



**Proposed Auditing Standard – The Auditor’s
Use of Confirmation, and Other Proposed
Amendments to PCAOB Standards**

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PCAOB Rulemaking
Docket Matter No. 028

Summary: The Public Company Accounting Oversight Board (“PCAOB” or the “Board”) is proposing to replace its auditing standard related to an auditor’s use of confirmation, AS 2310, *The Confirmation Process*, with a new proposed standard, AS 2310, *The Auditor’s Use of Confirmation*, and to make conforming amendments to certain related PCAOB auditing standards. This proposing release follows a previous public comment period on amendments that were proposed in a 2010 Board release. The new proposed standard is designed to improve the quality of audits when confirmation is used by the auditor and to reflect changes in the means of communication and in business practice since the standard was originally issued.

Public Comment: Interested persons may submit written comments to the Board. Comments should be sent by e-mail to comments@pcaobus.org or through the Board’s website at www.pcaobus.org. Comments may also be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 028 in the subject or reference line and should be received by the Board by February 20, 2023.

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I. EXECUTIVE SUMMARY

We are proposing to replace AS 2310, *The Confirmation Process*, in its entirety with a new standard, AS 2310, *The Auditor's Use of Confirmation* ("new proposed standard") to strengthen and modernize the requirements for the confirmation process. As described in the new proposed standard, the confirmation process involves sending a confirmation request directly to a confirming party (e.g., a financial institution), evaluating the information received, and addressing nonresponses and incomplete responses to obtain audit evidence about one or more financial statement assertions. If properly designed and executed by the auditor, the confirmation process may provide important evidence that auditors obtain as part of an audit of a company's financial statements.

Why the Board is Proposing These Changes Now

AS 2310 is an important standard for audit quality and investor protection, as the audit confirmation process touches nearly every audit. The standard was initially written over 30 years ago and has had minimal amendments since its adoption by the PCAOB in 2003.

The Board previously considered updating AS 2310 by issuing a concept release in 2009 and a proposal in 2010 for a new auditing standard that would supersede AS 2310. While the Board did not amend or replace AS 2310 at that time due to changing priorities, subsequent developments – including the increasing use of electronic communications and third-party intermediaries in the confirmation process – have led us to conclude that enhancements to AS 2310 and modifications to the approach proposed in 2010 could improve the quality of audit evidence obtained by auditors. In addition, we have also observed continued inspection findings related to auditors' use of confirmation, as well as enforcement actions involving failures to adhere to requirements in the existing auditing standard regarding confirmation, such as the requirement for the auditor to maintain control over the confirmation process. Accordingly, having considered these developments and input from commenters, we have revisited the previously proposed changes and are issuing the new proposed standard and conforming amendments to other PCAOB auditing standards.

Key Provisions of the New Proposed Standard

The new proposed standard and amendments, which would apply to all audits conducted under PCAOB standards, are intended to enhance the Board's standard on the use of confirmation by describing principles-based requirements that apply to all methods of confirmation, including paper-based and electronic means of communications. Further, the new proposed standard would be more expressly integrated with the Board's risk assessment standards by incorporating certain risk-based considerations and emphasizing the auditor's responsibilities for obtaining relevant and reliable audit evidence through the confirmation process. Key proposals in the new proposed standard would:

- Include a new requirement regarding confirming cash held by third parties, and carry forward the existing requirement regarding confirming accounts receivable;
- State that the use of negative confirmation requests alone does not provide sufficient appropriate audit evidence (and include examples of situations where the auditor may use negative confirmation requests to supplement other substantive audit procedures);
- Identify situations in which alternative audit procedures should be performed by the auditor (and include examples of such alternative procedures that may provide relevant and reliable audit evidence); and
- Clarify that there are certain activities in the confirmation process for which the auditor may not use internal auditors to provide direct assistance.

This release provides background on the Board’s standard-setting project, discusses the new proposed standard, and includes an economic analysis that further considers the need for standard setting and the anticipated economic impacts of our proposed approach. The release also includes two appendices. Appendix 1 sets forth the text of the new proposed standard. Appendix 2 includes conforming amendments to other PCAOB auditing standards.

Requesting Public Comment on Our Proposal

We are seeking comment on all aspects of the new proposed standard and conforming amendments to other PCAOB auditing standards. Throughout the release, we have included detailed questions soliciting your feedback on specific aspects of our proposal. You are encouraged to comment on any or all topics, respond to any or all questions, provide feedback in areas not covered by specific questions, and provide any evidence, including data or your practical experiences, that informs your views.

Instructions on how to comment, including by e-mail or postal mail, can be found on the cover sheet of this release. The release, previous releases, and previous comments can be found at the [docket page](#) of PCAOB Rulemaking Docket Matter No. 028.

II. BACKGROUND

Confirmation can be an important source of evidence obtained as part of an audit of a company’s financial statements,¹ and has long been used by auditors. For example, one early auditing treatise noted the importance of confirmation for cash deposits, accounts receivable,

¹ See, e.g., paragraph 08 of AS 1105, *Audit Evidence* (providing that “[e]vidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources”).

and demand notes.² In addition, confirmation of accounts receivable has been a required audit procedure in the United States since 1939, when the American Institute of Accountants³ adopted Statement on Auditing Procedure No. 1 ("SAP No. 1") as a direct response to the *McKesson & Robbins* fraud case, which involved fraudulently reported inventories and accounts receivable that the independent auditors failed to detect through procedures other than confirmation.⁴

SAP No. 1 required confirmation of accounts receivable by direct communication with customers in all independent audits of financial statements, subject to the auditor's ability to overcome the presumption to confirm accounts receivable for certain reasons. Following the adoption of SAP No. 1, the accounting profession also adopted a requirement in 1942, which remained in effect until the early 1970s, that auditors should disclose in the auditor's report when confirmation of accounts receivable was not performed.

The AICPA's subsequent revisions to its auditing standards included the promulgation of AU sec. 330, *The Confirmation Process*, which was adopted in 1991 and took effect in 1992. The PCAOB adopted AU sec. 330 (now AS 2310) as an interim standard in 2003.⁵

In 2009 the Board issued a concept release seeking public comment on the potential direction of a standard-setting project that could result in an amendment to the Board's existing standard on the confirmation process or a new auditing standard that would supersede the existing standard.⁶ The 2009 Concept Release discussed existing requirements and posed questions about potential amendments to those requirements. The Board received 24 comment letters on the 2009 Concept Release. Commenters generally were supportive of the Board's updating the existing confirmation standard given the significance of the changes in the

² Robert H. Montgomery, *Auditing Theory and Practice* 91 (confirmation of cash deposits), 263 (confirmation of accounts receivable), and 353 (confirmation of demand notes) (1912).

³ The American Institute of Accountants was the predecessor to the American Institute of CPAs ("AICPA").

⁴ See *In the Matter of McKesson & Robbins, Inc.*, SEC Rel. No. 34-2707 (Dec. 5, 1940).

⁵ Shortly after the Board's inception, the Board adopted the existing standards of the AICPA, as in existence on Apr. 16, 2003, as the Board's interim auditing standards. See *Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-006 (Apr. 18, 2003). AU sec. 330 was one of these auditing standards. As of Dec. 31, 2016, the PCAOB reorganized its auditing standards using a topical structure and a single, integrated number system, at which time AU sec. 330 was designated AS 2310. See *Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Rel. No. 2015-002 (Mar. 31, 2015).

⁶ *Concept Release on Possible Revisions to the PCAOB's Standard on Audit Confirmations*, PCAOB Rel. No. 2009-002 (Apr. 14, 2009) ("2009 Concept Release").

business environment since the promulgation of the standard by the AICPA particularly with respect to changes in the means of communication.

Having considered the input from commenters, in 2010, the Board proposed an auditing standard that, if adopted, would have superseded the existing confirmation standard.⁷ The 2010 Proposal was intended to strengthen the existing standard by, among other things, expanding certain requirements and introducing new requirements. The Board received 28 comment letters on the 2010 Proposal. In general, commenters supported updating the existing standard to address relevant developments in audit practice, including greater use of e-mailed confirmation requests and responses and the involvement of third-party intermediaries. At the same time, some commenters asserted that the proposed requirements in the 2010 Proposal were unduly prescriptive (i.e., included too many presumptively mandatory requirements) and would result in a significant increase in the volume of confirmation requests without a corresponding increase in the quality of audit evidence obtained by the auditor. The Board did not adopt the 2010 Proposal.

We have considered comments received on the 2009 Concept Release and the 2010 Proposal in developing the new proposed standard. In addition, since the 2010 Proposal, the Board has continued to monitor developments relating to the use of confirmation through its oversight and research activities. In 2011, the PCAOB issued a staff practice alert that included examples of conditions and situations involving confirmation that indicate heightened fraud risk in certain companies in emerging markets.⁸ In 2021, the PCAOB issued a staff Spotlight discussing, among other things, the use of technology in the confirmation process.⁹ In addition, in 2022, the PCAOB issued a staff Spotlight that specifically discussed observations and reminders on the use of a service provider in the confirmation process.¹⁰

This rulemaking proposal builds upon the Board's prior work and would specify the auditor's responsibilities regarding the confirmation process (i.e., the process of sending a confirmation request directly to a confirming party, evaluating information received, and addressing nonresponses and incomplete responses to obtain audit evidence about one or

⁷ *Proposed Auditing Standard Related to Confirmation and Related Amendments to PCAOB Standards*, PCAOB Rel. No. 2010-003 (July 13, 2010) ("2010 Proposal").

⁸ *See Audit Risks in Certain Emerging Markets*, Staff Audit Practice Alert No. 8 (Oct. 3, 2011), available at https://pcaobus.org/Standards/QandA/2011-10-03_APA_8.pdf.

⁹ *See Spotlight: Data and Technology Research Project Update* (May 2021), available at <https://pcaobus.org/resources/staff-publications>.

¹⁰ *See Spotlight: Observations and Reminders on the Use of a Service Provider in the Confirmation Process* (Mar. 2022), available at <https://pcaobus.org/resources/staff-publications>.

more financial statement assertions).¹¹ The remainder of this section presents additional background information on the proposed rulemaking, including an overview of existing requirements addressing the confirmation process, a description of current practice, and a discussion of our reasons for proposing the new proposed standard at this time.¹²

A. Existing Standard

This section discusses key provisions of the existing PCAOB auditing standard that addresses the confirmation process.

In 2003, the Board adopted the standard now known as AS 2310, *The Confirmation Process* (at that time, AU sec. 330), when it adopted the AICPA's standards then in existence. Existing AS 2310 indicates that confirmation is 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. For example, an auditor might request a company's customers to confirm balances owed at a certain date, or request confirmation of a company's accounts or loans payable to a bank at a certain date.

Key provisions of existing AS 2310 include the following:

- A presumption that the auditor will request confirmation of accounts receivable. The standard states that confirmation of accounts receivable is a generally accepted auditing procedure and provides the situations in which the auditor may overcome the presumption.
- Procedures for designing the confirmation request, including the requirement that the auditor direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed.
- Procedures relating to the use of both positive and negative confirmation requests. A positive confirmation request directs the recipient to send a response back to the auditor stating the recipient's agreement or disagreement with information stated in the request, or furnishing requested information. A negative confirmation request

¹¹ Under PCAOB standards, financial statement assertions can be classified into the following categories: existence or occurrence, completeness, valuation or allocation, rights and obligations, and presentation and disclosure. See, e.g., AS 1105.11.

¹² A PCAOB staff document that compares the new proposed standard with the analogous requirements under International Standard on Auditing 505, *External Confirmations* ("ISA 505"), issued by the International Auditing and Assurance Standards Board ("IAASB"), and AU-C Section 505, *External Confirmations* ("AU-C 505"), issued by the Auditing Standards Board of the AICPA, is available on the Board's website in Docket 028.

directs the recipient to respond back to the auditor only when the recipient disagrees with information in the auditor's request. The standard states that "[n]egative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration."¹³ If negative confirmation requests are used, the auditor should consider performing other substantive procedures to supplement their use.¹⁴

- A requirement for the auditor to maintain control over confirmation requests and responses by establishing direct communication between the intended recipient and the auditor.
- Procedures to consider when the auditor does not receive a written confirmation response via return mail, including how the auditor should evaluate the reliability of oral and facsimile responses to written confirmation requests. The standard provides that, when confirmation responses are in other than a written format mailed to the auditor, additional evidence may be necessary to establish the validity of the respondent.
- A requirement that the auditor should perform alternative auditing procedures when the auditor has not received a response to a positive confirmation request.
- Requirements for the auditor's evaluation of the results of confirmation procedures and any alternative procedures performed by the auditor. These provisions include the requirement that, if the combined evidence provided by confirmation, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures.

B. Current Practice

This section discusses our understanding of current practice based on, among other things, observations from oversight activities of the Board, and enforcement actions of the U.S. Securities and Exchange Commission ("SEC" or "Commission").

¹³ See AS 2310.20.

¹⁴ *Id.*

1. Overview of Current Practice

The audit confirmation process touches nearly every financial statement audit conducted under PCAOB auditing standards. This is due in part to the presumption in AS 2310 that the auditor will confirm accounts receivable, which include claims against customers that have arisen from the sale of goods or services in the normal course of business and a financial institution's loans, unless certain exemptions apply. In addition, audit methodologies of many larger audit firms affiliated with global networks recommend or require confirming cash accounts. The use of confirmation is also a common practice for auditing a financial institution's customer deposits. In recent years, however, there has been an increased wariness about phishing attempts and some customers might not understand or trust an unsolicited confirmation request from an auditor.

AS 2310 was written at a time when paper-based confirmation requests and responses were the prevailing means of communication. Since then, e-mailed confirmation requests and responses, and the use of technology-enabled confirmation tools, including the use of intermediaries to facilitate the confirmation process, have become commonplace. For example, numerous financial institutions in the United States, and an increasing number of international banks, mandate the use of an intermediary as part of the confirmation process and will not otherwise respond to an auditor's confirmation request.

As noted above, AS 2310 provides that the auditor should maintain control over the confirmation process. In practice, complying with this requirement involves sending the confirmation request to the confirming party via mail or e-mail directly by the auditor, without involving company personnel. The auditor's confirmation request generally specifies that any correspondence should be sent directly to the auditor's location (or e-mail) to minimize the risk of interference by company personnel. When an intermediary facilitates direct electronic communications between the auditor and the confirming party, the auditor is still required to maintain control over the confirmation process. Procedures performed by audit firms to address this requirement vary depending on facts and circumstances. Some auditors have used an Independent Service Auditor's Report on Service Organization Controls ("SOC report") to evaluate the design and operating effectiveness of the intermediary's controls relevant to sending and receiving confirmations.

Under the existing standard, auditors can use positive confirmation requests and, provided certain conditions are met, negative confirmation requests. A positive confirmation request either asks the recipient to respond directly to the auditor about whether the recipient agrees with information that is stated in the request or asks the recipient to provide the requested information by filling in a blank form. In comparison, a negative confirmation request directs the recipient to respond only when the recipient disagrees with the information included in the request. In practice, negative confirmation requests have typically been used to obtain audit evidence related to the completeness of deposit liabilities and other accounts of a similar nature and, less frequently, to obtain evidence related to the existence of accounts

receivable. In some cases, auditors use a combination of positive and negative confirmation requests.

2. Observations from Inspections and Enforcement Actions

This section discusses observations from PCAOB oversight activities and SEC enforcement actions, including (1) PCAOB inspections of registered public accounting firms, and (2) enforcement actions relating to deficient confirmation procedures performed by the auditor.

Inspections. Over the past several years, PCAOB inspections indicated that some auditors did not fulfill their responsibilities under the existing standard when performing confirmation procedures. The shortcomings have been noted at large and small domestic firms, and at large firms with domestic and international practices. For example, some auditors did not: (1) consider performing procedures to verify the source of confirmation responses received electronically; (2) perform sufficient alternative procedures; (3) restrict the use of negative confirmation requests to situations where the risk of material misstatement was assessed as low; or (4) maintain appropriate control over the confirmation process, including instances where company personnel were involved in either sending or receiving confirmations.

Enforcement actions. Over the years, there have been a number of enforcement actions by the PCAOB and the SEC alleging that auditors failed to comply with PCAOB standards related to the confirmation process. Enforcement actions have been brought against large and small firms, and against U.S. and non-U.S. firms.

For example, PCAOB enforcement cases have involved allegations that auditors failed to: (1) perform appropriate confirmation procedures to address a fraud risk;¹⁵ (2) adequately respond to contradictory audit evidence obtained from confirmation procedures;¹⁶ (3) perform

¹⁵ See, e.g., *In the Matter of Marcum LLP*, PCAOB Rel. No. 105-2020-012 (Sept. 24, 2020); *In the Matter of Whitley Penn LLP*, PCAOB Rel. No. 105-2020-002 (Mar. 24, 2020); *In the Matter of PMB Helin Donovan, LLP*, PCAOB Rel. No. 105-2019-031 (Dec. 17, 2019); *In the Matter of Ronald R. Chadwick, P.C.*, PCAOB Rel. No. 105-2015-009 (Apr. 28, 2015).

¹⁶ See, e.g., *In the Matter of Marcum LLP*, PCAOB Rel. No. 105-2020-012 (Sept. 24, 2020); *In the Matter of Ronald R. Chadwick, P.C.*, PCAOB Rel. No. 105-2015-009 (Apr. 28, 2015); *In the Matter of Price Waterhouse, Bangalore*, PCAOB Rel. No. 105-2011-002 (Apr. 5, 2011).

appropriate confirmation procedures and alternative procedures for accounts receivable;¹⁷ or (4) maintain proper control over the confirmation process.¹⁸

In several confirmation-related enforcement cases, the SEC alleged that the deficient confirmation procedures by the auditors involved companies that had engaged in widespread fraud, where properly performed confirmation procedures might have led to the detection of the fraudulent activity.¹⁹

Further, in a number of proceedings, the SEC alleged that the auditors failed to perform confirmation procedures in circumstances where such procedures would have been appropriate, or the auditors had falsely represented that such procedures were performed.²⁰ In some actions, the SEC alleged that confirmation procedures were not properly designed²¹ or, more frequently, that the auditors failed to adequately evaluate responses to confirmation requests and perform alternative or additional procedures in light of exceptions, nonresponses, or responses that should have raised issues as to their reliability.²² Several of these proceedings were brought in recent years, suggesting that problems persist in this area.

¹⁷ *In the Matter of Whitley Penn LLP*, PCAOB Rel. No. 105-2020-002 (Mar. 24, 2020); *In the Matter of PMB Helin Donovan, LLP*, PCAOB Rel. No. 105-2019-031 (Dec. 17, 2019); *In the Matter of Wander Rodrigues Teles*, PCAOB Rel. No. 105-2017-007 (Mar. 20, 2017); *In the Matter of Ronald R. Chadwick, P.C.*, PCAOB Rel. No. 105-2015-009 (Apr. 28, 2015); *In the Matter of Price Waterhouse, Bangalore*, PCAOB Rel. No. 105-2011-002 (Apr. 5, 2011).

¹⁸ *See, e.g., In the Matter of Marcum LLP*, PCAOB Rel. No. 105-2020-012 (Sept. 24, 2020); *In the Matter of Price Waterhouse, Bangalore*, PCAOB Rel. No. 105-2011-002 (Apr. 5, 2011).

¹⁹ *See, e.g., In the Matter of Ravindranathan Raghunathan, CPA*, SEC Rel. No. 34-93133 (Sept. 27, 2021); *In the Matter of Mancera, S.C.*, SEC Rel. No. 34-90699 (Dec. 17, 2020); *In the Matter of Schulman Lobel Zand Katzen Williams & Blackman, LLP A/K/A Schulman Lobel LLP*, SEC Rel. No. 34-88653 (Apr. 15, 2020); *In the Matter of William Joseph Kouser Jr., CPA*, SEC Rel. No. 34-80370 (Apr. 4, 2017).

²⁰ *See, e.g., In the Matter of Winter, Kloman, Moter & Repp, S.C.*, SEC Rel. No. 34-83168 (May 4, 2018); *In the Matter of Edward Richardson, Jr., CPA*, SEC Rel. No. 34-80918 (June 14, 2017).

²¹ *See, e.g., In the Matter of Ravindranathan Raghunathan, CPA*, SEC Rel. No. 34-93133 (Sept. 27, 2021); *In the Matter of Winter, Kloman, Moter & Repp, S.C.*, SEC Rel. No. 34-83168 (May 4, 2018); *In the Matter of Edward Richardson, Jr., CPA*, SEC Rel. No. 34-80918 (June 14, 2017).

