



United States Government Accountability Office
Washington, DC 20548

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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 028: PCAOB Release No. 2010-003,
Proposed Auditing Standard Related To Confirmation and Related Amendments to PCAOB
Standards

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standard on confirmations.

We appreciate the PCAOB's efforts to establish auditing standards on audit confirmations for registered companies and agree that confirmation procedures can be an important means of obtaining audit evidence. However, we have serious concerns about the proposed standard, specifically, (1) the proposed standard could lead to over-reliance on confirmation procedures as the presumptive requirement to perform confirmation procedures would cause auditors to spend time on confirmations when other audit procedures may be more appropriate, (2) the appendix identifies certain significant differences among the analogous standards but does not adequately explain the reasons for all significant differences, and (3) the drafting conventions and wording used in some sections of the proposed standard are unclear and will likely lead to confusion among users and inconsistency of practice. These concerns, along with other comments and suggestions for improving the clarity and other aspects of the standard, are noted below.

The Proposed Standard Could Lead to Over-Reliance on Confirmation Procedures

GAO does not dispute the premise that confirmation procedures can provide adequate and reliable evidence, but we reiterate our position from our previous letter to PCAOB, dated May 29, 2009, that (1) such procedures may not provide the most adequate and reliable evidence in every situation to support management's assertions, and (2) auditors should use professional judgment, based on audit risk and materiality, to determine the most effective procedures for obtaining sufficient appropriate audit evidence, including whether or not to use confirmation procedures in specific circumstances.

The proposed standard could reduce the use of auditor professional judgment when determining the proper combination of procedures that they should use to obtain adequate and reliable evidence to support management's assertions. The presumptively mandatory requirement to perform confirmation procedures supplants auditor judgment by

presuming that confirmation procedures are the most effective audit procedure to address the risk of material misstatement. Rather than requiring auditors to use their professional judgment, based on risk assessment and materiality to inform their decisions to send confirmation requests, the presumptive requirement would have auditors use the same procedures regardless of risk, materiality, or any other relevant facts and circumstances.

We recommend that the PCAOB reconsider the appropriateness of presumptively requiring auditors to use confirmation procedures and the related risk of over-reliance on these procedures. A more effective approach to obtaining evidence to support the entity's assertions is to apply provisions of the audit risk and evidence standards to determine whether audit confirmation procedures would be most effective. These standards and the related guidance provide sufficient principles-based direction for auditors to determine when to use confirmation procedures.

Providing Reasons for Significant Differences Between the Proposed PCAOB Standard and the Analogous Standards of the IAASB and the ASB in Appendix 3: *“Comparison of the Objectives and Requirements of the Proposed Auditing Standard and the Analogous Standards of the IAASB and the ASB”*

We commend the PCAOB for developing a separate appendix to help users recognize differences between the proposed standard and analogous standards of the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board (ASB.) However, while Appendix 3 identifies certain significant differences among the various standards, it does not adequately explain the reasons for all significant differences or the changes in practice that are expected to result from these differences.

For example, differences in the requirements for investigating exceptions in confirmation responses are identified on page A3-17 of Appendix 3, but reasons for the differences are not provided. This is also true for the discussion of requirements for evaluating results of confirmation procedures on pages A3-22 and A3-23 of Appendix 3.

To reduce the likelihood of misinterpretation of the standard and improve consistency of application, we recommend that, in addition to identifying the differences, the PCAOB provide reasoned, logical explanations for all significant differences from the IAASB and ASB requirements, along with the objectives of the differences, e.g.: the desired changes in practice.

