

# IAASB CAG PAPER



**International Federation of Accountants**

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

## Agenda Item

# K

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** New York

**Meeting Date:** April 2-3, 2007

### External Confirmations

#### Objective of Agenda Item

1. To inform the IAASB CAG on the status of the project to revise and redraft ISA 505, “External Confirmations,” and to note any comments that the Representatives may have.
2. The IAASB conducted a first read of the proposed revised ISA at the February 2007 meeting. Significant comments raised by the IAASB and the Task Force’s proposed responses are summarized below.

#### Background

3. The objective of the project is:
  - To revise extant ISA 505 to provide enhanced guidance to the auditor for executing an effective external confirmation routine, including evaluating the reliability of information obtained via external confirmation responses, when the auditor determines that such procedures represent an appropriate and effective response to an assessed risk of material misstatement; and
  - To determine whether the revised ISA should mandate use of external confirmations in an audit of financial statements in any particular circumstances.

#### Overview of the Proposed Revised ISA

4. The following summarizes key elements of the proposed revised ISA presented to the IAASB in February 2007(*see Agenda Item K.1*):
  - The proposed revised ISA sets out a list of important definitions. The proposed definition of “external confirmation” is different from the existing definition in the Glossary. The Glossary definition refers to external confirmation as a process of obtaining evidence. The proposed definition refers to external confirmation as audit evidence represented by a response to an external confirmation request. The external confirmation process is defined separately in order to clearly differentiate between audit evidence obtained and the process of obtaining such evidence.
  - The requirement in paragraph 8 of the proposed revised ISA emphasizes the importance of determining whether external confirmations are expected to provide relevant and reliable audit evidence before deciding whether to seek external

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confirmations as audit evidence (however, see paragraph 10 below). The proposed revised ISA includes guidance on assessing the relevance and reliability of information obtained via external confirmations and identifies those assertions that may be addressed by requesting external confirmations of accounts receivable and banking relationships.

- The proposed revised ISA provides guidance for those circumstances when the auditor determines that obtaining audit evidence directly from a third party is the only means of obtaining sufficient appropriate audit evidence to address the risk of material misstatement at the assertion level.
- The proposed revised ISA directs the auditor to follow an effective process when he or she concludes that external confirmation procedures will be performed. Guidance is provided with respect to key elements of the external confirmation process and relevant considerations for designing an effective process to enhance the likelihood of obtaining persuasive audit evidence upon execution of an external confirmation routine.
- The proposed revised ISA indicates that the use of negative confirmation requests is permitted when they are used with other substantive procedures to address a risk of material misstatement. The use of negative confirmations to address a risk of financial statement misstatement, without performing other substantive audit procedures to address that risk, would be permitted only in very limited circumstances.
- The proposed revised ISA includes requirements and guidance that may be relevant when management requests that the auditor not send an external confirmation request to a particular party. The proposed revised ISA notes that the auditor only rarely accepts as valid management's request to not send an external confirmation request and that the implications of such refusal on management's part may lead to a modification of the opinion in the auditor's report.
- The proposed revised ISA includes several requirements that deal with consideration of the results of the external confirmation process. Paragraph 15 of the proposed ISA requires the auditor to specifically address concerns relative to the reliability of information that may be obtained via responses to external confirmation requests.

#### **Transition between Audit Risk Model and Procedural ISA**

5. In September 2006, the IAASB directed the Task Force to revise ISA 505 on the basis that the auditor should seek external confirmations in the context of the audit risk model reflected in the ISAs. The revised ISA should provide guidance for the effective execution of an external confirmation routine when the auditor concludes that external confirmations will be sought.
6. ISA 315 (Redrafted), "Identifying and Assessing the Risks of Misstatement Through and Understanding of the Entity and Its Environment" and ISA 330 (Redrafted), "The

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Auditor's Responses to Assessed Risks" provide guidance on how the auditor determines the nature, timing and extent of audit procedures, and includes references to when external confirmations are used. The Task Force developed an introduction for the proposed revised ISA that explains how the proposed revised ISA, which is largely procedures-based, links to the audit risk standards. **See Agenda Item K.1, paragraphs 2-4.**

7. The IAASB agreed with this approach at its February 2007 meeting. It suggested that the proposed revised ISA contain more extensive links to ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" to emphasize that external confirmations may be an appropriate procedure to address fraud risk factors and that exceptions or non-responses to external confirmation requests may be indicative of fraud.