²² *See, e.g., In the Matter of Mancera, S.C.*, SEC Rel. No. 34-90699 (Dec. 17, 2020); *In the Matter of Schulman Lobel Zand Katzen Williams & Blackman, LLP A/K/A Schulman Lobel LLP*, SEC Rel. No. 34-88653 (Apr. 15, 2020); *In the Matter of Anton & Chia, LLP*, SEC Rel. No. 34-87033 (Sept. 20, 2019); *In the Matter of Edward Richardson, Jr., CPA*, SEC Rel. No. 34-80918 (June 14, 2017); *In the Matter of William Joseph Kouser Jr., CPA*, SEC Rel. No. 34-80370 (Apr. 4, 2017).

C. Reasons to Improve Auditing Standards

Since the AICPA's standard on the confirmation process took effect in 1992, there has been a significant change in the auditing environment. Electronic communications between auditors and confirming parties have become ubiquitous. Many auditors and confirming parties now engage third-party intermediaries to facilitate the electronic transmission of confirmation requests and responses between auditors and confirming parties. The means by which an auditor communicates with confirming parties have also changed, and the use of e-mail and other electronic forms of communication is prevalent. We are proposing to modify the standard to further support the auditor's use of electronic forms of communication between the auditor and the confirming party.

We also believe that our auditing standards should allow for continued innovation by auditors in the ways they obtain audit evidence. Traditionally, auditors have used confirmation in circumstances where reliable evidence about financial statement assertions could be obtained directly from a third party that transacts with the company (e.g., to confirm the existence of cash or accounts receivable). Generally, audit evidence from the confirmation process has been viewed as more reliable than evidence obtained through other audit procedures available to the auditor,²³ especially where the auditor identified a risk of fraud, chose not to test controls, or determined that controls could not be relied on. However, the staff's research indicates that some audit firms may have developed or may yet develop audit techniques that enable the auditor to obtain sufficient appropriate audit evidence for the same assertions by performing substantive audit procedures that do not include confirmation, as discussed in more detail below. To reflect these developments, the existing standard could be modified to allow the performance of other procedures for accounts receivable in situations where the auditor is able to obtain audit evidence that is at least as persuasive as evidence obtained through confirmation.

While information obtained through the confirmation process can be an important source of audit evidence, the confirmation process must be properly executed for the evidence obtained to be relevant and reliable. The enforcement actions discussed in Section II.B and other recent high-profile financial reporting frauds have also called attention to the importance of well-executed confirmation procedures, including the confirmation of cash.²⁴ In addition,

²³ The confirmation process involves obtaining audit evidence from a confirming party. Under PCAOB standards, in general, evidence obtained from a knowledgeable source that is independent from the company is more reliable than evidence obtained only from internal company sources. *See, e.g., AS 1105.08.*

²⁴ *See, e.g., In the Matter of Mancera, S.C., SEC Rel. No. 34-90699 (Dec. 17, 2020)* (failure by auditors to properly evaluate confirmation responses to requests for information on cash balances of a Mexican homebuilder subsequently found to have engaged in a "multi-billion dollar financial fraud"). *See also* Olaf Storbeck, Tabby Kinder, and Stefania Palma, *EY failed to check Wirecard bank statements*

PCAOB oversight activities have identified instances in which auditors did not obtain sufficient appropriate audit evidence when using confirmation.

We believe that the new proposed standard would contribute to enhancing audit quality by clarifying and strengthening the requirements for the auditor's use of confirmation. This would also emphasize the importance of obtaining relevant and reliable external evidence. The new proposed standard would include a new requirement regarding confirming certain cash balances and enhancing requirements addressing the reliability of confirmation responses. We believe that the quality of audit evidence obtained through the confirmation process can be further enhanced by clarifying the auditor's responsibilities to evaluate the reliability of evidence obtained through confirmation responses and, when necessary, to obtain audit evidence through alternative procedures.

Question:

1. Are there problems relating to the auditor's use of confirmation that are not described above? If so, what are the problems and what changes should be considered to address them?

III. DISCUSSION OF THE NEW PROPOSED STANDARD: AS 2310 THE AUDITOR'S USE OF CONFIRMATION

A. Overview of New Proposed Standard

We are proposing to replace the existing auditing standard on the confirmation process with the new proposed standard, which would replace the existing standard, AS 2310, in its entirety. The new proposed standard is designed to enhance existing confirmation requirements by:

- *Including more principles-based requirements that are designed to apply to all methods of confirmation.* The new proposed standard is designed to enhance requirements that apply to longstanding methods (such as the use of paper-based confirmation requests and responses sent via regular mail), methods that have been adopted by auditors since existing AS 2310 was issued (such as the use of e-mail or an intermediary to facilitate direct electronic transmission of confirmation requests and responses), and methods that are yet to emerge (thus encouraging audit innovation).

for 3 years, Financial Times (June 26, 2020) (potential failure by auditors to confirm cash balances purportedly held by Wirecard AG, a German company whose securities were not registered with the SEC, directly with a Singapore-based bank).

- *Expressly integrating the requirements for the auditor's use of confirmation with the requirements of the Board's risk assessment standards, including AS 1105.* The new proposed standard would more clearly specify certain risk-based considerations and emphasize the auditor's responsibilities for obtaining relevant and reliable audit evidence through confirmation.
- *Emphasizing the use of confirmation procedures in certain situations.* The new proposed standard would (i) add a new requirement that the auditor should perform confirmation procedures for cash held by third parties, (ii) carry forward the existing requirement that the auditor should perform confirmation procedures for accounts receivable, and (iii) carry forward the existing requirement to consider confirming the terms of certain transactions.
- *Addressing when the presumption to confirm accounts receivable may be overcome.* The new proposed standard would specify that an auditor may overcome the presumptively mandatory responsibility regarding confirming accounts receivable, and perform other substantive procedures instead of confirmation, if the auditor determines that those other procedures would provide audit evidence that is at least as persuasive as the evidence the auditor might expect to obtain through confirmation.²⁵
- *Reflecting the relatively insignificant amount of audit evidence obtained when using negative confirmation requests.* Under the new proposed standard, the use of negative confirmation requests may provide sufficient appropriate audit evidence only when combined with other substantive audit procedures. The new proposed standard would include examples of situations in which the use of negative confirmation requests in combination with other substantive audit procedures may provide sufficient appropriate audit evidence.
- *Providing more specific direction for circumstances where the auditor is unable to obtain relevant and reliable audit evidence through confirmation.* The new proposed standard would identify situations where other procedures should be performed by the auditor as an alternative to confirmation. The new proposed standard would include examples of such alternative procedures that may provide relevant and reliable audit evidence.

²⁵ Under PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, the auditor must comply with requirements that establish presumptively mandatory responsibilities unless the auditor demonstrates that alternative actions followed by the auditor in the circumstances were sufficient to achieve the objectives of the standard.

- *Identifying the activities in the confirmation process for which the auditor may not use internal auditors to provide direct assistance.* The new proposed standard states that an internal auditor should not select the items to be confirmed, send confirmation requests, or receive confirmation responses.

Questions:

2. Would investors find it useful in making investment decisions to have more information about the auditor's use of confirmation in the audit of an issuer's financial statements? If so, what type of information would be useful to investors and how might it be provided?
3. Should the new proposed standard more explicitly address the use of technology, including situations where the use of technology might improve the quality of evidence obtained through the confirmation process? If so, how?

B. Introduction and Objective

See paragraphs .01 and .02 of the new proposed standard in Appendix 1

The new proposed standard would establish requirements for the auditor's use of confirmation. The confirmation process involves sending a confirmation request directly to a confirming party, evaluating the information received, and addressing nonresponses and incomplete responses to obtain audit evidence about one or more financial statement assertions. Confirmation is one of the specific audit procedures described in PCAOB standards that an auditor could perform when addressing a risk of material misstatement.²⁶ As is the case with other audit procedures, information obtained through confirmation may support and corroborate management's assertions or it may contradict such assertions.²⁷

AS 2110, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and addressing the risks of material misstatement of the financial statements, and AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements regarding designing and implementing appropriate responses to the risks of material misstatement. Where the auditor determines to use confirmation as part of the auditor's response, the new proposed standard would address the auditor's responsibilities for designing and executing the confirmation process to obtain relevant and reliable audit evidence. If the auditor uses sampling in the confirmation process, the auditor should use AS 2315, *Audit Sampling*, which discusses planning, performing, and evaluating audit samples. Auditor responsibilities regarding inquiries concerning litigation,

²⁶ See, e.g., AS 1105.14 and .18.

²⁷ See AS 1105.02.

claims, and assessments are addressed in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

The objective included in the new proposed standard is based on the objective proposed in 2010, which provided that the auditor's objective in designing and performing confirmation procedures is to obtain relevant and reliable audit evidence. Existing AS 2310 does not include an objective. Commenters on the 2010 Proposal either supported or did not object to having an objective in the standard, and some commenters suggested changes to the proposed objective. Some of those commenters who suggested changes noted that the objective in the 2010 Proposal was too generic as it could be used for other standards. Having considered these and other comments, we decided to carry forward the proposed objective and add that audit evidence is obtained about one or more relevant financial statement assertions of a significant account or disclosure.

Question:

4. Is the objective of the new proposed standard clear? If not, how should it be clarified?

C. Relationship of the Confirmation Process to the Auditor's Identification and Assessment of and Response to the Risks of Material Misstatement

See paragraphs .03 - .07 of the new proposed standard in Appendix 1

The new proposed standard would apply to situations where the auditor determines to use confirmation to address a risk of material misstatement. Paragraphs .03 - .07 of the new proposed standard are intended to outline how the new proposed standard would work alongside the PCAOB standards on risk assessment, which were adopted after the 2010 Proposal was issued.

Fundamental to the PCAOB's risk assessment standards is the concept that as risk increases, so does the amount of evidence that the auditor should obtain.²⁸ Further, evidence obtained from a knowledgeable source outside the company generally is more reliable than evidence obtained only from internal company sources.²⁹ When properly designed and executed, the confirmation process can be an effective and efficient way of obtaining relevant and reliable external audit evidence, including in situations where the auditor identifies an elevated risk of material misstatement due to error or fraud.

²⁸ See AS 1105.05.

²⁹ See AS 1105.08.

As is the case with performing other audit procedures under PCAOB standards, the auditor is required to exercise professional skepticism when gathering and evaluating audit evidence from confirmation, including when identifying information to confirm, identifying confirming parties, evaluating confirmation responses, and addressing nonresponses.³⁰ Requirements related to exercising professional skepticism in combination with requirements in other PCAOB standards are designed to reduce the risk of confirmation bias, a phenomenon wherein decision makers have been shown to actively seek out and assign more weight to evidence that confirms their hypothesis, and ignore or underweight evidence that could disconfirm their hypothesis.³¹

Performing confirmation procedures can efficiently and effectively provide evidential matter about certain financial statement assertions, including existence, occurrence, completeness, and rights and obligations. For example, confirmation may provide audit evidence related to the existence of cash, accounts receivable, and financial instruments, or the completeness of debt. However, the confirmation process generally provides less relevant evidence about the valuation assertion (e.g., the confirming party may not intend to repay in full the amount owed, or the custodian may not know the value of shares held in custody). Confirmation could also be used to obtain audit evidence about the terms of contractual arrangements (e.g., by verifying supplier discounts or concessions, corroborating sales practices, or substantiating oral arrangements and guarantees). Information in confirmation responses may indicate the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor.

In many situations, confirmation could provide audit evidence that is more persuasive than evidence obtained solely through other substantive procedures. This may occur, for example, where the auditor has determined not to test company controls or has found controls to be ineffective. In situations involving fraud risks and significant unusual transactions, audit evidence obtained through the confirmation process generally is more persuasive than audit evidence obtained solely through other procedures.

In some situations, an auditor may determine that evidence obtained through confirmation may constitute sufficient appropriate audit evidence for a particular assertion, while in other situations performing audit procedures in addition to confirmation may be necessary to obtain sufficient appropriate audit evidence. For example, for significant unusual sales transactions and the resulting accounts receivable balances, an auditor might confirm significant terms of the transactions and the receivable balances with the transaction counterparties, and perform additional substantive procedures such as examination of shipping documents and subsequent cash receipts. Determining the nature, timing, and extent of

³⁰ See paragraph .07 of AS 1015, *Due Professional Care in the Performance of Work*.

³¹ For a discussion of confirmation bias, see, e.g., Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 *Review of General Psychology*, 175 (1998).

confirmation procedures, and any other additional audit procedures, is part of designing and implementing the auditor's response to the assessed risk of material misstatement.

The 2010 Proposal would have provided that the auditor should send confirmation requests in response to significant risks that related to assertions that could be "adequately addressed" through confirmation. Some commenters on the 2010 Proposal either supported or did not object to the proposed approach. Many other commenters, however, viewed the requirement as overly prescriptive and inconsistent with PCAOB standards on risk assessment, which were adopted after the 2010 Proposal was issued. These commenters recommended that the standard allow for the use of professional judgment in determining the most effective and efficient approach to obtain sufficient appropriate audit evidence in response to the assessed risk. Having considered these comments, we have removed the requirement to send confirmation requests in response to significant risks.

As discussed in Section III.D, we continue to believe that confirmation procedures would generally provide more persuasive audit evidence than other procedures (without confirmation) for cash and accounts receivable. Accordingly, the new proposed standard would provide that the auditor should perform confirmation procedures for these accounts. In addition, the new proposed standard would specify that for significant risks of material misstatement associated with either a complex transaction or significant unusual transaction, the auditor should consider confirming terms of the transaction with the counterparty to the transaction.

Questions:

5. Does the new proposed standard provide for an appropriate amount of auditor judgment in determining whether to perform confirmation procedures in situations other than those specifically addressed in the new proposed standard?
6. Are there accounts other than those addressed in the new proposed standard or financial statement assertions for which the auditor should be required to perform confirmation procedures? Why or why not?
7. As discussed above, the new proposed standard would not include a requirement to send confirmation requests in response to significant risks related to assertions that could be adequately addressed through confirmation. Is the proposed approach appropriate? Why or why not?
8. Is the new proposed standard sufficiently flexible to accommodate situations where an auditor chooses to confirm information about newer types of assets (e.g., existence, and rights and obligations of digital assets based on blockchain or similar technologies)? If not, what changes or additions should we consider to address confirmation of newer types of assets?

9. Are there ways in which the new proposed standard should be changed to further align with the PCAOB's risk assessment standards? If so, how should the new proposed standard be changed?

D. Confirming Certain Accounts and Terms of Transactions

See paragraphs .09 - .15 of the new proposed standard in Appendix 1

1. Cash Held by Third Parties

i. Confirming Cash

Under the new proposed standard, when auditing cash and cash equivalents held by a third party ("cash"), the auditor should perform confirmation procedures. Existing AS 2310 does not separately address auditor responsibilities for confirming cash. The 2010 Proposal would have provided that the auditor should perform confirmation procedures for cash with financial institutions.

Several commenters on the 2010 Proposal asked the Board to clarify whether the auditor would be required to confirm all cash accounts. In the view of some commenters, the auditor should be allowed to select cash items and other financial relationships to confirm based on the assessed risk of material misstatement associated with cash. In the view of one commenter, requiring the auditor to send confirmation requests in all instances might shift the auditor's focus away from areas of higher risk. Another commenter suggested that addressing the risk could also involve performing audit procedures other than confirmation.

Having considered the comments, we note that an auditor need not necessarily confirm all cash accounts in all cases. Under PCAOB standards, the alternative means of selecting items for testing are selecting all items, selecting specific items and audit sampling.³² As with other confirmation procedures under the new proposed standard, an auditor would select individual cash items to confirm following the relevant direction in PCAOB standards, including identifying and assessing the risk of misstatement and developing an audit response.³³ The particular means or combination of means of selecting cash items to confirm would depend on, for example, the characteristics of the cash items and the evidence necessary to address the assessed risk of material misstatement.³⁴

The new proposed standard would emphasize that, in selecting the individual items of cash to confirm, the auditor should take into account the auditor's understanding of the company's cash management and treasury function, and the substance of the company's

³² See AS 1105.22.

³³ See, e.g., AS 2110 and AS 2301.

³⁴ See AS 1105.23 and AS 2301.03.

arrangements and transactions with third parties. For example, an auditor might select bank accounts with balances over a certain amount, accounts with a high volume of transactions, accounts opened or closed during the period under audit, or accounts the auditor identifies as particularly risk-prone. Alternatively, the auditor might determine it is appropriate to confirm all cash accounts. The auditor would also follow the direction in PCAOB standards when determining whether performing procedures in addition to confirmation is necessary to address the assessed risk of material misstatement relating to cash.

Unlike with the requirement to confirm accounts receivable, which is discussed below, the new proposed standard would not address overcoming the presumption to confirm cash. In general, the Board is not aware of other types of substantive procedures that would provide audit evidence that is as persuasive as audit evidence obtained through confirmation of cash.

ii. The Term “Cash and Cash Equivalents Held by Third Parties”

Under the new proposed standard, the term “cash” would comprise cash and cash equivalents. The 2010 Proposal used the term “cash” without specifying the types of assets to which it refers. Some commenters on the 2010 Proposal recommended expressly extending the applicability of the proposed requirements to confirm cash with financial institutions to cash equivalents. Cash equivalents generally refer to short-term, highly liquid investments that are readily convertible to known amounts of cash and are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.³⁵ Such assets are commonly used by companies to manage their cash holdings. Having considered the comments on the 2010 Proposal, we are proposing that the term “cash” in the new proposed standard refers to both cash and cash equivalents.

In the new proposed standard, the requirements for confirming cash would apply to cash held by third parties. The analogous requirements in the 2010 Proposal would have applied more narrowly to cash held by financial institutions. We believe that this expansion of confirmation requirements in the new proposed standard is appropriate, as company funds can be held by third parties other than financial institutions, such as money transfer providers.

iii. Confirming Other Financial Relationships

Under the new proposed standard, the auditor should consider confirming other financial relationships with the third parties with which the auditor determines to confirm cash. Such relationships can include lines of credit, other indebtedness, compensating balance arrangements, or contingent liabilities, including guarantees. Under PCAOB standards, the auditor would be required to document the consideration given to the confirmation of other

³⁵ See, e.g., definition of “cash equivalents” in the Master Glossary of the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification and of “cash equivalents” in the International Financial Reporting Standard (“IFRS”) Glossary.

financial relationships and the conclusions reached.³⁶ Existing AS 2310 does not have an analogous requirement. The 2010 Proposal would have provided that the auditor should confirm financial relationships like those mentioned above and, in addition, confirm whether certain other information came to the attention of the confirming party.

As discussed above, commenters on the 2010 Proposal recommended establishing more risk-based requirements for confirming cash and other financial relationships. Having considered the comments, we believe that information about financial relationships, including off-balance sheet relationships, could be important for the audit, as it could be part of significant disclosures in a company's financial statements. We also believe that an auditor should be able to take into account the facts and circumstances of the company in determining whether to inquire of a particular confirming party about financial relationships other than the company's cash holdings.

Accordingly, the requirement in the new proposed standard to consider confirming other financial relationships is designed to allow the auditor to tailor the confirmation procedures based on the auditor's understanding of the company. For example, a third party – which under the new proposed standard could be an entity other than a traditional financial institution – may simply not offer services that would give rise to the financial relationships discussed in the standard, or the nature of a company's business with a third party may indicate that no such financial relationships exist. In other situations, however, based on the auditor's understanding of the company's arrangements and transactions with third parties, the auditor could identify a risk of potential undisclosed relationships. Addressing this risk could necessitate the auditor sending confirmation requests to one or more of the parties involved.

Questions:

10. Are the requirements in the new proposed standard regarding confirming cash held by third parties, as well as other financial relationships, sufficiently clear and appropriate? If not, what changes should be considered?

³⁶ See Note to PCAOB Rule 3101(a)(3), which states that “(i)f a Board standard provides that the auditor “should consider” an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not,” and paragraphs .05-.06 of AS 1215, *Audit Documentation* (audit documentation should “[d]emonstrate that the engagement complied with the standards of the PCAOB” and must “document the procedures performed ... with respect to relevant financial statement assertions”). See also *Audit Documentation and Amendment to Interim Auditing Standards*, PCAOB Rel. No. 2004-006 (June 9, 2004), at 3 (“the auditor documents not only the nature, timing, and extent of the work performed, but also the professional judgments made by members of the engagement team and others”).

11. Are there substantive audit procedures other than confirmation that would provide audit evidence that is at least as persuasive as evidence the auditor might expect to obtain through confirming cash? If so, please describe these procedures.
12. For other financial relationships with the confirming party, is the requirement in the new proposed standard that the auditor should consider confirmation sufficiently clear and appropriate?
13. Are the requirements in the new proposed standard sufficiently risk-based to enable the auditor to use professional judgment in selecting which cash accounts and other relationships would be subject to confirmation?

