PROPOSED ISA 505 (REVISED AND REDRAFTED)

EXTERNAL CONFIRMATIONS

(Effective for audits of financial statements for periods beginning on or after [date][*])

CONTENTS

Introduction	Paragraph
Scope of this ISA	1
External Confirmations as a Response to Assessed Risks	2-6
Effective Date	7
Objective	8
Definitions	9
Requirements	
External Confirmation Process	10
Management Request to Not Confirm	11-12
Results of the Confirmation Process	13-15
Evaluating the Evidence Obtained	16
Negative Confirmations	17
Application and Other Explanatory Material	
External Confirmations as a Response to Assessed Risks	A1-A5
External Confirmation Process	A6-A10
Management Request to Not Confirm	A11-A12
Results of the External Confirmation Process	A13-A21
Negative Confirmations	A22-A23

[*] See footnote 1.

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) establishes requirements and provides guidance for the performance of external confirmation procedures. This ISA does not address inquiries regarding litigation and claims. Part C: Procedures Regarding Litigation and Claims of ISA 501, "Audit Evidence – Additional Considerations for Specific Items", establishes requirements and provides guidance on such inquiries.

External Confirmations as a Response to Assessed Risks

2. ISA 315 (Redrafted), "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. When designing the nature, timing and extent of audit procedures, different procedures may provide appropriate audit evidence in addressing the assessed risks of material misstatement at the assertion level. The auditor's selection of audit procedures from a range of possible 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 evidence 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.

4. [Proposed] ISA 500 (Redrafted), "Considering the Relevance and Reliability of Audit Evidence" indicates 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. [Proposed] ISA 500 (Redrafted) indicates that the following generalizations applicable to 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, whether paper, electronic, or other medium.

5. Audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more relevant than internally generated evidence. In addition, other ISAs recognize the importance of external confirmations as audit evidence, for example:

- ISA 330 (Redrafted), "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, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.
- ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement due to fraud at the assertion level.
- [Proposed] ISA 500 (Redrafted) indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from representations made by management. (Ref: Para. A1-A4)

6. The auditor also may determine that obtaining a response to an external confirmation request is the only means of obtaining sufficient appropriate audit evidence to address an assessed risk of material misstatement. (Ref: Para. A5)

Effective Date

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

Objective

8. When the auditor decides to perform confirmation procedures in response to an assessed risk of material misstatement, the objective of the auditor is to design and perform such procedures to provide relevant and reliable audit evidence.

Definitions

9. For the purpose of the ISAs, the following terms have the meanings attributed below:

   (a) External confirmation – Audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), or the lack of response to a negative confirmation request.

   (b) External confirmation process – The process of performing procedures directed towards obtaining an external confirmation.

   (c) Positive confirmation request – A request for information that asks the confirming party to respond directly to the auditor.

   (d) 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.

(e) Non-response – When the confirming party does not respond, or does not fully respond, to a positive confirmation request, or when any confirmation request is returned undeliverable.

(f) Exception – A response to any confirmation request indicating that there is a difference between the information requested for confirmation, or contained in the entity's records, and the information provided by the confirming party.

Requirements

External Confirmation Process (Ref: Para. A6-A10)

10. When the auditor decides to perform confirmation procedures in response to an assessed risk of material misstatement, the auditor shall maintain control over the external confirmation process, including:

    (a) Designing and preparing the confirmation requests;

    (b) Directing the communication of the confirmation requests to the confirming party;

    (c) Considering the results (responses, non-responses and exceptions) of the confirmation requests; and

    (d) Evaluating the evidence obtained.

Management Request to Not Confirm

11. When management requests that the auditor not send a confirmation request, the auditor shall:

    (a) Perform alternative procedures with respect to the information contained in that request to provide relevant and reliable audit evidence; and (Ref: Para. A11)

    (b) Evaluate the impact of management's request on the assessment of the relevant risks of material misstatement and on the nature, timing and extent of other audit procedures. (Ref: Para. A12)

12. When the auditor is prevented from requesting a confirmation and is unable to perform sufficient alternative procedures, the auditor shall consider the possible impact on the auditor's opinion in accordance with [proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report."

