to each and every engagement, but a customized set of procedures designed to be responsive to the risks identified. Accordingly, standards should not represent a checklist of requirements, but a collection of guiding principles for the auditor to apply to the particular facts and circumstances of a given audit.

We also support the Board's objective to update its existing interim standard as an opportunity to clarify the responsibility of and the relationship between the respondent and the auditor. In our view, Section 303 of the Sarbanes Oxley Act of 2002 has been largely misunderstood by some confirmation recipients. Although Section 303 applies to the relationship between the auditor and their client, we observe that would-be respondents frequently do not complete or fully respond to audit confirmation requests based on the potential risk of violating the provisions of Section 303.

We have observed declining response rates to requests for confirmation and an increase in the number of responses containing disclaimer or other restrictive language. Clarification of the responsibility that a respondent bears when replying in good faith to a confirmation request might assist in improving the effectiveness of the confirmation process.

There currently are no obligations on respondents to respond to an auditor's confirmation request. Therefore, we caution the Board against expanding confirmation requirements on auditors through a revised auditing standard without also considering how the PCAOB and others might collaborate on obliging third parties from whom confirmations are sought.

The Board indicates in the Concept Release that it has considered the International Auditing and Assurance Standards Board's (IAASB) recently revised auditing standard, *External Confirmations*, (ISA 505). We continue to urge the Board to use the ISAs as a baseline for its standard-setting process. We believe doing so will accelerate the Board's efforts to converge U.S. and international auditing standards where appropriate. Some of the aspects of ISA 505 are referred to below in this letter.

Confirmation objective

The confirmation objective can be categorized into two fundamental components: (1) the decision by the auditor to use confirmations to obtain audit evidence and (2) considerations for performing confirmation procedures in an appropriate manner (i.e., the confirmation process). We believe the determination as to whether to use confirmations to obtain audit evidence should be a function of the auditor's risk assessments and the auditor's judgment regarding the nature and extent of procedures necessary to obtain sufficient appropriate audit evidence. Therefore, we believe that these requirements should more appropriately reside in auditing standards relating to responding to assessed risks and audit evidence. We believe this view is consistent with paragraph 5 of the PCAOB's proposed auditing standard, *Audit Evidence*, which describes the sufficiency or quantity of audit evidence as being affected by the risk of material misstatement and quality of evidence obtained. Upon determining to use confirmations to gather audit evidence, the revised auditing standard should address aspects of, and considerations related to, the confirmation process, including the design of confirmations to support specific assertions and the design and execution of confirmation procedures to produce reliable audit evidence.

Accordingly, we recommend that the objective of the audit confirmation standard should be focused on the confirmation process once the decision to send confirmations has been made. We suggest that the objective of the confirmation be defined, consistent with ISA 505, paragraph 5, as follows: "The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence."

Definition of confirmation

Paragraph 4 of PCAOB AU section 330 currently defines confirmation as "the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions." We believe this current definition should be revised by adding the word "written" after the word "direct" to indicate that

communications from third parties need to be in writing. We believe this revised definition would be consistent with the definition in paragraph 6(a) of ISA 505, which defines an external confirmation as “audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.” The revised definition would serve to indicate that an oral response does not constitute a confirmation, but a lower level of audit evidence.

We believe this revised definition would be preferable to crafting a definition that attempts to specifically encompass various alternative forms of confirmations. We encourage the Board to instead provide examples of possible forms of confirmations that are consistent with the revised definition. Example forms of confirmations might include the following:

- where the respondent responds directly to the auditor through a written response mailed to the auditor
- where the respondent provides direct access to information (e.g., read-only website access) in response to an audit confirmation request
- where the respondent directly responds to an auditor using electronic medium
- where a respondent responds to an auditor through a third-party service provider

While we believe the revised definition of the confirmation process provided above would be appropriate, we recommend that the revised standard provide a broadened discussion of the design and execution of the confirmation process to include alternate forms of written confirmations that may be “other than in a written communication mailed to the auditor.” Please refer to the section, *Designing the confirmation process*, below for further discussion on the considerations for leveraging technology in the confirmation process.

