

**PROJECT PROPOSAL
EXTERNAL CONFIRMATIONS**

1. Subject

Revision of ISA 505, “External Confirmations” and Part C: Procedures Regarding Litigation and Claims of ISA 501 “Audit Evidence – Additional Considerations for Specific Items.”

2. Project Rationale and Objectives

(a) Issue Identification

High profile financial failures such as Barings and Parmalat in Europe are heightening awareness of the use of, and the consideration of the reliability of, external confirmations as audit evidence. Accordingly, some regulatory authorities in major jurisdictions around the world are calling for more rigorous requirements pertaining to the use of confirmations.

Some national standard setters also see a need to enhance the standards and guidance on confirmations.

Specific developments of relevance include:

- In the United States, a review of the equivalent national standards by the US Panel on Audit Effectiveness and the US ASB identified several areas where guidance on the use of external confirmations could be strengthened; in particular, the more precise articulation of the considerations that should be present to overcome the presumption that it is necessary to send confirmations.
- In Europe, the European Commission (EC) indicated that some Member States reported to it areas where ISA 505 may deserve improvement in substance, specifically in relation to specifying a requirement that auditors shall obtain for each audited entity direct confirmation for each bank and related types of accounts, and from each lawyer with which the audited entity has worked.
- From an international perspective, IOSCO suggested that ISA 505 may need to be strengthened, recommending amongst other things that the ISA should indicate the circumstances when use of confirmations should be required – for example, confirmation of bank balances and other matters such as guarantees, covenants and terms of related agreements, and accounts receivable – and that its guidance pertaining to negative confirmations should be reconsidered.

Set against these developments, there is the question of whether requiring the use of confirmations is appropriate in the international context, and indeed whether it would in fact strengthen ISA 505. Relevant observations include the following:

- The issue of whether the standard should require the use of confirmations was addressed by the International Auditing Practices Committee (IAPC, predecessor to the IAASB) when it revised ISA 505 in 2001. The IAPC concluded that the quality, timeliness and response rates to confirmations varied widely in different cultural environments and it was not appropriate to mandate the use of confirmations as an audit procedure. The extant

ISA, accordingly, requires the auditor to determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence, but does not mandate their use in any particular circumstance.

- Some are questioning the usefulness of auditors' requests for confirmation even in those jurisdictions where such practice is culturally acceptable. An increasing number of entities refuse to provide third party confirmations¹. These circumstances suggest that changes to the legal or regulatory environments in individual jurisdictions may be necessary before auditors will be able to obtain confirmations.
- In some cases where a confirmation has been responded to, there is a question of whether responding entities are demonstrating less rigor in the preparation of confirmation responses², raising a very real concern by auditors whether the evidence can be considered reliable.

From a practice perspective, advances in technology now allow companies and their auditors to directly access accounts at third parties, such as banks, customers and suppliers on a real time, on-line basis. Such advances may be superior means of obtaining audit evidence than external confirmations.

(b) Recommendations for IAASB's Consideration of the Project

- The European Commission, in its letter issued in October 2005 to the IAASB Chairman.
- IOSCO, in its letter issued in December 2002 to the IAASB.
- FEE, in its letter issued July 2004 to the IAASB Chairman, following the survey facilitated by FEE on 'ISA+' in the European Union which identified ISAs where there may be significant national add-ons or "pluses" within national standards.

(c) Objectives to be Achieved

- To determine whether to change the extent of the obligation on the auditor to obtain external confirmations.
- To develop, as necessary, additional standards 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.

3. Outline of the Project

(a) Project Scope

This project will seek to update and strengthen the standards and guidance in ISA 505 and ISA 501 addressing the auditor's use of external confirmations.

¹ For example, there is evidence in the US that entities will not give confirmations because if there is an error in the confirmation this might be regarded as evidence of a weakness in internal control.

² For example, the Canadian Auditing and Assurance Board has recently had discussions with the Canadian Bankers Association about means of improving the bank confirmations process arising out of increasing concerns raised by practitioners of errors in bank confirmations.

