



13 September 2010

Our ref: ICAEW Rep 90/10

Your ref:

Office of the Secretary
PCAOB
1666 K Street
N.W.
Washington
D. C. 20006-2803

PCAOB Rulemaking Docket No. 028

Dear Sir

Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards

The ICAEW welcomes the opportunity to comment on the *Proposed Auditing Standard Relating to Confirmation and Related Amendments to PCAOB Standards* published in July 2010.

The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

It is our continued belief that as part of the risk-based approach, auditors should be required to use their judgement in determining whether confirmation requests are an effective and efficient manner of obtaining audit evidence.

Our main comments and answers to the PCAOB's specific questions are set out below. Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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Main Comments

1. The PCAOB's standards need to work abroad

The PCAOB is a *de facto* global auditing standard-setter because the effects of its standard-setting activities extend far beyond its shores. We believe that the PCAOB must therefore take account of the likely effect of its actions outside the USA as well as those within, in order to fulfil its mandate to protect US investors. With the best of intentions, the PCAOB's standards may be applied in a way different to that intended when transplanted into different cultural and legal contexts. In order to be effective, the PCAOB must necessarily seek a balance; its standards and requirements must be set at a sufficiently high level so as to be translatable into different contexts but they must also be sufficiently detailed. The proposed standard on confirmations could achieve this balance better. The lack of balance is exemplified by the statement in the Release to the effect that 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. To an extent, this misses the point and urges auditors to work harder, instead of smarter. We remain of the view that gearing up and fine tuning processes will not compensate for or address:

- human error on the part of auditors
- the carelessness, or worse, of third party respondents
- very low response rates (which are also unlikely to be improved by confirming individual transactions).

In short, we do not believe that it will improve audit quality for auditors to be required to send audit confirmation requests where expected response rates to any sort of request is very low, or where local customs of simply agreeing to requests prevail. The auditor could also waste time if it is known in advance that any responses will include disclaimers that render such responses of limited value as audit evidence. We believe that it is not appropriate to send requests in such circumstances; auditors should instead be required to move directly to alternative audit procedures. It is our continued belief that auditors should be required to use their judgement in determining *whether* confirmation requests are an effective and efficient manner of obtaining audit evidence.

2. How can response rates be improved?

It is clear from this ED that the PCAOB intends to encourage the use of confirmations in the audit, including where they can effectively be used in connection with significant risks. We believe that a more holistic approach needs to be taken if low levels of responses are to be significantly improved because action on the part of auditors is likely to have limited effect. A policy of non-response to confirmation requests on the part of large corporate entities in the UK, and ever-tighter audit deadlines, are two reasons for the declining response rates. If regulatory bodies in the UK, and their equivalents in the US, were to encourage or mandate responses from the entities that they oversee, response rates would rise. If investors want an efficient and effective audit process, then regulators and auditors have a right to ask for wider co-operation. There are some situations where confirmations are demonstrably the most efficient and effective form of audit evidence and their use should not be circumscribed by cost-cutting on the part of large corporate entities.

3. Will confirmation requests be effective?

It seems clear that there will be additional work to be performed when the proposals are finalised, but it is not at all clear that there will be a corresponding improvement to audit quality. We remain unconvinced that the additional work required will result in any significant improvement. This is mostly because of the highly procedural nature of the proposed standard.

We noted in our response to the Concept Release that any new standard should more clearly recognise that each confirmation will give rise to a unique set of risks that the auditor should be required to consider, and respond to appropriately, rather than encouraging auditors to hide behind a codified set of rules that are not tailored to address the risks identified.

We also noted that a:

‘...corollary of the risk based approach, and an important aspect of confirmations that the PCAOB has not really addressed, is the combined effect of the decline in use of confirmations, low response rates and respondent errors because an increasing number of entities regard them as a low priority, and the widespread increase in the use of restrictive language and disclaimers. The... comment on Page 4 of the Concept Release to the effect that some auditors believe that confirmation is not a particularly effective audit procedure in many situations, is important. It calls into question the statement on page 5 that expanding the requirements of the standard to other areas may enhance audit quality and investor protection; it may only appear to do so....and that

A greater discussion of high quality alternative evidence would be helpful here, particularly for those assertions such as existence, for which confirmations, when they can be performed, are good.’

