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Public Company Accounting Oversight Board  
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Re: PCAOB Rulemaking Docket Matter No. 028, *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations* ("Concept Release"). We agree with the Public Company Accounting Oversight Board's ("Board" or "PCAOB") conclusion that AU sec. 330, *The Confirmation Process*, would benefit from review, especially given the significant advances in technology in the 15 years since it became effective. We also support the practice of issuing a concept release, such as this one, seeking input on high-level issues prior to the issuance of an exposure draft of a proposed standard. We expect you will find the input you receive useful, and hope you continue the practice going forward.

As independent, third-party evidence, confirmations may be an important source of the evidence that auditors obtain as part of an audit of a company's financial statements. However, to provide relevant audit evidence, confirmations must be an appropriate response to an identified risk of material misstatement. Also, auditors must use professional judgment in deciding when to request confirmations, and professional skepticism in evaluating confirmation responses. A standard that fails to emphasize these points will increase the risk that confirmations will be regarded by auditors as reliable audit evidence in cases where they are not.

#### Objective

We generally are comfortable with the objective of the confirmation standard. In particular, we believe that it is important for the objective to link to the response to identified risks, as it does. However, to be consistent with *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* and *Proposed Auditing Standard – Engagement Quality Review*, we suggest that the objective be phrased in terms of "the objective of the auditor," as opposed to "the objective of the confirmation standard." Also, based on the identified risks, auditors often will be unable to obtain *sufficient* competent audit evidence through the design and performance of confirmation procedures alone. In many cases, auditors may need to obtain other, corroborating evidence. In

those cases, the auditor will not have met the proposed objective. We would suggest the following objective:

The objective of the ~~confirmation standard [is] for the auditor~~ **is** to design and perform confirmation procedures to obtain ~~sufficient, competent~~ **relevant and reliable** audit evidence from knowledgeable third parties outside the company in response to identified risks.

#### Definition of confirmation

The benefit of a confirmation comes from a third party, knowledgeable of the subject matter being confirmed, exerting the discipline to confirm, in writing, to the auditor, the terms of a particular agreement or transaction, or that a particular account balance is correct. The form of writing (facsimile, e-mail or other electronic medium) is not important, nor is the fact that the client has outsourced the processing of confirmations to a third-party service provider. We believe the situation where a bank maintains a website whereby the auditor has direct access to bank records, meets the definition of a “confirmation,” because we believe that the personnel maintaining the website are “knowledgeable third parties,” and the direct access serves as the communication in writing. If the access is not direct (for example, via the client’s access), then the procedure provides audit evidence, but it is not a confirmation because the client’s access undermines the role of the third party.

An oral response is a response to an inquiry, which may be valuable audit evidence, but it does not have the benefit of the same discipline as a written response, and therefore, should be treated as an inquiry, but not as a confirmation.

Regardless of the form of confirmation, the auditor needs to consider the risk that the results will be compromised because of interception, alteration, or fraud. When responding to a risk that a paper confirmation may not be reliable, the auditor has some “hard” evidence in the form of the confirmation itself to consider. We suggest that the Board consider the Auditing Standards Board’s interpretation to AU sec. 330, *Use of Electronic Confirmations*, which suggests one way that the auditor may respond to a risk that an electronic confirmation may not be reliable.

#### Requirement to confirm

We believe that prescriptive requirements may result in procedures being performed in situations where a more effective or efficient procedure might be appropriate; require additional, unnecessary documentation; and undermine the exercise of the auditor’s judgment in responding to identified risks of material misstatement. We would be concerned about an expansion of the presumptively mandatory requirement to request confirmation of accounts receivable to include confirmation of the significant terms of complex or unusual agreements or transactions. Similarly, we would be concerned about requirements for the auditor to confirm other items, or to perform specific procedures when evaluating whether confirmation of accounts receivable would be ineffective.

A presumptive requirement to request confirmations in certain situations implies a presumption that confirmations will provide competent audit evidence in those situations. We do not believe

that this is always an appropriate presumption. In fact, confirmations have many limitations as audit evidence, of which the auditor should be mindful.

Auditing literature has long maintained the tenet that evidential matter obtained from an independent party outside the entity is more reliable than that secured solely within the entity. This tenet is reinforced by the presumptively mandatory requirement to confirm accounts receivable. The auditing literature sets confirmations up as unquestioned high-quality audit evidence when, in fact, we believe that the standards should provide guidance to the auditors in using professional judgment regarding when it is appropriate to request confirmations, and professional skepticism when evaluating the reliability of confirmations as audit evidence.

Confirmations should be considered as audit evidence in the context of the auditor's risk assessment, including the strengths or weakness of controls and the inherent risk of misstatement related to the assertion. Perhaps one of the most important aspects of AU sec. 330 that should be updated is the relationship between the fraud risk assessment and confirmations. In some cases, confirmations can be a very effective response to an identified risk of material misstatement, whether due to error or fraud. In other cases, however, confirmations can be used to conceal fraud. Certain fraud risk factors might point to whether confirmations would serve as an effective response to an identified risk, or as a way to conceal a fraud. The possibilities, including the possible responses to the risk of a fraudulent confirmation response, might be part of the discussion in the brainstorming session.

#### Designing confirmation requests

We caution the Board against setting too many prescriptive requirements regarding the design of confirmation requests. The types of information that it is appropriate to confirm vary so widely that it would be very difficult for the Board to draft prescriptive requirements regarding how to perform confirmations that would be appropriate in all cases. We believe that the guidance in extant AU sec. 330 regarding the design of confirmation requests is appropriate.

