

December 2008

**Basis for Conclusions:  
ISA 505 (Revised and Redrafted),  
External Confirmations**

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*Prepared by the Staff of the International Auditing and  
Assurance Standards Board*



**International Federation  
of Accountants**

## **BASIS FOR CONCLUSIONS:**

### **ISA 505 (REVISED AND REDRAFTED), EXTERNAL CONFIRMATIONS**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 505 (Revised and Redrafted), "External Confirmations," which was approved by the IAASB in September 2008.<sup>1</sup>

#### **Background**

1. A number of high profile corporate financial failures in the recent past have elevated awareness of the use of, and consideration of the reliability of, external confirmations as audit evidence. As a result, some regulatory authorities around the world have called for more rigorous requirements relating to the auditor's use of external confirmations. In addition, national auditing standard setters have noted a need to enhance auditing standards and guidance relating to their use.
2. A fundamental question is whether, or under what circumstances, requiring the use of external confirmations is appropriate in the international context, and whether such practice would, in fact, enhance the persuasiveness of audit evidence obtained by the auditor.
3. In response to the above developments, the IAASB commenced this project in December 2005 with a view to updating and strengthening the standards and guidance in extant ISA 505 addressing the auditor's use of external confirmations, within the context of the audit risk model.
4. In revising ISA 505, the IAASB consulted widely on its proposals. Significant proposals were discussed with the IAASB Consultative Advisory Group (CAG) at various stages of developing the proposed ISA. The IFAC Small and Medium Practices Committee also commented on various drafts of the proposed ISA.
5. The IAASB issued the exposure draft of the proposed ISA 505 (Revised and Redrafted) (ED-ISA 505) in October 2007. The comment period closed February 15, 2008. A total of 46 comment letters were received from various respondents, including regulators and oversight authorities, IFAC member bodies, national auditing standard setters, audit firms, and professional and public sector organizations. Respondents to ED-ISA 505 generally expressed support for the revision and redrafting of the ISA. This Basis for Conclusions explains the more significant issues raised by respondents to ED-ISA 505, and how the IAASB has addressed them.

#### **Determining Whether to Use External Confirmation Procedures**

6. Extant ISA 505 requires that the auditor determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. The Explanatory Memorandum to ED-ISA 505 explained that the IAASB determined, after much deliberation, that it would not be necessary for proposed ISA 505 (Revised and Redrafted) to include a requirement for the auditor to consider whether, and

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<sup>1</sup> See minutes of the September 15-19, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4426>.

to what extent, to use external confirmation procedures when performing an audit of financial statements. The IAASB's rationale was that ISA 330 (Redrafted)<sup>2</sup> already provides adequate guidance to the auditor relative to determining the nature, timing and extent of audit procedures in response to assessed risks of material misstatement, including references to when external confirmation procedures may be an effective response. Accordingly, the IAASB agreed that, while ED-ISA 505 should provide guidance for when the auditor considers using external confirmation procedures as a response to an assessed risk, it was unnecessary to include a requirement similar to that in extant ISA 505.

7. While a majority of respondents agreed with the IAASB's proposal, a significant minority expressed some form of disagreement with the approach in ED-ISA 505. Some argued that not retaining the extant requirement would weaken the standard and downplay the importance of external confirmation procedures. Others argued that the guidance in ISA 315 (Redrafted)<sup>3</sup> and ISA 330 (Redrafted) would be insufficient to prompt auditors to consider external confirmation procedures as an appropriate audit approach because there is no explicit requirement in those ISAs for the auditor to consider the use of such procedures. Some commented that external confirmation procedures are presumptively the most appropriate audit procedures to obtain sufficient appropriate audit evidence regarding existence and other assertions relating to certain balances, such as accounts receivable, and bank and other third party balances. Accordingly, they suggested that the proposed ISA should include a rebuttable presumption that the auditor will use external confirmation procedures to audit certain account balances.
8. A few respondents were of the view that the auditor should be required to use external confirmations when a significant risk has been assessed and the auditor has an expectation that external confirmation procedures will be an effective means of responding to such a risk. They argued that this should be so because, when properly designed, external confirmations provide persuasive audit evidence. Other respondents also argued that having a specific requirement to consider the use of external confirmation procedures would be consistent with the approach taken in proposed ISA 620 (Revised and Redrafted),<sup>4</sup> which includes a requirement for the auditor to determine whether to use the work of an auditor's expert if expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence.

### **IAASB Decision**

9. The IAASB acknowledged the strength of the concerns raised and accepted that some clarity about the extent to which the auditor considers the use of external confirmation procedures might have been lost in the original proposal not to carry forward the extant requirement. Accordingly, the IAASB determined that a requirement should be established for the auditor to consider whether external confirmation procedures should be performed as substantive audit procedures, and that such a requirement should be placed within the section

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<sup>2</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

<sup>3</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment."

<sup>4</sup> Proposed ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert."

addressing substantive procedures in ISA 330 (Redrafted) by means of a conforming amendment. Supporting guidance that describes the relevance of external confirmations has been moved from the proposed ISA to ISA 330 (Redrafted) through a conforming amendment (see paragraphs 20a and A47a-A47d of the conforming amendments to ISA 330 (Redrafted)).