2. Accounts Receivable

i. Confirming Accounts Receivable

The new proposed standard would carry forward the requirement to confirm accounts receivable. This approach to confirming accounts receivable is similar to the approach in existing AS 2310, except for certain differences in describing the circumstances under which the presumption could be overcome.

The 2010 Proposal also included a presumptively mandatory requirement for confirming accounts receivable but, unlike existing AS 2310 and the new proposed standard, did not specify circumstances in which the presumption could be overcome. One commenter on the 2010 Proposal supported excluding the auditor's ability to overcome the presumption by expressing the view that confirmation provides better audit evidence for the existence assertion than other audit procedures, even if the auditor expects a low response rate. A number of other commenters were critical about not specifying circumstances in which the presumption to confirm accounts receivable could be overcome. In the view of such commenters, sending confirmation requests could be ineffective, for example, where response rates are low, for certain industries (e.g., healthcare, utilities), or for companies that have a stated policy of not replying to auditor confirmation requests. Some commenters expressed concern about the auditor's potential inability under the 2010 Proposal to apply auditor judgment in selecting accounts receivable to confirm. Having considered the comments, we believe that it would be beneficial to clarify in the new proposed standard how the presumption to confirm accounts receivable may be overcome.

Under the new proposed standard, the auditor could overcome the presumption to confirm accounts receivable (including in situations described by commenters) when the auditor determines that an audit response that only includes substantive audit procedures other than confirmation would provide audit evidence that is at least as persuasive as evidence the auditor might expect to obtain through performing confirmation procedures. An auditor's determination would necessarily involve careful judgment when considering the assessed risk of material misstatement (including the consideration of potential fraud risk and management

bias) and the relative amount and quality of audit evidence that could be obtained from effective confirmation procedures in comparison with audit evidence that could be obtained from audit procedures that do not include confirmation.

For example, an auditor may have determined from firsthand experience that sending positive confirmation requests to a company's customers has not resulted in obtaining relevant and reliable audit evidence, because of poor rates of response, as well as unreliable responses, from the customers contacted by the auditor. Accordingly, for the upcoming audit, the auditor may design and implement an audit approach that does not involve the use of confirmation. Instead, the new audit approach may involve inspecting the details of transactions posted to accounts receivable, cash, and revenue, analyzing their correlation, examining third-party evidence (such as purchase orders submitted by the customers and customer payments reported by the bank), and testing the relevant controls.

Obtaining and examining appropriate third-party evidence increases the quality of the audit evidence obtained. In the example above, the auditor's approach includes examining third-party evidence, which could result in obtaining audit evidence of higher quality than an audit approach that does not include third-party evidence. At the same time, paragraph .19 of the new proposed standard would make clear that the auditor should consider information that may indicate a potential confirming party has incentives or pressures to provide responses that are inaccurate or otherwise misleading.

As noted, the necessary nature, timing, and extent of audit procedures performed in lieu of confirmation would depend on the facts and circumstances of the company and the audit. Under PCAOB standards, as the risk of material misstatement increases, the amount of evidence that the auditor should obtain also increases.³⁷ In the above example, as the risk increases, the auditor could increase the number of individual transactions for which the auditor examines third-party evidence. Further, the auditor may determine that to obtain audit evidence that is at least as persuasive as evidence from confirmation, the auditor may need to apply the other procedures to a greater number of items than the auditor would otherwise address through confirmation. The auditor's determinations (including the basis for the determinations) would be required to be documented in the working papers and a failure to do so would violate PCAOB standards.³⁸

The new proposed standard would include a requirement for the auditor to communicate to the audit committee³⁹ instances where the auditor has determined that the presumption to confirm accounts receivable has been overcome. Considering the long-standing

³⁷ See AS 1105.05.

³⁸ See AS 1215.06.

³⁹ The term "audit committee," as used in the new proposed standard, has the same meaning as defined in Appendix A of AS 1301, *Communications with Audit Committees*.

practice by auditors in the United States to confirm accounts receivable, there may be some expectation by audit committees that the auditor would use confirmation as part of a planned audit response. We believe that a new communication requirement when the presumption to confirm is overcome would enhance the audit committee's understanding of the auditor's strategy. Effective two-way communications between the auditor and the audit committee throughout the audit assist both the auditor and the audit committee in understanding matters relevant to the audit. The proposed communication requirement would complement the auditor's existing obligations to communicate to the audit committee about the auditor's overall audit strategy, significant changes to the planned audit strategy, and significant difficulties encountered during the audit.⁴⁰ In addition, the proposed communication requirement may reinforce the auditor's obligation to exercise due professional care before determining that the presumption to confirm accounts receivable has been overcome. As with other matters arising from the audit of financial statements and communicated or required to be communicated to the audit committee, the auditor would determine whether these matters are critical audit matters in accordance with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.⁴¹

It is possible that an auditor would not be able to design and implement other procedures that provide audit evidence that is at least as persuasive as the auditor might expect to obtain through performing confirmation procedures. This may occur, for example, if an auditor identifies indicators of fraudulent financial reporting or instances of management's override of internal controls around the relevant assertions. If the auditor is unable to obtain sufficient appropriate audit evidence for a relevant assertion through performing confirmation procedures or other substantive procedures, the auditor would need to determine whether a limitation on the scope of the audit exists and evaluate the implications for the auditor's report.⁴²

The new proposed standard would not carry forward the provisions addressing materiality or a combination of risk assessments that are currently available to overcome the presumption to confirm accounts receivable,⁴³ as these matters would be considered by the auditor as part of identifying and assessing the risks of material misstatement and designing and implementing an audit response under PCAOB risk assessment standards. Further, instead of providing examples of situations in which the use of confirmation for accounts receivable would be ineffective, the new proposed standard would establish a principle that would be applicable in any situation involving accounts receivable – i.e., the auditor obtains audit

⁴⁰ See AS 1301.23.

⁴¹ See AS 3101.11-.12.

⁴² See paragraphs .05 through .09 of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

⁴³ See AS 2310.34.

evidence that is at least as persuasive as the auditor might expect to obtain through performing confirmation procedures and reduces audit risk to an appropriately low level.⁴⁴

Similar to existing AS 2310 and the 2010 Proposal, the new proposed standard would not specify the extent of confirmation procedures for accounts receivable. As noted above in Section III.B, the timing and extent of confirmation procedures are part of the auditor's response to the risks of material misstatement under PCAOB risk assessment standards. The new proposed standard would require the auditor to take into account the auditor's understanding of the substance of the company's arrangements and transactions with third parties and the nature of the items that make up the company's account balances in selecting the individual accounts receivable to confirm. For example, an auditor might assess the risk of material misstatement relating to accounts receivable higher for a company that is being audited for the first time by the auditor, or for accounts receivable from a newly acquired operation in a foreign location.

ii. The Term "Accounts Receivable"

Under the new proposed standard, accounts receivable would comprise receivables arising from the transfer of goods or services to a customer or from a financial institution's loans. The new proposed standard is designed to apply to the same types of items as existing AS 2310, which describes accounts receivable as the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business, and a financial institution's loans. The new proposed standard would update the existing description to align more closely with the terminology of current accounting requirements, which have been updated since existing AS 2310 was written.⁴⁵

Accordingly, the new proposed standard would apply to receivables that arise from a company contracting with a customer to provide goods or services that are an output of the company's ordinary revenue-generating activities. Such receivables would include, for example, items for which revenue has been or will be recognized by a company, such as receivables from selling manufactured products, or from providing a service to customers. They would also include a financial institution's loans to customers that the institution has originated or purchased from another institution. Examples of financial institutions are banks, non-bank lenders, and mortgage companies that provide financing to customers.

The 2010 Proposal would have modified the approach in AS 2310 by establishing confirmation procedures for "receivables that arise from credit sales, loans or other transactions." That change was proposed "because confirmation of receivables can provide audit evidence regarding the occurrence assertion for revenue and can potentially address the

⁴⁴ See, e.g., paragraph .03 of AS 1101, *Audit Risk*.

⁴⁵ See, e.g., FASB Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers*, and IFRS 15, *Revenue from Contracts with Customers*.

risk of material misstatement due to fraud relating to revenue recognition.”⁴⁶ Some commenters on the 2010 Proposal indicated that the expanded requirement was not sufficiently clear with respect to “other transactions.” Other commenters expressed concern about expanding the scope of the confirmation procedures from accounts receivable as described in existing AS 2310 to all types of receivables and questioned the effectiveness of that change. In contrast, two commenters supported expanding the scope on the grounds that external evidence from confirmation procedures would be more relevant and reliable than evidence from other procedures. Having considered the comments, we have determined to focus the requirements in the new proposed standard on accounts receivable arising from revenue-generating transactions, as discussed above.

Questions:

14. Is the continued requirement to confirm accounts receivable sufficiently clear and appropriate? Are there other approaches that we should consider instead?
15. Are the provisions of the new proposed standard sufficiently principles-based to allow auditors to use professional judgment to determine the extent of confirmation of accounts receivable?
16. Is the description of accounts receivable sufficiently clear? Is there any reason to broaden the description to include other types of receivables, and if so, which ones?
17. Is the ability to overcome the presumption to confirm accounts receivable when another substantive audit procedure would provide evidence that is at least as persuasive as performing confirmation procedures sufficiently clear and appropriate?
18. Are there certain factors that should be present when determining that other substantive audit procedures would provide audit evidence that is at least as persuasive as the evidence that the auditor might expect to obtain through performing confirmation procedures for accounts receivable? If so, what are those factors?
19. Is the requirement for the auditor to communicate to the audit committee instances in which the auditor has determined that the presumption to confirm accounts receivable has been overcome and the basis for the auditor’s determination sufficiently clear and appropriate? Why or why not?

⁴⁶

PCAOB Rel. No. 2010-003, at 12.

3. Confirming Terms of Certain Transactions

The new proposed standard would update a provision in existing AS 2310.08 that the auditor should consider confirming the terms of certain transactions that are associated with high levels of risk. The new proposed standard would use the terminology “significant risk” and “significant unusual transactions,” but the new proposed provision is intended to be similar to that in existing AS 2310.

As discussed in Section III.C above, the 2010 Proposal would have required the auditor to send confirmation requests in response to significant risks that related to assertions that could be adequately addressed through confirmation. To be consistent with PCAOB risk assessment standards and allow for the exercise of professional judgment by the auditor, the new proposed standard does not include this provision from the 2010 Proposal.

Questions:

20. Are the provisions of the new proposed standard related to confirming the terms of certain transactions that have a significant risk of material misstatement sufficiently clear and appropriate?
21. Is the new proposed standard sufficiently clear that an auditor’s use of confirmation is not limited to the circumstances discussed in paragraphs .09 through .15 of the new proposed standard? If not, how should it be clarified?

E. Designing Confirmation Requests

See paragraphs .16 - .21 and .B1 of the new proposed standard in Appendix 1

As noted above, a properly designed and executed confirmation process may provide relevant and reliable audit evidence. Auditor responsibilities regarding designing a confirmation request are described in paragraphs .16 - .21 and .B1, as follows:

- Paragraphs .16 and .17 discuss identifying information to confirm;
- Paragraphs .18 through .20 discuss identifying the confirming parties for confirmation requests; and
- Paragraphs .21 and .B1 discuss using negative confirmation requests.

The new proposed standard would not prescribe a particular format for a confirmation request. For example, requests could be paper-based or electronic, specifying the information to be confirmed or providing a blank response form, or sent with or without the help of an intermediary that facilitates electronic transmission. As a practical matter, the auditor would determine the format of a confirmation request, taking into consideration, among other things,

the facts and circumstances of the company and the confirming party, to increase the likelihood that the request is received and clearly understood by the confirming party.

1. Identifying Information to Confirm

Under the new proposed standard, the auditor should, as part of designing confirmation requests, identify information related to the relevant assertions that the auditor plans to verify with confirming parties or (when using a blank form) obtain from confirming parties. Such information could include transaction amounts, transaction dates, significant terms of transactions, and balances due from the confirming party or due to the confirming party as of a specific date. The 2010 Proposal would have included a similar requirement in addition to a requirement for the auditor to determine the timing of confirmation procedures.

To improve the reliability of audit evidence obtained through the confirmation process, the new proposed standard would include a reminder of an existing requirement in AS 1105.10, pursuant to which the auditor should test the accuracy and completeness of information produced by the company that the auditor uses as audit evidence. The new proposed standard would emphasize that, in the confirmation process, the requirement in AS 1105.10 applies to the information produced by the company (e.g., populations from which items are selected for confirmation, such as detailed account listings, vendor listings, and contractual agreements) that the auditor uses in selecting the items to confirm. Additionally, the new proposed standard does not include a specific requirement for the auditor to determine the timing of confirmation procedures as timing of substantive procedures is addressed by AS 2301.⁴⁷

Existing AS 2310 includes details regarding the form of confirmation requests, which includes general information on blank-form positive confirmation requests.⁴⁸ This information has been substantially retained in the new proposed standard in a note to paragraph .16. Using a blank confirmation request generally provides more reliable audit evidence than using a confirmation request that includes information the auditor is seeking to confirm (e.g., customer account balance). In the latter scenario, it is possible that a confirming party could agree to the information without verifying it against the confirming party's records.

Question:

22. Are the provisions of the new proposed standard related to identifying information to confirm sufficiently clear and appropriate?

⁴⁷ See AS 2301.43-.46.

⁴⁸ See AS 2310.17-.22.

2. Identifying Confirming Parties for Confirmation Requests

Under the new proposed standard, identifying the confirming party is part of the auditor's responsibilities when designing a confirmation request. To obtain reliable audit evidence from the confirmation process, the auditor should direct the confirmation requests to third parties who are knowledgeable about the information to be confirmed. A confirmation request can be addressed to an individual or an organization. This approach is similar to the approach in existing AS 2310.⁴⁹ In contrast, the 2010 Proposal stated that even if the company provides the auditor with the name of an appropriate confirming party, the auditor should select the confirming party. Additionally, the 2010 Proposal included an example in which the auditor should direct the confirmation to an individual as opposed to an organization.

Some commenters on the 2010 Proposal stated that, because auditors often have no or limited interaction with the personnel of confirming organizations, auditors may not be able to select an appropriate addressee for the confirmation request. Having considered the comments, we have made revisions to clearly indicate that the confirming party can be either an individual or an organization.

We note, however, that under the Board's risk assessment standards, which were adopted after the 2010 Proposal, it is the auditor's responsibility to obtain more persuasive audit evidence the higher the auditor's assessment of risk.⁵⁰ For example, identifying a knowledgeable individual within a confirming party's organization and sending the confirmation request directly to that individual could increase the reliability of audit evidence obtained through the confirmation process. To emphasize this point, the new proposed standard includes a note reminding auditors that, under existing PCAOB standards, sending confirmation requests to a specific party within an organization is an example of an audit response to the risk of fraud.

The auditor is responsible for maintaining control over the confirmation process, as discussed below. When designing confirmation requests, an auditor may become aware of information about a potential confirming party's motivation, ability, or willingness to respond, or about the potential confirming party's objectivity and freedom from bias with respect to the audited entity. Similar to the requirements in existing AS 2310,⁵¹ because this type of information can affect the reliability of audit evidence provided by the confirming party to the auditor, under the new proposed standard the auditor should consider any such information that comes to the auditor's attention when selecting the confirming parties. The auditor should also consider the source of any such information. For example, if management indicates to the auditor that a potential confirming party is unlikely to respond to a confirmation request,

⁴⁹ See AS 2310.26.

⁵⁰ See AS 2301.09.

⁵¹ See AS 2310.27.

management may have other reasons to avoid a confirmation request being sent (e.g., concealing management's fraudulent understatement of the amount the company owes to that party).

In addition, the new proposed standard would provide more specific direction than existing AS 2310 for situations in which the auditor is unable to identify a confirming party who, in response to a confirmation request, would provide relevant and reliable audit evidence about a selected item. As noted above, the auditor's objective under the new proposed standard is to obtain relevant and reliable audit evidence from confirming parties. An auditor who is unable to select a confirming party that is likely to provide such evidence should perform alternative procedures.

The 2010 Proposal would have provided that the auditor should perform procedures to determine the validity of addresses of the potential confirming parties, including substantive procedures or test of controls. Several commenters on the 2010 Proposal stated that the characterization of procedures as "substantive procedures" or "test of controls" was not clear in the context of validating addresses. In addition, some commenters noted that the requirements did not appropriately consider the use of electronic confirmation.

Having considered the comments, we have retained a requirement regarding determining that confirmation requests are properly addressed (thus increasing the likelihood that they are received by the confirming party). However, the new proposed standard would not prescribe the nature or extent of procedures to be performed by the auditor when making the determination, thereby allowing the auditor to tailor the procedures to the facts and circumstances of the audit. For example, in practice, some auditors compare some or all confirming party addresses, which are typically provided by the company, to physical addresses or e-mail domains included on the confirming party's website.

Alternatively, when using an intermediary to facilitate direct electronic transmission of confirmation requests and responses (as discussed in Section III.F), Appendix B of the new proposed standard would require the auditor to obtain an understanding of the intermediary's controls that address the risk of interception and alteration of the confirmation requests and responses and determine that the relevant controls used by the intermediary are designed and operating effectively. Where an auditor determines that controls that address the risk of interception and alteration also include controls related to validating the addresses of confirming parties, the auditor may be able to determine that audit procedures performed in accordance with proposed Appendix B are sufficient to determine that confirmation requests are properly addressed. In situations where the auditor determines that the intermediary's controls that address the risk of interception and alteration do not also include controls related

to validating the addresses of confirming parties, the auditor would need to perform other procedures to comply with the requirements in paragraph .18 of the new proposed standard.

Questions:

23. Are the provisions of the new proposed standard related to identifying confirming parties sufficiently clear and appropriate?
24. Is the requirement in the new proposed standard to send a confirmation request directly to the confirming party, and determine that the request is properly addressed, sufficiently clear and appropriate? Should the new proposed standard contain specific procedures for the auditor to test information about the confirming party such as the address?

3. Using Negative Confirmation Requests

When designing a confirmation, the auditor may send a “positive” or a “negative” confirmation request (or both). A positive confirmation request is a confirmation request in which the auditor requests a confirmation response. With a negative confirmation request, the auditor requests a confirmation response only if the confirming party disagrees with the information provided in the request. The auditor generally obtains significantly less audit evidence when using negative confirmation requests than when using positive confirmation requests. A confirming party might not respond to a negative confirmation request because it did not receive or open the request, or alternatively the confirming party might have read the request and agreed with the information included therein.

Because of the limited evidence provided when using negative confirmation requests, the new proposed standard would not allow the auditor to use negative confirmation requests as the sole substantive procedure for addressing the risk of material misstatement to a financial statement assertion. Under the new proposed standard, the auditor may use negative confirmation requests only to supplement audit evidence provided by other substantive procedures (e.g., examining subsequent cash receipts, including comparing the receipts with the amounts of respective invoices being paid, examining shipping documents, examining subsequent cash disbursements, or sending positive confirmation requests). In contrast, under existing AS 2310, the auditor may use negative confirmation requests where certain criteria are present and should consider performing other substantive procedures to supplement their use. Similar to the new proposed standard, the 2010 Proposal would have disallowed using negative confirmation requests as the sole substantive procedure and would have allowed for the use of negative confirmation requests as the only form of confirmation request only if certain factors were present and the auditor also performed other substantive procedures.

Several commenters on the 2010 Proposal expressed concern with the requirement to supplement the use of negative confirmation requests with other substantive audit procedures in all circumstances and instead suggested a risk-based approach to determining whether the

auditor should perform supplementary substantive procedures. In developing the new proposed standard, we have considered both the comments received and the developments in practice that have occurred since the issuance of the 2010 Proposal. The new proposed standard carries forward the approach in the 2010 Proposal with some modifications, including the removal of the requirement for certain factors to be present in order to use negative confirmation requests as the only form of confirmation request in conjunction with other substantive procedures.

As noted above, since the auditing standard on confirmation was promulgated by the AICPA in 1992, the amount of correspondence, especially electronic correspondence, has increased dramatically. This trend has continued since the 2010 Proposal was issued. Accordingly, the likelihood that a negative confirmation request would not be considered by the recipient, either because the recipient would treat the request with suspicion (e.g., as a phishing attempt) or not receive it at all (e.g., if an e-mailed request were caught in a spam filter) has continued to increase. We therefore believe that negative confirmation requests should not be used as the sole substantive procedure for addressing the risk of material misstatement to a financial statement assertion.

