



International Federation of Accountants

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Agenda Item

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Committee: IAASB

Meeting Location: New York

Meeting Date: February 13-16, 2007

External Confirmations

Objective of Agenda Item

1. To review as a first read the draft proposed revised ISA 505, “External Confirmations”.

Task Force Members

2. The members of the Task Force are:

Craig Crawford (Chair) IAASB member

David Swanney IAASB public member

Roberto Tizzano IAASB member

Simon Hancox External member

John O’Brien External member

Background

3. The purpose of this Project is:
 - To develop a revised ISA to replace extant ISA 505 with the overarching objective of providing improved guidance to the auditor for executing an effective external confirmation routine, including evaluation of the reliability of information obtained via confirmation responses, when the auditor determines that such procedures represent an appropriate and effective response to an assessed risk of financial statement misstatement; and
 - To determine whether the revised ISA should mandate use of external confirmations in a financial statement audit in any particular circumstances.
4. An Issues Paper developed by the Task Force was discussed by the IAASB at its meeting in September 2006. The matters discussed in September included:
 - The relationship of extant ISA 505 to the audit risk model.
 - Mandating the use of external confirmations under certain circumstances.
 - The reliability of information obtained via external confirmation and the related challenges that may impact reliability.
 - The use of negative confirmations.

- ISA 501 Part C.
5. The Confirmations Task Force has developed a proposed ISA on the basis of the following:
- IAASB deliberations at the September 2006 meeting;
 - Input received from members of the IFAC Small and Medium Sized Practices Committee and the Forum of Firms;
 - Extant ISA 505;
 - Relevant authoritative and non-authoritative literature developed by a variety of national standard setters; and
 - Comments received from the IAASB Consultative Advisory Group.

Drafting Approach

Transition between Audit Risk and Procedural ISA

6. At its September 2006 meeting, the IAASB directed the Task Force to develop a revised ISA 505 on the basis that the auditor should seek external confirmations in the context of the existing audit risk model evidenced in the ISAs. In addition, the IAASB directed the Task Force to place particular emphasis on providing guidance for the effective execution of an external confirmation routine when the auditor concludes that external confirmations will be sought. The general direction of the IAASB in September was that external confirmations should not be mandated in any particular circumstances.
7. ISAs 315 and 330 provide guidance on how the auditor determines the nature, timing and extent of audit procedures, and contain references to when external confirmations are used. The Task Force noted that, if guidance on when external confirmations should be used is contained in ISA 505, some overlap would exist between ISA 505 and ISAs 315 and 330. While some overlap and duplication is not necessarily contrary to sound standard-setting practices, the Task Force concluded that there should be appropriate guidance provided in ISA 505 that explains how ISA 505, which in large part is a procedural ISA, relates to the audit risk model standards. In other words, the Task Force believes that some transitional information in this procedural auditing standard would be helpful to the auditor to provide appropriate context.
8. The Task Force notes that some recently clarified ISAs – ISAs 240 and 320, for example – contain information in their Introduction that is neither Requirements nor Application and Other Explanatory Material. This information does, however, provide appropriate context for the respective ISA with the intended purpose of assisting the auditor in effectively executing the requirements of that particular ISA. The Task Force believes that the Introduction section is the appropriate location for the transitional guidance on external confirmations and effectively serves to link the risk assessment process to the procedural nature of the requirements and application material in the proposed ISA. Paragraphs 2-4 of the proposed ISA include this transitional information.

Mandating Use of External Confirmations

9. During the September 2006 IAASB meeting, the Board directed the Task Force to pursue an approach in revised ISA 505 that would not mandate 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 confirmations 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 obtained via external confirmation.

10. The Task Force believes that the proposed ISA, as drafted, does not discourage use of external confirmations as an effective response to an identified risk of financial statement misstatement. In addition, the proposed ISA does require 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 financial statement misstatement.

Overview of the Proposed ISA

11. The following summarizes key elements of the proposed ISA.
 - The proposed 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 a 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 ISA emphasizes the importance of determining whether external confirmations are expected to provide relevant and reliable audit evidence before deciding whether to seek external confirmations as audit evidence. The proposed 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 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 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 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 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 ISA includes requirements and guidance that may be relevant when management requests that the auditor not send a confirmation request to a particular party. The proposed 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 auditors' report.
- The proposed 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.

Material Presented

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Proposed ISA 505 (Revised), "External Confirmations"

(Pages 497 - 510)

Action Requested

The IAASB is asked to consider the accompanying draft and provide comments and recommendations to the Task Force for the purpose of furthering the drafting process.