



**International Federation of Accountants**

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## Agenda Item

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Toronto

**Meeting Date:** September 4-5, 2008

### **Proposed ISA 505 (Revised and Redrafted), “External Confirmations”**

#### **Objective of Agenda Item**

To review a summary of significant comments received on the exposure draft of proposed ISA 505 (Revised and Redrafted), “Electronic Confirmations” (ED-ISA 505), and the Task Force’s recommendations. **Approval of the final ISA is planned for the September IAASB meeting.**

#### **IAASB Task Force**

The IAASB Task Force members are:

- Craig Crawford (Task Force Chair), IAASB member
- Josef Ferlings, IAASB member
- David Swanney, IAASB member
- Simon Hancox, External member
- John O’Brien, External member

#### **Background**

The IAASB approved the project to revise ISA 505 to:

- Determine whether to change the extent of the obligation on the auditor to obtain external confirmations; and
- Develop, as necessary, additional requirements and guidance to improve the effectiveness of the external confirmation process and the reliability of confirmation responses.

Significant proposals were discussed with the IAASB Consultative Advisory Group (CAG) at all stages of developing the proposed ISA.

In October 2007, the IAASB issued ED-ISA 505. The comment period ended February 15, 2008. Forty-six comment letters were received. (ED-ISA 505 and the comment letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0097>.)

At its June 2008 meeting, the IAASB considered significant comments received on ED-ISA 505 and the Task Force’s related recommendations. Significant matters identified for the CAG’s consideration are summarized below.

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#### **Significant Matters**

##### **DETERMINING WHETHER TO USE EXTERNAL CONFIRMATION PROCEDURES**

1. The Explanatory Memorandum to ED-ISA 505 indicated that the IAASB believes that it is not necessary for the ISA to include a requirement for the auditor to consider whether, and to what extent, to use external confirmation procedures when performing an audit of financial statements. The IAASB's view is that ISA 315 (Redrafted)<sup>1</sup> and ISA 330 (Redrafted)<sup>2</sup> provide adequate guidance to the auditor relative to determining the nature, timing and extent of audit procedures in response to assessed risks of misstatement, and contain references to when external confirmation procedures may be an effective response. ED-ISA 505 therefore provided references to other ISAs that recognize the importance of external confirmations as audit evidence and provide guidance for when the auditor considers using external confirmation procedures as a response to an assessed risk of misstatement at the financial statement assertion level.
2. Of the thirty-eight respondents to ED-ISA 505 that commented on this matter, twenty-two agreed with the IAASB's position. Sixteen respondents, however, expressed some form of disagreement with the approach taken. The main themes in the comments from the latter respondents were:
  - Paragraph 2 of the extant ISA requires the auditor to determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the financial statement assertion level. Not retaining this requirement in ISA 505 (Revised and Redrafted) weakens the standard and downplays the importance of external confirmation procedures.
  - The guidance in ISA 315 (Redrafted) and ISA 330 (Redrafted) is not sufficient to lead the auditor to an appropriate audit approach because there is no explicit requirement to consider the use of external confirmation procedures. ISA 505 (Revised and Redrafted) should therefore include an explicit requirement for the auditor to determine whether to use such procedures.
  - External confirmation procedures are presumptively the most appropriate audit procedure to obtain sufficient appropriate audit evidence regarding existence and other assertions relating to certain balances, such as accounts receivable, bank and other third-party balances. Accordingly, ISA 505 (Revised and Redrafted) should include a rebuttable presumption that the auditor will use external confirmation procedures to audit certain account balances.
  - The auditor should be required to use external confirmations when the related audit risk is high, or is a significant risk and the auditor has an expectation that external confirmation

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<sup>1</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

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

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procedures will be an effective means of responding to such risks because, when properly designed, external confirmations provide persuasive evidence.

- Having a specific requirement is consistent with the approach taken in proposed ISA 620 (Revised and Redrafted),<sup>3</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.
3. In discussing this matter at its June 2008 meeting, the IAASB was persuaded by the comments received on exposure that there should be a requirement, in some form within the ISAs, for the auditor to determine whether the use of external confirmation procedures is necessary to obtain sufficient appropriate audit evidence at the assertion level. Nevertheless, some IAASB members expressed concern that a requirement to determine whether to use external confirmation procedures (as is contained in paragraph 2 of the extant ISA) may be difficult to operationalize, and may ultimately result in a perfunctory compliance exercise. Other IAASB members indicated that the decision to use external confirmations should be driven by risk assessments. Further, there were differing views among IAASB members on where the requirement might be placed – for example, some favored proposed ISA 500 (Redrafted),<sup>4</sup> some ISA 505 (Revised and Redrafted), and some ISA 330 (Redrafted).
  4. The IAASB rejected the approach of developing a requirement following a rebuttable presumption approach because of the need, when the presumption is rebutted, to document why confirmation requests were not sent, and because there are many circumstances where external confirmation procedures may not be an effective response to an assessed risk of material misstatement.

