

Standard on Auditing (SA) 505 (Revised)*

External Confirmations

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Standard on Auditing (SA) 505 (Revised), "External Confirmations" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services¹", which sets out the authority of SAs and SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

* Earlier known as SA 505 (AAS 30), "External Confirmations".

¹ Published in the July, 2007 issue of the Journal.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330² and SA 500 (Revised)³. It does not address inquiries regarding litigation and claims. SA 501 (Revised)⁴ deals with obtaining sufficient appropriate audit evidence from such inquiries.

External Confirmation Procedures to Obtain Audit Evidence

2. SA 500 (Revised) 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 obtained⁵. That SA also includes the following generalisations applicable to audit evidence⁶:

- 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.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

3. Other SAs recognise the importance of external confirmations as audit evidence, for example:

- SA 330 discusses the auditor's responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level⁷. In addition, SA 330 requires that, irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures⁸.
- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk⁹. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud

² SA 330, "The Auditor's Responses to Assessed Risks".

³ SA 500 (Revised), "Audit Evidence".

⁴ SA 501 (Revised), "Audit Evidence—Specific Considerations for Selected Items".

⁵ SA 500 (Revised), paragraph A5.

⁶ SA 500 (Revised), paragraph A31.

⁷ SA 330, paragraphs 5-6.

⁸ SA 330, Paragraph 20 and 20a. Paragraph 20a will be inserted in SA 330 when the final revised SA 505 comes into force.

⁹ SA 330, paragraph 7(b).

or error¹⁰.

- SA 240 (Revised) indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level¹¹.
- SA 500 (Revised) 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 the representations made by the management¹².

Effective Date

4. This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

Objective

5. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:
 - a) External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
 - b) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
 - c) Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - d) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
 - e) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

Requirements

External Confirmation Procedures

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
 - (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
 - (b) Selecting the appropriate confirming party; (Ref: Para. A2)
 - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain

¹⁰ SA 330, paragraph A49.

¹¹ SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph A37.

¹² SA 500 (Revised), paragraph A8.

return information for responses to be sent directly to the auditor; and (Ref: Para. A3-A6)

- (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

Management's Refusal to Allow the Auditor to Send a Confirmation Request

8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260 (Revised)¹³. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705¹⁴.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11-A16)

11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

Non-Responses

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19)

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with SA 705. (Ref: Para A20)

Exceptions

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21-A22)

¹³ SA 260 (Revised), "Communication with Those Charged with Governance", paragraph 12.

¹⁴ SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. (Ref: Para A24-A25)

Application and Other Explanatory Material

External Confirmation Procedures

Determining the Information to be Confirmed or Requested (Ref: Para. 7(a))

A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a “side agreement”.

Selecting the Appropriate Confirming Party (Ref: Para. 7(b))

A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests (Ref: Para. 7(c))

A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

A4. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.

- The method of communication (for example, in paper form, or by electronic or other medium).
- Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party 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 confirming parties.

A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

Follow-Up on Confirmation Requests (Ref: Para. 7(d))

A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

Reasonableness of Management's Refusal (Ref: Para. 8(a))

A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Implications for the Assessment of Risks of Material Misstatement (Ref: Para. 8(b))

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures in accordance with SA 315¹⁵. For example, if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240 (Revised)¹⁶.

Alternative Audit Procedures (Ref: Para. 8(c))

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18-A19 of this SA. Such procedures also would take account of the results of the auditor's evaluation in paragraph 8(b) of this SA.

Results of the External Confirmation Procedures

¹⁵ SA 315, paragraph 30.

¹⁶ SA 240 (Revised), paragraph 24.

Reliability of Responses to Confirmation Requests (Ref: Para. 10)

A11. SA 500 (Revised) indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability¹⁷. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

- (a) The response may not be from the proper source;
- (b) A respondent may not be authorised to respond; and
- (c) The integrity of the transmission may have been compromised.

A14. The auditor is required by SA 500 (Revised) to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence¹⁸. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

Unreliable Responses (Ref: Para. 11)

A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of

¹⁷ SA 500 (Revised), paragraph A31.

¹⁸ SA 500 (Revised), paragraph 11.

the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with SA 315¹⁹. For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240 (Revised)²⁰.

Non-Responses (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315²¹. For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SA 240 (Revised)²².

When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

- The information available to corroborate management's assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

Exceptions (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by SA 240 (Revised) to evaluate whether such misstatement is indicative of fraud²³. Exceptions may provide a guide to the quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

Negative Confirmations (Ref: Para. 15)

¹⁹ SA 315, paragraph 30.

²⁰ SA 240 (Revised), paragraph 24.

²¹ SA 315, paragraph 30.

²² SA 240 (Revised), paragraph 24.

²³ SA 240 (Revised), paragraph 35.

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A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that the balance in their account is understated in the confirmation request, but may be less likely to respond when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of bank deposit accounts may be a useful procedure in considering whether such balances may be understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Evaluating the Evidence Obtained (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:

- (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
- (b) A response deemed unreliable;
- (c) A non-response; or
- (d) A response indicating an exception.

A25. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330²⁴.

Modifications vis-a-vis ISA 505, "External Confirmations"

The Revised SA 505, "External Confirmations" does not contain any modifications vis-à-vis ISA 505.

²⁴ SA 330, paragraphs 27-28.

Limited Revisions Consequential to issuance of the Standard on Auditing (SA) 505 (Revised), “External Confirmations”

The amendments to SA 330 have been shown in Track Changed mode.

SA 330, “The Auditor’s Responses to Assessed Risks”

20a. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A47a-A47d)

[When the consequential limited revisions are included in SA 330, paragraph 20a will become paragraph 21 and the SA will be renumbered accordingly.]

Considering Whether External Confirmation Procedures Are to Be Performed

A47a. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may 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 held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A47b. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A47c. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor’s decision about whether to perform external confirmation procedures.

A47d. Factors that may assist the auditor in determining whether external confirmation procedures are to be

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performed as substantive audit procedures include:

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
 - o May not accept responsibility for responding to a confirmation request;
 - o May consider responding too costly or time consuming;
 - o May have concerns about the potential legal liability resulting from responding;
 - o May account for transactions in different currencies; or
 - o 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, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 22)

- A49. Paragraph 22 of this SA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations s procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations s procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms. ~~Substantive procedures related to significant risks are most often designed to obtain audit evidence with high reliability.~~

[When the consequential limited revisions are included in SA 330, paragraph A47a will become paragraph A48 and the SA will be renumbered accordingly.]