The 2010 Proposal described certain factors, all of which would have needed to have been present, to allow the use of negative confirmation requests, without positive confirmation requests but in combination with other substantive procedures, to address the assessed risk to a relevant assertion. Except for one factor, the new proposed standard would reframe these factors as examples of situations in which the auditor may use negative confirmation requests in combination with other substantive procedures. We believe that reframing the factors as examples would allow for a more flexible audit approach (e.g., by allowing for the use of negative confirmation requests, provided that the auditor performs other substantive procedures), reflecting the variety of situations that may exist in practice.

The factor that the new proposed standard does not carry forward from the 2010 Proposal would have limited the use of negative confirmation requests to situations where the auditor “reasonably believes that recipients of negative confirmation requests will give such requests consideration.” Several commenters expressed concern with this factor and stated that it was not an appropriate condition in all circumstances, given that the auditor may not have an existing relationship with the confirming party. Having considered the comments, we have determined not to include this factor as an example in the new proposed standard. As discussed above, however, under the new proposed standard any negative confirmation request should be directed by the auditor to confirming parties who the auditor believes are knowledgeable about the information to be confirmed in accordance with paragraph .18 of the new proposed standard.

Question:

25. Are the provisions of the new proposed standard related to the auditor's use of negative confirmation requests sufficiently clear and appropriate?

F. Maintaining Control over the Confirmation Process

See paragraphs .22 - .24 and .B2 - .B3 of the new proposed standard in Appendix 1

1. The Requirement for the Auditor to Maintain Control over the Confirmation Process

The reliability of audit evidence provided by confirmation depends in large part on the auditor's ability to control the integrity of confirmation requests and responses. The new proposed standard would carry forward the provision in existing AS 2310 that the auditor should maintain control over the confirmation process to minimize the likelihood that information exchanged between the auditor and the confirming party is intercepted and altered. Under the new proposed standard, as part of maintaining control, the auditor should send confirmation requests directly to the confirming party and receive confirmation responses directly from the confirming party. It would not be appropriate for company personnel, including internal auditors, to be involved in either sending confirmation requests or receiving confirmation responses.

The 2010 Proposal would have included an analogous requirement regarding maintaining control over the confirmation process. In addition, in the 2010 Proposal, the section on maintaining control would have addressed the auditor's responsibilities for selecting the items to confirm, the confirming party, and the type of confirmation request. Although no comments were received on the location of those requirements in the 2010 Proposal,⁵² we determined, upon further consideration, that they would be more appropriately placed in the section on designing the confirmation request in the new proposed standard.

2. Using an Intermediary to Facilitate Direct Electronic Transmission of Confirmation Requests and Responses

i. Background and Proposed Requirements

Certain financial institutions and other companies have adopted the policy of responding to electronic confirmation requests from auditors only through another party that they, or the auditor, engage as an intermediary to facilitate the direct transmission of information between the auditor and the confirming party. We understand that such policies

⁵² Comments on the specific requirements are discussed in the relevant sections of this release.

are aimed at managing the timeliness and quality of confirmation responses provided by the confirming party to the auditor.

The involvement of intermediaries is not discussed in existing AS 2310. The 2010 Proposal referred to intermediaries as recipients of confirmation requests and senders of confirmation responses. Upon further consideration of intermediaries' role in the confirmation process, we determined that it would be more appropriate to refer to intermediaries in the new proposed standard as facilitators of the electronic transmission of confirmation requests and responses between the confirming party and the auditor.

The use of an intermediary does not relieve the auditor of the responsibility under PCAOB standards to maintain control over confirmation requests and responses. Because an intermediary's involvement may affect the integrity of information transmitted between the confirming party and the auditor, the new proposed standard would provide that the auditor should evaluate the implications of such involvement for the reliability of confirmation requests and responses.

Under the new proposed standard, the auditor's evaluation should address certain aspects of the intermediary's controls that address the risk of interception and alteration of communications between the auditor and the confirming party. In addition, the auditor's evaluation should assess whether circumstances exist that give the company the ability to override the intermediary's controls (e.g., through financial or other relationships). An intermediary that, based on the auditor's evaluation, does not meet the criteria established by the new proposed standard should not be used in the confirmation process.

The new proposed standard does not specify how the particular procedures should be performed by the auditor, thus allowing auditors to customize their approach based on facts and circumstances of the audit firm as well as of the audit engagement. For example, in obtaining an understanding of the intermediary's controls that address the risk of interception and alteration of confirmation requests and responses and determining whether they are designed and operate effectively, the auditor could (i) use, where available, an independent service auditor's report on service organization controls that evaluates the design and operating effectiveness of the relevant controls at the intermediary; or (ii) test the intermediary's controls that address the risk of interception and alteration directly.⁵³

⁵³ See *Spotlight: Observations and Reminders on the Use of a Service Provider in the Confirmation Process* (Mar. 2022), available at <https://pcaobus.org/resources/staff-publications>.

ii. Interaction of the New Proposed Standard with Proposed QC 1000

In November 2022 the Board issued for public comment a new quality control standard, referred to as proposed QC 1000, *A Firm's System of Quality Control*.⁵⁴ Proposed QC 1000 addresses resources used by a registered public accounting firm that are sourced from third-party providers. An intermediary that facilitates direct electronic transmission of confirmation requests and responses is one example of a "third-party provider" under proposed QC 1000.

Under proposed QC 1000, the firm would consider the nature and extent of resources or services obtained from third-party providers in its risk assessment process and whether the use of third-party providers poses any quality risks to the firm in achieving its quality objectives. One of the required quality objectives relates to obtaining an understanding of how such resources or services are developed and maintained and whether they need to be supplemented and adapted as necessary, such that their use enables the performance of the firm's engagements.⁵⁵

As noted above, the new proposed standard on the auditor's use of confirmation would require specific procedures related to the use of an intermediary, which includes obtaining an understanding of the intermediary's controls that address the risk of interception and alteration of a confirmation request or response and determining whether they are designed and operate effectively. The auditor's evaluation of the intermediary's controls could be performed by an engagement team, an audit firm's national office, or a combination of both. Therefore, a firm would be able to perform some of these controls evaluations in conjunction with its QC activities under proposed QC 1000. Further, as part of its QC activities, a firm could determine it would be appropriate to include additional guidance as part of its methodology, for example, on how to use the services of the intermediary or to specify circumstances in which an engagement team should or should not use the service.

Questions:

26. Are the requirements in the new proposed standard to evaluate the implications of using an intermediary to facilitate direct electronic transmission of confirmation requests and responses (including as set forth in paragraph .B2 of the new proposed standard) sufficiently clear and appropriate? Are there other requirements or considerations that the auditor should perform or take into account when using an intermediary in the confirmation process?

⁵⁴ See *A Firm's System of Quality Control and Other Proposed Amendments to PCAOB Standards, Rules, and Forms*, PCAOB Rel. No. 2022-006 (Nov. 18, 2022).

⁵⁵ See paragraph .44.j of proposed QC 1000.

27. Is the potential interaction between using an intermediary in the new proposed standard and the proposed requirements in QC 1000 related to third-party providers sufficiently clear?

G. Evaluating Confirmation Responses and Confirmation Exceptions, and Addressing Nonresponses and Incomplete Responses

See paragraphs .25 - .30 of the new proposed standard in Appendix 1

1. Overall Approach

Under the new proposed standard, the auditor's responsibilities related to the confirmation process include evaluating the information received in confirmation responses and addressing nonresponses and incomplete responses. If the auditor is unable to determine whether the confirmation response is reliable, or in the case of a nonresponse or an incomplete response (i.e., a confirmation response that does not provide the auditor with all of the audit evidence the auditor seeks to obtain), the auditor should perform other audit procedures as an alternative to confirmation.⁵⁶ The new proposed standard would build on and improve the requirements in existing AS 2310 that discuss addressing information obtained from the performance of confirmation procedures.

The new proposed standard would not carry forward a requirement, included in both existing AS 2310 and the 2010 Proposal, for the auditor to evaluate in the aggregate audit evidence obtained from performing confirmation procedures and any alternative procedures. Excluding this requirement from the new proposed standard would avoid the unnecessary duplication of certain requirements of AS 2810, *Evaluating Audit Results*, that discuss the auditor's responsibilities for evaluating audit results and determining whether the auditor has obtained sufficient appropriate audit evidence.

2. Evaluating the Reliability of Confirmation Responses

The new proposed standard would provide additional direction beyond what is currently set forth in AS 2310 to assist the auditor's evaluation of the reliability of confirmation responses. Specifically, the new proposed standard would (i) describe information that the auditor should take into account when performing the evaluation, and (ii) provide examples of indicators that a confirmation response may have been intercepted or altered. A similar approach was used in the 2010 Proposal, which included factors that the auditor should take into account in assessing the reliability of confirmation responses.

⁵⁶ Alternative procedures, including the relevant exception described in a note to paragraph .31 of the new proposed standard, are discussed in Section III.H of this release.

Certain commenters on the 2010 Proposal suggested that the auditor should be required to perform further audit procedures only when the auditor identifies concerns as to the reliability of a confirmation response. Other commenters indicated that the factors included in the 2010 proposal should be described as factors that the auditor may consider in assessing the reliability of a confirmation response.

Taking into consideration these comments, the new proposed standard specifies that the auditor should take into account any information about events, conditions, or other information the auditor becomes aware of in assessing the reliability of the confirmation response. The new proposed standard also includes examples of indicators that a confirmation response may have been intercepted or altered and thus not be reliable. Under existing PCAOB standards, the auditor is not expected to be an expert in document authentication, but, if conditions indicate that a confirmation response may not be authentic or may have been altered, the auditor should modify the planned audit procedures or perform additional audit procedures to respond to those conditions and should evaluate the effect, if any, on the other aspects of the audit.⁵⁷ The new proposed standard would not modify these requirements. It would specify that, if the auditor is unable to determine that the confirmation response is reliable, the auditor's response should include performing alternative procedures as discussed in paragraph .31.

The 2010 Proposal included additional procedures regarding the reliability of electronic confirmation responses. Several commenters indicated that the 2010 Proposal, in general, included adequate requirements regarding electronic confirmation procedures. However, one commenter stated that specific procedures related to electronic media should not be promulgated and that the standard should instead focus on the auditor's responsibility to obtain and evaluate evidence that meets both the sufficiency and appropriateness criteria. Considering that the use of electronic means of confirmation has become routine since the 2010 Proposal was issued, we have designed the new proposed standard so that its principles apply to all methods of confirmation, including electronic confirmation. The new proposed standard therefore would not provide a separate set of provisions specifically for electronic confirmation.

Considering that confirming parties may qualify their responses, we have included in the new proposed standard a reminder about the auditor's responsibilities under PCAOB standards to evaluate third-party evidence that is subject to restrictions, limitations, or disclaimers.⁵⁸

⁵⁷ See AS 1105.09.

⁵⁸ See footnote 8 of the new proposed standard, which references a note to AS 1105.08.

Question:

28. Are the provisions of the new proposed standard related to evaluating the reliability of confirmation responses sufficiently clear and appropriate?

3. Evaluating Confirmation Exceptions and Addressing Nonresponses

For various reasons, information in a confirmation response received by the auditor could differ from other information in the company's records obtained by the auditor. The new proposed standard would provide that the auditor should evaluate the confirmation exceptions and determine their implications for certain aspects of the audit, as discussed below. The direction in the new proposed standard is more detailed than in existing AS 2310.

The 2010 Proposal would have provided that the auditor should investigate all confirmation exceptions to determine why each confirmation exception occurred. Several commenters on the 2010 Proposal asked the Board to clarify whether the auditor would be required to investigate immaterial differences. Having considered the comments, we continue to believe that it is important to accumulate all potential misstatements from individual confirmation exceptions and evaluate whether the confirmation exceptions in combination represent a material misstatement, as discussed in AS 2810. Accordingly, the new proposed standard would provide that the auditor should evaluate whether the confirmation exceptions individually or in the aggregate indicate a misstatement that should be evaluated in accordance with AS 2810. The new proposed standard would not require, however, investigating all confirmation exceptions to determine why every confirmation exception occurred.

Further, several commenters on the 2010 Proposal suggested that evaluating confirmation exceptions should include considering potential deficiencies in the company's internal control over financial reporting ("ICFR"). In response to these comments, the new proposed standard includes a provision that the auditor should evaluate whether the confirmation exceptions individually or in the aggregate indicate a deficiency in the company's ICFR.

In the case of a nonresponse to a positive confirmation request, the 2010 Proposal would have provided that the auditor should send a second positive confirmation request. A number of commenters expressed concern with this requirement, indicating, for example, that in some instances the auditor may have no or a low expectation of receiving a response to a second or third confirmation request. Many of these commenters suggested a risk-based approach whereby the auditor would be allowed to exercise professional judgment when determining whether to send follow-up confirmation requests. Having considered these comments, we propose that the auditor send a second positive confirmation request to the confirming party (e.g., which, in the case of an electronic confirmation request, could be in the form of a reminder or automated reminder) unless the auditor has become aware of information that indicates that the confirming party would be unlikely to respond to the auditor.

Similar to the 2010 Proposal, the new proposed standard specifies that if a confirmation response is returned by the confirming party to anyone other than the auditor, the auditor should contact the confirming party and request that the response be re-sent directly to the auditor. The new proposed standard also specifies that if the auditor does not subsequently receive a confirmation response from the intended confirming party, the auditor should treat the situation as a nonresponse. One commenter on the 2010 Proposal indicated that an oral verification of the confirmation response by the confirming party should also be permitted as oral verification would reduce audit risk to an acceptable level; in another commenter's view an oral confirmation response is a form of audit evidence. Having considered these comments, we continue to believe that obtaining direct written communication (in paper or electronic form) from the confirming party is necessary for a confirmation response to provide reliable audit evidence.

As noted above, the new proposed standard would provide that the auditor should perform alternative procedures if a confirmation response is not received or is incomplete. Neither existing AS 2310 nor the 2010 Proposal specifies the auditor's responsibilities regarding incomplete responses. We believe that if the auditor did not obtain audit evidence that the auditor planned to obtain through confirmation (e.g., because information was not included in the confirmation response), it is necessary to obtain sufficient audit evidence through the performance of alternative procedures.

Questions:

29. Are the provisions of the new proposed standard related to confirmation exceptions and nonresponses sufficiently clear and appropriate?
30. Are the provisions about when the auditor should send a second positive confirmation request sufficiently clear and appropriate? Would this provision be a change from current practice?

H. Performing Alternative Procedures

See paragraph .31 of the new proposed standard in Appendix 1

Under the new proposed standard, the auditor should perform alternative procedures in certain scenarios involving identifying confirming parties or evaluating the reliability of confirmation responses, as well as in scenarios involving nonresponses and incomplete responses.⁵⁹ This range of scenarios would be broader than under existing AS 2310, which provides that, with certain exceptions, the auditor should apply alternative procedures where the auditor has not received replies to positive confirmation requests. The scenarios discussed

⁵⁹ See paragraphs .20 (inability to identify a confirming party), .26 (unreliable response), and .30 (nonresponse or incomplete response) of the new proposed standard.

in the new proposed standard are similar to those in the 2010 Proposal. In addition, existing AS 2310 requires, and the 2010 Proposal would have provided, that the auditor should evaluate the combined evidence provided by confirmation and any alternative procedures and send additional confirmation requests or perform other audit tests, as needed, to obtain sufficient appropriate audit evidence.

The new proposed standard provides examples of alternative procedures that may provide relevant and reliable audit evidence regarding accounts receivable, accounts payable, and the terms of a transaction or agreement. These provisions expand upon the examples of alternative procedures discussed in existing AS 2310 and the 2010 Proposal.

The new proposed standard does not specify whether performing alternative procedures for the items the auditor was unable to confirm, alone or in combination with other audit procedures, would be necessary to obtain sufficient appropriate audit evidence. The auditor would make that determination based on the facts and circumstances of the audit. Further, an auditor might determine that, without obtaining a reliable confirmation response, the auditor is unable to obtain sufficient appropriate audit evidence for a relevant assertion through performing alternative procedures for the items the auditor could not confirm, other audit procedures, or both (e.g., if the auditor observes conditions during the confirmation process that indicate a heightened fraud risk). In such scenarios, the auditor would consider the impact on the audit opinion in accordance with AS 3105.

A number of commenters on the 2010 Proposal suggested clarifying whether alternative procedures described in the 2010 Proposal were examples or required procedures, as the 2010 Proposal used the term “should include” when describing the procedures. Having considered the comments, we have removed this term to clarify that the procedures described in the new proposed standard are examples. Further, the new proposed standard uses the term “alternative procedures” consistently when discussing situations in which the auditor should perform other audit procedures as an alternative to confirmation.⁶⁰

Under the new proposed standard, performing alternative procedures may not be necessary where items selected for confirmation for which the auditor was not able to complete audit procedures would not – if misstated – change the outcome of the auditor’s evaluation of the effect of uncorrected misstatements performed in accordance with AS 2810.17.⁶¹ For example, following the direction in AS 2810.17, an auditor may determine that an item that the auditor was unable to confirm would not be material individually or in combination with other misstatements. In such situations, under the new proposed standard,

⁶⁰ Depending on the scenario, the 2010 Proposal referred to such procedures as “other audit procedures” or “alternative procedures.” See, e.g., paragraphs 20 and 28 of the 2010 Proposal.

⁶¹ The auditor’s evaluation of materiality under AS 2810.17 takes into account both relevant quantitative and qualitative factors.

the auditor would not be required to perform alternative procedures.⁶² Existing AS 2310 includes an analogous exception. The exception was not retained in the 2010 Proposal.

Some commenters on the 2010 Proposal suggested that alternative procedures should be required for nonresponses. Other commenters recommended retaining the exception discussed in existing AS 2310 and asserted that alternative procedures for nonresponses may not be necessary if, for example, an auditor chose a larger sample anticipating a certain rate of nonresponses. Having considered the comments, we believe that alternative procedures should generally be performed in the case of a nonresponse as a nonresponse could indicate, among other things, the existence of a previously unidentified risk of material misstatement that could be identified through the performance of alternative procedures. However, determining whether alternative procedures are necessary should also take into account the effect of any potential misstatements resulting from items selected for confirmation but not confirmed. The proposed exception, discussed above, reflects this approach.

Questions:

31. Are the proposed circumstances in the new proposed standard under which the auditor generally would be required to perform alternative procedures sufficiently clear and appropriate?
32. Are there any additional examples of alternative procedures that we should consider for inclusion as examples in the new proposed standard?

I. Using Internal Audit in the Confirmation Process

See paragraph .32 of the new proposed standard in Appendix 1

The new proposed standard identifies certain activities in the confirmation process where the auditor may not use the assistance of the company's internal audit function. Specifically, the auditor would not be permitted to use internal auditors for selecting items to be confirmed, sending confirmation requests, and receiving confirmation responses.

In contrast, existing AS 2310 does not address the use of internal audit in the confirmation process other than to provide in a footnote that the auditor's need to maintain control does not preclude the use of internal auditors and that AS 2605, *Consideration of the Internal Audit Function*, provides guidance on considering the work of internal auditors and on

⁶² In certain circumstances, auditors may have obligations independent of the Board's auditing standards to perform either confirmation procedures or other auditing procedures. *See, e.g.*, Section 30(g) of the Investment Company Act of 1940, 15 U.S.C. § 80a-29(g) (providing that the auditor's report on the financial statements of a registered investment company "shall state that such independent public accountants have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian, as the Commission may prescribe by rules and regulations").

using internal auditors to provide direct assistance to the auditor.⁶³ In comparison, the release accompanying the 2010 Proposal provided, in discussing a proposed requirement to maintain control over the confirmation process, that the auditor would not have been permitted to use internal auditors to send confirmation requests, receive confirmation responses, or evaluate audit evidence obtained from performing confirmation procedures.

Several commenters on the 2010 Proposal suggested moving the discussion of auditor responsibilities regarding the use of internal auditors from the release to the standard for clarity. In response to these comments, we have placed the relevant requirements in the text of the new proposed standard. Further, several commenters either expressly agreed with or did not object to the proposed approach regarding the use of internal audit. At the same time, other commenters expressed concern about the proposed approach. Some of these commenters, for example, suggested that the proposed approach would be inconsistent with the direction in AS 2605, which does not establish a similar restriction on the use of internal auditors. Some commenters stated that they did not understand the Board's rationale for restricting the use of internal auditors in the confirmation process.