Results of the Confirmation Process

13. When the auditor determines that a response to a confirmation request is not reliable, the auditor shall treat the response as a non-response. (Ref: Para. A14-A15)

14. The auditor shall perform alternative audit procedures for non-responses to obtain relevant and reliable audit evidence. 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 assessed risks of material misstatement, and the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion. (Ref: Para A16-A19)

15. The auditor shall investigate exceptions to determine whether or not they represent misstatements. (Ref: Para. A20-A21)

Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation process provide the expected audit evidence or whether further audit procedures are necessary to obtain relevant and reliable audit evidence. ISA 330 (Redrafted) provides guidance when further audit procedures are necessary.

Negative Confirmations

17. The use of negative confirmations without also performing other substantive procedures that address an assessed risk shall be limited to circumstances when all of the following conditions are met:

    (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 exceptions is not expected; and

    (d) The auditor does not believe that respondents will disregard the confirmation requests. (Ref: Para. A22-A23)

* * *

Application and Other Explanatory Material

External Confirmations as a Response to Assessed Risks (Ref: Para. 2-6)

Relevance of External Confirmations

A1. Confirmation procedures frequently are relevant when addressing assertions associated with account balances and their constituent parts, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements, contracts or transactions that 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 affect assertions such a cut-off assertion. Other examples of situations where confirmation procedures provide relevant audit evidence in responding to assessed risks of material 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, which may be relevant for the valuation and cut-off assertions.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A2. While external confirmations may provide relevant evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant evidence. For example, they provide less relevant evidence relating to the recoverability of accounts receivable balances.

A3. The auditor may decide to perform confirmation procedures rather than other audit procedures on the basis of the factors in paragraph 3 of this ISA. For example, even though there may be other procedures for obtaining audit evidence about the existence of an entity's bank balances, the auditor may decide to seek confirmation from the entity's banks because such confirmation request may provide the opportunity to confirm other information relevant to the entity's banking relationships.

Considerations in Determining the Appropriateness of External Confirmations

A4. Factors that may assist the auditor in determining whether confirmation procedures are an appropriate response to an assessed risk include:

- The confirming party's knowledge of the subject matter – if the subject matter on which confirmation procedures are being performed is extremely complex or highly subjective, responses may be more reliable if the requests are sent to the appropriate person at the confirming party;
- The ability or willingness of the confirming party to respond – for example, the confirming party:
  - may not view responding to a confirmation request as its responsibility,
  - may consider responding too costly or time consuming,
  - may account for transactions in different currencies, or
  - may operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

  In such situations, confirming parties may not respond, respond in a casual manner or restrict the reliance to be placed on the response;
- The objectivity of the confirming party– if the confirming party is an unrelated party of the entity, responses to confirmation requests may be more reliable.

When a Response to a Positive Confirmation Request is the Only Means of Obtaining Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A5. The auditor may determine that a response to a positive confirmation request is the only means of obtaining sufficient appropriate audit evidence to address an assessed risk.

Examples of circumstances when obtaining a response to a confirmation request directly from a confirming party may be the only way of obtaining appropriate audit evidence to address the assessed risk include:

- The only information available to corroborate management's assertion(s) resides outside the entity;
- The entity's information systems and internal controls are unreliable or ineffective;
- The subject matter is highly subjective and 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 from the entity.

External Confirmation Process (Ref: Para. 10)

Control Over the Confirmation Process

A6. Control over communications between the intended confirming parties and the auditor minimizes the possibility that the results of the external confirmation process will not be reliable because of the interception, or alteration, of confirmation requests or responses. Such control may include ensuring that:

- The auditor sends out the confirmation requests,
- The requests are properly addressed,
- The auditor's return information is included in the request, and
- All responses are requested to be sent directly to the auditor.

Designing the Confirmation Request

A7. The design of the confirmation request may have a direct effect on the confirmation response rate and the reliability and the nature of the audit evidence obtained from responses to confirmation requests.