10. The IAASB believes that establishing this requirement appropriately elevates the profile of external confirmation procedures as substantive procedures by providing a clear obligation for the auditor to consider them as part of the audit, without establishing a presumption that they be used for any particular assertion. By placing the requirement in ISA 330 (Redrafted), the IAASB agreed that the purpose and scope of ISA 505 (Revised and Redrafted) would be appropriately focused on establishing requirements that improve auditor performance when using external confirmations, once the auditor has decided to do so.
11. The IAASB did not agree with respondents' suggestion that a requirement be established for a rebuttable presumption that external confirmation procedures be performed in a particular circumstance because there are many circumstances where external confirmation procedures may not be effective. In addition, a documentation burden would arise if the auditor were to rebut the presumption.
12. The IAASB also did not agree with respondents' suggestion that the auditor be required to use external confirmations when a significant risk has been assessed and the auditor has an expectation that external confirmation procedures will be effective in responding to such a risk, because that would in effect establish a presumptive requirement in such a situation. Nevertheless, the IAASB agreed that it would be appropriate to clarify, through a conforming amendment to paragraph A49 of ISA 330 (Redrafted), that external confirmations may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.

### **Use of Negative Confirmations**

13. In considering whether the use of negative confirmation requests as the sole substantive procedure to address an assessed risk of material misstatement at the assertion level should be prohibited or limited to specific circumstances, the IAASB agreed on the principle that an ISA should not prevent an auditor from performing a particular audit procedure simply because that procedure may provide limited audit evidence. Instead, an ISA should help the auditor understand the limitations of audit evidence obtained from such a procedure. Accordingly, ED-ISA 505 did not prohibit the use of negative confirmation requests in an audit of financial statements, but instead specified preconditions under which the procedure might be applied as the sole substantive response to an assessed risk of material misstatement at the assertion level. The majority of respondents supported this approach to the use of negative confirmations.
14. Several respondents nevertheless commented that the specified preconditions were insufficiently strict on the grounds that negative confirmations do not normally provide reliable audit evidence. Further, some of the respondents suggested that the use of negative

confirmations should not be permitted because of the lack of effectiveness of the procedure and the possibility that auditors might seek to downplay its shortcomings in order to justify using it. Other respondents, however, took the view that the preconditions limiting the use of the procedure as a sole response to an assessed risk imposed overly stringent hurdles for the auditor to overcome (particularly in relation to the requirement that the auditor ensure that there is no reason to believe that recipients of negative confirmation requests would disregard such requests). These respondents felt that this would unduly discourage consideration of the procedure.

### **IAASB Decision**

15. Given the strong support expressed by the majority of the respondents for the proposal set out in ED-ISA 505, and the absence of a preponderance of views from respondents arguing that the preconditions are either overly restrictive or overly lenient, the IAASB determined that the proposal should be retained. The IAASB believes that this appropriately provides the auditor with the flexibility to consider using negative confirmations as a sole response to an assessed risk when the strict preconditions have been satisfied, without unnecessarily constraining practice by barring performance of the procedure altogether. Nevertheless, the IAASB agreed to refine the wording of the preconditions to make them clearer (see paragraph 15 of ISA 505 (Revised and Redrafted)).

### **Objective of the ISA**

16. ED-ISA 505 proposed the following objective for the auditor:

The objective of the auditor when using external confirmation procedures in response to an assessed risk of material misstatement is to design and perform such procedures to obtain relevant and reliable audit evidence.
17. Many respondents indicated support for this objective, although several of them felt that it should be expanded to include determining whether to use external confirmations. A few respondents noted that linking the design and performance of external confirmation procedures to *an assessed risk of material misstatement* was inconsistent with ISA 330 (Redrafted). This is because the latter requires that “*irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure,*” and therefore such substantive procedures might include external confirmation procedures. Accordingly, these respondents suggested that the words “in response to an assessed risk of material misstatement” should be deleted from the objective.
18. One respondent commented that the objective of ED-ISA 505 was an incomplete reflection of the objectives of ISA 330 (Redrafted) and ISA 500 (Redrafted).<sup>5</sup> This respondent suggested that the objective should be restated with closer reference to the objectives of these ISAs.

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<sup>5</sup> ISA 500 (Redrafted), “Audit Evidence.”

## **IAASB Decision**

19. The IAASB accepted that it would not be appropriate to refer to the use of external confirmation procedures only as a response to an assessed risk of material misstatement. Accordingly, the IAASB determined that the phrase “in response to an assessed risk of material misstatement” should be deleted from the objective. In addition, on the basis of its decision to position in ISA 330 (Redrafted) a requirement for the auditor to consider whether external confirmation procedures are to be performed as substantive audit procedures (see discussion of the issue of determining whether to use external confirmation procedures above), the IAASB agreed that the objective should not be expanded to include an obligation for the auditor to determine whether to use external confirmations.
20. The IAASB agreed, however, that ISA 505 (Revised and Redrafted) should be more clearly linked with ISA 330 (Redrafted) and ISA 500 (Redrafted). The IAASB determined that this linkage should be more appropriately made outside the objective but within the Scope section of the ISA. Accordingly, paragraphs 1 and 3 of ISA 505 (Revised and Redrafted) have been expanded to that effect.