#### *Task Force Recommendations*

5. The Task Force is of the view that a new requirement should be established that directs the auditor to address whether external confirmation should be used. However, the Task Force believes that it is important that the wording of the requirement should not suggest the need to obtain external confirmations for all assertions. The Task Force also feels that the requirement should not set too high a bar that might deter auditors from using external confirmations in response to assessed risks of material misstatement.
6. In addition, the Task Force believes that the new requirement is most appropriately located in ISA 330 (Redrafted). This is consistent with the IAASB's preference that the scope and focus of ISA 505 (Revised and Redrafted) be on establishing requirements intended to improve auditor performance when using external confirmations, with the starting point being when the auditor has determined that the use of external confirmation procedures is an appropriate response to an assessed risk of misstatement.

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<sup>3</sup> Proposed ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert."

<sup>4</sup> Proposed ISA 500 (Redrafted), "Audit Evidence."

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7. The Task Force therefore proposes the following conforming amendment to paragraph 7 of ISA 330 (Redrafted): *(See paragraph 7 of ISA 330 (Redrafted) in the “Conforming Amendments to Other ISAs” section of Agenda Item 2-D of the September 2008 IAASB meeting material):*

7. In designing the further audit procedures to be performed, the auditor shall:

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
  - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
  - (ii) Whether the risk assessment takes account of relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9-A18); ~~and~~
- (b) Obtain more persuasive audit evidence the higher the auditor’s assessment of risk; ~~and~~ (Ref. Para. A19)
- (c) Identify those assessed risks of material misstatement at the assertion level for which external confirmation procedures are to be performed as further audit procedures. (Ref. Para. A19A)

8. The Task Force also proposes that paragraph A5 of ED-ISA 505 (Revised and Redrafted) be added as a new application material paragraph in ISA 330 (Redrafted). This paragraph provides factors that may assist the auditor in determining whether external confirmation procedures are performed as further audit procedures. *(See paragraph A19A of ISA 330 (Redrafted) in the “Conforming Amendments to Other ISAs” section of Agenda Item 2-D of the September 2008 IAASB meeting material.)*

#### Matter for Consideration by the IAASB CAG:

1. **Do the Representatives believe the nature of the proposed requirement (for the auditor to identify those assessed risks of material misstatement at the assertion level for which external confirmation procedures are to be performed as further audit procedures) to be appropriate?**

#### ELECTRONIC CONFIRMATIONS

9. Some respondents to ED-ISA 505 were of the view that the proposed ISA does not provide sufficient guidance on the use of external confirmation procedures in an electronic context. A respondent suggested that the guidance issued by the AICPA’s Auditing Standards Board on

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the use of electronic confirmations could be a useful basis for developing application material specific to electronic confirmations.

10. At its June 2008 IAASB meeting, the IAASB concurred with this observation and asked that the Task Force include guidance specific to electronic confirmations in proposed ISA 505 (Revised and Redrafted). In particular, it was suggested that some examples should be provided addressing issues associated with the use of electronic confirmations, such as whether an email confirmation is coming from the appropriate confirming party.

#### *Task Force Recommendation*

11. The Task Force believes that guidance relating to electronic confirmations should address the following matters:
- The reliability of electronic responses received by the auditor, including consideration of whether there is an appropriate process for responding or receiving responses electronically.
  - The increasing prevalence of the use of third party service providers to facilitate electronic responses to confirmation requests.
12. The Task Force has therefore developed two new application material paragraphs that it believes are responsive to the request that the proposed ISA contain more guidance on electronic confirmations. *(See paragraphs A16 and A17 of Agenda Item 2-D of the September IAASB meeting material.)*

#### **Matter for Consideration by the IAASB CAG:**

- 2. Do the Representatives believe the nature and extent of the proposed application material addressing the subject of electronic confirmations to be appropriate?**

#### OTHER ISSUES

13. *See Agenda Item 8-A of the June IAASB meeting material for other issues identified by the Task Force:*
- Negative confirmations – paragraphs 9-13 of Agenda Item 8-A.
  - Objective – paragraphs 14-17 of Agenda Item 8-A.
  - When a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence – paragraphs 20-22 of Agenda Item 8-A.
  - Reliability of responses to confirmation requests – paragraphs 23-26 of Agenda Item 8-A.

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**Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY**

Agenda Item 2-D of the September 2008  
IAASB Meeting – Proposed ISA 505  
(Revised and Redrafted) (Marked from  
Exposure Draft) <http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4107>

Agenda Item 8-A of the June 2008 IAASB  
Meeting – Summary of Significant  
Comments and Task Force  
Recommendations—Exposure Draft of  
Proposed ISA 505 (Revised and Redrafted) <http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=3966>

**Action Requested**

The IAASB CAG is asked to review the matters highlighted in this paper, and to comment on the Task Force's recommendations.