4. Risk-based approach and the role of judgement

We remain concerned that the proposed standard which will require auditors to pay more attention to procedural detail will not necessarily result in an overall increase in audit quality and may distract the auditor from focusing on higher risk judgemental areas.

Micromanaging auditor behaviour and improving confirmation requests will not compensate for the low and declining level of response rates and the increased use of disclaimers. Is it better to ask a valet to park one's car carefully, or to require him to put the key in the ignition, release the brake, engage the clutch and so forth, and risk a response to the effect that ‘...there was no requirement not to hit the kerb...?’

Our response to the PCAOB on its Concept Release noted

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

We note that the word skepticism does not appear in the proposed standard, and the word judgment just once, as a footnote.

5. The PCAOB should effectively challenge the IAASB

We referred in our 28 May 2010 response to the PCAOB on its proposed auditing standard on communications with audit committees and our 2 March 2010 response to the exposure of the risk standards, to the need for the PCAOB to effectively challenge the IAASB in areas in which it believes that ISAs should be improved. We noted that in order for that challenge to be effective, there is a need for the PCAOB to be robust and detailed in its explanations of differences between PCAOB standards and ISAs; this type of challenge is an important part of the convergence process, which is not well-served by many of the small wording differences noted below (in our answers to questions 1, 2, and 11, for example).

We remain particularly concerned that the proposed standard would create further differences between PCAOB standards and the ISAs by mandating procedures that are driven by judgement under ISAs. Examples include:

- the scope of the document (which we note in our answer to question 4, below, will create some problems)
- the requirements for second and possibly third confirmation requests
- requiring sales cut-off testing when confirmations are carried out at an interim date
- assessing a confirming party's competence, motivation and objectivity.

We understand the rationale for removing the pre-existing exemptions and requiring auditors to perform such procedures in all circumstances - auditors who have not in the past applied their judgement appropriately will now be forced to perform procedures - but we do not believe that mandating such procedures in all circumstances will improve audit quality.

A general risk-based approach, as envisaged by the ISAs would mean that such procedures would be applied where appropriate, and not indiscriminately. This would not prevent failures in the audit confirmations process but neither will the PCAOB's approach, and the ISA approach has the added advantage of enabling audit inspectors to require auditors to justify their approach, thereby holding them to a higher standard than that which is required if inspectors can only ask for auditors to show that they have performed a procedure.

While a small element of judgement will still be applied by auditors under the proposals, (in selecting the receivables sample, for example), the emphasis in audit planning will shift toward requirements to carry out confirmation procedures and away from the need to thoughtfully identify, assess and respond appropriately to risks. We noted in our response to the Concept Release that while standardised confirmation procedures facilitate more consistent (and to that extent reliable) responses in the case of requests to, say, banks, the benefit of such standardisation derive from requestees being a homogenous group subject to regulation. This is simply not the case with, say, recipients of requests for confirmation of accounts receivable.

6. Proposals that may be of very limited value

There remain three elements of the document which we believe in practice will be of very limited value at best.

Firstly, requiring confirmation of the amounts and terms of undisclosed oral or undisclosed written modifications to those agreements, such as undisclosed side agreements, is likely to produce little or nothing in terms of additional audit evidence in the vast majority of cases. Such agreements by definition are shielded from the public eye and it seems very unlikely that confirmation requests will draw out details of such agreements. It would be better to require auditors to make such enquiries where their suspicions are aroused rather than devalue the requirement by applying it indiscriminately.

Secondly, the procedures requiring checking of addresses seem to be fixing a non-existent problem. We noted in our response to the Concept Release that checking addresses will not deter those intent on deceiving auditors, that PCAOB reports do not highlight problems in this area and that additional direction should therefore be kept to a minimum.

Finally, while PCAOB reports do highlight problems with disclaimers, in our answer to question 26 below, we note that we remain unconvinced that the proposed solution to the problem of disclaimers is workable. Paragraph 37 states that if a disclaimer or restrictive language cause doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence. We note that the language used in disclaimers, almost by definition, always causes doubts about the reliability of a confirmation response. We fear that paragraph 37 and the examples given of problem disclaimers could be extended by implication to a large majority of disclaimers in use in practice, and will result in inconsistent application of the standard. We would prefer see wording closer to that used by the ISA which states that restrictive language does not necessarily invalidate the reliability of the response as audit evidence.

