

## Heads Up

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## PCAOB Issues Proposed Standard on Audit Confirmations

by Megan Zietsman, Jennifer Haskell, and Robin Kramer, Deloitte & Touche LLP

On July 13, 2010, the PCAOB issued a [proposed auditing standard, \*Confirmation\*](#) (Release No. 2010-003). The proposed standard would supersede PCAOB AU Section 330, [The Confirmation Process](#), which establishes the requirements for and provides guidance on the confirmation process in audits. The proposed standard defines confirmation as the "process of obtaining and evaluating a direct communication from a third party in response to a request, either in paper form or by electronic or other medium, for information about a particular item affecting financial statement assertions." Comments on the proposal are due by September 13, 2010. A final standard would be effective for audits of fiscal years ending on or after December 15, 2011.

In developing the proposed standard, the PCAOB considered (1) comments received on [Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations](#) (issued on April 14, 2009); (2) input from the PCAOB's Standing Advisory Group; (3) the PCAOB's inspection activities; (4) academic research; and (5) the activities of other standard setters, including the International Auditing and Assurance Standards Board and the AICPA's Auditing Standards Board.

The PCAOB's exposure of the proposal creates an opportunity for a variety of groups that may be affected by such a standard to share what may be diverse perspectives on the proposed requirements. Such groups include not only issuers and their auditors, but potentially also a broader array of respondents to confirmation requests from auditors (i.e., confirming parties) and other interested parties. Affected parties are therefore encouraged to carefully read and analyze the PCAOB's proposed standard and the accompanying release, evaluate the potential impact of the proposals, and share feedback and views with the PCAOB.

The PCAOB indicated that its "proposed standard is intended to strengthen the existing requirements for confirmation." Among other items, the new standard:

- Expands on the existing standard by requiring the performance of confirmation procedures for more accounts and in response to significant risks.
- Updates the existing standard to reflect significant advances in technology, including increased use of electronic communication methods in the performance of confirmation procedures.
- Enhances requirements when confirmation responses include disclaimers and restrictive language.

### Expansion of Existing Requirements

In proposing to expand the requirements for when confirmation procedures should be performed, the PCAOB noted that audit evidence from a third party is generally more reliable than audit evidence generated internally by a company or provided directly to an auditor by the company. The proposed standard expands the range of receivables and loans for which confirmation is required and would include "receivables that arise from

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credit sales, loans, or other transactions." The existing standard includes a rebuttable presumption that auditors confirm "accounts receivable," which are defined as (a) the "entity's claims against customers that have arisen from the sale of goods or services in the normal course of business" and (b) a "financial institution's loans." The existing standard also provides for the presumption to be overcome if (1) the specified accounts receivable are immaterial; (2) the auditor believes that the confirmation procedures are likely to be ineffective; or, (3) in the absence of significant risk, the auditor can otherwise address the risk of misstatement by performing tests of relevant controls and other substantive procedures. In addition to expanding the range of receivables that would require confirmation, the proposed standard removes the ability of the auditor to support a conclusion that confirmation of receivables will not be performed for reasons (2) or (3) above. As a general matter, the auditor is not required to perform audit procedures in connection with accounts that are immaterial. The PCAOB noted also that it proposed the expanded requirements because "confirmation procedures can provide audit evidence to address the risk of material misstatement due to fraud."

The proposed standard contains new requirements that confirmation procedures be performed for the following:

- "[C]ash accounts and other relationships with financial institutions."
- "[I]n response to significant risks that relate to relevant assertions that can be adequately addressed by confirmation procedures."

The proposal points out in addition to using confirmation procedures as required above, auditors may use them to address risks of material misstatement in other areas to obtain audit evidence.

**Editor's Note:** It appears likely that the provisions in the proposed standard expanding required confirmation procedures will result in (1) an overall increase in confirmation requests being sent by auditors and therefore needing to be responded to by confirming parties and (2) requests being made of confirming parties for confirmation of data or information that may not have been historically requested. For example, auditors of hospitals historically may not have sent confirmation requests for patient receivables, having concluded (on the basis of prior experience or experience with similar engagements) that the response rates to properly designed requests would be inadequate and that therefore the use of confirmations would be ineffective in addressing the existence of such receivables. Under the proposed standard, the auditor would be required to send the confirmation requests regardless of whether the auditor expects that the response rates will be sufficient to result in the confirmation procedures being effective in addressing their intended objective.

In addition to expanding when confirmation procedures will be required, the proposed standard imposes specific limitations on the auditor's ability to use the work of internal auditors in helping to send confirmation requests and in receiving and evaluating confirmation responses. The proposed standard precludes the auditor from using company personnel or internal auditors to send confirmation requests, receive confirmation responses, or evaluate the audit evidence obtained from performing confirmation procedures. The existing standard does not contain such specific limitations; that is, in addressing the requirement that the auditor maintain control over the confirmation process, the existing standard merely notes the auditor's ability to use the work of internal auditors to assist in the confirmation process, subject to the existing requirements in *PCAOB AU Section 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (which addresses use of work performed by internal auditors, including in a direct assistance capacity).