Having considered the comments, we believe that using internal auditors for selecting items to be confirmed, or for sending or receiving responses, would not be consistent with the auditor's responsibility to maintain control over the confirmation process. Involving internal auditors or other company employees in these activities would create a risk that information exchanged between the auditor and the confirming party is intercepted and altered. Accordingly, under the new proposed standard, using direct assistance from internal auditors for these activities would not be allowed.⁶⁴

We are not carrying forward the 2010 Proposal's restriction on using internal auditors for evaluating the audit evidence obtained from performing confirmation procedures. We believe that is not necessary as the overall responsibility for determining whether sufficient appropriate audit evidence has been obtained is the auditor's obligation under AS 2810.33. The new proposed standard would allow using internal auditors to assist with administrative aspects of the confirmation process, such as preparing the confirmation request and researching differences in confirmation responses. When using internal auditors to provide direct assistance to the auditor, the auditor should comply with the relevant requirements of AS 2605.

⁶³ See footnote 3 of AS 2310.

⁶⁴ Consistent with the requirement in the new proposed standard for the auditor to confirm cash, we have proposed to amend AS 2605.22 to delete the reference to cash in the example of an assertion "that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence." See Appendix 2 – Proposed Amendments to Related PCAOB Auditing Standards.

Questions:

33. Are the requirements in the new proposed standard to exclude the internal auditor from selecting items to be confirmed, sending confirmation requests, and receiving confirmation responses sufficiently clear and appropriate? If not, what changes should be considered?
34. Based upon information available, we understand auditors' use of internal audit in a direct assistance capacity to send confirmation requests or receive confirmation responses to be infrequent. Are commenters aware of information to the contrary?

J. Other Matters

As noted above, certain matters that were discussed in the 2010 Proposal have not been retained in the new proposed standard. This section discusses additional matters that were included in the 2010 Proposal but not in the new proposed standard. In addition, this section covers definitions included in the new proposed standard and other proposed amendments to related PCAOB auditing standards as included in Appendix 2.

1. Management Requests Not to Confirm

Existing AS 2310 does not address situations in which management requests that the auditor not confirm one or more items. The 2010 Proposal would have provided that, in such situations, the auditor should perform certain audit procedures, including communicating the management request to the audit committee, obtaining additional audit evidence through the performance of alternative procedures if the auditor agreed to the management request, and evaluating the implications of the management request for the audit report.

Some commenters on the 2010 Proposal supported or did not object to the proposed approach. Other commenters, however, raised concerns about various aspects of the proposed requirements. For example, several commenters questioned the usefulness of communicating to the audit committee all management requests, even those without a significant impact on the audit. In addition, some commenters asked the Board to clarify the rationale for requiring the auditor to obtain more persuasive audit evidence when management requests that the auditor not confirm an item and inquired about the auditor's responsibilities if such evidence did not exist. Further, some commenters asked about applying the proposed requirements in the context of other PCAOB standards (e.g., standards addressing the consideration of fraud risks and scope limitations).

Having considered these comments, we have determined not to carry forward the proposed requirements related to management requests to avoid potential confusion with, or unnecessary duplication of, other requirements under PCAOB standards. For example, in 2012, after the issuance of the 2010 Proposal, the Board adopted AS 1301. Among other things, AS 1301 requires that the auditor communicate to the audit committee disagreements with

management⁶⁵ and difficulties encountered in performing the audit, including unreasonable management restrictions encountered by the auditor on the conduct of the audit.⁶⁶ In addition, AS 3105 sets forth requirements regarding limitations on the scope of an audit,⁶⁷ including scope limitations relating to confirmation.⁶⁸

We also considered that PCAOB standards, including AS 2110 and AS 2401, *Consideration of Fraud in a Financial Statement Audit*, describe auditor responsibilities regarding identifying, assessing, and responding to fraud risks. For example, AS 2401.09 states that fraud may be concealed by withholding evidence. A management request to limit audit testing by not obtaining external audit evidence could be relevant to the auditor's consideration of fraud risk factors, including the consideration of management incentives, opportunities, and rationalization for perpetrating fraud.

Questions:

35. In the event of a management request not to confirm a certain item, are there procedures that the auditor should perform which are not currently required by other PCAOB standards? If so, what other procedures should be required?
36. Based upon information available, we understand management requests not to confirm certain items or accounts to be infrequent. Are commenters aware of information to the contrary? If so, in what circumstances do management requests not to confirm commonly arise in practice?

2. Restrictions and Disclaimers

The 2010 Proposal acknowledged that a response to a confirmation request might contain restrictions or disclaimers. Under the 2010 Proposal, the auditor should evaluate the effect of such restrictions or disclaimers on the reliability of the confirmation response and perform appropriate alternative procedures to obtain relevant and reliable audit evidence.

Several commenters on the 2010 Proposal supported the proposed requirements while other commenters indicated that the Board should clarify the requirements by providing guidance and examples on how an auditor can assess the effect of disclaimers and restrictive language on the reliability of a confirmation response.

Having considered these comments, we have determined not to carry forward the proposed requirements related to restrictions and disclaimers as they may be viewed as

⁶⁵ AS 1301.22.

⁶⁶ AS 1301.23.

⁶⁷ AS 3105.05-.17.

⁶⁸ AS 3105.07.

duplicative of the requirement in AS 1105, with which auditors are already familiar, according to which the auditor should evaluate the effect of restrictions, limitations, or disclaimers on the reliability of audit evidence.⁶⁹ However, as discussed in Section III.G, we have included a reminder in the new proposed standard about the auditor’s responsibilities under AS 1105.

3. Direct Access

The 2010 Proposal addressed situations in which a third party grants an auditor access to information in the third party’s information system concerning the third party’s transactions or balances with the company under audit (e.g., the company’s balance at a bank). Under the 2010 Proposal, such direct access could be considered a confirmation procedure in certain circumstances. Some commenters on the 2010 Proposal expressed concerns regarding the practicability or clarity of the proposed provisions, including the definition “direct access.” Having considered the comments, we decided not to describe direct access as a confirmation procedure in the new proposed standard because it does not involve sending a confirmation request and receiving a confirmation response.

4. Definitions

To operationalize the requirements included in the new proposed standard, Appendix A of the new proposed standard includes definitions for “confirmation exception,” “confirmation process,” “confirmation request,” “confirmation response,” “confirming party,” “negative confirmation request,” “nonresponse,” and “positive confirmation request.” One commenter on the 2010 Proposal indicated that the definition of “nonresponse” should include situations where the auditor receives no response, not just an incomplete response, from the confirming party. Other commenters asked for clarification on what is meant by the term “other medium” as included in the definitions of “confirmation,” “confirmation request,” and “confirmation response.” Considering these comments, we have made modifications to definitions included in the new proposed standard.

Question:

37. Are the definitions included in the new proposed standard sufficiently clear and appropriate? If not, what changes should be made to the definitions?

5. Proposed Amendments to Related PCAOB Auditing Standards

We are proposing conforming amendments to AS 1105, AS 1301, AS 2401, AS 2510, *Auditing Inventories*, and AS 2605, as described in Appendix 2 to this release.

⁶⁹ See AS 1105.08.

Question:

38. Are there other amendments that should be made to the PCAOB's existing standards to conform them with the new proposed standard?

IV. ECONOMIC ANALYSIS

The Board is mindful of the economic impacts of its standard setting. This section describes the economic baseline, need, and expected economic impacts of the new proposed standard, as well as alternative approaches considered by the Board. Because there are limited data and research findings available to estimate quantitatively the economic impacts of the new proposed standard, the economic analysis is largely qualitative in nature.

A. Baseline

Section II describes important components of the baseline against which the economic impact of the new proposed standard can be considered, including the Board's existing standard governing the audit confirmation process, firms' current practices when performing confirmation procedures, and observations from the Board's inspections program and enforcement cases. We discuss below two additional components that inform our understanding of the economic baseline: (i) the staff's analysis of audit firm methodologies and the use of technology-based tools in the confirmation process, and (ii) a summary of academic and other literature on the confirmation process.

1. Auditing Practices Related to the Confirmation Process

Through its inspection and other oversight activities, the PCAOB has access to sources of information that help inform our understanding of how firms currently engage in the confirmation process. As part of this standard-setting project, the staff has reviewed a selection of firms' audit methodologies, as well as other information about firms' use of technology-based tools when performing confirmation procedures. While this information is not a random sample that can be extrapolated accurately across all registered public accounting firms, we are able to make some general inferences that help inform development of the economic baseline.

i. PCAOB Staff Analysis of Audit Methodologies

PCAOB staff has reviewed the methodologies of selected registered public accounting firms to determine how they currently address the confirmation process and the extent to which changes to those methodologies would be necessary to implement the new proposed standard. Specifically, the staff compared methodologies of selected global network firms

(“GNFs”)⁷⁰ and some methodologies commonly used by U.S. non-affiliate firms (“NAFs”),⁷¹ which are smaller than GNFs, to existing AS 2310 as well as to the new proposed standard. The review focused on the following aspects of the new proposed standard:

- Substantive procedures for confirming cash and cash equivalents (paragraphs .09-.11);
- Substantive procedures for confirming accounts receivable (paragraphs .12-.14);
- The auditor’s use of negative confirmation requests (paragraphs .21 and .B1);
- Maintaining control over the confirmation process, including when an intermediary is used (paragraphs .22-.24 and .B2-.B3); and
- Other areas addressed in the new proposed standard, including the use of internal audit, the evaluation of the reliability of confirmation responses, and the performance of alternative procedures.

For the GNF methodologies reviewed, we observed that the methodologies generally reflect requirements in existing AS 2310 and other auditing standards on external confirmation, such as ISA 505 and AU-C 505. In addition, some of the methodologies already incorporate certain concepts included in the new proposed standard, although amendments would nonetheless be needed if the new proposed standard were adopted.

Specifically, some GNF methodologies, but not all, include requirements for confirmation of cash and cash equivalents held by third parties similar to the requirements described in the new proposed standard. Other GNF methodologies suggest, but do not require, that engagement teams consider specific confirmation procedures for cash and cash equivalents held by third parties. GNF methodologies for confirmation of accounts receivable are generally consistent with existing AS 2310. Some also include guidance that is similar to the new requirements in the new proposed standard when the auditor is unable to obtain relevant and reliable audit evidence through confirmation procedures. With respect to negative confirmation requests, GNF methodologies acknowledge that negative confirmation requests provide less persuasive evidence than positive confirmation requests. However, some GNF

⁷⁰ GNFs are the member firms of the six global accounting firm networks (BDO International Ltd., Deloitte Touche Tohmatsu Ltd., Ernst & Young Global Ltd., Grant Thornton International Ltd., KPMG International Ltd., and PricewaterhouseCoopers International Ltd.).

⁷¹ NAFs are both U.S. and non-U.S. accounting firms registered with the Board that are not GNFs. Some of the NAFs belong to international networks.

methodologies still allow the use of negative confirmation requests as the sole substantive procedure under certain conditions.⁷²

The staff also observed that GNF methodologies generally include guidance on maintaining control and the use of intermediaries in the confirmation process. The firms' guidance in this area focuses on the performance of audit procedures to ensure that the electronic confirmation process occurs in a secure and controlled environment and that confirmation responses received are reliable. For example, the methodologies of some firms provide that an auditor may obtain a SOC report that would assist the engagement team in assessing the design and operating effectiveness of the intermediary's controls that address the risk of interception and alteration of confirmation requests and responses. Finally, although current GNF methodologies include guidance on the other areas to be modernized or clarified in the new proposed standard, firms may be required to make certain modifications to their methodologies to conform to the new proposed standard, such as where it would not be permissible to use internal audit in the confirmation process and whether to perform alternative procedures.

For the NAF methodologies reviewed, the staff observed that the methodologies generally align with existing AS 2310 across each of the areas studied, but include some guidance related to the requirements in the new proposed standard. For example, in some of the NAF methodologies, the confirmation of cash and cash equivalents held by third parties is a consideration but not a requirement. In other NAF methodologies, the confirmation of cash and cash equivalents held by third parties and negative confirmation requests are not discussed at all. NAF methodologies for confirmation of accounts receivable are generally consistent with existing AS 2310. Some include guidance that is similar to the new requirements described in the new proposed standard when the auditor is unable to obtain relevant and reliable audit evidence through confirmation procedures.

The NAF methodologies also generally include guidance on maintaining control and the use of intermediaries in the confirmation process. Similar to GNF methodologies, NAF guidance in this area focuses on the performance of audit procedures to ensure that the electronic confirmation process occurs in a secure and controlled environment and that confirmation responses received are reliable. For example, a firm's methodology may provide that an auditor may obtain a SOC report that would assist the engagement team in assessing the design and operating effectiveness of the intermediary's controls that address the risk of interception and alteration of confirmation requests and responses.

In general, the staff's review indicates that all firms would likely need to revise their methodologies to some extent to implement the new proposed standard, if adopted. For example, all firms would need to update their methodologies to ensure that negative confirmation requests are not used as the sole source of audit evidence. NAF methodologies

⁷² See AS 2310.20 for these conditions.

would likely require more revisions than the GNF methodologies which have incorporated certain concepts included in the new proposed standard.

ii. Use of Technology-Based Tools

The PCAOB staff has also reviewed information collected through PCAOB oversight activities on firms' use of technology-based tools in the confirmation process. The staff's review focused primarily on the use of technology-based tools by GNFs, but also encompassed certain technology-based tools used by some NAFs. In addition, the review encompassed information on both proprietary technology-based tools that firms have developed internally and third-party or "off-the-shelf" tools that firms purchase and use (in certain cases, with further customizations) to assist in performing confirmation procedures as part of the audit process. The staff found that the number of technology-based tools used in the confirmation process varies across firms, and also varies based on the facts and circumstances of specific engagements. Generally speaking, firms allow engagement teams to select a tool but do not provide that the use of one or more tools is required.

Both GNFs and NAFs within the scope of the staff's review use third-party tools to automate certain confirmation procedures, or to independently verify balances, terms of arrangements, or other information under audit. GNFs appear to be more likely to invest in customizing off-the-shelf tools they have purchased to their particular environment. For example, such modifications may permit a firm to automate the reconciliation of confirmed balances to client records. In comparison, NAFs tend to use the off-the-shelf tools without customization.

The staff's review also found that GNFs have developed proprietary applications to facilitate various aspects of the confirmation process, whether conducted manually or electronically. These applications may facilitate the preparation of confirmation requests, their dissemination to recipients (including the preparation of logs to track confirmation requests and receipts), and the analysis of confirmation responses to determine their completeness and accuracy. GNFs have also developed tools used when auditing specific accounts, other than cash and accounts receivable, where confirmation may provide audit evidence. For example, tools are used to prepare, log, and track confirmation requests and responses for various deposit, loan, and liability accounts.

As discussed in Section II, auditors or confirming parties may engage an intermediary to facilitate the direct electronic transmission of confirmation requests and responses between the auditor and the confirming party.⁷³ In one area, market forces have influenced firms' willingness to use an intermediary: a majority of financial institutions will only respond to confirmation requests through a centralized process and with a specified intermediary. As a

⁷³ See *Spotlight: Observations and Reminders on the Use of a Service Provider in the Confirmation Process* (Mar. 2022), available at <https://pcaobus.org/resources/staff-publications>.

result, all firms' methodologies required, and in practice firms did use, the specified intermediary in these circumstances.

The PCAOB staff has observed diverse practices related to the procedures auditors perform to support their reliance on an intermediary's controls when establishing direct communication between the auditor and the confirming party.⁷⁴ In some situations where the procedures performed included obtaining a SOC report, the staff has observed insufficient evaluation of SOC reports, lack of consideration of the period covered and complementary user entity controls, and insufficient coordination of procedures performed centrally by the audit firm and by the engagement team.⁷⁵

These observations suggest that there may be a need for uniform guidance for situations involving the use of intermediaries. For example, enhanced procedures to be performed when auditors place reliance on an intermediary's controls could help address the risk of interception and alteration of communications between the auditor and the company and address the risk of override of the intermediary's controls by the company.

2. Literature on the Confirmation Process

There is limited data on auditor confirmation decisions and research findings on the confirmation process.⁷⁶ The literature documents that confirmation is "extensively used" and that confirmation responses received directly from a third party are often perceived by practitioners to be among "the most persuasive forms of audit evidence."⁷⁷ Consistent with the staff's observations from PCAOB oversight activities,⁷⁸ studies find that the use of electronic confirmation has become prevalent.⁷⁹ One study also observes that current U.S. auditing standards do not fully address how auditors should authenticate confirmations sent or received electronically, and it asserts that there is a need for audit guidance related to electronic forms

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ See Paul Caster, Randal J. Elder, and Diane J. Janvrin, *A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness*, 27 *Auditing: A Journal of Practice & Theory* 253, 254 (2008).

⁷⁷ See *id.* at 253.

⁷⁸ See *Spotlight: Data and Technology Research Project Update* (May 2021), available at <https://pcaobus.org/resources/staff-publications>. See also *Spotlight: Observations and Reminders on the Use of a Service Provider in the Confirmation Process* (Mar. 2022), available at <https://pcaobus.org/resources/staff-publications>.

⁷⁹ See, e.g., Paul Caster, Randal J. Elder, and Diane J. Janvrin, *An Exploration of Bank Confirmation Process Automation: A Longitudinal Study*, 35 *Journal of Information Systems* 1, 5 (2021).

of evidence.⁸⁰ Further, an earlier study reviews enforcement actions described in the SEC's Accounting and Auditing Enforcement Releases and concludes that additional direction regarding when cash and accounts receivable confirmation requests are required or recommended may be needed.⁸¹ Additionally, the literature suggests that more guidance may be necessary to identify when the risk is sufficiently low to justify the use of negative confirmation requests in certain areas.⁸² Moreover, a recent article on bank confirmation advocates a risk-based approach to the determination of confirmation procedures.⁸³ Finally, a study finds that "anecdotal evidence and some research suggest confirmation response rates are declining."⁸⁴

Accordingly, the academic literature is consistent with the conclusion that the Board's auditing requirements for the confirmation process should (i) accommodate electronic communications, and evaluate the implications of using an intermediary, (ii) address the confirmation of cash and accounts receivable, (iii) limit the use of negative confirmation requests, and (iv) align with the PCAOB's risk assessment standards.

Question:

39. We request comment generally on the baseline for evaluating the economic impacts of the new proposed standard. Are there additional data (e.g., data on the use of electronic confirmation, types of accounts confirmed, or confirmation response rates) or academic studies that we should consider?

B. Need

Several attributes of the audit market support a need for the PCAOB to establish effective audit performance standards. First, the company under audit, investors, and other financial statement users cannot easily observe the services performed by the auditor or the

⁸⁰ See *id.* at 2.

⁸¹ See Paul Caster, Randal J. Elder, and Diane J. Janvrin, *A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness*, 27 *Auditing: A Journal of Practice & Theory* 253, 261-62 (2008).

⁸² See *id.* at 266.

⁸³ See L. Ralph Piercy and Howard B. Levy, *To Confirm or Not to Confirm-Risk Assessment is the Answer*, 91(12) *The CPA Journal* 54, 54 (2021).

⁸⁴ See Paul Caster, Randal J. Elder, and Diane J. Janvrin, *A Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness*, 27 *Auditing: A Journal of Practice & Theory* 253, 254 (2008). The staff has also observed that the use of electronic confirmation may affect the confirmation response rate. See *Spotlight: Data and Technology Research Project Update* (May 2021), available at <https://pcaobus.org/resources/staff-publications>.

quality of the audit. This leads to a risk that, unbeknownst to the company under audit, investors, or other financial statement users, the auditor may perform a low-quality audit.⁸⁵

Second, the auditor is retained, dismissed, and compensated by the company under audit. This leads to a risk that the auditor may aim to satisfy the interests of management of the company under audit rather than the interests of investors and other financial statement users.⁸⁶ The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) requires that the audit committee be responsible for the appointment, compensation, and retention of the auditor,⁸⁷ which attenuates the incentives for the auditor to seek to please management. However, in practice, management may exert influence over the audit committee, resulting in a *de facto* principal-agent relationship between the company’s management and the auditor.⁸⁸ Effective auditing standards address these risks by explicitly assigning responsibilities to the auditor that, if implemented properly, are expected to lead to high-quality audits that protect the interests of investors and other users of a company’s audited financial statements.

This section discusses the specific problem that the new proposed standard is intended to address and explains how the new proposed standard is expected to address it.