## **Electronic Confirmations**

21. Some respondents commented that ED-ISA 505 did not provide sufficient guidance on the use of external confirmation procedures in an electronic context. One suggested that the IAASB consider guidance issued by the American Institute of Certified Public Accountants’ Auditing Standards Board regarding the use of electronic confirmations as a useful basis for developing application material specific to electronic confirmations.

## **IAASB Decisions**

22. The IAASB did not disagree that more extensive guidance pertaining to electronic confirmations as audit evidence would be warranted but took the view that it would be more appropriate to consider this matter separately, perhaps as part of a wider consideration of the nature of audit evidence in an electronic world.
23. Nevertheless, in view of the increasing prevalence of electronic confirmations in some environments, the IAASB agreed that it would be appropriate to provide some guidance in ISA 505 (Revised and Redrafted) to highlight relevant considerations pertaining to the use of electronic confirmations, i.e.:
  - There may be issues regarding the reliability of responses to confirmation requests received electronically, and a secure environment for such responses may mitigate the attendant risks.
  - There are risks in the use by entities of third parties to coordinate and provide responses (including electronic ones) to confirmation requests, and the auditor may perform certain procedures to mitigate such risks.

The relevant guidance is included in paragraphs A12-A13 of ISA 505 (Revised and Redrafted).

## **When a Response to a Positive Confirmation Request Is Necessary to Obtain Sufficient Appropriate Audit Evidence**

24. Paragraph 12 of ED-ISA 505, under the subsection dealing with non-responses, proposed that the auditor be required to perform alternative audit procedures to obtain relevant and reliable audit evidence in the case of non-responses to confirmation requests. It also proposed that the auditor determine the implications for the audit and the auditor's opinion if the auditor determines that a response to a positive confirmation request is *necessary* to obtain sufficient appropriate audit evidence, and that response is not obtained.
25. Some respondents commented that ED-ISA 505 did not clearly articulate the circumstances envisaged in that second requirement. A few respondents also commented that this second requirement seemed to deal only with non-response situations by virtue of its being located in the subsection of ED-ISA 505 dealing with non-responses, and that the requirement would also be applicable when the auditor does not receive *reliable* confirmation responses.

### **IAASB Decision**

26. The IAASB accepted the respondents' comments and agreed to place the second requirement in paragraph 12 of ED-ISA 505 under a new sub-heading that deals solely with circumstances when a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. In addition, to address the concerns that the circumstances in which the requirement would apply were not sufficiently clear in the exposure draft, the IAASB agreed to clarify the wording of the requirement and the related guidance in the application material (see paragraphs 13 and A20 of ISA 505 (Revised and Redrafted)).

## **Reliability of Responses to Confirmation Requests**

27. Paragraph 10 of ED-ISA 505 proposed the requirement that if the auditor has doubts about the reliability of the response to a confirmation request, the auditor obtain further audit evidence to resolve such doubts. Paragraph 20 of ED-ISA 505 proposed the requirement that if the auditor determines that a response to a confirmation request is not reliable, the auditor evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures.
28. A few respondents commented that the underlying guidance in paragraphs A16-A20 of ED-ISA 505 (particularly the statement in paragraph A16 that no response is without some risks of interception, alteration or fraud) seemed to suggest that the auditor should adopt an excessively skeptical approach. They argued that the guidance appeared to over-emphasize the risks of fraud relative to the risks of error. Further, in relation to the statement in paragraph A22 of ED-ISA 505 (in the context of performing alternative audit procedures for non-responses) that a non-response to a confirmation request may indicate a previously unidentified risk of material misstatement, these respondents commented that it is unrealistic to suggest that a non-response alone may be indicative of a fraud risk factor.

They argued that it would not be practicable for auditors to treat all non-responses in such a way.

### **IAASB Decisions**

29. The IAASB believes that it remains appropriate for auditors to elevate their level of professional skepticism when considering the reliability of responses to confirmation requests, especially given the significant reliance auditors may place on such procedures for providing persuasive audit evidence. As certain corporate failures have demonstrated in the recent past, unreliable responses to confirmation requests can be a factor in fraud not being detected through the auditor's procedures. The IAASB does not believe that sufficient reasons have been given by the above respondents for there to be grounds for not emphasizing a need for heightened skepticism by auditors when considering the reliability of responses to confirmation requests.
30. In regards to the guidance in paragraph A22 of ED-ISA 505, the IAASB did not agree with the respondents that this implied a requirement for the auditor to treat a non-response alone as evidence of a fraud risk factor. Rather, the guidance appropriately suggests that the auditor raise the auditor's level of skepticism regarding the *possibility* that a non-response might indicate the existence of a previously unidentified risk of material misstatement. For these reasons, the IAASB determined that the above-mentioned guidance should, with some refinements, continue to apply (see paragraphs A11, A14-A17 and A19 of ISA 505 (Revised and Redrafted)).