

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 11-12, 2006

External Confirmations

Objectives of Agenda Item

To obtain the views of the CAG on the direction to the project proposed by the Task Force.

Task Force Members

Craig Crawford, Chair (IAASB member - TAC)

David Swanney (IAASB public member - UK)

Roberto Tizzano (IAASB member - Italy)

Simon Hancox (Australia)

John O'Brien (Canada – nominated by INTOSAI)

Project Status

The project proposal (<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=1905>) was approved by the IAASB in December 2005.

The purpose of the project is:

- To determine whether to change the extent of the obligation on the auditor to obtain external confirmations.
- To develop, as necessary, additional requirements and guidance to improve the effectiveness of the external confirmation process, and the reliability of confirmation responses, including that relating to audit evidence obtained with respect to lawyer letters.

Existing Standards **(Refer to Existing Standards and Research in Agenda Item G.1)**

Existing ISA 505, "External Confirmations," was issued in 2001. Its purpose is to establish requirements and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence. ISA 505 does not require that external confirmations be requested by the auditor. Paragraph 2 of ISA 505 states:

The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit

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evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.

Existing Part C: Procedures Regarding Litigation and Claims of ISA 501, “Audit Evidence,” provides guidance on the procedures an auditor should perform with respect to litigation and claims. Paragraph 32 requires the auditor to carry out procedures to become aware of any litigation or claims involving the entity which may result in a material misstatement of the financial statements. Paragraph 33 states:

When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity’s legal counsel.

Summary of Proposed Direction of Project

The general approach adopted by the Task Force in identifying issues and developing the project approach is to consider external confirmations in the context of the audit risk model. The preliminary conclusion of the Task Force is that the auditor should design audit procedures that are responsive to the risks of material misstatement. The Task Force is proposing that confirmation requests not be mandated to address pre-defined risks. The Task Force believes that the benefits of this approach will include:

1. *Improved relevance of confirmations:* auditors will make a conscious decision to seek confirmations that will be responsive to risks assessed at the assertion level rather than as a residual procedure on all assertions as under existing ISA 505.
2. *Improved reliability of confirmations:* auditors will be less likely to inappropriately rely on confirmations because they seek confirmations when a confirmation is an appropriate response to the assessed risk.
3. *Improved execution by auditors:* by linking guidance on the design of confirmations with the assessed risks, and enhancing the guidance in ISA 505 to improve the design of requests and improve follow up of responses, auditors will be more likely to obtain confirmations that will provide the audit evidence the auditor requires.

The Task Force believes that the outcome of the project will be an enhanced standard that will improve the quality of audits with respect to use of external confirmations and, therefore, meet the ultimate objective of those who are calling for changes to ISA 505.

Matters for CAG Consideration

The Issues Paper discusses a number of issues considered by the Task Force in developing a proposed direction for the Project as follows:

ISSUE 1: DOES THE EXISTING ISA 505 FIT IN THE AUDIT RISK MODEL? (Refer to Issue 1 in Agenda Item G.1)

In addressing the project objectives and scope, the Task Force has considered whether the existing ISA 505 is appropriately positioned in relation to the audit risk model.

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The Task Force believes that ISA 505 does not fully address where external confirmations fit within the audit risk model. The Task Force proposes that the Project improve the linkages in ISA 505 between the audit risk model and the decision to request external confirmations. The Task Force proposes to develop an approach that requires a more rigorous assessment of whether to seek confirmations than under the current standard (which assessment would need to be documented). This may involve more clearly linking certain types of confirmation request with specific financial statement assertions. Paragraphs 1 to 16 of ISA 505 would be revised accordingly.

ISSUE 2: WHEN, OR UNDER WHAT CIRCUMSTANCES, SHOULD CONFIRMATIONS BE USED? *(Refer to Issue 2 in Agenda Item G.1)*

Given the discussion in Issue 1, the Task Force sought to identify when the auditor should use confirmations in an audit of financial statements.