⁸⁵ See, e.g., Monika Causholli and Robert W. Knechel, *An Examination of the Credence Attributes of an Audit*, 26 *Accounting Horizons* 631, 632 (2012):

During the audit process, the auditor is responsible for making decisions concerning risk assessment, total effort, labor allocation, and the timing and extent of audit procedures that will be implemented to reduce the residual risk of material misstatements. As a non-expert, the auditee may not be able to judge the appropriateness of such decisions. Moreover, the auditee may not be able to ascertain the extent to which the risk of material misstatement has been reduced even after the audit is completed. Thus, information asymmetry exists between the auditee and the auditor, the benefit of which accrues to the auditor. If such is the case, the auditor may have incentives to: Under-audit, or expend less audit effort than is required to reduce the uncertainty about misstatements in the auditee’s financial statements to the level that is appropriate for the auditee.

⁸⁶ See, e.g., Joshua Ronen, *Corporate Audits and How to Fix Them*, 24 *Journal of Economic Perspectives* 189, 192 (2010).

⁸⁷ See Section 301 of Sarbanes-Oxley, 15 U.S.C § 78j-1(m).

⁸⁸ See, e.g., Liesbeth Bruynseels and Eddy Cardinaels, *The audit committee: Management watchdog or personal friend of the CEO?*, 89 *The Accounting Review* 113, 114 (2014) (finding that social ties between management and the audit committee are present in 39% of the companies in their sample and “may reduce the quality of the audit committee’s oversight”).

1. Problem to be Addressed

i. Focus on Obtaining Reliable Audit Evidence from the Confirmation Process

In situations where audit evidence can be obtained through confirmation with a knowledgeable external source, the resulting audit evidence is likely to be more reliable than audit evidence obtained from internal company sources. For evidence obtained through confirmation to be reliable, however, the confirmation process must be properly executed. Proper execution involves assessing the reliability of a confirmation response and performing robust, additional alternative procedures when the auditor is unable to determine that a confirmation response is reliable. Similarly, proper execution may entail the performance of alternative procedures when the auditor is unable to identify a confirming party, the auditor does not receive a confirmation response from the intended confirming party, or the confirmation response is incomplete.

As discussed in Section II, the PCAOB staff has observed situations where auditors did not perform procedures to assess the reliability of confirmation responses or, where applicable, perform sufficient alternative procedures.⁸⁹ In addition, the staff has noted that, in the case of some financial reporting frauds, the company's misconduct possibly could have been detected at an earlier point in time had the auditor made an appropriate assessment of the reliability of confirmation responses received, or performed additional procedures needed to obtain reliable audit evidence.⁹⁰ These observations suggest a need for enhancements to auditing standards to more clearly address those situations where confirmation can be expected to provide more reliable audit evidence, including the requirements for evaluating the reliability of confirmation responses and, if appropriate, performing alternative procedures.

ii. Developments in Practice

There are areas of the confirmation process where developments in practice have outpaced existing requirements in the Board's auditing standards. In particular, existing AS 2310 does not reflect significant changes in technology and the methods by which auditors perform the confirmation process, including the use of electronic communication and the involvement of third-party intermediaries.

Regulatory standards that do not reflect changes in practice may lead to inconsistency in their application, potential misinterpretation, and ineffective regulatory intervention. For

⁸⁹ See Section II.B for observations from the PCAOB's audit inspections and from SEC enforcement cases.

⁹⁰ See also Diane Janvrin, Paul Caster, and Randy Elder, *Enforcement Release Evidence on The Audit Confirmation Process: Implications for Standard Setters*, 22 *Research in Accounting Regulation* 1, 10 (2010).

example, the PCAOB staff has observed diverse practices and audit deficiencies related to the procedures performed by auditors to support their use of an intermediary to facilitate the electronic transmission of confirmation requests and confirmation responses with confirming parties.⁹¹

In addition, the presumption to confirm accounts receivable in existing AS 2310 may discourage the use of new technologies that could improve the efficiency and effectiveness of the audit. For example, an auditor may have access to newer audit tools that can provide audit evidence that is at least as persuasive as the evidence the auditor might expect to obtain through confirmation of accounts receivable. Absent further clarification as to the circumstances when the presumption to confirm accounts receivable may be appropriately overcome, the auditor may decide not to use other audit tools available, or to perform redundant procedures when audit effort would have been better directed elsewhere.

2. How the New Proposed Standard Would Address the Need

The new proposed standard would help address the need by (i) strengthening requirements in certain areas to focus on the need to obtain reliable audit evidence from the confirmation process; and (ii) modernizing AS 2310 to accommodate certain developments in practice, including the use of electronic communications, intermediaries, and new audit tools. The new proposed standard is expected to promote consistent and effective practice relating to the confirmation process in audits subject to PCAOB standards, reducing the risk of low-quality audits caused by (i) the lack of observability of audit quality and (ii) the influence of the auditor-client relationship discussed above.

i. Focus on Obtaining Reliable Audit Evidence from the Confirmation Process

The new proposed standard would strengthen the Board's requirements in certain areas to focus on the need to obtain reliable audit evidence when executing the confirmation process. Specifically, the new proposed standard would require the auditor to confirm certain cash and cash equivalents held by third parties. In addition, the new proposed standard would strengthen the requirements for evaluating the reliability of confirmation responses. It also continues to emphasize the importance of maintaining control over the confirmation process and provides additional examples of indicators that a confirmation response may have been intercepted and altered. When confirmation responses are deemed to be unreliable, the auditor would be directed to perform alternative procedures to obtain audit evidence.

Moreover, as discussed in Section III.E, electronic communications likely have reduced the efficacy of negative confirmation requests. Under the new proposed standard, the auditor

⁹¹ See *Spotlight: Observations and Reminders on the Use of a Service Provider in the Confirmation Process* (Mar. 2022), available at <https://pcaobus.org/resources/staff-publications>.

would not be able to use negative confirmation requests as the sole substantive procedure for addressing the risk of material misstatement for a financial statement assertion.

ii. Developments in Practice

Under the new proposed standard, the requirement to maintain control over the confirmation process would address both traditional and newer, more prevalent forms of communication between the auditor and confirming parties, including e-mailed confirmation requests and responses and intermediaries facilitating electronic communication of confirmation requests and responses. The new proposed standard is intended to apply to methods of confirmation currently in use and to be flexible enough to apply to new methods that may arise from technological changes in auditing in the future.

Additionally, under the new proposed standard, the auditor would be able to overcome the presumption to confirm accounts receivable, and instead perform other substantive audit procedures where the auditor has determined those other procedures would provide audit evidence that is at least as persuasive as evidence the auditor would expect to obtain through confirmation. To the extent that there are newer tools available to auditors that can provide such audit evidence (for example, certain tools that also make use of information from sources independent of the company), the new proposed standard is not intended to disincentivize the use of those tools.

Question:

40. We request comment generally on the analysis provided above regarding the need for the new proposed standard. Should we consider any additional arguments, academic studies, or data related to the need for standard setting?

C. Economic Impacts

This section discusses the expected benefits and costs of the new proposed standard and potential unintended consequences. Overall, we expect that the economic impact of the new proposed standard, including both benefits and costs, would be relatively modest, especially for those firms that have already incorporated in practice some of the new requirements. We also expect that the benefits of the new proposed standard would justify the costs and any unintended negative effects.

1. Benefits

We expect the new proposed standard to improve the consistency and effectiveness of the confirmation process, reducing the risk of low-quality audits caused by (i) the lack of observability of audit quality and (ii) the influence of the auditor-client relationship discussed in Section IV.B above. Specifically, there exists a risk that, unbeknownst to the company under audit, investors, or other financial statement users, the auditor may perform a low-quality audit

since audit quality is difficult to observe. In addition, some auditors may aim to satisfy the interests of the company under audit or their own financial interests rather than the interests of investors and other financial statement users — interests that may lead them to perform insufficiently rigorous confirmation procedures to minimize the burden on clients and their counterparties to respond to confirmations, or to minimize audit costs.

The new proposed standard would help to mitigate these risks in the confirmation process by strengthening and modernizing the requirements for the auditor regarding the design and execution of the audit confirmation process. Specifically, an audit confirmation process designed and executed under the new proposed standard should benefit investors and other users of a company's financial statements by reducing the likelihood that the financial statements are materially misstated, whether due to error or fraud.

The enhanced quality of audits and financial information available to financial markets should also increase investor confidence in financial statements. In general, investors may use the more reliable financial information to improve the efficiency of their capital allocation decisions (e.g., investors may reallocate capital from less profitable companies to more profitable companies). Investors may also perceive less risk in capital markets generally, leading to an increase in the supply of capital. An increase in the supply of capital could increase capital formation while also reducing the cost of capital to companies.⁹²

Auditors also are expected to benefit from the new proposed standard, because the additional clarity provided by the new proposed standard would reduce regulatory uncertainty and the associated compliance costs. Specifically, the new proposed standard would provide auditors with a better understanding of their responsibilities and our expectations, as well as reduce the risk that auditors would perform unnecessary or ineffective confirmation procedures.

The following discussion describes the benefits of key changes to existing confirmation requirements that are expected to impact auditor behavior. As discussed in Section IV.B above, the changes aim to (1) enhance the auditor's focus on obtaining reliable audit evidence from the confirmation process, and (2) accommodate certain developments in practice. As further discussed below, the changes that enhance the auditor's focus on obtaining reliable audit evidence are expected to strengthen confirmation procedures for cash held by third parties, promote consistency in practice, improve the reliability of confirmation responses, improve the quality of audit evidence, and increase the auditor's likelihood of identifying potential financial statement fraud. The changes that accommodate developments in practice are expected to

⁹² See, e.g., Hanwen Chen, Jeff Zeyun Chen, Gerald J. Lobo, and Yanyan Wang, *Effects of audit quality on earnings management and cost of equity capital: Evidence from China*, 28 *Contemporary Accounting Research* 892, 921 (2011); Richard Lambert, Christian Leuz, and Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, 45 *Journal of Accounting Research* 385 (2007).

clarify the auditor's responsibilities regarding the use of electronic communications in the confirmation process, standardize the procedures that auditors perform to support their use of intermediaries, and allow for the use or development of more sophisticated and effective technology-based auditing tools. To the extent that a firm has already implemented certain of the provisions of the new proposed standard into its firm methodology, the benefits described below would be reduced.

i. Focus on Obtaining Reliable Audit Evidence from the Confirmation Process

The new proposed standard should benefit investors and other users of a company's financial statements by placing additional emphasis on the auditor's need to obtain reliable audit evidence when undertaking to perform confirmation procedures. In this regard, the new proposed standard: (1) identifies certain accounts for which the auditor should perform confirmation procedures, (2) enhances the requirements for assessing the reliability of confirmation responses, (3) addresses the performance of alternative procedures when the auditor is unable to obtain relevant and reliable audit evidence through confirmation, (4) strengthens requirements regarding the use of negative confirmation requests, and (5) specifies which activities in the confirmation process may not be performed using the assistance of internal auditors.

Specifically, the proposed requirement to confirm certain cash and cash equivalents held by third parties may reduce the risk of material errors in financial statements and strengthen investor protection to the extent that auditors are not already confirming cash pursuant to their existing audit methodologies.⁹³ This requirement also specifies that the extent of audit evidence to obtain through cash confirmation procedures should be based on the auditor's understanding of the company's cash management and treasury function.

The new proposed standard does not require that all cash accounts or all accounts receivable should be selected for confirmation. The auditor's assessment of the risk of material misstatement is an important consideration when designing audit procedures, including the use of confirmation. For both cash and accounts receivable, the new proposed standard specifies that the auditor should take into account the auditor's understanding of the substance of a company's arrangements and transactions with third parties when selecting the individual items to confirm.

⁹³ As discussed above, the staff's review of firm methodologies indicated that some firms are already confirming cash balances, while other firms' methodologies do not require auditors to perform procedures beyond those required by AS 2310. The growth in corporate cash holdings also highlights the need to confirm cash and cash equivalents. See, e.g., Kevin Amess, Sanjay Banerji, and Athanasios Lampousis, *Corporate Cash Holdings: Causes and Consequences*, 42 *International Review of Financial Analysis* 421, 422 (2015).

The additional clarity in the new proposed standard should reduce uncertainty in auditor responsibilities and promote consistency in practice with respect to the confirmation of cash accounts and accounts receivable. In addition, the specificity in the new proposed standard should encourage the auditor to determine the extent of confirmation procedures with regard to an assessment of material misstatement risk and avoid more work than necessary to obtain sufficient appropriate audit evidence.

The new proposed standard strengthens requirements addressing the reliability of confirmation responses by describing information that the auditor should take into account when evaluating the reliability of confirmation responses and providing examples of indicators that a confirmation response may have been intercepted or altered. These requirements are expected to improve the reliability of confirmation responses and therefore increase the quality of the audit evidence obtained by the auditor.

The new proposed standard also expands on the existing requirement to address the auditor's potential need to apply alternative procedures. The enhanced requirements for alternative procedures would provide a greater level of detail and clarity to auditors for situations that are not currently addressed explicitly in existing AS 2310, potentially raising the quality of evidence obtained by auditors.

Under the new proposed standard, the auditor may only use negative confirmation requests to supplement other substantive audit procedures; they may not be used as the sole substantive audit procedure. As discussed in Section III.E, the amount of electronic correspondence has increased dramatically over the years, leading to an increased likelihood that a negative confirmation request would not be appropriately considered by the confirming party and, therefore, would provide less persuasive audit evidence. The new proposed standard addresses this issue by providing examples of situations in which negative confirmation requests, in combination with the performance of other substantive audit procedures, may provide sufficient appropriate audit evidence. As negative confirmation requests could not be the sole source of audit evidence obtained, insofar as the new proposed standard would affect practice, the overall quality of audit evidence obtained by the auditor likely would increase.⁹⁴

Further, existing AS 2310 does not specify which activities within the confirmation process may or may not be performed using the assistance of internal auditors. As a result, some auditors may involve internal auditors in the confirmation process in a manner that is inconsistent with the auditor's responsibility to maintain control over the confirmation process, which is essential to obtaining reliable audit evidence. The new proposed standard would

⁹⁴ The Board understands through its oversight activities that few, if any, GNFs use negative confirmation requests as the sole substantive procedure in practice. As discussed in Section IV.A, however, the staff's firm methodology review suggests that all the GNFs and NAFs reviewed would need to update their methodologies to ensure that negative confirmation requests are not used as the sole source of audit evidence.

specify that the auditor may not use the assistance of the company's internal audit function for selecting items to be confirmed, sending confirmation requests, and receiving confirmation responses, while otherwise allowing auditors to use internal auditors in accordance with AS 2605.⁹⁵ The specificity provided by the new proposed standard should strengthen the reliability of evidence obtained through the confirmation process.

Overall, the additional requirements and examples discussed above are expected to improve the reliability of confirmation responses, and therefore increase the quality of the audit evidence obtained by the auditor. By introducing a new requirement to confirm certain cash balances and enhancing the requirements for evaluating the reliability of confirmation responses, the new proposed standard may also increase the auditor's likelihood of identifying potential financial statement fraud. Early detection of accounting fraud is an important aspect of investor protection, because such fraud can cause significant harm to investors in the companies engaged in fraud, as well as indirect harm to investors in other companies.⁹⁶ In addition, by clarifying and strengthening the auditor's responsibilities, including by specifying additional situations where alternative procedures may be necessary and providing additional examples of indicators that a confirmation response may have been intercepted and altered, the new proposed standard takes into account past inspection findings by the Board that auditors did not obtain sufficient appropriate audit evidence when using confirmation.

ii. Developments in Practice

The new proposed standard would modernize AS 2310 to accommodate certain developments in practice, including the use of electronic communications, intermediaries, and new audit tools.

Specifically, the new proposed standard would accommodate changes in how communications occur between the auditor and confirming parties. It would clarify the auditor's responsibilities by taking into account current confirmation practices among auditors and acknowledging differing methods of confirmation. These methods include not only longstanding methods such as the use of paper-based confirmation requests and responses sent via regular mail, but also increasingly common methods such as e-mailed confirmation requests and responses and the use of intermediaries to facilitate the direct electronic transmission of confirmation requests and responses. This additional clarity may enhance the reliability of audit evidence by decreasing the risk that a confirmation request or response is

⁹⁵ Research shows that the objectivity of internal audit functions has an impact on financial reporting quality. *See, e.g.,* Lawrence J. Abbott, Brian Daugherty, Susan Parker, and Gary F. Peters, *Internal Audit Quality and Financial Reporting Quality: The Joint Importance of Independence and Competence*, 54 *Journal of Accounting Research* 3, 6 (2015).

⁹⁶ *See* Yang Bao, Bin Ke, Bin Li, Y. Julia Yu, and Jie Zhang, *Detecting Accounting Fraud in Publicly Traded US Firms Using a Machine Learning Approach*, 58 *Journal of Accounting Research* 199, 200 (2020).

intercepted and altered. In addition, the new proposed standard includes requirements specific to an intermediary's controls that mitigate the risk of interception and alteration. The requirements are expected to standardize the procedures auditors perform to support their use of intermediaries and reduce audit deficiencies in this area.

With regards to accounts receivable, the new proposed standard would retain the requirement to confirm accounts receivable and, therefore, would not decrease or remove the auditor's responsibility to obtain relevant and reliable audit evidence from confirmation. The auditor would be able to overcome the presumption to confirm accounts receivable and instead perform other substantive audit procedures, however, when the auditor has determined that those procedures would provide audit evidence that is at least as persuasive as the evidence that the auditor might expect to obtain through performing confirmation procedures. This change would allow for the use or development of more sophisticated and effective audit procedures, which might include the use of technology-based auditing tools, subject to the requirement that they provide the same or increased level of audit evidence about the relevant financial statement assertion. Accordingly, this change could potentially improve the efficiency and effectiveness of the audit. The requirement to communicate to the audit committee instances where the auditor has determined that the presumption to confirm accounts receivable has been overcome (including the basis for the auditor's determination) may reinforce the auditor's obligation to exercise due professional care in making that determination.

Question:

41. Are there additional potential benefits that should be considered?

2. Costs

We expect the costs associated with the new proposed standard to be relatively modest. The staff's review of audit firm methodologies related to the confirmation process indicates that some firms have already incorporated in practice some of the new proposed requirements. For example, the methodologies of some GNFs and NAFs include requirements for confirmation of cash that are similar to the requirements described in the new proposed standard. Similarly, both the GNF and NAF methodologies reviewed generally include guidance on maintaining control over the confirmation process and the use of intermediaries to facilitate the electronic transmission of confirmation requests and responses.

To the extent that audit firms would need to make changes to meet the new proposed requirements, they may incur certain fixed costs (i.e., costs that are generally independent of the number of audits performed) to implement the new proposed standard. These include costs to update audit methodologies and tools, and costs to prepare training materials and conduct internal training. GNFs are likely to update methodologies using internal resources, whereas NAFs are more likely to purchase updated methodologies from external vendors. The costs to update these methodologies likely depend on the extent to which the new

requirements have already been incorporated in the firms' current methodologies. For firms that have implemented confirmation procedures like those required by the new proposed standard, the costs of updating methodologies may be lower than for firms that currently do not have such procedures. In this regard, large firms may also benefit from economies of scale.

In addition, audit firms may incur certain engagement-level variable costs related to implementing the new proposed standard. For example, the requirement to confirm certain cash balances could impose engagement-level costs on some auditors if additional procedures need to be performed. Similarly, limiting the use of negative confirmation requests to situations where the auditor is also performing other substantive audit procedures could lead to additional time and effort by the auditor to perform the other audit procedures.

The magnitude of the variable costs likely depends on the extent to which existing practice differs from the new requirements. As discussed above, the staff's review of firm methodologies, which included the methodologies of certain NAFs, suggests that the new proposed standard likely would lead to a greater impact on confirmation procedures performed by smaller firms. Because the new proposed standard generally applies a risk-based approach (i.e., by providing that the use of confirmation may be part of the auditor's response to the assessed risks of material misstatement), the costs of performing the additional procedures are unlikely to be disproportionate to the benefits.

To the extent that auditors incur higher costs to implement the new proposed standard and are able to pass on at least part of the increased costs through an increase in audit fees, companies being audited could incur an indirect cost. Moreover, confirming parties could incur additional costs from supporting the confirmation process as a result of the enhanced requirements of the new proposed standard, although the additional costs are expected to be limited.

Some requirements under the new proposed standard may result in more costs than others. The following discussion describes the potential costs associated with specific changes to existing confirmation requirements.

i. Focus on Obtaining Reliable Audit Evidence from the Confirmation Process

The new proposed standard: (1) identifies certain accounts for which the auditor should perform confirmation procedures, (2) enhances the requirements for assessing the reliability of confirmation responses, (3) addresses the performance of alternative procedures when the auditor is unable to obtain relevant and reliable audit evidence through confirmation, (4) strengthens requirements regarding the use of negative confirmation requests, and (5) specifies which activities in the confirmation process may not be performed using the assistance of internal auditors.