#### Whether to Mandate the Use of External Confirmations

8. In September 2006, the IAASB directed the Task Force to pursue an approach that does not mandate the use of external confirmations in any particular circumstance. The Task Force believes that seeking external confirmations can be, and is, an effective audit procedure when they are effectively designed and the confirmation routine is effectively executed. In addition, the reliability of information obtained via external confirmation bears on the appropriateness of audit evidence.
9. The proposed revised ISA presented to the IAASB in February 2007, did not discourage the use of external confirmations as an effective response to an identified risk of material misstatement. In addition, the proposed revised ISA required that external confirmations be sought when obtaining audit evidence directly from a confirming third party is considered the only means of obtaining sufficient appropriate audit evidence in response to a particular risk of material misstatement.
10. In February 2007, the IAASB debated whether to change the tone of the proposed revised ISA from one that does not discourage the use of external confirmations to one that encourages their use. Based on the IAASB's comments, the Task Force proposes to:
  - Move some of the application material, dealing with the uses of external confirmations (**see Agenda Item K.1, paragraphs A1 and A2**), to the introduction of the proposed revised ISA;
  - Include in the introduction of the proposed revised ISA references to other ISAs that specifically refer to external confirmations as an appropriate audit procedures.
  - Delete the following requirements, and the application material in paragraph A 9 (**see Agenda Item K.1**):
    - "8. In assessing the appropriateness of requesting external confirmation of information as a means of obtaining sufficient appropriate audit evidence, the auditor shall evaluate whether external confirmations likely will provide relevant

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and reliable audit evidence in response to an assessed risk of financial statement misstatement. (Ref: Para. A1-A13)

9. The auditor shall seek external confirmations when that is the only means of obtaining sufficient appropriate audit evidence in response to an assessed risk of financial statement misstatement. If, in this circumstance, the auditor determines that external confirmation will not provide reliable audit evidence, the scope of the auditor's work has been limited and the auditor shall consider the possible impact on the auditor's report in accordance with ISA 705, "Modifications to the Opinion in the Independent Auditor's Report". (Ref: Para. A14)"
- Revise other text that the IAASB perceived as being too negative or that may serve as a disincentive to the use of external confirmations.

#### Objective of the Proposed Revised ISA

11. The proposed revised ISA presented to the IAASB in February 2007, contained the following objectives **(see Agenda Item K.1, paragraph 6)**:  
"6. The objectives of the auditor are:
  - (a) To determine whether and to what extent, in the circumstances of the audit, to request external confirmation of information as a means of obtaining sufficient appropriate audit evidence in response to an assessed risk of financial statement misstatement; and, if so,
  - (b) To design and perform effective external confirmation procedures."
12. Based on the IAASB's comments, the Task Force proposes to revise the objectives to refer to the design and performance of external confirmation procedures to provide relevant and reliable audit evidence. The objective of ISA 330 (Redrafted) is for the auditor to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks. The objective of the proposed revised ISA will be for the auditor to design and perform external confirmation procedures to provide relevant and reliable audit evidence.

#### Negative Confirmations

13. In February 2007, the IAASB requested that the importance of negative confirmations as an audit procedure downplayed, because they only provide limited audit evidence. The IAASB suggested that the guidance on negative confirmations **(see paragraphs A13 and A23 of Agenda Item K.1)** be placed at the end of the proposed revised ISA.

#### Other Comments Raised by the IAASB

14. In February 2007, the IAASB requested the Task Force to consider whether the proposed revised ISA should be expanded to include specific documentation requirements, i.e., in addition to those in proposed ISA 230 (Redrafted), "Audit Documentation."

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15. The IAASB also suggested that the guidance in the Appendix be moved to the application material and that the Appendix be deleted.

#### **Material Presented – IAASB CAG REFERENCE PAPERS ONLY**

Agenda Item K.1      Proposed Revised ISA 505, “External Confirmations” (February 2006  
IAASB Agenda Item 7A)