Its primary focus is to review the circumstances when external confirmations (a) are required and (b) when they are not, within the context of the audit risk model. Although it may be found that there is other qualitative and quantitative information which may be considered candidates for a requirement for confirmation, this project will initially address the need, if any, to, and practicality of, requiring confirmation of:

- Bank balances and related matters (i.e. side agreement, guarantees, etc.)
- Legal matters from lawyers with which the audited entity has worked.

In developing recommendations, an understanding of environmental factors affecting the use of external confirmations and lawyer letters as a source of audit evidence will be obtained through consultations with key stakeholders and other research.³

The project's secondary focus is to identify whether there is a need, if any, to amplify the standards and guidance in ISA 505. This will be determined by considering input received to date from various stakeholders and developments in national standards, including consideration of any existing national add-ons that may be appropriate in the international environment.

The scope of this project excludes confirmations that are in the nature of representations, which is being addressed by the project to revise ISA 580, "Management Representations."

The project will apply the new drafting conventions of the IAASB to the ISA, considering specifically whether sentences in the present tense ought to be elevated to a requirement or retained (and redrafted) as application material.

(b) List the Major Problems and Key Issues that Should be Addressed

Mandatory Confirmations

The major issue to be dealt with by the project is to seek a solution that achieves a balance between the conflicting circumstances in which regulators and others are calling for increasing prescription in the use of confirmations, while there is anecdotal evidence from practitioners that responses to confirmation requests may be unreliable or unobtainable.

The project will seek to address the conflict, by developing a clear understanding of the different perspectives, the consequences of change to practice, and the challenges that need to be overcome. Specific issues to be addressed include:

- What are the reasons that confirmations are problematic in these situations? How can problems be overcome, if at all?
- If ISA 505 makes it mandatory to obtain confirmations, will there be a significant increase in the number of modified opinions in these situations, and is this an acceptable result?

³ As a first step, IAASB technical staff circulated questionnaires in November 2005 to national audit standard setters seeking information about practices and issues being faced with respect to bank confirmations and lawyer letters. Further, the views of the IAASB CAG on the issue of mandating the use of confirmations were sought at its November 2005 meeting. The findings from these consultations will be reported to the IAASB at its December meeting.

- If auditors are able to obtain sufficient appropriate audit evidence in these situations other than by obtaining external confirmations, is it reasonable to require in ISA 505 that confirmations be mandatory in all circumstances on an audit?
- Can ISA 505 articulate the circumstances when mandatory confirmation would not be required, so that in all other circumstances the auditor would have a scope limitation if he or she did not obtain a confirmation?
- Does there need to be additional guidance in ISA 505 with respect to alternative audit procedures in the situations when the ISA specifically permits the auditor not to obtain a confirmation?

It may be possible to address some of the underlying conflicts by working with international organizations. More effective means of obtaining audit evidence in certain circumstances may need to be identified.

In considering the need for requirements with respect to bank confirmations and lawyer letters, it is likely that such requirements will only be operational in certain jurisdictions when the national bankers' association and law society have agreed to a confirmation protocol. The project will therefore include discussions with the Basel Committee and the International Bar Association in this respect. However, achieving consistency of international practice for bank confirmations and lawyer letters may only be achievable on the basis that there are international protocols developed that will be accepted globally, a challenge that may not be capable of resolution internationally or within a reasonable period of time.

Amplification of the Guidance in ISA 505

As indicated above, there have been suggestions to further enhance the guidance in ISA 505. Although addressing the need to amplify ISA 505 in response to these suggestions will form an important part of the project, the key issue will be ascertaining whether such issues are in substance already covered by the guidance in ISA 505, and whether further amplification is necessary and appropriate for an international standard. There are no specific issues requiring the attention of the IAASB at this time.

(c) Cost-Benefit Considerations

A decision by the IAASB to require the use of external confirmation for certain matters or under certain circumstances may have cost benefit implications. The task force will consider and explore such cost benefit implications in developing its recommendations to the IAASB.

4. Describe the Implications for any Specific Persons or Groups

- The EC, given the importance of the revision of this ISA towards the goal of endorsement of the ISAs in the EU.
- The Basel Committee on Banking Supervision, due to its regulation of the banking sector.
- The International Bar Association, due to its role as representative of the interests of lawyers who are requested to respond to lawyer letters.
- Other regulators, including IOSCO, due to stakeholder and regulatory interest in preventing fraud by confirmation of various balances and other information such as terms of contracts.