For some firms, the requirement in the new proposed standard to confirm certain cash balances could be expected to result in the revision of firm methodologies and the performance of additional audit procedures. As discussed in Section IV.A, the methodologies of some GNFs already include requirements for cash confirmation that are similar to the new requirement described in the new proposed standard. In addition, the risk-based approach in the new requirement should encourage the auditor to determine the extent of confirmation with regard to an assessment of the risks of material misstatement and avoid more work than is necessary to obtain sufficient audit evidence.

The new proposed standard would also require the auditor to evaluate the reliability of confirmation responses and provides examples of indicators that a confirmation response may have been intercepted and altered. The costs associated with this requirement, however, are expected to be limited. First, the Board's auditing standards already require the auditor to obtain sufficient appropriate audit evidence to provide a reasonable basis for the auditor's report, and to evaluate the combined evidence provided by confirmation and other auditing procedures performed when the auditor has not received replies to confirmation requests (i.e., nonresponses) to determine whether sufficient evidence has been obtained about all the applicable financial statement assertions.⁹⁷ Second, the methodologies of some firms reflect application material in ISA 505 regarding factors (similar to indicators in the new proposed standard) that may indicate doubts about the reliability of a confirmation response. One of these factors is analogous to the requirement in the new proposed standard (i.e., the confirmation response appears not to come from the originally intended confirming party), which may further limit the potential costs for firms that have incorporated this factor in their methodologies.

Insofar as the new proposed standard identifies additional situations in which the auditor generally would be required to perform alternative procedures, firms may incur additional costs. Specifically, the new proposed standard would extend the requirement in existing AS 2310 to perform alternative procedures in relation to nonresponses to positive confirmation requests to other situations, including the auditor's inability to identify a confirming party and the receipt of an unreliable response.

In contrast with existing AS 2310, negative confirmation requests may not be used as the sole substantive audit procedure under the new proposed standard. This limitation reflects, among other things, the increase in the volume of electronic correspondence since existing AS 2310 was issued and the increasing likelihood that a recipient of a negative confirmation request would not consider the request. As a result, auditors may have to perform other substantive audit procedures for certain financial statement assertions. Although the Board understands through its oversight activities that few, if any, GNFs use negative confirmation requests as the sole substantive procedure in practice, as discussed in Section IV.A, the staff's firm methodology review suggests that all the GNFs and NAFs reviewed would need to review

⁹⁷ See AS 1105.04; AS 2310.33.

their methodologies to ensure that negative confirmation requests are not allowed to be used as the sole source of audit evidence.

The new proposed standard explicitly restricts the auditor from using internal auditors to select the items to be confirmed, send confirmation requests, and receive confirmation responses. In comparison, existing AS 2310 provides that the auditor should maintain control over confirmation requests and responses (i.e., establish direct communication between the intended recipient of a confirmation request and the auditor), but states that the auditor is not precluded from using internal auditors in the confirmation process pursuant to AS 2605. While the new proposed standard is intended to clarify the existing requirement to maintain control over the confirmation process, and still allow for other situations where internal auditors may provide direct assistance to the auditor in accordance with AS 2605, audit firms that have been using internal auditors to perform tasks that would be expressly prohibited under the new proposed standard could incur additional costs.

ii. Developments in Practice

As discussed in Section III.F, the new proposed standard includes requirements that seek to clarify the procedures auditors should perform to support their use of intermediaries to facilitate the direct electronic transmission of confirmation requests and responses between the auditor and the confirming party. These requirements may lead to modifications to firm methodologies. Further, the required procedures may involve additional auditor time and effort. The resulting costs likely depend on the extent to which the new requirements have already been incorporated in a firm's current methodologies. As discussed in Section IV.A, both the GNF and NAF methodologies reviewed generally already include guidance on maintaining control over the confirmation process and the use of intermediaries, which may limit the costs.

In addition, the new proposed standard would specify that the auditor may overcome the presumption to confirm accounts receivable when the auditor determines that other substantive audit procedures would provide audit evidence that is at least as persuasive as the evidence the auditor might expect to obtain through performing confirmation procedures. This provision is intended to highlight the flexibility of the new proposed standard and is not expected to impose new costs on firms. To the extent that the auditor is able to replace confirmation with other substantive audit procedures and chooses to do so, consistent with the requirement in the new proposed standard that the other procedures provide audit evidence that is at least as persuasive as the evidence that the auditor might expect to obtain through performing confirmation procedures, the new proposed standard could reduce costs for firms. The requirement for the auditor to communicate to the audit committee when the presumption to confirm accounts receivable has been overcome could impose a modest incremental cost.

Questions:

42. Are there additional potential costs that should be considered? If so, what are they?

43. Are there additional academic studies or data related to the potential benefits and costs of the proposed requirements? If so, please provide citations and other reference information for such studies and data.

3. Potential Unintended Consequences

In addition to the benefits and costs discussed above, the new proposed standard could have unintended economic impacts. The following discussion describes potential unintended consequences we have considered and, where applicable, factors that mitigate the negative consequences, such as steps we have taken or the existence of other countervailing forces.

i. Potential Decline in Auditors' Usage of Confirmation

An unintended consequence of the new proposed standard would occur if, contrary to the Board's expectation, there were a significant reduction in the use of confirmation procedures by auditors in circumstances where confirmation would provide relevant and reliable audit evidence.

Under the new proposed standard, auditors would retain the ability to use confirmation as one procedure, among others, to audit one or more financial statement accounts or disclosures. At the same time, the new proposed standard would strengthen the requirements for an auditor regarding evaluating the reliability of confirmation responses, and addressing confirmation exceptions and incomplete responses, including performing alternative procedures to obtain audit evidence. Further, the new proposed standard would describe the types of procedures the auditor should perform in evaluating the effect of using an intermediary on the reliability of confirmation requests and responses, including determining whether relevant controls of the intermediary are designed and operating effectively. In addition, the new proposed standard would not allow the auditor to use negative confirmation requests as the sole substantive procedure. As a result, when not required to use confirmation, auditors might decline to use confirmation and use other audit procedures instead if they perceive there could be more time or cost involved in the confirmation process than in the performance of other procedures.

This potential unintended consequence is mitigated, however, by the requirements that the auditor should perform confirmation procedures for cash and accounts receivable (including specifying situations where the auditor may overcome the presumption to confirm accounts receivable). In addition, the Board's standards already provide that the auditor should evaluate whether the combined evidence provided by confirmation and other auditing procedures provide sufficient evidence about the applicable financial statement assertions. Several of the changes to existing requirements in the new proposed standard would align with our understanding of current practice (for example, many audit firms' methodologies include guidance on maintaining control and the use of intermediaries). Additionally, the potential unintended consequence may be mitigated to the extent that a firm has experienced efficiencies from using newer audit tools for confirmation through reduced time or costs.

Further, we do not anticipate that the requirements of the new proposed standard would cause a significant change in the timing or extent of confirmation procedures for auditors, as we have not proposed to amend the requirements of AS 2301 that address those matters. Accordingly, we do not believe that the new proposed standard, if adopted, would lead to a significant decline in the use of confirmation.

ii. Potential Performance of Confirmation Procedures That Do Not Result in Obtaining Relevant and Reliable Audit Evidence

An unintended consequence of the presumed requirement in the new proposed standard to confirm accounts receivable would arise if auditors misinterpreted the language in the new proposed standard as requiring the confirmation of accounts receivable in all situations. In particular, the new proposed standard would not carry forward a provision (included in existing AS 2310) that an auditor could overcome the presumption to confirm accounts receivable if, among other things, “[t]he use of confirmations would be ineffective.” It is possible that some auditors might misinterpret the elimination of this language as precluding the exercise of auditor judgment with respect to the confirmation of accounts receivable.

We do not intend, however, that an auditor send confirmation requests for accounts receivable when such procedures do not provide relevant and reliable audit evidence. To mitigate the unintended consequence described above, the new proposed standard provides that the auditor may overcome the presumption to confirm accounts receivable when the auditor determines that other substantive audit procedures would provide evidence that is “at least as persuasive as the evidence that the auditor might expect to obtain through confirmation.” Notably, this provision does not require the auditor to determine that the evidence that the auditor would obtain through other substantive auditing procedures is “more persuasive” than the evidence that might be obtained through confirmation. In our view, the language is sufficiently clear to allow for the continued exercise of professional judgment in circumstances where auditors might face particular challenges in obtaining audit evidence by confirming accounts receivable.

Question:

44. We request comment generally on the potential unintended consequences of the proposal. Are the responses to the potential unintended consequences discussed in the release adequate? Are there additional potential unintended consequences that we should consider? If so, what responses should be considered?

D. Alternatives Considered

The development of the new proposed standard involved considering a number of alternative approaches to address the problems described above. This section explains: (i) why standard setting is preferable to other policy-making approaches, such as providing interpretive guidance or enhancing inspection or enforcement efforts; (ii) other standard-setting

approaches that were considered; and (iii) key policy choices made by the Board in determining the details of the new proposed standard-setting approach.

1. Why Standard Setting is Preferable to Other Policy-Making Approaches

The Board's policy tools include alternatives to standard setting, such as issuing additional interpretive guidance or an increased focus on inspections or enforcement of existing standards. We considered whether providing guidance or increasing inspection or enforcement efforts would be effective mechanisms to address concerns with the auditor's use of confirmation.

Interpretive guidance inherently provides additional information about existing standards. Inspection and enforcement actions take place after insufficient audit performance (and potential investor harm) has occurred. Devoting additional resources to interpretive guidance, inspections, or enforcement activities, without improving the relevant performance requirements for auditors, would at best focus auditors' performance on existing standards and would not provide the benefits discussed in Section IV.C associated with improving the standards. The new proposed standard, on the other hand, is designed to improve existing requirements for the auditor's use of confirmation. For example, the new proposed standard, unlike existing AS 2310, includes requirements relating to the confirmation of cash accounts, imposes additional limitations on the use of negative confirmation requests, clarifies the circumstances in which auditors would be expected to perform alternative procedures, and includes explicit restrictions on the use of internal auditors in the confirmation process.

2. Other Standard-Setting Alternatives Considered

Several alternative standard-setting approaches were also considered, including: (i) making amendments to the existing standard; and (ii) adopting an approach based on ISA 505 with certain modifications to reflect the PCAOB's statutory responsibilities with respect to audits of public companies and registered broker-dealers.

i. Amendments to Existing Standard

We considered, but are not proposing, limiting the amendments to AS 2310 solely to modifications relating to changes in technology that have affected the confirmation process. While this approach could result in fewer changes to firms' audit methodologies, we believe there are a number of other areas discussed throughout this release, beyond amending AS 2310 to reflect the increasing use of technology in the confirmation process, where the existing standard should be improved.

ii. Standard Based on ISA 505

Some commenters on the 2009 Concept Release and the 2010 Proposal suggested that the Board should consider adopting ISA 505, the IAASB's standard on audit confirmation, which

was issued in 2008. We have taken the requirements and application material of ISA 505 into account in developing the new proposed standard (e.g., the ISA 505 application material relating to the use of a third party to coordinate and provide responses to confirmation requests).

We concluded, however, that the new proposed standard should also establish certain requirements that are not included in ISA 505 (e.g., requirements to confirm cash and accounts receivable) or should not include certain provisions that are described in ISA 505 (e.g., regarding management's refusal to allow the auditor to send a confirmation request). In addition, audit practices have continued to evolve since ISA 505 was issued in 2008, and we believe that the new proposed standard should reflect these developments (e.g., by addressing electronic communication and the use of intermediaries in the requirements of the standard rather than in application materials).

3. Key Policy Choices

Given a preference for replacing existing AS 2310 in its entirety, we considered different approaches to addressing key policy issues.

i. Use of Confirmation Procedures for Specific Accounts

The new proposed standard provides that the auditor should perform confirmation procedures for cash and cash equivalents held by third parties, as well as for accounts receivable that arise from the transfer of goods or services to a customer or a financial institution's loans. In addition, under the new proposed standard, when confirming cash, the auditor should consider sending confirmation requests about other financial relationships with the confirming party. The auditor also should consider, for significant risks of material misstatement associated with either a complex or significant unusual transaction, confirming terms of the transaction with the counterparty. The new proposed standard does not specify other significant accounts or disclosures that the auditor should confirm or consider confirming. We considered several alternatives to this approach, as discussed below.

First, we considered an approach that would have no requirement for the auditor to confirm specified accounts or transactions. In our view, this approach might result in the selection by some auditors of audit procedures that provide less relevant and reliable audit evidence than confirmation with respect to cash and accounts receivable (e.g., if an auditor mistakenly assessed the risk of material misstatement too low for cash or accounts receivable). Further, confirmation of cash and accounts receivable is already a standard practice for many auditors and is consistent with the concept that audit evidence obtained from an external knowledgeable source, including through the confirmation process, is more reliable than evidence obtained only from internal company sources. Accordingly, we have decided against an approach that does not require the confirmation of any accounts and disclosures in the new proposed standard.

In addition, we considered including a requirement that the auditor should confirm other accounts in addition to cash and accounts receivable, such as investments, in the new proposed standard. We have decided against this approach, as it would limit auditor judgment in circumstances where the performance of other auditing procedures might provide relevant and reliable audit evidence, could be viewed as unduly prescriptive, and would not allow the auditor to take company-specific facts and circumstances into account. Instead, under the new proposed standard, the auditor could decide to perform confirmation procedures with respect to financial statement assertions relating to other accounts and disclosures but would not be required to do so.

We also considered adding an additional requirement that the auditor should perform confirmation procedures in response to significant risks that relate to relevant assertions, when such assertions can be adequately addressed by confirmation procedures. A similar requirement was included in the 2010 Proposal. Several commenters on the 2010 Proposal asserted, however, that the requirement was too broad and was inconsistent with the Board's risk assessment standards, which allow for auditor judgment in determining the audit response to significant risks identified by the auditor. In response to these comments, we have not included this requirement in the new proposed standard.

ii. Management Requests Not to Confirm

We considered addressing situations where management requests that the auditor not confirm one or more items in the new proposed standard. Specifically, we considered requiring the auditor to obtain an understanding of the reasons for management's request, perform alternative procedures as discussed in paragraph .31 of the new proposed standard, and communicate the request to the audit committee. In addition, we considered a requirement that the auditor should evaluate the implications for the auditor's report if the auditor determines that management's request impairs the auditor's ability to obtain sufficient appropriate audit evidence or indicates that one or more fraud risk factors are present. The 2010 Proposal includes similar requirements. For the reasons discussed in Section III.J, we have decided not to include such provisions in the new proposed standard.

Questions:

45. We request comment generally on the alternative approaches described in this release that we considered but are not proposing. Are any of these approaches, or any other approaches, preferable to the approaches that are being proposed? What reasons support those approaches over the approaches proposed?
46. Are there additional economic impacts or considerations associated with this proposal that should be considered? If so, what are those considerations?

V. SPECIAL CONSIDERATIONS FOR AUDITS OF EMERGING GROWTH COMPANIES

Pursuant to Section 104 of the Jumpstart Our Business Startups Act (“JOBS Act”), rules adopted by the Board subsequent to April 5, 2012, generally do not apply to the audits of emerging growth companies (“EGCs”), as defined in Section 3(a)(80) of the Securities Exchange Act of 1934 (“Exchange Act”), unless the SEC “determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.”⁹⁸ As a result of the JOBS Act, the rules and related amendments to PCAOB standards that the Board adopts are generally subject to a separate determination by the SEC regarding their applicability to audits of EGCs.

To inform consideration of the application of auditing standards to audits of EGCs, PCAOB staff prepares a white paper annually that provides general information about characteristics of EGCs.⁹⁹ As of the November 15, 2020 measurement date, PCAOB staff identified 1,940 companies that self-identified with the SEC as EGCs and filed audited financial statements in the 18 months preceding the measurement date.

Confirmation is a longstanding audit procedure used in nearly all audits, including audits of EGCs. The discussion of benefits, costs, and unintended consequences in Section IV is generally applicable to audits of EGCs. The economic impacts of the new proposed standard on an EGC audit depend on factors such as the audit firm’s current methodologies, the audit firm’s ability to distribute implementation costs across engagements, and the auditor’s assessed level of material misstatement risk.

EGCs are likely to be newer companies, which may increase the importance to investors of the external audit to enhance the credibility of management disclosures.¹⁰⁰ Further,

⁹⁸ See Pub. L. No. 112-106 (Apr. 5, 2012). Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as added by Section 104 of the JOBS Act also provides that any rules of the Board requiring (1) mandatory audit firm rotation or (2) a supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an EGC. The new proposed standard does not fall within either of these two categories.

⁹⁹ See *White Paper on Characteristics of Emerging Growth Companies and Their Audit Firms at November 15, 2020* (Jan. 24, 2022), available at <https://pcaobus.org/resources/other-research-projects>.

¹⁰⁰ Researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs. To the extent that EGCs exhibit one or more of these properties, there may be a greater degree of information asymmetry for EGCs than for the broader population of companies, which increases the importance to investors of the external audit to enhance

compared to non-EGCs, EGCs are more likely to be audited by NAFs.¹⁰¹ As discussed in Section IV.A, NAFs are expected to make more changes to their methodologies and practice to comply with the new proposed standard. Therefore, all else equal, the benefits of the higher audit quality resulting from the new proposed standard may be larger for EGCs than for non-EGCs, including improved efficiency of market capital allocation, lower cost of capital, and enhanced capital formation. In particular, because investors who face uncertainty about the reliability of a company's financial statements may require a larger risk premium that increases the cost of capital to companies, the improved audit quality resulting from applying the new proposed standard to EGC audits could reduce the cost of capital to those EGCs.¹⁰²

Moreover, because of the scalability of the risk-based requirements, the costs of performing the procedures are unlikely to be disproportionate to the benefits of the procedures. Conversely, if any of the new proposed amendments were determined not to apply to the audits of EGCs, auditors would need to address differing audit requirements in their methodologies, or policies and procedures, with respect to audits of EGCs and non-EGCs, which would create the potential for confusion. The new proposed standard could impact competition in an EGC product market if the indirect costs to audited companies disproportionately impact EGCs relative to their competitors. However, as discussed in Section IV.C above, the costs associated with the new proposed standard are expected to be relatively modest. Therefore, the impact of the new proposed standard on competition, if any, is expected to be limited. Overall, the new proposed standard is expected to enhance audit quality and contribute to an increase in the credibility of financial reporting by EGCs.

Accordingly, and for the reasons explained above, the Board anticipates that, if it adopts the new proposed standard, it will request that the Commission determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether

the credibility of management disclosures. *See, e.g.,* Steven A. Dennis and Ian G. Sharpe, *Firm Size Dependence in the Determinants of Bank Term Loan Maturity*, 32 *Journal of Business Finance and Accounting* 31, 59 (2005); Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 *Journal of Financial Economics* 361, 363 (1995); David Aboody and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 *Journal of Finance* 2747, 2755 (2000); Raymond Chiang and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 *Journal of Finance* 1041, 1047 (1988); Molly Mercer, *How Do Investors Assess the Credibility of Management Disclosures?*, 18 *Accounting Horizons* 185, 194 (2004).

¹⁰¹ This statement is based on staff analysis of SEC filings and data from Audit Analytics and Standard & Poor's as of the Nov. 15, 2021 measurement date. The non-EGC-population is limited to exchange-listed companies that are not registered investment companies or EGCs and have filed audited financial statements with the SEC, including an audit report signed by a firm in the 18 months preceding the measurement date.

¹⁰² For a discussion of how increasing reliable public information about a company can reduce risk premium, *see* David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 *The Journal of Finance* 1553, 1578 (2004).

the action will promote efficiency, competition, and capital formation, to apply the new proposed standard to audits of EGCs.

Question:

47. We request comment generally on the analysis of the proposal on EGCs. Are there reasons why the proposal should not apply to audits of EGCs? If so, what changes should be made so that the proposal would be appropriate for audits of EGCs? What impact would the proposal likely have on EGCs, and how would this affect efficiency, competition, and capital formation?

VI. EFFECTIVE DATE

The Board seeks comment on the amount of time auditors would need before the new proposed standard and related amendments would become effective, if adopted by the Board and approved by the SEC. Specifically, the Board is considering whether compliance with adopted amendments and a new auditing standard should be required for audits of fiscal years beginning in the year after approval by the SEC (or for audits of fiscal years beginning two years after the year of SEC approval if SEC approval occurs in the fourth quarter of a calendar year).

Questions:

48. How much time following SEC approval would audit firms need to implement the proposed requirements?
49. Would requiring compliance for fiscal years beginning after the year of SEC approval present challenges for auditors? If so, what are those challenges, and how should they be addressed?