It would be helpful to provide guidance regarding the fact that there are some assertions for which confirmations provide little (if any) audit evidence. For example, although a confirmation may provide significant audit evidence regarding existence of investments in securities, it may provide much less evidence regarding valuation, particularly where a readily determinable fair value does not exist.

#### Testing of addresses

We acknowledge that one of the biggest limitations regarding confirmations is the fact that the confirmation may not reach the intended recipient, particularly since technology provides additional opportunities for skilled individuals to intercept confirmation requests. However, we caution the Board against requiring the testing of some or all of the addresses. With respect to traditional paper confirmations, a requirement to test all addresses would be onerous on large audits. Furthermore, a requirement to test addresses only provides limited assurance as to whether the confirmation reached the intended, knowledgeable party within an organization.

In the case of electronic confirmations, it is more difficult for the auditor to test addresses. If the auditor believed it necessary to respond to a risk that a confirmation did not come from the proper source, it might be more effective for the system or process that facilitates the electronic confirmation to be tested. We suggest that the Board consider the guidance in the Auditing Standards Board's interpretation to AU sec. 330, *Use of Electronic Confirmations*.

In either case, we believe that the auditor might consider testing addresses in response to an identified risk. For example, an auditor might be more likely to test the address of a party confirming a large, unusual transaction, and less likely to test the addresses of parties confirming many, small account balances.

#### Maintaining control over confirmation requests and responses

We believe the guidance in AU sec. 330 requiring the auditor to maintain control over the confirmation requests and responses is appropriate. We suggest that the Board consider the guidance in the Auditing Standards Board's interpretation to AU sec. 330, which provides guidance on maintaining the required control in the case of electronic confirmations.

#### Reliability of confirmation responses

We support the inclusion of more specific requirements for the auditor to evaluate the reliability of confirmations in a manner that is similar to the guidance in revised and redrafted International Standard on Auditing (ISA) 505, *External Confirmations*.

#### Exceptions and non-responses

We support the inclusion of more specific requirements for the auditor to deal with exceptions and non-responses in a manner that is similar to the guidance in ISA 505.

#### Management requests not to confirm

We support the Board's proposal to provide additional guidance to the auditor in situations when management requests that the auditor not confirm selected accounts, transactions, agreements, or other items. We believe that the procedures listed in the concept release are appropriate. We would add to the list:

- Evaluating the implications of management's request on the audit report, particularly whether a limitation on the scope of the audit exists; and
- Communicating with the audit committee.

#### Disclaimers and restrictive language

We appreciate the Board's concerns regarding the effect that disclaimers and restrictive language may have on whether the responses provide competent audit evidence. This is a practice problem with which firms are struggling. On the one hand, it is difficult to accept, as competent audit evidence, a confirmation that, on its face, states that it may not be competent audit evidence. On the other hand, confirming parties generally respond to confirmation requests as a matter of courtesy, and cannot be compelled to respond at all, much less not to try to limit their liability with disclaimers.

We caution the board against requiring the auditor to perform specific procedures to evaluate the effects of disclaimers and restrictive language on confirmation responses. Similarly, we caution the Board against requiring alternative procedures in all cases where confirmations contain disclaimers or restrictive language. First, requiring additional evaluations and alternative procedures will affect severely the value of confirmations as an audit procedure, particularly as disclaimers and restrictive language become more common. Second, it has been our experience that there is a “continuum” of disclaimers and restrictive language. On one extreme, some language appears to be “boilerplate” legal language, intended to protect the confirming party in an abstract way. On the other extreme, some language appears seriously to call into question the value of the specific confirmation received. We do not believe that a single set of procedures is appropriate in all cases. It would be unfortunate if the Board required specific procedures in cases where the restrictive language was “boilerplate,” thus limiting the value of otherwise valuable audit evidence.

We believe that the auditor’s response to disclaimers or restrictive language should be based on the nature of the language, and the identified risks associated with the assertion in question. General, boilerplate language on confirmations of a large number of small account balances would be dealt with differently by the auditor than specific restrictive language on a confirmation of an unusual transaction. The question goes to whether the effect of the disclaimers or restrictive language is to deny that the confirmation response has been provided by a knowledgeable third party.

The PCAOB, in conjunction with groups that represent confirming parties, such as the American Banking Association, should develop guidance in this area, similar to the agreement that was reached between the American Bar Association and the AICPA in the development of AU sec. 337, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims and Assessments*. Hopefully, such guidance would make bankers and other respondents to confirmation requests more comfortable in providing full responses. Such guidance could be based on the most recent developments, and could be issued as a staff alert, which could be more easily kept current than an auditing standard.

#### Negative confirmations

Given that an auditor can always do more than what is required by a standard, we do not understand how the Board could prohibit the use of negative confirmations. We do, however, believe that the standard should make clear, as does ISA 505, that negative confirmations provide less persuasive audit evidence than do positive confirmations.

#### Convergence with international standards

We would like to again express our recommendation that the Board consider the feasibility of adopting the ISAs as a base. In doing so, PCAOB standards can be focused on the incremental requirements that would be necessary for audits of issuers. ISA 505 recently has been updated. We believe it provides an appropriate base from which to start, incorporating recent thinking on confirmations, including electronic confirmations.

We would be pleased to discuss this letter with you. If you have any questions, please contact Mr. John L. Archambault, National Managing Partner of Professional Standards, at (312) 602-8701.

Sincerely,