Requirement to confirm

We believe that auditing standards that either require the auditor to use confirmations or establish a rebuttable presumption that the auditor will use confirmations to address certain assertions is inconsistent with the premise that the auditor should use professional judgment and tailor his or her audit procedures to be responsive to the assessed risks. Rather than require the use of confirmations, we recommend that the Board instead provide application guidance for determining the various types of confirmations that auditors may want to consider using when planning their procedures, including, among other possible items, confirmation of the existence and terms of material complex or unusual agreements or transactions.

Designing the confirmation process

The confirmation procedures described in the current standard reflect the most appropriate considerations for the confirmation process when it was drafted. Subsequent advances in technologies available to the auditor serve as an impetus to revisit the confirmation process as described in the existing standard. We believe there is significant opportunity to leverage

technology to increase efficiencies without sacrificing the reliability of the confirmation process and the evidence obtained. We believe that the benefits gained with a properly designed electronically-enabled confirmation process can increase efficiencies and, in some cases, can be more secure than a traditional paper-based confirmation and may result in higher response rates. We observe that the workplace has become more accepting of electronic forms of communication and we believe that a properly designed confirmation process can leverage technology and result in reliable audit evidence.

We believe a revised standard should address aspects of the appropriate design of confirmation requests as well as their distribution, collection and evaluation. We also believe the fundamental considerations for the proper design of a confirmation process are the same regardless of the medium or extent of use of technology; however, there may be differing risks that would need to be addressed in the confirmation process. Confirmations also should be designed so that the respondent has the ability to positively respond to the confirmation request. The auditor should not attempt to confirm information for which the respondent would have no basis for a response.

We believe there are three key considerations of the confirmation process that could serve as principles within the standard:

1. Direct the confirmation to a third party that the auditor believes is knowledgeable about the information to be confirmed and maintain control over the confirmation request.
2. Receive the confirmation directly from the respondent or through a third-party service provider.
3. Evaluate whether the response can be relied upon.

The auditor should consider the risks that the three key considerations of the confirmation process may not be satisfied. Each of these three considerations is discussed in more detail below. The discussion below may be useful as supporting guidance for these principles.

Direct the confirmation to a third party that the auditor believes is knowledgeable about the information to be confirmed and maintain control over the confirmation request. The auditor should be satisfied that the confirmation request is delivered to the intended recipient. Depending on the method of distribution (e.g., paper or electronic) the validation of this information may take several different forms. If using e-mail, some of the various forms of validation may include:

- A conversation with the intended recipient to validate the recipient's e-mail address,
- Agreement of the individual's e-mail address to the recipient's letterhead or business card, or as posted to the company website¹ or trade directory,

¹ Validation of the website or reliability of the certificate or domain registry information should also be considered, as applicable.

- Agreement of the domain of the e-mail address to the company's domain (e.g., @ey.com is a domain for Ernst & Young) based on a company's letterhead, business card, website¹, website certificate¹, domain registration information¹ or other reliable identifying source, or
- Other procedures to validate the propriety of the e-mail address of the recipient or the recipient's organization.

The nature and extent of the validation should be a function of risk and therefore also be a matter of professional judgment.

Receive the confirmation directly from the respondent or through a third-party service provider.

The auditor should obtain the confirmation directly from the respondent or from a third-party conduit. We believe this consideration applies equally to traditional and electronic forms of confirmation.

Evaluate whether the response can be relied upon. We note that the Board has suggested communications through e-mail and confirmation responses processed through third-party service providers would be acceptable forms of confirmations. While we agree that these mediums are acceptable, it is the proper design and execution of the confirmation process as a whole that ultimately determines whether an e-mail or a response from a third-party service provider represents a confirmation.

As part of the confirmation process, the auditor should implement measures to determine that the confirmation response can be relied upon. This will necessitate that the auditor design the confirmation process so that he or she can later evaluate the responses and conclude as to whether the confirmation is authentic. For example, e-mail address spoofing can mask the senders' information. As part of determining that the confirmation request is delivered to the intended recipient (see discussion above), the auditor might establish an authentication feature (i.e., a unique code) with the recipient that he or she may later use to verify that the response came from the intended recipient.

Consideration of a third-party service provider

A third-party service provider may take several different forms. The Concept Release suggests that a third-party service provider may facilitate the confirmation process between an auditor and a respondent, or a third-party service provider may maintain certain information that could be used to respond to a confirmation request.

