



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

February 15, 2008

International Federation of Accountants
545 Fifth Ave, 14th Floor
New York, New York 10017 USA

Subject: International Auditing and Assurance Standards Board (IAASB) October 2007 Exposure Draft: *ISA 505, External Confirmations*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the IAASB's proposed revisions to ISA 505.

GAO is committed to transforming and modernizing the accountability profession; accordingly, we support the IAASB's efforts to improve the requirements and guidance governing external confirmations. Overall, we believe that the proposed revisions to ISA 505 help clarify the auditor's responsibility with regard to performing confirmation procedures. We especially support the IAASB's position of not mandating the use of external confirmation procedures in particular circumstances. However, we have concerns that, if not appropriately addressed, could prevent the proposed standard from achieving the stated objectives. Our concerns and related suggestions address the following items in the proposed standard:

- Require the Auditor to Determine the Need for Confirmation Procedures
- Prohibit Negative Confirmation Procedures as the Sole Substantive Test
- Definitions
- Control Over External Confirmation Requests and Responses
- Considerations in Determining the Appropriateness of External Confirmations
- Use of Electronic Confirmations

Require the Auditor to Determine the Need for Confirmation Procedures

The proposed standard should not be directed solely at the effective performance of external confirmation procedures. Instead, after completing the audit risk assessment, the auditor should be required to determine whether confirmation procedures are needed to obtain reasonable assurance of detecting material misstatements in assertions and accounts for which the auditor has assessed the risk of material misstatement as high, such as revenue recognition and accounts receivable. When properly designed, external confirmation procedures provide persuasive evidence, thereby making the procedures especially valuable in auditing high risk assertions and accounts. The auditor should be required to document his or her reasoning and conclusions.

The objective of the proposed standard also should be revised to include these additional objectives, as follows:

Paragraph 5: The objectives of the auditor are: (1) when auditing assertions or accounts for which the auditor has assessed the risk of material misstatement as high, to determine whether external confirmation procedures are necessary, and (2) when using external confirmation procedures, to design and perform such procedures to obtain relevant and reliable audit evidence. The objective of the auditor when using external confirmation procedures in response to an assessed risk of material misstatement is to design and perform such procedures to obtain relevant and reliable audit evidence.

Prohibit Negative Confirmation Procedures as the Sole Substantive Test

We propose revisions to paragraph 14 of the proposed standard to further emphasize that the auditor should understand the limitations of the audit evidence obtained from negative confirmation procedures and should **not** use negative confirmation requests as the sole substantive procedure to address an assessed risk of material misstatement at the assertion level. Our proposed changes are as follows:

Paragraph 14: Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall ~~not only~~ use negative confirmation ~~procedures requests~~ as the sole substantive ~~test of an account or assertion procedure to address an assessed risk of material misstatement at the assertion level when the auditor has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion and concluded that the risk of material misstatement is low, and:~~ Situation when negative confirmations may be useful include when:

(a) the auditor has used some positive requests on the same account and assertion;

(b) the auditor has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion and concluded that the risk of material misstatement is low;

~~(ca) t~~The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances;

~~(db) v~~Very few or no misstatements exceptions are expected; and

~~(e) The auditor has no reason to believe that recipients of negative confirmation requests will disregard such confirmation requests.~~

(e) the auditor believes that recipients will notify the auditors of misstatements and that negative confirmations would provide appropriate evidence.

Definitions

We recommend removing “written” from the definition of “external confirmation” in paragraph 6(a). External confirmations can be received in many different forms, such as in writing, orally, or electronically.

We also recommend defining “non-response” in paragraph 6(d) as a failure of the confirming party to respond to all or specific items in a positive confirmation request. To incorporate this suggestion, we recommend revising paragraph 6(d) as follows:

Paragraph 6(d): Non-response – A failure of the confirming party to respond to all or specific items in , or fully respond, to a positive confirmation request, or a confirmation request returned undelivered

Further, we recommend developing and including definitions for “response” and “alternative procedures” in the proposed standard as follows:

Paragraph 6(f): Response – A reply from a confirming party responding to all items in the confirmation request.

Paragraph 6(g): Alternative procedures – Procedures performed by the auditor when there are non-responses to confirmation requests in order to obtain the evidence necessary to reduce audit risk to an acceptably low level.

Control Over External Confirmation Requests and Responses

We recommend that the title “External Confirmation Procedures” above paragraph 7 of the proposed standard be changed to “Maintaining Control over External Confirmation Requests and Responses.” This section discusses the importance of maintaining control over external confirmation requests and responses, rather than the actual procedures. In addition, we suggest discussing in paragraph 7 that the client may assist the auditor in the external confirmation process, but that the auditor

should maintain control of the procedures, the confirmation requests, and the responses.

To further clarify the guidance related to the auditor maintaining control over the confirmation requests and responses, we also recommend revising paragraph A7 as follows:

Paragraph A7: ~~Auditor control of Controlling~~ communications between the intended confirming parties and the auditor reduces the risk of unreliable results. ~~of the external confirmation procedures. Maintaining control includes establishing direct communication between the confirming party and the auditor to minimize the possibility of unreliable results because of interception and alteration of the confirmation requests and responses.~~

Considerations in Determining the Appropriateness of External Confirmations

We are concerned that auditors may misinterpret paragraph A5 of the proposed standard related to the confirming party's knowledge of the subject matter. The proposed standard states "if the subject matter of external confirmation procedures is complex or highly subjective, responses may be more reliable if provided by a person at the confirming party who is more knowledgeable about the information being confirmed." However, regardless of how complex or highly subjective the subject matter is, the auditor should direct the confirmation request to the specific individual at the confirming entity who the auditor believes is knowledgeable about the information. We recommend revising the first bullet point in paragraph A5 as follows:

Paragraph A5: Factors that may assist the auditor in determining whether external confirmation procedures are an appropriate response to an assessed risk of material misstatement include:

- The confirming party's knowledge of the subject matter – ~~Responses are normally more reliable if provided by a person at the confirming party who is more knowledgeable about the information being confirmed. This is especially important~~ if the subject matter of external confirmation procedures is complex or highly subjective. ~~responses may be more reliable if provided by a person at the confirming party who is more knowledgeable about the information being confirmed.~~

Use of Electronic Confirmations

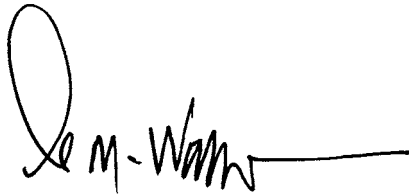
Some auditors now use email to send confirmation requests and receive responses. Also, there may be situations in which the confirming party, because of timeliness or other considerations, responds to a confirmation request other than a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. Therefore, we recommend adding the following language related to this subject matter between paragraphs A10 and A11 of the proposed standard to encourage consistency of practice:

Electronic Confirmations

Properly controlled electronic confirmations may be considered to be reliable audit evidence. It is important for the auditor and the confirming party to use a process or mechanism for electronic confirmations designed to minimize the possibility that the results will be compromised because of interception, alteration, or fraud. If the auditor is satisfied that the electronic confirmation process is secure and properly controlled and the confirmation is directly from a third party who is a bona fide authorized confirming party, electronic confirmations may be considered as sufficient, valid confirmation responses.

We thank you for considering our comments on these important issues.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. M. Walker", followed by a horizontal line extending to the right.

David M. Walker
Comptroller General
Of the United States

cc: Mr. James M. Sylph, Technical Director
International Auditing and Assurance Standards Board

The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman
Public Company Accounting Oversight Board

Mr. Harold Monk, Chair
Auditing Standards Board