Our other specific comments and suggestions relating to the drafting conventions and wording used in some sections of the proposed standard are detailed below:

Clarifying the Requirement to Assess the Risk of Material Misstatement When Confirming Receivables That Arise from Credit Sales, Loans, or Other Transactions

Paragraph 8 of the proposed standard states that the auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, when selecting receivables to confirm. While we support PCAOB's effort to incorporate the auditor's risk assessment into the audit confirmation procedures, the auditor should consider the risk of material misstatement when planning and designing procedures for selecting receivables to confirm, rather than in the actual process of selecting receivables

to confirm. Accordingly, we recommend that the PCAOB reword paragraph 8 to state that the auditor should consider the risk of material misstatement when planning and designing procedures to confirm receivables that arise from credit sales, loans, or other transactions, as follows:

8. The auditor should perform confirmation procedures for receivables that arise from credit sales, loans, or other transactions. These receivables may be in the form of loans, notes, and other financial instruments and may be originated by the company or purchased from another entity. The auditor should assess the risk of material misstatement due to error or fraud, including whether the risk is a significant risk, ~~when selecting which receivables to confirm~~ **when planning and designing procedures for selecting receivables to confirm.**

Clarifying the Requirement from another PCAOB Standard in the Discussion of Relationship of Confirmation to the Auditor's Assessment of Audit Risk

The requirement in paragraph 4 of the standard for the auditor to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement is a repetition of paragraph 8 of the PCAOB's Auditing Standard, *The Auditor's Responses to the Risks of Material Misstatement*. Since some readers may not realize the requirement repeats that of another PCAOB standard, it would be more helpful to refer specifically to the other PCAOB standard, as follows:

4. ~~The auditor should~~ **The PCAOB Auditing Standard *The Auditor's Response to the Risks of Material Misstatement* requires auditors to** design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure. In designing the audit procedures to be performed, the auditor should obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Removing Presumptively Mandatory Requirement from Illustrative Example in Discussion of Significant Risks

The second sentence of paragraph 10 of the proposed standard includes a presumptively mandatory requirement presented as an illustrative example. This is not a logical construct, and as written, will likely confuse the reader and result in an inconsistent application of the standard. A more logical construct would be to provide an example to illustrate potential auditor procedures that the auditor may perform in response to significant risks. A clearer construct for the paragraph may be as follows:

10. The auditor should perform confirmation procedures in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures. For example, ~~for one procedure the auditor might use to address~~ significant risks related to agreements or transactions for which confirmation procedures adequately address the relevant assertions, ~~the auditor should confirm~~ **is to confirm** the amounts and terms of such agreements or transactions, including whether there are any undisclosed

oral or undisclosed written modifications to those agreements, such as undisclosed side agreements.

Similarly, the second sentence of paragraph 14, the second sentence of paragraph 15, the third sentence of paragraph 19, and the third sentence of paragraph 28 of the proposed standard also include presumptively mandatory requirements in the illustrative examples. Accordingly, we recommend similarly revising these sentences to remove the presumptively mandatory requirement from the illustrative examples.

Clarifying Threshold for Determining if Disclaimers and Restrictive Language Cause Doubts about the Reliability of Confirmation Responses

The requirement in paragraph 37 of the proposed standard that the auditor should evaluate the effect of a disclaimer or restrictive language on the reliability of a confirmation response further states that if a disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence. However, the term “*causes doubts*” is an ambiguous threshold and should be replaced with a threshold that more appropriately reflects the risk that a disclaimer or restrictive language causes the auditor to believe that it may limit the auditor’s ability to obtain sufficient appropriate evidence necessary to reduce the risk of material misstatement to an acceptable level. A clearer term requiring the auditor to obtain additional appropriate audit evidence may be as follows:

37. The auditor should evaluate the effect of a disclaimer or restrictive language on the reliability of a confirmation response. If a disclaimer or restrictive language ~~causes doubts~~ **causes the auditor to believe that it may limit the auditor’s ability to obtain sufficient appropriate evidence necessary to reduce the risk of material misstatement to an acceptable level**, the auditor should obtain additional appropriate audit evidence.

We thank you for considering our comments on this very important issue.

Sincerely yours,



James R. Dalkin
Director
Financial Management and Assurance