Answers to the PCAOB's Specific Questions

1. Are the definitions included in the proposed standard sufficiently clear and appropriate? If not, what changes should the Board make to the definitions?

We find the differences between the wording of the PCAOB's definitions of positive confirmation requests, external confirmations and exceptions, and the wording of the IAASB's definitions, to be so small as to be trivial. We see no difference whatsoever of substance in these definitions, and we urge the PCAOB to consider the merits of aligning the wording with that of the ISA, and the disadvantages of maintaining such apparently hair-splitting differences. We are pleased to note that the PCAOB's and the IAASB's definition of a negative confirmation request are identical.

2. Is the objective of the proposed standard clear and appropriate? If not, what changes should the Board make to the objective? and

3. What other matters, if any, should the objective include?

We are pleased to note that the objective now relates to the auditor rather than the standard, although we find the difference between the wording of this objective and the wording of the objective of ISA 505 so small as to be trivial. Once again, we see no difference whatsoever of substance and we urge the PCAOB to consider the merits of aligning the wording with that of the ISA, and the disadvantages of maintaining the difference.

4. Is the description of "receivables that arise from credit sales, loans, or other transactions" sufficiently clear and appropriate? If not, what changes should the Board make?

The description of receivables which includes *other transactions* will potentially catch a large number of complex financial instruments, some parts of which will have characteristics of receivables, albeit within wrappers that result in the instrument not being classified as such. We do not believe that confirmation requests could be easily drafted for such instruments, nor would responses be forthcoming, nor would they be of much value even if they were. We suggest that the standard note that auditors are not expected to deconstruct complex financial instruments for these purposes and that unless a financial instrument is properly classified as a receivable, confirmation requests are not required.

5. Is the requirement in the proposed standard to confirm cash and other relationships with financial institutions sufficiently clear and appropriate? If not, what changes should the Board make?

Yes.

6. Does the proposed standard appropriately address the risk of material misstatement by requiring confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures? If not, what changes should the Board make?

Yes.

7. Should the proposed standard include additional requirements with regard to sending confirmation requests in response to significant risks? If so, what additional requirements should the Board include?

No.

8. Is the description in the proposed standard of other risks sufficiently clear and appropriate? If not, what changes should the Board make?

It would be helpful for the standard to make it clear in paragraph 11 that the auditor should use his judgement in determining what might be an appropriate response to obtain audit evidence.

9. Are the requirements in the proposed standard for maintaining control over the confirmation process sufficiently clear and appropriate? If not, what changes should the Board make?

The requirements for maintaining control over the confirmation process are clear but not appropriate, because they are likely to increase costs without any corresponding improvement in the extent of the response rate, the quality thereof or the quality of the audit evidence thereby obtained. Furthermore, where audit time and costs are circumscribed, it is very likely that such excessive attention to detail will result in auditors taking their eye off the ball and focussing on compliance with detailed requirements of the standard instead of its ultimate objective, which is for auditors to use their judgement to assess whether cash and receivables are overstated and/or payables understated.

10. Is the description with respect to the use of internal auditors in the confirmation process sufficiently clear and appropriate? If not, what changes should the Board make?

The severe limitations imposed on the extent to which external auditors can involve internal auditors in the mechanics of confirmations (p20 *Therefore, the auditor cannot use internal auditors to send confirmation requests, receive confirmation responses, or evaluate the audit evidence obtained from performing confirmation procedures...*) sit uncomfortably with the licence for external auditors to take comfort from the confirmations already conducted by internal audit (p21 *...an auditor may consider work performed by internal auditors in determining the timing and extent of the auditor's procedures... For example, if the internal auditors, as part of their work, confirm certain receivables, the auditor may... change the timing of his or her confirmation procedures or the number of receivables to confirm*). Whilst the distinction may be clear, the sub-text appears to be that internal auditors can be trusted not to misrepresent what they have already done, but cannot be trusted to work under the direct supervision of the external auditor. We agree that internal auditors should not send or receive confirmation requests, but we do not see a bar to their assisting external auditors with evaluating the evidence thereby obtained.

11. Are the factors for designing confirmation requests in the proposed standard sufficiently clear and appropriate? If not, what changes should the Board make?

