

# IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (April 2007)

Agenda Item K.1

External Confirmations—Proposed Revised ISA 505 – February 2007 IAASB Agenda Item 7-A

## PROPOSED ISA 505 (REVISED)

### EXTERNAL CONFIRMATIONS

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## **Introduction**

### **Scope of this ISA**

1. This International Standard on Auditing (ISA) establishes requirements and provides guidance for the performance of external confirmation procedures when the auditor determines that confirmation of information with third parties will be used as a means of obtaining audit evidence.

### **External Confirmations as a Response to Assessed Risks**

2. ISA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” requires the auditor to identify and assess the risks of material misstatement of the financial statements to provide a basis for designing and performing further audit procedures.
3. ISA 330, “The Auditor’s Responses to Assessed Risks” requires the auditor to obtain more persuasive audit evidence the higher the auditor’s assessment of risk. Consequently, as the assessed risk of material misstatement increases, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable.
4. When designing the nature, timing and extent of audit procedures, different procedures may be effective in addressing the assessed risks of material misstatement at the financial statement assertion level. The auditor’s selection of audit procedures from a number of possible effective procedures is a matter of professional judgment and depends on a number of factors, including:
  - The nature and significance of the assessed risk;
  - The relevance of the audit procedures in addressing the assessed risk;
  - The likely persuasiveness of the audit evidence to be obtained;
  - Whether the audit procedures also may provide evidence relating to other assessed risks or corroborate evidenced obtained by performing other audit procedures; and
  - The cost of the procedures relative to the quantity and/or quality of audit evidence that might be obtained.

The auditor may determine that seeking external confirmations is an effective response to address risk of material misstatement at the financial statement assertion level on the basis of these factors. (Ref: Para.A7)

### **Effective Date**

5. This ISA is effective for audits of financial statements for periods beginning on or after [date].

## **Objectives**

6. The objectives of the auditor are:

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- (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.

### **Definitions**

7. For the purpose of this ISA, the following terms have the meanings attributed below:

- (a) External confirmation – Audit evidence relating to assertions in the financial statements or related disclosures either as a direct response to the auditor from a confirming party as a result of a positive or a negative confirmation request, or the lack of response to a negative confirmation request.
- (b) External confirmation process – The process of performing procedures directed toward obtaining audit evidence in the form of an external confirmation.
- (c) Negative confirmation request – A request for information that asks the confirming party to respond directly to the auditor only in the event of disagreement with the information provided in the request.
- (d) Positive confirmation request – A request for information that asks the confirming party to respond directly to the auditor, whether he or she agrees with the information presented, or to provide information requested by the auditor.
- (e) Non-response – When the confirming party does not reply, or does not fully reply, to a positive confirmation request, or when a positive or negative confirmation request is returned undeliverable.
- (f) Exception – A response to a positive or negative confirmation request indicating that there is a difference between the information contained in the entity's records and the information reported by the confirming party.

### **Requirements**

#### **Seeking External Confirmations**

- 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 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

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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)

#### **External Confirmation Process**

10. When the auditor decides to request positive or negative confirmations, the auditor shall plan, design, undertake and control the external confirmation procedures, including:
  - (a) Identification of the member or members of the audit team responsible for controlling the external confirmation process, the resources assigned and the timing of the related procedures;
  - (b) Selection of items for which external confirmations will be requested;
  - (c) Design and preparation of the confirmation requests;
  - (d) Communication of the confirmation requests to the appropriate confirming party;
  - (e) Consideration of the results (responses, non-responses and exceptions) of confirmation requests; and
  - (f) Evaluation of the evidence obtained from the confirmation requests. (Ref: Para. A15-A26)
11. The auditor shall only use negative confirmations to reduce the risk of financial statement misstatement to an acceptable level without also performing other substantive procedures when:
  - (a) The assessed risk of material misstatement associated with the relevant financial statement assertion is low;
  - (b) A large number of small balances is involved;
  - (c) A substantial number of errors is not expected; and
  - (d) The auditor believes that respondents will not disregard the confirmation requests.

