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Accountability \* Integrity \* Reliability

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United States Government Accountability Office  
Washington, DC 20548

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Subject: AICPA Auditing Standards Board (ASB) May 2009 Exposure Draft of proposed Statement on Auditing Standards (SAS) on external confirmations.

This letter provides the U.S. Government Accountability Office's (GAO) comments on the ASB's proposed statement on auditing standards. Except for serious concerns about retaining the presumptive requirement to request confirmation of accounts receivable, we support the proposed standard. This concern, along with our comments on other aspects of the proposed standard, is noted below.

**Presumptive requirement to use external confirmation procedures for accounts receivable:**

The ASB is seeking views on its decision to retain the presumptive requirement to use external confirmation procedures for accounts receivable through a conforming amendment to the proposed SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (Redrafted).

The presumptive requirement to confirm accounts receivable is problematic because it supplants auditor judgment by presuming that confirmation procedures are the most effective audit procedure to address the risk of material misstatement in accounts receivable, and directs the auditor to perform the audit using that assumption. Rather than requiring auditors to use judgment based on audit risk and materiality as the starting point to determine the most effective procedure to obtain audit evidence related to accounts receivable, the presumptive requirement directs auditors to use the same procedure unless the auditor can justify not using confirmations if certain conditions exist.

The unintended consequences of the presumptive requirement are that it may encourage auditors to: (1) minimize the importance of risk and materiality assessments of accounts receivable, since the procedures to be performed on accounts receivable are predetermined; (2) spend too much time performing

confirmation procedures in situations when there is a low risk of material misstatement for accounts receivable or when relevant and reliable audit evidence, such as subsequent collection, is available; and (3) spend too little time evaluating

risk and performing analyses in situations when there is a risk of material misstatement for accounts receivable due to collusion between the audited entity and the customer.

The current presumptive requirement has led many auditors to conclude that external confirmations are the only evidence needed to support management assertions related to accounts receivable. This over-reliance may result from the presumption that evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.<sup>1</sup> Research suggests that practitioners may place undue reliance on confirmation procedures by assuming that the confirmations are received from knowledgeable independent sources.<sup>2</sup> Studies of Accounting and Auditing Enforcement Releases issued by the Securities and Exchange Commission (SEC) have identified significant risks associated with confirmations, including a significant number of cases of collusion between auditees and customers.<sup>3</sup>

For these reasons, we recommend removing paragraph 19b and its requirement to use confirmation procedures for material accounts receivable from the proposed conforming amendments to the SAS *Performing Audit Procedures* (from pages 22-26 of the Exposure Draft). We recommend retaining in the proposed conforming amendments the requirement in paragraph 19a to consider using external confirmation procedures as substantive procedures, along with the valuable guidance in paragraphs A57a-f and A59 on considering whether to perform external confirmation procedures.

If, however, the Board believes it is important to retain the presumptively mandatory requirement to request confirmation of accounts receivable, we then urge the ASB to enhance, clarify, and streamline the requirements in the conforming amendment to

- explain the conditions that would justify a departure from the presumptively mandatory requirement, such as when an auditor has reason to believe that external confirmation procedures likely would be unreliable or the confirming party would be unlikely to respond,
- establish a new requirement for auditors to determine whether additional substantive procedures besides requesting confirmation of accounts receivable may be necessary to obtain sufficient, appropriate evidence to support management assertions concerning accounts receivable,
- move the statement of fact from subparagraph b of paragraph 19b to the application material section of the standard, and
- remove the redundant documentation requirement.

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<sup>1</sup> AU Sec 326.08.

<sup>2</sup> P. Caster, R. Elder, and D. Janvrin, "Summary of Research and Enforcement Release Evidence on Confirmation Use and Effectiveness," *Auditing: A Journal of Practice & Theory*, vol. 27, no. 2 (2008). Pg. 270.

<sup>3</sup> Ibid. pg 261.

Accordingly, if the presumptive requirement is retained, we recommend revising proposed paragraphs 19b and A57a as follows:

Paragraph 19b: The auditor should use external confirmation procedures for material accounts receivable, except when one or more of the following is applicable: (Ref: par. A57e)

a. External confirmation procedures for accounts receivable are likely to be ineffective, for example, they would be unreliable or the confirming party is unlikely to respond (Ref: par. A57d and A57f)

b. The auditor's assessed level of risk of material misstatement is low, and the auditor plans to obtain sufficient appropriate audit evidence by performing other substantive procedures. ~~In many situations, use of external confirmation procedures for accounts receivable and the performance of other substantive tests are necessary to reduce audit risk to an acceptably low level for the relevant assertions.~~

Auditors also should determine whether other substantive audit procedures, in addition to external confirmations, may be necessary to obtain sufficient, appropriate evidence to support management assertions concerning material accounts receivable. The auditor should document the basis for any determination not to use external confirmation procedures for accounts receivable.