A8. Factors to be considered in designing the confirmation request may include:

- The assertions being addressed,
- Specific risks identified, including fraud risks,
- The layout and presentation of the confirmation request,
- Prior experience on the audit or similar engagements, and
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Identifying the Appropriate Confirming Party

A9. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are 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 person at the confirming party from which to request confirmation.

Follow-Up on Confirmation Requests

A10. The auditor may perform procedures to obtain external confirmations for non-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.

Management Request to Not Confirm (Ref: Para. 11)

A11. When management requests that the auditor not send a confirmation request, the alternative procedures performed are those appropriate for a non-response as set out in paragraphs A16 to A19 of this ISA.

A12. 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 evaluate the impact of management's request on the assessment of the relevant risks of material misstatement and on the nature, timing and extent of other audit procedures.

Results of the Confirmation Process

A13. Responses to confirmation requests may be categorized as follows:

(a) A response confirmed correct by the appropriate confirming party;

(b) A response deemed unreliable;

(c) A non-response; or

(d) A response indicating an exception.

Reliability of External Confirmations (Ref: Para. 13)

A14. [Proposed] ISA 500 (Redrafted) requires the auditor to consider the reliability of information to be used as audit evidence. [Proposed] ISA 500 (Redrafted) indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. Accordingly, when evaluating responses to confirmation requests, the auditor may have doubts 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 responses that:

- Are not delivered directly to the auditor;
- Do not come from the originally intended confirming party; or

- Are received by a means that does not provide sufficient evidence as to their origin, for example by facsimile or electronically.

A15. [Proposed] ISA 500 (Redrafted) provides guidance when the auditor has doubts over the reliability of information to be used as audit evidence and requires the auditor to determine what modifications, or additional procedures, are necessary to resolve the matter. In this respect, the auditor may choose to verify the source and contents of a response to a confirmation request in a telephone call to the purported confirming party. In addition, the auditor may request that the purported confirming party mail the original response to the confirmation request directly to the auditor.

Non-responses (Ref: Para. 14)

A16. An oral response to a confirmation request constitutes a non-response for the purposes of this ISA.

A17. Examples of alternative audit procedures the auditor may perform when a response to a positive confirmation request is not considered the only means of obtaining sufficient appropriate audit evidence include:

- Accounts receivable balances – examination of specific subsequent cash receipts, examination of shipping documentation, and examination of sales near the period-end to provide audit evidence for the cutoff assertion;
- Accounts payable balances – examination of subsequent cash disbursements or correspondence from third parties, and examination of other records, such as goods received notes;
- Bank balances – direct access by the auditor to information held by a third party concerning a client's account, for example by using the client's personal identification number to make an on-line inquiry.

A18. The nature and extent of alternative audit procedures is affected by the assessed risks of material misstatement 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.

A19. If a response to a positive confirmation request is the only means of obtaining sufficient appropriate audit evidence that will address an assessed risk, and the auditor does not receive an external confirmation, then a limitation in the scope of the audit may result. [Proposed] ISA 705 (Revised and Redrafted) provides guidance when there is a limitation in the scope of the audit.

Exceptions (Ref: Para. 15)

A20. Exceptions noted in responses to confirmation requests may provide information to assist the auditor in determining the extent of misstatements and potential misstatements. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud in accordance with ISA 240 (Redrafted). Exceptions may provide a guide

to the quality of responses to confirmation requests from similar confirming parties or for similar accounts. Exceptions also may indicate a weakness in the entity's internal control over financial reporting.

A21. Some exceptions may not represent misstatements. For example, the auditor may conclude that differences identified in responses to confirmation requests are due to timing, measurement, or clerical errors.

Negative Confirmations (Ref: Para. 17)

A22. When no response is received to a negative confirmation request, there is no explicit indication 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.

A23. The circumstances when the auditor may use negative confirmation requests alone to reduce the assessed risks of material misstatement to an acceptable level are limited. The auditor may, however, use negative confirmation requests to supplement other substantive audit procedures.