#### **Management Request to Not Confirm**

12. When management requests that the auditor not send a positive or negative confirmation request, the auditor shall evaluate whether there are valid reasons for such request. The existence of a dispute between the entity and the confirming party, in and of itself, is not a valid reason for not requesting confirmation of a balance or other information. (Ref: Para. A27)
13. When the auditor is prevented from requesting confirmation, the auditor shall perform appropriate alternative procedures and shall consider the possible impact on the auditor's report in accordance with ISA 705. (Ref: Para. A28)

#### **Considering the Results of the External Confirmation Process**

14. When the auditor requests confirmation of multiple items in a single confirmation request, the auditor shall evaluate the results for each item individually.

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15. If the auditor has concerns about the reliability of an external confirmation, then the auditor shall appropriately respond to such concerns. If the information in an oral external confirmation is significant, then the auditor shall request that the parties involved submit written confirmation of the specific information directly to the auditor. (Ref: Para. A29-A31)
16. The auditor shall perform alternative audit procedures for non-responses. (Ref. Para. A32-A33)
17. When the auditor determines that a response to a positive confirmation request is the only means of obtaining sufficient appropriate audit evidence to respond to an assessed risk of financial statement misstatement, and the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditors' report. (Ref: Para A34-A35)
18. The auditor shall investigate exceptions to determine whether they represent misstatements or acceptable differences. (Ref: Para. A36)

#### **Evaluating Audit Evidence**

19. The auditor shall evaluate misstatements identified in performing external confirmation procedures in accordance with ISA 450, "Evaluation of Misstatements Identified during the Audit".

\* \* \*

### **Application and Other Explanatory Material**

#### **Seeking External Confirmations**

*Relevance and Reliability of External Confirmations* (Ref: Para. 8)

- A1. ISA 330 indicates that the higher the auditor's assessment of risk, the more persuasive is the audit evidence obtained by the auditor. Consequently, as the assessed risk of material misstatement increases, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.
- A2. ISA 500, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. It indicates that, while recognizing exceptions may exist, the following generalization about the reliability of audit evidence may be useful:
  - Audit evidence is more reliable when it is obtained from independent sources outside the entity.
  - Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
  - Audit evidence is more reliable when it exists in documentary form.

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- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.
- A3. Accordingly, audit evidence in the form of external confirmations received directly by the auditor from confirming parties who are not related to the entity being audited, may be more reliable audit evidence than internally created evidence. However, the reliability of external confirmations as audit evidence may be affected by numerous factors. For example, the reliability of accounts receivable confirmations may be affected by:
- The reputation and objectivity of the confirming party;
  - The confirming party's understanding of the external confirmation request;
  - The confirming party's willingness to respond; and
  - Whether the confirming party is the appropriate person to provide the information requested.
- A4. External confirmations can provide relevant evidence relating to certain assertions, for example in determining whether unpaid accounts receivable exist at a certain date. On the other hand, external confirmation of accounts receivable amounts outstanding as of a particular date provide less relevant evidence relating to the recoverability of such amounts. Refer to Appendix 1 for examples of assertions addressed by accounts receivable and bank confirmations.
- A5. Confirmation procedures frequently are relevant when addressing assertions associated with account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts or transactions an entity has executed with other parties. Confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a confirmation request may specifically address the absence of a "side agreement" that may influence revenue recognition in certain circumstances. Other examples of situations where confirmation requests may be effective in responding to particular risks of financial statement misstatement include:
- Bank balances and other information relevant to banking relationships.
  - Accounts receivable balances and terms.
  - 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 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.