The Task Force believes that the auditor will ordinarily seek to obtain confirmations, when:

- (a) Confirmations are the most efficient means of obtaining the required audit evidence, or
- (b) The auditor concludes that obtaining evidence from a third party is the only way to obtain sufficient audit evidence.

The Task Force believes that it is important that these two situations be discussed in the ISAs due to the differing consequences. For example, under (a), if the auditor does not receive a response to a confirmation request, there are other audit procedures that the auditor can perform that may provide the evidence necessary to address the risk; under (b), if the auditor does not receive a response to a confirmation request there may not be other procedures that the auditor can perform to address the risk.

The Task Force also proposes to consider whether it would be useful to provide guidance on the use of confirmations with respect to specific financial statement items where external confirmation is common practice, such as accounts receivable, bank balances, accounts payable, etc. Such guidance would be application guidance under the clarity format and provide guidance relative to effectively executing the confirmation process when a determination has been made that external confirmations will be requested.

ISSUE 3: HOW DOES THE AUDITOR CONCLUDE THAT EVIDENCE RECEIVED FROM EXTERNAL CONFIRMATIONS IS RELIABLE? *(Refer to Issue 3 in Agenda Item G.1)*

An underlying presumption for the use of external confirmations is that they provide reliable audit evidence. However, there are issues concerning the reliability of confirmations as audit evidence. Many of these issues are outside of the auditor's control, although some may be the result of inadequate execution by auditors (e.g., over-reliance on confirmations). The question is whether changes to the ISAs can help improve the reliability of confirmations auditors obtain.

The Task Force believes the presumption that confirmations will provide reliable audit evidence may be overstated. For example, while confirmation may appear to be an appropriate response to an assessed risk, this conclusion is valid only to the extent that the confirming party is diligent in

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preparing its response to the confirmation request. Accordingly, the Task Force believes that, prior to seeking to obtain confirmations, the auditor should assess whether external confirmations will, in fact, provide relevant and reliable audit evidence. The Task Force believes that ISA 505 should recognize more explicitly that there are inherent limitations to the confirmation process that vary depending on the circumstances and that, in determining the nature, timing and extent of use of confirmations, the auditor should assess the likelihood that confirmations will provide relevant and reliable audit evidence.

The Task Force also believes that once the auditor has determined that confirmations should be requested and that they are likely to provide relevant and reliable audit evidence, the emphasis should be on ensuring that the confirmation process should be conducted properly.

The Task Force proposes to:

- Develop guidance to assist auditors in determining whether confirmations are likely to provide relevant and reliable audit evidence;
- Expand on the guidance in ISA 505 dealing with the design and effectiveness of the confirmation process;
- More clearly link confirmation design with the risk and assertions being addressed;
- Provide more guidance to assist the auditor in assessing the reliability of responses;
- Expand the guidance addressing confirmation exceptions and non-responses;
- Emphasize that, once the auditor has determined to seek confirmations, it is important to design an effective confirmation process as set out in the ISA in order to obtain relevant and reliable audit evidence.

ISSUE 4: UNDER WHAT CIRCUMSTANCES CAN THE AUDITOR USE NEGATIVE CONFIRMATIONS?

(Refer to Issue 4 in Agenda Item G.1)

Concerns have been raised that auditors are placing excessive reliance on negative confirmations as a source of audit evidence.

The Task Force concluded that negative confirmations may be useful in specific circumstances, particularly when there is a strong incentive for recipients to respond to the request. In addition, the Task Force believes that negative confirmations should only be used to address assertions with low risk of material misstatement.

The Task Force proposes that the ISA not preclude use of negative confirmations to obtain audit evidence. However, the guidance in the ISA should be enhanced.

The Task Force proposes to expand the guidance in paragraphs 21-24 of ISA 505 to articulate more clearly the limitations on the level of assurance that can be obtained through the use of negative confirmations and reaffirm that negative confirmations should not be used to address high risk assertions.