VII. APPENDICES

This proposal includes this release and its appendices:

- Appendix 1 – New Proposed Auditing Standard
- Appendix 2 – Proposed Amendments to Related PCAOB Auditing Standards

VIII. OPPORTUNITY FOR PUBLIC COMMENT

The Board is seeking comments on all aspects of its proposal, as well as specific comments on the new proposed standard and amendments. Among other things, the Board is seeking comment on the economic analysis relating to its proposal, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data regarding the new proposed standard and amendments.

Comments should be sent by e-mail to comments@pcaobus.org or through the Board's website at www.pcaobus.org. Comments may also be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. All comments should refer to PCAOB Rulemaking Docket Matter No. 028 in the subject or reference line and should be received by the Board by February 20, 2023.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the proposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Sarbanes-Oxley Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Sarbanes-Oxley Act.

* * *

On the 20th day of December, in the year 2022, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

December 20, 2022

* * *

APPENDIX 1 – NEW PROPOSED AUDITING STANDARD

[AS 2310 is amended in its entirety with the following:]

AS 2310: The Auditor’s Use of Confirmation

Introduction

.01 This standard establishes requirements for the auditor’s use of confirmation.

Objective

.02 The objective of the auditor in designing and executing the **confirmation process** is to obtain relevant and reliable audit evidence about one or more relevant financial statement assertions of a significant account or disclosure.¹

Relationship of the Confirmation Process to the Auditor’s Identification and Assessment of and Response to the Risks of Material Misstatement

.03 AS 2110, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements and provides that the auditor’s assessment of risks of material misstatement, including fraud risks, should continue throughout the audit. When the auditor obtains audit evidence during the course of the audit (including through the confirmation process) that contradicts the audit evidence on which the auditor originally based the risk assessment, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in respect to the revised risk assessments.²

.04 AS 2301, *The Auditor’s Responses to the Risks of Material Misstatement*, requires the auditor to design and implement appropriate responses that address risks of material misstatement. This may include using confirmation to address the assessed risks of material misstatement for certain relevant assertions of significant accounts and disclosures.

Note: If different components in a significant account or disclosure are subject to significantly differing risks of material misstatement, the auditor’s responses should include procedures that are responsive to the differing risks of material misstatement.

.05 AS 2301 provides that as the assessed risk of material misstatement increases, the evidence from substantive procedures that the auditor should obtain also increases. The

¹ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

² See AS 2110.74; see also paragraphs .02 and .29 of AS 1105, *Audit Evidence*.

evidence provided by substantive procedures depends upon the mix of the nature, timing, and extent of those procedures.

Note: AS 2110.68 provides that the auditor should presume that there is a fraud risk involving improper revenue recognition. According to paragraph .54 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*, examples of audit procedures that might be performed in response to this risk include confirming with customers certain relevant contract terms and the absence of side agreements.

.06 Audit evidence obtained through the confirmation process from an external knowledgeable source is generally more reliable than evidence obtained only from internal company sources.³ The following are examples of financial statement assertions for which the confirmation process, when properly designed and executed, can provide relevant and reliable audit evidence:

- Existence (e.g., cash, accounts receivable, investments)
- Occurrence (e.g., revenue transactions)
- Completeness (e.g., accounts payable, debt)
- Rights and obligations (e.g., cash, assets pledged as collateral)

.07 In situations involving fraud risks and significant unusual transactions, audit evidence obtained through the confirmation process generally is more persuasive than audit evidence obtained solely through other procedures.

.08 This standard describes the auditor's responsibilities related to the confirmation process, as follows:

- Paragraphs .09-.15 discuss confirming certain accounts and terms of transactions.
- Paragraphs .16-.21 discuss designing the **confirmation request**.
- Paragraphs .22-.24 discuss maintaining control over the confirmation process.
- Paragraphs .25-.30 discuss **confirmation responses, confirmation exceptions and nonresponses**.

³ See AS 1105.08.

- Paragraph .31 discusses alternative procedures.
- Paragraph .32 discusses using internal audit in the confirmation process.

Other PCAOB standards also address auditor responsibilities relevant to the auditor's use of confirmation.⁴ This standard does not address matters described in AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

Confirming Certain Accounts and Terms of Transactions

.09 For cash and cash equivalents held by third parties (“cash”), the auditor should perform confirmation procedures.

.10 In selecting the individual items of cash to confirm, the auditor should take into account the auditor's understanding of the company's cash management and treasury function, and the substance of the company's arrangements and transactions with third parties.

.11 When confirming cash, the auditor should consider sending confirmation requests about other financial relationships with the **confirming party**. Examples of other financial relationships are lines of credit, other indebtedness, compensating balance arrangements, or contingent liabilities, including guarantees.

.12 For accounts receivable that arise from the transfer of goods or services to a customer or a financial institution's loans (“accounts receivable”), the auditor should perform confirmation procedures.

.13 In selecting the individual accounts receivable to confirm, the auditor should take into account the auditor's understanding of the substance of the company's arrangements and transactions with third parties and the nature of items that make up account balances.

.14 The presumption to confirm accounts receivable in paragraph .12 may be overcome when the auditor determines that performing other substantive procedures (without using confirmation) would provide audit evidence that is at least as persuasive as the evidence that the auditor might expect to obtain through performing confirmation procedures. The auditor should communicate to the audit committee instances in which the auditor has determined that the presumption to confirm accounts receivable has been overcome and the basis for the auditor's determination. The communications to the audit committee should be made and

⁴ See, e.g., AS 2301 (regarding the nature, timing, and extent of audit procedures); and AS 2315, *Audit Sampling* (regarding planning, performing, and evaluating audit samples).

documented in accordance with paragraphs .25 and .26 of AS 1301, *Communications with Audit Committees*.⁵

.15 For significant risks of material misstatement associated with either a complex transaction or a significant unusual transaction, the auditor should consider confirming terms of the transaction with the counterparty to the transaction.

Designing Confirmation Requests

Identifying Information to Confirm

.16 The auditor should identify the information related to the relevant assertions that the auditor plans to verify with confirming parties or (when using a blank form) obtain from confirming parties.

Note: Some forms of **positive confirmation requests** ask the confirming party to indicate whether the confirming party agrees with the information stated on the request. Other forms of positive confirmation requests, referred to as blank forms, do not state the amount (or other information) to be confirmed, but request the confirming party to fill in the balance or furnish other information. Using a blank form confirmation request may provide more reliable audit evidence than using a confirmation request that includes information the auditor is seeking to confirm (e.g., customer account balance).

.17 The auditor should test the accuracy and completeness of information produced by the company that the auditor uses in selecting the items to confirm.⁶

Identifying Confirming Parties for Confirmation Requests

.18 The auditor should direct confirmation requests to confirming parties (individuals or organizations) who are knowledgeable about the information to be confirmed and determine that the confirmation requests are properly addressed.

Note: AS 2401.53 provides that when the auditor has assessed a fraud risk, sending confirmation requests to a specific party within an organization is an example of an audit response to the risk.

⁵ The term "audit committee," as used in this standard, has the same meaning as defined in Appendix A of AS 1301.

⁶ See AS 1105.10.

.19 If the auditor is aware of information about a potential confirming party's (i) motivation, ability, or willingness to respond, or (ii) objectivity and freedom from bias with respect to the audited entity,⁷ the auditor should consider this information, including its source, in selecting the confirming parties.

Note: Such information may indicate that the potential confirming party has incentives or pressures to provide responses that are inaccurate or otherwise misleading.

.20 If the auditor is unable to identify a confirming party who, in response to a confirmation request, would provide relevant and reliable audit evidence about the selected item, the auditor should perform alternative procedures as discussed in paragraph .31.

Using Negative Confirmation Requests

.21 Generally, the auditor obtains significantly less audit evidence when using **negative confirmation requests** than when using positive confirmation requests because the auditor typically does not receive from the confirming party a confirmation response to a negative confirmation request unless the confirming party disagrees with the information provided in the request. Therefore, the use of negative confirmation requests alone does not provide sufficient appropriate audit evidence for addressing the risk of material misstatement to a financial statement assertion.

Note: Appendix B discusses examples of situations where the use of negative confirmation requests in combination with the performance of other substantive audit procedures may provide sufficient appropriate audit evidence.

Maintaining Control over the Confirmation Process

.22 The auditor should maintain control over the confirmation process to minimize the likelihood that information exchanged between the auditor and the confirming party is intercepted or altered.

.23 The auditor should send the confirmation request directly to the confirming party and obtain the confirmation response directly from the confirming party.

.24 The auditor or the confirming party can engage another party as an intermediary to facilitate direct electronic transmission of confirmation requests and responses between the auditor and the confirming party. When using an intermediary for this purpose, the auditor

⁷ AS 2410, *Related Parties*, requires the auditor to perform procedures to obtain an understanding of the company's relationships and transactions with related parties.

should evaluate the implications on the reliability of confirmation requests and responses as discussed in Appendix B.

Evaluating Confirmation Responses and Confirmation Exceptions, and Addressing Nonresponses and Incomplete Responses

Evaluating Reliability of Confirmation Responses

.25 The auditor should evaluate the reliability of confirmation responses, taking into account any information about events, conditions, or other information that the auditor becomes aware of that (i) contradicts the information used when selecting the confirming party pursuant to paragraphs .18 and .19 or (ii) indicates that the confirmation request or confirmation response may have been intercepted and altered.⁸

Note: The following are examples of indicators that a confirmation response may have been intercepted or altered:

- a. The confirmation response comes from a physical or electronic address other than the address on the confirmation request.
- b. The confirmation response does not include a signature of the confirming party or otherwise identify the confirming party.
- c. The confirmation response does not include a copy of the original confirmation request, e-mail chain, or any other information indicating that the confirming party is responding to the auditor's confirmation request.

.26 If the auditor is unable to determine that the confirmation response is reliable, the auditor should perform alternative procedures as discussed in paragraph .31.

Evaluating Confirmation Exceptions

.27 The auditor should evaluate confirmation exceptions and determine whether the confirmation exceptions individually or in the aggregate indicate (i) a deficiency in the

⁸ A note to AS 1105.08 also describes the auditor's responsibilities to evaluate third-party evidence provided to the auditor subject to restrictions, limitations, or disclaimers.

company's internal control over financial reporting,⁹ (ii) a misstatement that should be evaluated in accordance with AS 2810, *Evaluating Audit Results*, or both.

Addressing Nonresponses and Incomplete Responses

.28 If the auditor does not receive a confirmation response to a positive confirmation request, the auditor should send a second positive confirmation request to the confirming party unless the auditor has become aware of information that indicates that the confirming party would be unlikely to respond to the auditor. The auditor should evaluate any response to a second confirmation request according to paragraphs .25-.27.

.29 If a confirmation response is returned by the confirming party to anyone other than the auditor, the auditor should contact the confirming party and request that the response be re-sent directly to the auditor. If the auditor does not subsequently receive a confirmation response from the intended confirming party, the auditor should treat the situation as a nonresponse.

.30 In the case of a nonresponse or an incomplete response, the auditor should perform alternative procedures as discussed in paragraph .31.

Performing Alternative Procedures

.31 Performing other audit procedures as an alternative to confirmation may be necessary when the auditor is unable to obtain relevant and reliable audit evidence about the selected item through confirmation. Paragraphs .20 (inability to identify a confirming party), .26 (unreliable response), and .30 (nonresponse or incomplete response) discuss certain situations in which the auditor should perform alternative procedures.¹⁰ The following are examples of alternative procedures that individually or in combination may provide relevant and reliable audit evidence:

- a. For terms of a transaction or agreement, inspecting the original signed contract and amendments thereto, comparing contractual terms to industry norms, and

⁹ In an integrated audit of financial statements and internal control over financial reporting, the auditor should perform the evaluation in accordance with AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. In an audit of financial statements, the auditor should follow the direction of AS 2201.62-.70, as stated in paragraph .03 of AS 1305, *Communications About Control Deficiencies in an Audit of Financial Statements*.

¹⁰ If the auditor is unable to obtain sufficient appropriate audit evidence about a relevant assertion, the auditor considers the impact on the audit opinion in accordance with AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

discussing and corroborating significant information with other parties involved in the transaction or agreement.

- b. For accounts receivable, examining one or more of the following: (i) subsequent cash receipts, including comparing the receipts with the amounts of the respective invoices being paid, (ii) shipping documents, or (iii) other supporting documentation (e.g., purchase orders or signed contracts and amendments thereto).
- c. For accounts payable, examining one or more of the following: (i) subsequent cash disbursements, (ii) correspondence from vendors and suppliers, or (iii) other supporting documentation.

Note: Performing alternative procedures may not be necessary if the inclusion of the items for which the auditor was not able to complete the audit procedures in the auditor's evaluation of the effect of uncorrected misstatements,¹¹ would not change the outcome of the evaluation.

Using Internal Audit in the Confirmation Process

.32 The auditor may use internal auditors to provide direct assistance to the auditor in the confirmation process in accordance with AS 2605, *Consideration of the Internal Audit Function*, except that an internal auditor should not (i) select the items to be confirmed, (ii) send confirmation requests, or (iii) receive confirmation responses.¹²

APPENDIX A – Definitions

.A1 For purposes of this standard, the terms listed below are defined as follows:

.A2 Confirmation exception – Information in a confirmation response that differs from information the auditor obtained from the company.

.A3 Confirmation process – The process that involves sending a confirmation request directly to a confirming party, evaluating the information received, and addressing nonresponses and incomplete responses to obtain audit evidence about one or more financial statement assertions.

¹¹ AS 2810.17 describes the auditor's responsibility to evaluate the effect of uncorrected misstatements.

¹² AS 2605 establishes requirements for using internal auditors to provide direct assistance to the auditor including supervising, reviewing, evaluating and testing the work performed by internal auditors.

.A4 Confirmation request – A request from the auditor to a confirming party regarding information about one or more particular accounts, balances, transactions, or other items as a means of obtaining audit evidence about one or more financial statement assertions.

.A5 Confirmation response – Information obtained as a direct written communication (in paper or electronic form) to the auditor from a confirming party in response to a confirmation request.

.A6 Confirming party – A third party, whether an individual or an organization, to which the auditor sends a confirmation request.

.A7 Negative confirmation request – A confirmation request in which the auditor requests a confirmation response only if the confirming party disagrees with the information provided in the request.

.A8 Nonresponse – A situation in which (i) after sending a confirmation request(s), the request is returned undelivered; (ii) the auditor does not receive a confirmation response to a positive confirmation request from the intended confirming party; (iii) the auditor receives correspondence from the intended confirming party indicating that the confirming party is unable or unwilling to respond to the confirmation request; or (iv) the auditor receives an oral response only.

.A9 Positive confirmation request – A confirmation request in which the auditor requests a confirmation response.

APPENDIX B – Additional Auditor Responsibilities

Considering Negative Confirmation Requests

.B1 The following are examples of situations in which the use of negative confirmation requests, in combination with the performance of other substantive audit procedures, may provide sufficient appropriate audit evidence:

- a. The auditor has (i) assessed the risk of material misstatement for the relevant assertions as low, and (ii) obtained sufficient appropriate audit evidence regarding the design and operating effectiveness of controls.¹³

¹³ See also AS 2301.16-.18 for a discussion of tests of controls.

- b. The population of items within the account balance or class of transactions for which the auditor considers sending negative confirmation requests is composed of many small, homogeneous items.
- c. The auditor expects a low exception rate in response to negative confirmation requests and has a reasonable basis for this expectation.

Evaluating the Implications of Using an Intermediary to Facilitate Direct Electronic Transmission of Confirmation Requests and Responses

.B2 Paragraph .24 requires that the auditor evaluate the implications of using an intermediary to facilitate direct electronic transmission of confirmation requests and responses between the auditor and the confirming party on the reliability of confirmation requests and responses. In performing the evaluation, the auditor should:

- a. Obtain an understanding of the intermediary's controls that address the risk of interception and alteration of the confirmation requests and responses.
- b. Determine that the controls used by the intermediary to address the risk of interception and alteration are designed and operating effectively.

Note: If the auditor performs procedures to determine that the controls used by the intermediary to address the risk of interception and alteration are designed and operating effectively at an interim date, the auditor should evaluate whether the results of the interim procedures can be used at period end or whether they need to be updated. In performing the evaluation, the auditor should consider the length of time between the date of the interim procedures and period end, and whether the process used by the intermediary has changed during that time.

- c. Assess the relationship of the intermediary with the company - specifically, whether circumstances exist that give the company the ability to override the intermediary's controls that address the risk of interception and alteration of the confirmation requests and responses (e.g., through financial, ownership, or other business relationships, contractual rights, or otherwise).

.B3 If information obtained by the auditor indicates that (i) the intermediary has not implemented controls that are necessary to address the risk of interception and alteration of the confirmation requests and responses, (ii) the necessary controls are not designed or operating effectively, or (iii) circumstances exist that give the company the ability to override the intermediary's controls, the auditor should not use the intermediary to send confirmation requests or receive confirmation responses.

APPENDIX 2 – PROPOSED AMENDMENTS TO RELATED PCAOB AUDITING STANDARDS

In connection with the new proposed auditing standard AS 2310, *The Auditor’s Use of Confirmation*, the Board is proposing amendments to several of its auditing standards to conform to the requirements of the new proposed auditing standard.

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added by the proposed amendments is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences, paragraphs, and footnotes is intended to assist the reader in easily comprehending the Board's proposed changes to the auditing standards. The Board's proposed amendments consist of only the deleted or added language. This presentation does not constitute or represent a proposal of all or of any other part of the auditing standard as amended by this proposal.

The Board is requesting comments on all aspects of the proposed amendments.

AS 1105, *Audit Evidence*

Confirmation

.18 A confirmation response is information ~~represents a particular form of audit evidence~~ obtained as a direct written communication (in paper or electronic form) to by the auditor from a confirming third party in response to a confirmation request in accordance with PCAOB standards.¹⁰

¹⁰ See AS 2310, *The Auditor’s Use of Confirmation Process*. The terms “confirmation response,” “confirmation request,” and “confirming party,” as used in this standard, have the same meaning as defined in Appendix A of AS 2310.

AS 1301, *Communications with Audit Committees*

Appendix B – Communications with Audit Committees Required by Other PCAOB Rules and Standards

- AS 2310, *The Auditor’s Use of Confirmation*, paragraph .14.

AS 2401, *Consideration of Fraud in a Financial Statement Audit*

Additional Examples of Audit Procedures Performed to Respond to Assessed Fraud Risks Relating to Fraudulent Financial Reporting

- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements.²¹ For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances

²¹ AS 2310, *The Auditor’s Use of Confirmation-Process*, establishes requirements regarding the use of confirmation process in audits of financial statements.

AS 2510, *Auditing Inventories*

Inventories Held in Public Warehouses

.14 If inventories are in the hands of public warehouses or other outside custodians, the auditor ordinarily would obtain direct confirmation in writing from the custodian.¹ If such inventories represent a significant proportion of current or total assets, to obtain reasonable

assurance with respect to their existence, the auditor should apply one or more of the following procedures as he considers necessary in the circumstances.

- a. Test the owner's procedures for investigating the warehouseman and evaluating the warehouseman's performance.
- b. Obtain an independent accountant's report on the warehouseman's control procedures relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable.
- c. Observe physical counts of the goods, if practicable and reasonable.
- d. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate).

¹ See AS 2310, *The Auditor's Use of Confirmation*, which establishes requirements for the auditor's use of confirmation.

AS 2605, *Consideration of the Internal Audit Function*

Extent of the Effect of the Internal Auditors' Work

.22 On the other hand, for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work (either tests of controls or substantive tests) performed by internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary. Assertions about the existence of ~~cash~~, prepaid assets, and fixed-asset additions are examples of assertions that might have a low risk of material misstatement or involve a low degree of subjectivity in the evaluation of audit evidence.

Using Internal Auditors to Provide Direct Assistance to the Auditor

.27 In performing the audit, the auditor may, unless prohibited by PCAOB standards,^{7A} request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, internal auditors may assist the auditor in obtaining an understanding of internal control or in performing tests of controls or substantive tests, consistent with the guidance about the auditor's responsibility in paragraphs .18 through .22. When direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity (see paragraphs .09 through .11) and supervise,⁸ review, evaluate, and test the work performed by internal auditors to the extent appropriate in the circumstances. The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

^{7A} See, e.g., paragraph .32 of AS 2310, *The Auditor's Use of Confirmation*, which prohibits the use of internal auditors in the confirmation process for selecting items to be confirmed, sending confirmation requests, and receiving confirmation responses.