The list of factors for designing confirmation requests in paragraph 16 is very similar to the list in paragraph A4 of the ISA, and, in line with our main comments above, we encourage the PCAOB to consider whether minor wording differences are worth maintaining. We are concerned about references to *local customs...of responding to confirmation requests without verifying the information*. We note in our main comments above our continued belief that auditors should be required to use their judgement in determining whether confirmation requests are an effective and efficient manner of obtaining audit evidence and we believe that such local customs as described above are on a par with very low expected response rates that cannot be improved. There is little value in sending requests in such circumstances; instead auditors should be able to move directly to alternative audit procedures.

12. Are the requirements in the proposed standard regarding the use of negative confirmation requests sufficiently clear and appropriate? If not, how should the Board change these requirements?

Yes, although we believe it would be fairer to auditors in the last bullet of paragraph 17 to state that the auditor *...has no reason not to believe that recipients of negative confirmation requests will give such*

requests consideration, rather than ...the auditor reasonably believes that...they will [do so]. This would bring it further into line with paragraph 15 (d) of the ISA. We are curious as to why the PCAOB has not adopted the seemingly higher hurdle of paragraph 15 (c) of the ISA in requiring a very low exception rate as a condition for conducting negative confirmations, rather than the low expectation rate set out in paragraph 17 on the PCAOB standard.

13. Are the procedures the auditor should perform to determine the validity of the addresses on confirmation requests sufficiently clear and appropriate? If not, what changes should the Board make to the proposed procedures? and

14. Are the procedures the auditor should perform when he or she determines that a confirmation request does not include a valid address sufficiently clear and appropriate? If not, what changes should the Board make to the proposed procedures?

We noted in our response to the Concept Release that:

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

We refer to our answer to question 9 above and our main comments. We do not believe that the detailed procedures set out in paragraphs 18 to 20 will result in any improvement to the quality of audit evidence obtained by confirmation requests, above and beyond that which would be obtained through a simple requirement for auditors use their judgement to determine the validity of addresses on confirmation requests on a sample basis.

15. Are the procedures the auditor should perform when management requests the auditor not to confirm certain accounts, balances, or other items sufficiently clear and appropriate? If not, what changes should the Board make to the proposed requirements?

Yes, although the communication of the request not to confirm to the audit committee and its inclusion in the management letter may be needed on a summary basis in order to avoid overloading the audit committee and representation letter with excessive, immaterial detail. We encourage the PCAOB to consider the merits of communicating these matters only where the auditor concludes that management's request is unreasonable, in line with paragraph 9 of the ISA.

16. Are there circumstances in which it would not be necessary for the auditor to perform alternative procedures for non-responses to positive confirmation requests? If so, what are those circumstances?

No.

17. Are the additional procedures that are required when the auditor does not receive a confirmation response for the terms of a significant transaction or agreement appropriate? If not, what changes should the Board make?

Management representations should not be substituted for third party or other audit evidence that should be available. When the auditor does not receive a confirmation response for the terms of a significant transaction or agreement, other procedures are carried out and which include including the terms in the management representation letter (paragraph 28). We think it important that PCAOB clarify that management representations, while necessary, are not sufficient. Firstly, there should be documentary evidence above and beyond management representations for significant transactions or

agreements. Management representations may supplement such evidence but not substitute for it. If the only evidence available for such transactions is the original written contract auditors should be encouraged to examine the contract in further detail and seek alternative audit evidence (other than or in addition to management representations). Furthermore, we do not believe that it is appropriate for auditors to seek individual written representations from company personnel involved with the transaction, even if they are management personnel.

We noted in our response to the Concept Release that:

Alternative procedures might include using the work of specialists, extending testing of revenue recognition surrounding contracts, requesting and examining copies of the contracts and amendments thereto and comparing contractual terms to industry norms.

18. Are there additional circumstances that make it necessary for the auditor to receive a confirmation response to a positive confirmation request to obtain sufficient appropriate audit evidence? If so, what are those circumstances?

No, although it may be worth noting the fact that it will be rare for information to corroborate management's assertion to be available only outside the company, or that there will only be one such source of information (this is also true of paragraph A20 if the ISA).

19. Is the requirement in the proposed standard for the auditor to investigate all exceptions in confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make to the requirement?

Yes.

20. Are the requirements in the proposed standard related to addressing the reliability of confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make to those requirements?

