

INTERNATIONAL STANDARD ON AUDITING 505

EXTERNAL CONFIRMATIONS

(Effective for audits of financial statements for periods beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 505, "External Confirmations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.



* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 505. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 505.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence.
2. **The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.**
3. 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.
 - Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Accordingly, audit evidence in the form of original written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other audit procedures, may assist in reducing the risk of material misstatement for the related assertions to an acceptably low level.

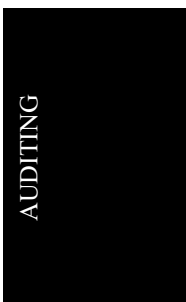
4. External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.
5. External confirmations are frequently used in relation to 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 or transactions an entity has with third parties. The confirmation request is

designed to ask if any modifications have been made to the agreement, and if so what the relevant details are. External confirmations may also be used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
 - Accounts receivable balances.
 - Stocks 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.
 - Loans from lenders.
 - Accounts payable balances.
6. The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor’s Assessments of the Risk of Material Misstatement

7. ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” discusses the auditor’s responsibility to obtain an understanding of the entity and its environment including its internal control; and to assess the risks of material misstatement. It outlines the audit procedures performed to assess the risks of material misstatements of the financial statements sufficient to design and perform further audit procedures.
8. ISA 330, “The Auditor’s Procedures in Response to Assessed Risks” discusses the auditor’s responsibility to determine overall responses and to design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement at the financial statement and assertion levels. In particular, ISA 330 indicates that the auditor determines the nature and extent of audit evidence to be obtained from the



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performance of substantive procedures in response to the related assessment of the risk of material misstatement, and that, irrespective of the assessed risk of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. These substantive procedures may include the use of external confirmations for certain assertions.

9. Paragraph 11 of ISA 330 indicates that the higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. Consequently as the assessed risk of material misstatement increases, the auditor designs substantive procedures to obtain more reliable and relevant audit evidence, or more persuasive audit evidence, at the assertion level. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.
10. The lower the assessed risk of material misstatement, the less assurance the auditor needs from substantive procedures to form a conclusion about an assertion. For example, an entity may have a loan that it is repaying according to an agreed schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has led to the risk of material misstatement over the balance of the loan outstanding being assessed as lower, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.
11. When the auditor has identified a risk as being significant (see paragraph 108 of ISA 315), the auditor may give particular consideration to whether confirmations of certain matters may be an appropriate way of reducing the risk of misstatement. For example, unusual or complex transactions may be associated with higher assessed risk than simple transactions. If the entity has entered into an unusual or complex transaction that results in a higher assessed risk of material misstatement, the auditor considers confirming the terms of the transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

12. ISA 500 requires the use of assertions in assessing risks and designing and performing audit procedures in response to the assessed risks. ISA 500 categorizes the assertions into those relating to classes of transactions, account balances, and disclosures. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.
13. External confirmation of an account receivable provides reliable and relevant audit evidence regarding the existence of the account as at a certain date.

Confirmation also provides audit evidence regarding the operation of cutoff procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

14. Similarly, in the case of goods held on consignment, external confirmation is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions, but might not provide audit evidence that supports the valuation assertion.
15. The relevance of external confirmations to auditing a particular assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the completeness assertion for accounts payable, the auditor needs to obtain audit evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.
16. When obtaining audit evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Design of the External Confirmation Request

17. **The auditor should tailor external confirmation requests to the specific audit objective.** When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the audit evidence obtained through external confirmation procedures.
18. Also, in designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the audit evidence obtained. For example, certain respondents' information systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.
19. Confirmation requests ordinarily include management's authorization to the respondent to disclose the information to the auditor. Respondents may be

more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains management's authorization.

Use of Positive and Negative Confirmations

20. The auditor may use positive or negative external confirmation requests or a combination of both.
21. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.
22. A negative external 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, the auditor remains aware that there will be no explicit audit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct. Accordingly, the use of negative confirmation requests ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.
23. Negative confirmation requests may be used to reduce the risk of material misstatement to an acceptable level when:
 - (a) The assessed risk of material misstatement is lower;
 - (b) A large number of small balances is involved;
 - (c) A substantial number of errors is not expected; and
 - (d) The auditor has no reason to believe that respondents will disregard these requests.
24. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large

balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Management Requests

25. **When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain audit evidence to support the validity of management's requests. If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter.**
26. **If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report.**
27. When considering the reasons provided by management, the auditor applies an attitude of professional skepticism and considers whether the request has any implications regarding management's integrity. The auditor considers whether management's request may indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor applies the guidance in ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements." The auditor also considers whether the alternative audit procedures will provide sufficient appropriate audit evidence regarding that matter.

Characteristics of Respondents

28. The reliability of audit evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.
29. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional audit procedures are necessary. The auditor also considers whether there is sufficient basis for

concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate audit evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

30. **When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.** Control is maintained over communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor ensures that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the auditor. The auditor considers whether replies have come from the purported senders.

No Response to a Positive Confirmation Request

31. **The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide.**
32. Where no response is received, the auditor ordinarily contacts the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor uses alternative audit procedures. The nature of alternative audit procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative audit procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide audit evidence for the existence assertion, and examination of sales near the period-end to provide audit evidence for the cutoff assertion. In the examination of accounts payable, 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.

Reliability of Responses Received

33. The auditor considers whether there is any indication that external confirmations received may not be reliable. The auditor considers the response's authenticity and performs audit procedures to dispel any concern. The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor requests the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor considers validating the source of replies received in electronic format (for example, fax or electronic mail). Oral confirmations are documented in the work papers. If the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor.

Causes and Frequency of Exceptions

34. **When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should perform additional audit procedures to obtain sufficient appropriate audit evidence.**

In forming the conclusion, the auditor considers the:

- (a) Reliability of the confirmations and alternative audit procedures;
- (b) Nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and
- (c) Audit evidence provided by other audit procedures.

Based on this evaluation, the auditor determines whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

35. The auditor also considers the causes and frequency of exceptions reported by respondents. An exception may indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

Evaluating the Results of the Confirmation Process

36. **The auditor should evaluate whether the results of the external confirmation process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited.** In conducting this evaluation the

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auditor considers the guidance provided by ISA 330 and ISA 530, “Audit Sampling and Other Selective Procedures.”

External Confirmations Prior to the Year-end

37. When the auditor uses confirmation as at a date prior to the balance sheet to obtain audit evidence to support an assertion, the auditor obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated. Depending on the assessed risk of material misstatement, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor considers the need to obtain further audit evidence relating to the remainder of the period. ISA 330 provides additional guidance when audit procedures are performed at an interim date.

Effective Date

38. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2004.