Auditors will need to specifically consider when relevant assertions related to significant risks can be “adequately addressed” by confirmation procedures and determine that such judgments are appropriately supported and documented in the audit working papers.

**Editor’s Note:** In evaluating the proposal’s expanded requirements for performing confirmation procedures, issuers, confirming parties, and auditors may wish to consider the effect on resources of what seems likely to be increased levels of confirmation activity. In addition, auditors will need to specifically consider when relevant assertions related to significant risks can be “adequately addressed” by confirmation procedures and determine that such judgments are appropriately supported and documented in the audit working papers. The proposed changes might also warrant other considerations, such as privacy and confidentiality matters and the need for or appropriateness of disclaimer language on confirmation responses (see further discussion below).

Confirmation procedures are by no means infallible, and the confirmation process may, for various reasons, be ineffective. For example, it may be difficult for the auditor to control or determine that the respondents to confirmations are indeed the individuals most suited to respond and that such respondents have indeed paid the appropriate attention to responding completely and accurately to the auditor’s confirmation requests.

**Editor’s Note:** Respondents may also wish to consider whether the proposed standard places the appropriate emphasis on performing confirmation procedures or whether it possibly overemphasizes the importance of performing them. That is, respondents may wish to explore whether such expanded requirements might result in confirmation procedures having to be performed instead of, or in addition to, other audit procedures that may be more effective in addressing the identified risks of misstatement.

## Updates to Reflect Significant Advances in Technology

The PCAOB is to be commended for its efforts in updating the existing standard to encompass current practices that take advantage of advances in technology that have taken place since the existing standard was issued. In addressing such technological advancements and related changes in confirmation practices, the proposal:

- Revises the definition of “confirmation” and “confirmation response” to take into account situations in which direct communication from a third party to the auditor occurs by electronic or other media or through the use of direct access by the auditor to a confirming party’s electronic records.
- Includes additional procedures to assess the reliability of, and address the risks associated with, electronic confirmation responses.

The proposed standard notes that direct access to information held by a confirming party constitutes a confirmation response only if the auditor’s access is provided by the confirming party and if the confirming party represents to the auditor, in writing, that (1) it is aware of the auditor’s request for and intended use of the information and (2) the files to be accessed contain information responsive to the auditor’s request.

**Editor’s Note:** Respondents to the proposed standard might consider the most effective way for such a representation to be requested from and provided by the confirming party, including whether such a representation is required only once between the confirming party and auditor to cover multiple requests, or whether the representation would be necessary for each individual confirmation. In addition, respondents might wish to consider whether the proposal’s requirements appropriately address practices that are in use today (e.g., whether the requirements should take into account processes that provide for direct access or those that involve third-party intermediaries) and whether such requirements are sufficiently principles-based to be applied to practices that might develop in the future as technology continues to evolve and become increasingly sophisticated.

## Enhancement of Requirements When Confirmation Responses Include Disclaimers and Restrictive Language

The PCAOB acknowledged in the proposal that the use of disclaimers and restrictive language is occurring more frequently in confirmation responses and that the inclusion of such disclaimers and restrictive language may diminish their reliability as audit evidence. Accordingly, the proposed standard requires the auditor to evaluate the effect of disclaimers and restrictive language on the reliability of a confirmation response. If the disclaimer or restrictive language precludes the auditor from using the response as a confirmation response, then the proposed standard requires the auditor to treat the response as a nonresponse and perform appropriate alternative audit procedures to obtain relevant and reliable audit evidence.

The proposed standard requires the auditor to evaluate the effect of disclaimers and restrictive language on the reliability of a confirmation response.

**Editor's Note:** Because of the proposal's expansion of required confirmations and its emphasis on evaluating the impact of disclaimers and restrictive language on the reliability of the confirmation response, respondents that are confirming parties, or that are likely to be confirming parties, may wish to consider (or reconsider) the rationale for and necessity of including disclaimers and restrictive language in confirmation responses. Because auditors are not in the position to make legal judgments, in many cases it may be time-consuming and difficult, if not impossible, for them to evaluate the effect of a disclaimer or restrictive language on the reliability of a response. In such cases, auditors might have to conclude that the reliability of the response is diminished or that the response is unreliable and therefore cannot be used at all. To the extent that the response cannot be used, or its reliability is diminished because of the nature of a disclaimer or restrictive language, auditors would then need to design and perform alternative procedures. In some cases doing so might be difficult or even impossible.

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