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- A6. When designing the nature, timing and extent of audit procedures, the auditor may determine that a number of different procedures would be effective in addressing the assessed risk of financial statement misstatement at the assertion level. For example, the auditor may determine that external confirmations will be effective in addressing the risk of material misstatement associated with the existence of unpaid accounts receivable balances as of a particular date. However, there may be other audit procedures that would effectively address the assessed risk, such as examining subsequent cash receipts. The auditor's selection of audit procedures from a number of possible effective procedures is a matter of professional judgment.
- A7. The auditor may decide to perform external confirmation procedures rather than other effective audit procedures on the basis of the factors in paragraph 4 of this ISA. For example, even though there may be other effective procedures for obtaining audit evidence about the existence of an entity's bank balances, the auditor may decide to seek an external confirmation from the entity's banks because such external confirmation may provide the opportunity to confirm other information relevant to the entity's banking relationships.
- A8. Direct access by the auditor to information held by a third party concerning a client's account balance does not constitute an external confirmation because it does not require a direct response from a confirming party. The auditor may use such access as an alternative audit procedure in accordance with paragraphs 16 and 18 of this ISA when considered appropriate.
- A9. An underlying presumption in seeking an external confirmation is that it provides more reliable audit evidence than internally generated audit evidence. However, this presumption may not always be the case. There may be factors relating to external confirmation procedures performed by the auditor and other factors that may be outside of the auditor's control that affect the reliability of external confirmations.
- A10. The reliability of the audit evidence obtained from an external confirmation depends, among other factors, upon the auditor designing and performing effective external confirmation procedures. Factors affecting the reliability of information obtained in external confirmations include the control the auditor exercises over confirmation requests and external confirmations received, the characteristics of the respondents, and restrictions that may be included in the external confirmation or imposed by management.
- A11. Factors outside of the auditor's control that may affect the reliability of external confirmations include:
- The subject matter being confirmed – if the subject matter on which external confirmation is being sought is extremely complex or highly subjective, external confirmations may be less reliable;
  - The relationship of the confirming party to the entity – if the confirming party is a related party of the entity, external confirmations may be less reliable;

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- The willingness of the confirming party to respond – the confirming party may not view responding to an external confirmation request as its responsibility, may consider responding too costly, or may consider responding to be too time consuming; accordingly, confirming parties may not respond or may do so in a casual manner, making information obtained in external confirmations less reliable;
- The confirmation of information with parties in other countries – transactions may be accounted for in different currencies or confirming parties may be reluctant to respond to requests for confirmation across jurisdictions;
- The industry in which entity operates – some industries, such as investment dealers, operate in an environment where external confirmation is a significant aspect of day-to-day operations; accordingly, the quality, reliability and speed of external confirmations generally are high; and
- The compatibility of entity and confirming party financial systems – if entity and confirming party financial systems are closely integrated and share information, obtaining a reliable external confirmation will be much easier than, for example, if the two information systems are not compatible with each other.

A12. Understanding the characteristics of the environment in which the entity subject to audit operates and the practice of potential respondents in dealing with confirmation requests may assist the auditor in deciding whether and to what extent to perform confirmation procedures.

#### *Reliability of Negative Confirmation Requests*

A13. A negative confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, there is no explicit audit evidence that the intended confirming party has received the confirmation request and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests provides less reliable audit evidence than the use of positive confirmation requests.

#### *When External Confirmations are the Only Means of Obtaining Sufficient Appropriate Audit Evidence (Ref: Para. 9)*

A14. The auditor may determine that a response to a positive confirmation request is the only means of obtaining sufficient appropriate audit evidence that will be effective in addressing an assessed risk. Examples of circumstances when obtaining an external confirmation directly from a confirming party may be the only way of obtaining appropriate audit evidence to address the assessed risk include:

- There is insufficient information available within the entity to substantiate the assertion(s) being audited;
- The entity's information systems and internal controls are unreliable or ineffective;

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- The subject matter is highly subjective or requires highly specialized expertise; and
- There are specific fraud risk factors, such as the risk of management override of internal controls, which prevent the auditor from relying on evidence obtained internal to the entity.

#### **External Confirmation Process (Ref. Para. 10)**

##### *Planned External Confirmation Process*

- A15. ISA 300, “Planning and Audit of Financial Statements” requires the auditor to develop an audit plan including a description of the nature, timing and extent of planned further audit procedures at the assertion level. The auditor’s planned performance of external confirmation procedures may be contained in the audit plan.

##### *Control Over the Confirmation Process*

- A16. Control over communications between the intended confirming parties and the auditor minimizes the possibility that the results of the external confirmation process will be biased because of the interception and alteration of confirmation requests or external confirmations. Such control may include ensuring that the auditor sends out the confirmation requests, that the requests are properly addressed, that the auditor’s return information is included in the request, and that all replies are requested to be sent directly to the auditor.

##### *Selecting Items for Confirmation*

- A17. The selection of items for confirmation may be influenced by the type of business, the quality of internal control, type of confirming party, size of balances and other similar considerations. Often, sampling techniques are used to select a representative sample of items to request confirmation. ISA 530, “Audit Sampling and Other Means of Testing” provides guidance on the use of audit sampling and other means of selecting items for testing when designing audit procedures to gather audit evidence.