Yes, although we refer to our answer to question 11 above regarding *local customs*.

21. Does the proposed standard include adequate requirements regarding electronic confirmation procedures? If not, what additional requirements should the Board include?

Yes, however, the proposed standard goes into more detail than the ISA and while it is useful to consider the questions and risks raised, there is limited help with how they should be addressed. There may well be a need for practical guidance outside the proposed standard, which could be tailored for specific situations (such as particular industries) and kept up to date as technology changes. Without such guidance, it may be difficult for auditors to interpret the requirement in the 3rd bullet of paragraph 35 to *obtain an understanding of the controls over the procedures used by the intermediary*, for example. It would be helpful for the standard to note a need for auditors to remain focussed on the high level risks, as failures in these are where failures in the conduct of confirmations often occur. Telephone calls are no longer necessarily an efficient or effective back-up audit procedure.

22. Are there risks related to the use of an intermediary that the proposed standard has not adequately addressed? If so, what are those risks, and how should the standard address them? and

23. The Board is interested in information about the services that an intermediary provides, specifically information about the responsibilities and obligations between the auditor and the intermediary and the intermediary and the confirming party.

Intermediaries are not routinely used in the UK but it is certainly possible that the use of them will increase. We believe that the key issue is for auditors to understand the controls in place to ensure that the information the auditor receives is reliable.

24. Are there risks related to the auditor's use of direct access that the proposed standard has not adequately addressed? If so, what are those risks, and how should the standard address them? and

25. Should direct access be permitted as a confirmation response only if such response is received from a financial institution? Why or why not?

We noted in our response to the Concept Release that

Direct electronic confirmation may be more efficient and reliable than manual transcription of electronic information which is then posted to the auditor but direct access to databases may equally be vulnerable to greater manipulation and fraud than more traditional methods. The databases themselves may be subject to a heightened risk of fraud or error and ...the information therein is often transient. Given the potentially relatively weak audit evidence provided by such databases, it is essential that the auditor either be satisfied with the controls over information delivered to the third party provider, the controls applied to the data during processing, and the control of information returned to the entity from such third parties.

We note that large corporate entities may well have adequate controls for these purposes and we are not convinced that all financial institutions, particularly smaller institutions, have the necessary controls in place to make direct access feasible. Again, the key issue is for auditors use their judgement to assess whether the process used is reliable.

26. Are the requirements in the proposed standard related to disclaimers and restrictive language in confirmation responses sufficiently clear and appropriate? If not, what changes should the Board make?

We remain unconvinced that the proposed solution to the problem of disclaimers is workable. The effect of disclaimers is a genuinely difficult area and a good example of one in which careful judgement is required. We noted on our response to the Concept Release that:

To require auditors to effectively discount the evidence provided by confirmation requests circumscribed by disclaimers and restrictive language is to enter into a downward spiral at the end of which lies an inability to rely on any confirmation response. Such disclaimers and restrictive language are increasingly common in the UK particularly in responses from banks and the view taken is that of themselves, they do not significantly impair the value of such evidence. Furthermore, the practical effect of a disclaimer or restrictive language is likely to require a legal analysis that is not within the auditor's competence

Paragraph 37 states that if a disclaimer or restrictive language cause doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

The language used in disclaimers, almost by definition, always causes doubts about the reliability of a confirmation response. We fear that paragraph 37 and the examples given of disclaimers that may affect the value of audit evidence¹, which could be extended by implication to a large majority of

¹ Such as

- information is obtained from electronic data sources, which might not contain all information in the bank's possession.
- information is not guaranteed to be accurate nor current and might be a matter of opinion.
- the confirming party does not accept any responsibility for errors or omissions.

disclaimers in use in practice, will result in inconsistent application of the standard. We are loath to call for further guidance, which would inevitably involve legal analysis. We would prefer to see wording closer to that used by the ISA which states that restrictive language does not necessarily invalidate the reliability of the response as audit evidence, with the implication that in some cases it may, and that auditors use their judgement in determining whether additional audit evidence is needed.

27. Are the requirements in the proposed standard related to evaluating the results of confirmation procedures sufficiently clear and appropriate? If not, what changes should the Board make?

Yes.

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- information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability, or warranty, express or implied
 - the confirming party has not sought to verify that the information contained in the attached report is true and complete and hereby expressly disclaims any liability.