Paragraph A57a: In many situations, use of external confirmation procedures for accounts receivable and the performance of other substantive tests are necessary to reduce audit risk to an acceptably low level for the relevant assertions.

External confirmation procedures frequently may be relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations in which external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include the following:

- Bank balances and other information relevant to banking relationships
- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties or purchased from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants
- Accounts payable balances and terms

## **Definition of External Confirmations**

The ASB has requested comment on its decision to expand the definition of an external confirmation to include direct access by the auditor to information held by a third party. We support this decision and believe that the requirements and guidance in this proposed standard on obtaining relevant and reliable audit evidence would apply to direct access to third party information as well as to responses received in paper form or by electronic or other medium.

## **Responses to Specific Questions**

The Board is also seeking comments on the effect of applying the clarity drafting conventions to the proposed standard and converging it with the International Standards on Auditing. We provide the requested comments below, along with recommended wording changes.

### **(1) Are the auditor's objectives appropriate?**

We believe that the auditor's objective when using external confirmation procedures "*to design and perform such procedures to obtain relevant and reliable audit evidence,*" is appropriate. This objective is consistent with the objective of ISA No. 505, *External Confirmations*.

### **(2) Are the revisions made to converge the existing standard with ISA No. 505 appropriate?**

We agree with most of the revisions from the existing standard to converge with the ISA. In particular, we support the changes to the existing standard in paragraphs 8 and 9 of the proposed SAS that address auditor responsibilities when management refuses to allow the auditor to send a confirmation request.

We also agree that negative confirmation requests provide less persuasive audit evidence than positive confirmations, and therefore, we believe they should be used only in very limited situations. Thus, we suggest further limiting the circumstances when negative confirmation requests may be used. Negative confirmation requests, in our view, should not be used as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.

Accordingly, we recommend revising paragraph 15 of the proposed standard as follows:

Paragraph 15: Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor should not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level. Negative confirmations may be used as corroborating evidence to support other substantive evidence when all of the following are present:

- a. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.
- b. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions, or conditions.
- c. A very low exception rate is expected.
- d. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests. (Ref: par. A26)

**(3) Are the differences between the proposed SAS and ISA No. 505 identified in the exhibit, and other language changes, appropriate?**

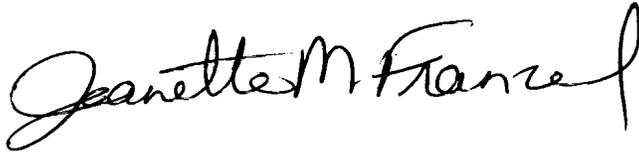
Except for the presumptive requirement to request confirmation of accounts receivable, we agree with the differences between the proposed SAS and ISA No. 505

We specifically support the changes made to ISA No. 505 paragraph A12 and the addition of paragraph A14 to the ASB draft, which provide important guidance on electronic confirmation procedures. To further enhance this guidance, we recommend clarifying in paragraph A12 that this guidance also applies to auditor direct access to information held by a third party when the access is received directly from the confirming party. We propose wording this change as follows:

Paragraph A12: Responses received electronically (for example, by fax, e-mail, or by auditor direct access to information held by a confirming party when the access is received directly from the confirming party) involve risks relating to reliability because proof of origin and knowledge of the respondent may be difficult to establish and alterations may be difficult to detect. An electronic confirmation process that creates a secure confirmation environment may mitigate the risks of interception or alteration. The key to creating a secure confirmation environment lies in the process or mechanism used by the auditor and the respondent to minimize the possibility that the results will be compromised because of interception or alteration of the confirmation. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. Various means might be used to validate the source of the electronic information and the respondent's knowledge about the requested information. For example, the use of encryption, electronic digital signatures, and procedures to verify Web site authenticity may improve the security of the electronic confirmation process.

We thank you for considering our comments on these important issues.

Sincerely yours,

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive style with a large, looped initial "J" and a long, sweeping tail on the "l".

Jeanette Franzel  
Managing Director  
Financial Management and Assurance

cc: Mr. Harold Monk, Chair  
Auditing Standards Board

Mr. Daniel Goelzer, Acting Chairman  
Public Company Accounting Oversight Board