- National standard setters and INTOSAI, due to the potential effect that the revised international standards and guidance on external confirmations may have on corresponding national and public sector standards, particularly from the perspective of convergence with, or adoption of, ISAs.
- TAC/Global Standards and Performance Working Group (GSPWG), due to its interest in practice concerns over the use of external confirmation.
- SMPs, particularly with regards to any additional requirements that may be unduly burdensome, or that may not be applicable in all cases, in the SME environment.
- The IAASB's ISA 580, "Management Representations" task force, to liaise with it and track its work to make sure the two projects are consistent.

5. Development Process, Project Timetable and Project Output

(a) Project timetable

The timetable for the project is expected to be as follows:

- Issues Paper – July 2006
- First Read of draft exposure draft – September 2006
- Exposure Draft – December 2006
- Final revised ISA – December 2007.

This timetable is based on IAASB agenda time anticipated to be available during 2006-2007. Depending on the priority of this project with other new projects to be considered by the IAASB, and on the progress of other projects against plan, it may be possible to move the timetable noted above earlier by three months; all attempts will be made to do so.

(b) Project output

A revised ISA 505 and a revised Part C of ISA 501, reflecting the decisions of the IAASB will respect to requirements to confirm certain matters and containing, as appropriate, additional application guidance addressing the use of external confirmations. The revised ISAs will be drafted in accordance with the new drafting conventions under the IAASB Clarity project (as refined, as necessary, based on the present consultation thereon).

Conforming amendments may be necessary in other ISAs that contain guidance on confirmation. Consideration will also be given to repositioning or amalgamating any related requirements and guidance in other ISAs, as appropriate.

6. Resources Required

It is suggested that the task force be made up of five members, with a majority drawn from the IAASB. The task force should include a public member, a TAC-appointed member, one member with SME/SMP experience and representation from INTOSAI. Two members should be drawn from North America and the European Union. Representation from others may be included as necessary.

Staff support for the task force will be provided by the Canadian Institute of Chartered Accountants (CICA). One IAASB staff member will monitor the project, and provide the necessary liaison and related support to the CICA staff member.

7. List Important Sources of Information that Address the Matter being Proposed

- Letter from the European Commission to the IAASB Chairman (October 2005) pertaining to the work program of the IAASB
- Letter from IOSCO to the IAASB (December 2002) pertaining to its review of selected International Standards on Auditing
- U.S. Auditing Standards Board, November 10, 2003 Letter to the PCAOB, "Recommendations for the Revision of SAS No. 67, The Confirmation Process" (http://www.aicpa.org/members/div/auditstd/recs_to_pcaob.asp)
- U.S. Auditing Standard AU 316, "Consideration of Fraud in a Financial Statement Audit"
- U.S. Auditing Standard AU 330, "The Confirmation Process."
- U.S. Auditing Standard AU 337, "Inquiry of Client's Lawyer Concerning Litigation, Claims, and Assessments"
- U.S. AICPA Practice Alert 03-1, "Audit Confirmations" (AICPA, Technical Practice Aids, vol. 2, sec. 16,230)
- U.S. AICPA Auditing Practice Release, Confirmation of Accounts Receivable (1995) product no. 021060)
- U.S. Public Oversight Board (POB) "The Panel on Audit Effectiveness, Report and Recommendations," August 31, 2000 (see chapter 2, 2.97 - 2.100), (www.pobauditpanel.org)
- Agenda material for September 8-9, 2004 meeting of the PCAOB's Standing Advisory Group, "Audit Confirmations"
- CICA Section 5303, "Confirmation"
- CICA Section 6560, "Communications With Law Firms Regarding Claims and Possible Claims"
- Australia Auditing Standard AUS 504, "External Confirmations"
- Standards and recent publications of National Standard Setters and others that are relevant
- Firms' methodologies and practices for use of external confirmations
- U.K. Other Audit Statement, Audit 03/02, "Bank Reports for Audit Purposes"
- Wall Street Journal or other press archives.
- Academic journals archives.

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Date November 16, 2005

Approved by _____

Date _____

(Chair on behalf of the IAASB)