##### *Designing the Confirmation Request*

- A18. Considering the assertions being addressed and the factors that are likely to affect the reliability of the external confirmations may assist the auditor when designing the confirmation request. Factors such as the form of the confirmation request, prior experience on the audit or similar engagements, including information that is relevant to the assertion being audited, the nature of the information being confirmed, and the ability and willingness of the intended confirming party to respond to the request affect the design of confirmation requests. These factors may have a direct effect on the confirmation response rate and the reliability and the nature of the audit evidence obtained in external confirmations.
- A19. For example, certain confirming parties may not be able to readily confirm certain types of information, such as an overall accounts receivable balance, but may be able to confirm

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individual invoice amounts within the total balance. This information may be useful in designing an effective confirmation request.

- A20. The auditor may employ a variety of means for requesting and receiving confirmations, including facsimile transmission, electronic mail or the internet. These means of confirmation may present challenges in evaluating the reliability of external confirmations. For example, the use of these means may not be appropriate if they will not provide sufficient evidence of the proof of origin of the external confirmation.

#### *Identifying the Appropriate Confirming Party*

- A21. External confirmation procedures are most effective when sent to a confirming party who the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is responsible for the institution's relationship with an entity or is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate confirming party from which to request confirmation.
- A22. Knowledge of the confirming party's competence, knowledge, motivation, ability, and willingness to respond, or about the confirming party's objectivity and freedom from bias with respect to the audited entity may assist the auditor in designing the confirmation request and in evaluating the results, including determining whether other procedures are necessary to respond to the assessed risk of financial statement misstatement. In addition, knowledge of such factors in relation to confirmation requests may lead the auditor to question whether there is sufficient basis for concluding that the external confirmation will provide reliable audit evidence.

#### *Use of Negative Confirmation Requests*

- A23. Paragraph A13 of this ISA indicates that the use of negative confirmation requests provides less reliable audit evidence than the use of positive confirmation requests. Accordingly, circumstances when the auditor may use negative confirmation requests alone to reduce the risk of financial statement misstatement to an acceptable level are limited. The auditor may, however, use negative confirmation requests to supplement other substantive audit procedures.

#### *Considering the Results of Confirmation Requests*

- A24. Confirmation requests may be categorized as follows:
- (a) A response confirmed correct by the appropriate confirming party;
  - (b) A response returned with an indicated difference between the information requested for confirmation and the information reported by the confirming party (exception);
  - (c) An unreliable response; or
  - (d) A non-response (including incomplete responses).

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- A25. The auditor may perform additional procedures to obtain reliable external confirmations for non-responses, including incomplete responses. For example, the auditor may send additional or follow-up requests or obtain correct addresses from the entity, verify the addresses by reference to external sources and then re-send the requests.
- A26. Exceptions noted in external confirmations may provide information to assist the auditor in determining the extent of misstatements and potential misstatements. Exceptions may also provide a guide to the quality of external confirmations from similar confirming parties or for similar accounts. Exceptions also may indicate a weakness in the entity's internal control over financial reporting that may have resulted in other confirming parties reporting similar differences. An effective external confirmation process may therefore include evaluating external confirmations to determine whether exceptions actually exist, whether exceptions represent misstatements in the financial statements, and whether the underlying cause of the exceptions is indicative of a weakness in the entity's internal control over financial reporting.

#### **Management Request to Not Confirm** (Ref: Para. 12)

- A27. ISA 705 indicates that limitations imposed by management may have other implications for the audit, for example, the auditor's assessment of fraud risks and consideration of engagement continuance. Accordingly, challenging the reasons provided by management and seeking corroborating evidence for the reasons provided by management may assist the auditor in evaluating whether there are valid grounds for a request to not confirm or there are fraud risks or other factors affecting engagement continuance.
- A28. ISA 705 indicates that an inability to perform a specific procedure does not constitute a scope limitation if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. When management requests the auditor not to confirm, the alternative procedures performed are those appropriate for a non-response as set out in paragraphs A32 and A33 of this ISA. If the auditor is not able to obtain sufficient appropriate audit evidence on which to base the opinion by performing these procedures, the auditor qualifies the opinion or disclaims an opinion, as appropriate, as required by ISA 705.