Whenever a third-party service provider acts as an intermediary between the auditor and the respondent, the auditor should understand the role of the third party in the confirmation process and obtain information about the nature of the process and related controls at the third-party service provider that persuade the auditor that the process will generate reliable information. While a Sys-Trust, Web-Trust or other report relating to the controls of a service provider may be useful in assisting the auditor in determining the reliability of a service provider, the lack of such report would not preclude an auditor from being able to form an understanding of the processes

and related controls of the service provider or to conclude that confirmations processed through or obtained by the service provider represent reliable audit evidence.

We note that “third party,” as used in the Concept Release, appears to refer to both the third-party confirmation respondent as well as the third-party confirmation service provider. We recommend the Board add appropriate clarification when referring to a third-party in different contexts.

Alternative procedures

A non-response is the failure of a confirming party to respond, or fully respond, to a positive confirmation request. Confirmation procedures are typically based on a sample of key or representative items, or both, and accordingly each item in the sample is individually important to the conclusion on the results of the confirmation procedures. An auditor should perform alternative procedures for non-responses to positive confirmation requests to obtain other corroborating evidence; however we believe the revised standard should continue to allow for the omission of alternative procedures in the circumstances described in paragraph 31 of PCAOB AU section 330. If a non-response is not able to be tested or is otherwise not tested, the item for which confirmation was requested should be considered an exception.

Exceptions are differences between the item being confirmed and the information contained in the response. We believe that the auditor should be required to resolve exceptions and consider the effect of an exception on the confirmation process; however the nature of those procedures should be left to the auditor based on specific facts and circumstances. We believe electronic confirmations may improve the ability to follow up with the respondent in obtaining clarifying information or when further exploring exceptions.

If a confirmation is returned undeliverable, the auditor should have a higher level of professional skepticism when performing alternative procedures and evaluating the propriety of the item being confirmed.

Disclaimers and restricted language

We observe with increasing frequency that responses to confirmation requests bear various forms of disclaimers and restrictive language that may raise questions about their value as audit evidence. The auditor should evaluate whether such language limits the reliability of the confirmation with regard to the purpose for which it was requested. A disclaimer as to the accuracy of the information with respect to the assertion being addressed by the confirmation would call into question the quality of the evidence provided by the confirmation response; however, much like an oral response it would constitute a form of audit evidence, albeit less persuasive than a valid confirmation. The auditor would evaluate the evidence the confirmation response provides and determine what other procedures, if any, to perform. Alternatively, a disclaimer with respect to information contained in the confirmation that is not relevant to the purpose for which confirmation was requested ordinarily would not call into question the quality of the evidence.

The existing auditing standard does not address disclaimers and restrictive language. We believe that the Board may be in a particularly unique position to address the issue of disclaimer language in certain types of confirmation responses, such as those received from financial institutions regarding cash, debt, and investment balances. We urge the Board to work with members of the relevant trade organizations of the financial profession to co-develop expectations for auditor confirmation requests and for financial institution responses with respect to the use of disclaimers and restrictive language.

Management requests not to confirm

When an auditor has designed audit procedures that include using confirmations to gather evidence about one or more account assertions and management requests that the auditor either not send confirmations or not send confirmations to a particular entity or class of entities, the auditor should have a higher level of professional skepticism with respect to the confirmation procedures and the given assertion. We recommend the Board incorporate those requirements of paragraphs 8 and 9 of ISA 505 that require the auditor to evaluate the implications of management's refusal on his or her assessment of the relevant risks of misstatements and to perform alternative procedures.

Negative confirmations

While a positive confirmation is a useful technique in testing the existence assertion for assets given the associated risk of overstatement, a negative confirmation can be a useful technique in obtaining audit evidence in conjunction with other procedures when testing the completeness assertion for liabilities considering that the associated balance sheet risk is understatement of the corresponding account balances. We believe that the nature, timing and extent of testing is a matter of professional judgment and auditing standards should not preclude an auditor from using a particular type of audit procedure when executing an audit. We believe paragraphs 15 and A23 of ISA 505 provide appropriate cautionary language and an appropriate balance as to the extent of reliance an auditor should place on negative confirmations.

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We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Sincerely,

Ernst & Young LLP