ISSUE 5: WHAT SHOULD BE DONE WITH ISA 501 PART C? **(Refer to Issue 5 in Agenda Item G.1)**

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The current guidance in ISA 501 dealing with legal confirmations covers several matters:

- Requirement to become aware of litigation and claims
- When confirmation of litigation and claims is required
- The process for communication with legal counsel
- Considerations when management does not give the auditor permission to communicate with legal counsel.

The Task Force believes that the guidance on this particular subject may be more appropriately located within the ISAs. The issue in moving it is that there is no obvious alternative.

The Task Force concluded that there is a logical connection between ISA 501 and ISA 505, as they both deal with external confirmations. However, the requirement to become aware of litigation and claims in paragraph 32 of ISA 501 does not logically fit within the requirements of ISA 505. Accordingly, the Task Force concluded that this requirement likely would have to be relocated, such as to ISA 315 (risk assessment procedures). The remaining material in the ISA appears to fall within the proposed requirements for ISA 505. The Task Force concluded that the final positioning of the material in ISA 501 Part C will depend on the results of the discussion of the issues surrounding ISA 505.

The Task Force proposes to discuss ISA 501 in more detail in due course. It expects that legal confirmations will be included in ISA 505 as an example of a type of confirmation to address risks relating to specific assertions and much of the existing guidance on obtaining a legal confirmation will be retained as application guidance in ISA 505.

ISSUE 6: SHOULD REQUESTING EXTERNAL CONFIRMATIONS TO ADDRESS CERTAIN FINANCIAL STATEMENT ASSERTIONS BE MADE MANDATORY? *(Refer to Issue 6 in Agenda Item G1)*

Some regulators have recommended to the IAASB that bank and legal confirmations be made mandatory. *(Refer Background and Current Environment in Agenda Item G1.)* Some national auditing standard setters also include such requirements in their standards. A fundamental question the Task Force has had to consider is whether ISAs 501 and 505 should be revised to make confirmations mandatory with respect to certain financial statement assertions.

The Task Force has concluded that making confirmation requests mandatory conflicts with the audit risk model, may not improve the quality of audits, and suffers from significant operational disadvantages. The main disadvantage of mandating confirmation requests is that it presumes that confirmations provide relevant and reliable audit evidence. Research and experience have proven that this is a flawed presumption. Accordingly, the Task Force believes that the ISAs should not be amended to require that confirmations be requested to address pre-defined financial statement risks.

The Task Force believes that the decision to use confirmations as audit evidence should reflect a consideration of factors that affect whether confirmations will be a relevant and reliable source of audit evidence. Accordingly, as outlined in Issue 2, the Task Force proposes to make improvements to ISA 505 to assist auditors as they consider these factors and determine whether

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confirmations are necessary to address assessed risks for specific assertions and, if considered necessary, that the confirmation process is designed and executed in an effective manner.

Summary of Preliminary Views of the Task Force

Based on a consideration of the issues set out in the Issues Paper, the Task Force is proposing a project approach that is founded on the audit risk model. This approach reflects the use of professional judgment by the auditor in designing the nature, timing and extent of audit procedures that are responsive to the risks of material misstatement at the assertion level. In making these judgments, there will be circumstances when the auditor concludes that confirmations are required in order to obtain sufficient appropriate audit evidence.

The Task Force believes that making confirmation requests mandatory conflicts with the audit risk model, may not improve the quality of audits, and suffers from significant disadvantages. The main disadvantage of mandating confirmation requests is that it presumes that confirmations will provide relevant and reliable audit evidence. Research and experience have proven that this is a flawed presumption primarily because the quality of responses is outside of the auditor's control. Accordingly, the Task Force believes that the ISAs should not be amended to require that confirmations be requested to address pre-defined financial statement risks. However, the Task Force believes that existing standards should be amended to help improve the reliability of confirmations when the auditor determines confirmations should be obtained.

Matters for Consideration by the IAASB CAG

The CAG is asked to reflect on the issues set out in the Issues Paper and consider whether it agrees with the conclusions reached by the Task Force and the proposed Project direction.

Material Presented – IAASB CAG REFERENCE PAPER ONLY

Agenda Item G.1 Issues Paper (September 2006 IAASB Agenda Item 9-A)