#### **Considering the Results of the External Confirmation Process**

##### *Reliability of External Confirmations* (Ref: Para. 15)

- A29. When reviewing responses to confirmation requests, the auditor may be concerned about the reliability of the external confirmation as audit evidence. For example, indications that information included in the external confirmation is not reliable may include external confirmations that:
- Are not delivered directly to the auditor;
  - Do not come from the originally intended confirming party; or

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- Are received by a means that does not provide sufficient evidence as to its origin, for example by facsimile or electronically.
- A30. When performing audit procedures to respond to concerns about an external confirmation's reliability, the auditor may choose to verify the source and contents of an external confirmation in a telephone call to the purported confirming party. In addition, the auditor may request that the purported confirming party mail the original external confirmation directly to the auditor. With use of technology, the auditor may validate the source of replies received in electronic format (for example, facsimile or electronic mail).
- A31. When the auditor determines that an external confirmation is not reliable, the auditor may consider whether that lack of reliability represents a fraud risk factor by reference to ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

#### *Non-responses* (Ref: Para. 16)

- A32. The nature of alternative audit procedures varies according to the particular financial statement assertion. For example, when performing alternative audit procedures associated with the confirmation of accounts receivable balances as of a particular date, alternative audit procedures may include examination of subsequent cash receipts, examination of shipping documentation or other documentation to provide audit evidence for the existence and valuation assertions, and examination of sales near the period-end to provide audit evidence for the cutoff assertion. Alternatively, when performing alternative audit procedures associated with the confirmation of accounts payable balances as of a particular date, alternative audit procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide audit evidence of the existence assertion, and examination of other records, such as goods received notes, to provide audit evidence of the completeness assertion.
- A33. The nature and extent of alternative audit procedures is affected by the assessed risk of material misstatement of the financial statements at the assertion level. Since audit evidence obtained through external confirmations ordinarily is more persuasive than internal audit evidence, the auditor may decide to perform a combination of alternative audit procedures in order to reduce audit risk to the intended level.

#### *When External Confirmations are the Only Means of Obtaining Sufficient Appropriate Audit Evidence* (Ref: Para. 17)

- A34. If a response to a positive confirmation request is the only means of obtaining sufficient appropriate audit evidence that will be effective in addressing an assessed risk, and the auditor does not receive an external confirmation, a limitation on the scope of the audit may result. ISA 705 provides guidance when there is a limitation in the scope of the audit.
- A35. Depending on the circumstances of the audit, and the results of other audit procedures, the auditor may conclude that the failure to obtain audit evidence with respect to the information subject to confirmation represents a misstatement.

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*Exceptions* (Ref: Para. 18)

- A36. Some differences identified in external confirmations may be acceptable upon further investigation. For example the auditor may conclude that differences identified in external confirmations are due to timing, measurement, or clerical errors. Other differences may be indicative of misstatements, weaknesses in internal control, or have implications for other areas of the audit.

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### Appendix 1

(Ref: Para. A4)

#### Assertions Addressed by Accounts Receivable and Bank Confirmations

<b>Accounts receivable</b>	
Existence of unpaid amount	Highly relevant because confirming party responds directly to auditor confirming amount owing to entity
Completeness of recording of transactions	Less relevant because confirming an account balance does not address recording of specific transactions, although they may reveal discrepancies in recording of transactions
Transactions have been recorded in the correct period	Less relevant because confirming parties are more likely only to respond to overstatements and not understatements of their accounts
Accuracy and valuation of recorded amount	Relevant to the accuracy of recording of amounts. Less relevant to valuation because they do not address the collectibility of accounts although they may result in the reporting of disputed amounts
<b>Bank balances and other information</b>	
Existence of amount	Highly relevant because the bank responds directly to the auditor confirming the bank balance
Completeness of recording of transactions	Less relevant because confirming a bank balance does not address recording of specific transactions, although they may reveal discrepancies in recording of transactions
Transactions have been recorded in the correct period	Less relevant because a bank confirmation does not provide cut-off information that the auditor can use to verify the recording of transactions in the correct period
Presentation and disclosure	Highly relevant because a bank confirmation may identify the existence of contingent liabilities, collateral lodged as security and other items that require disclosure in the financial statements

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