



Article – External Confirmations

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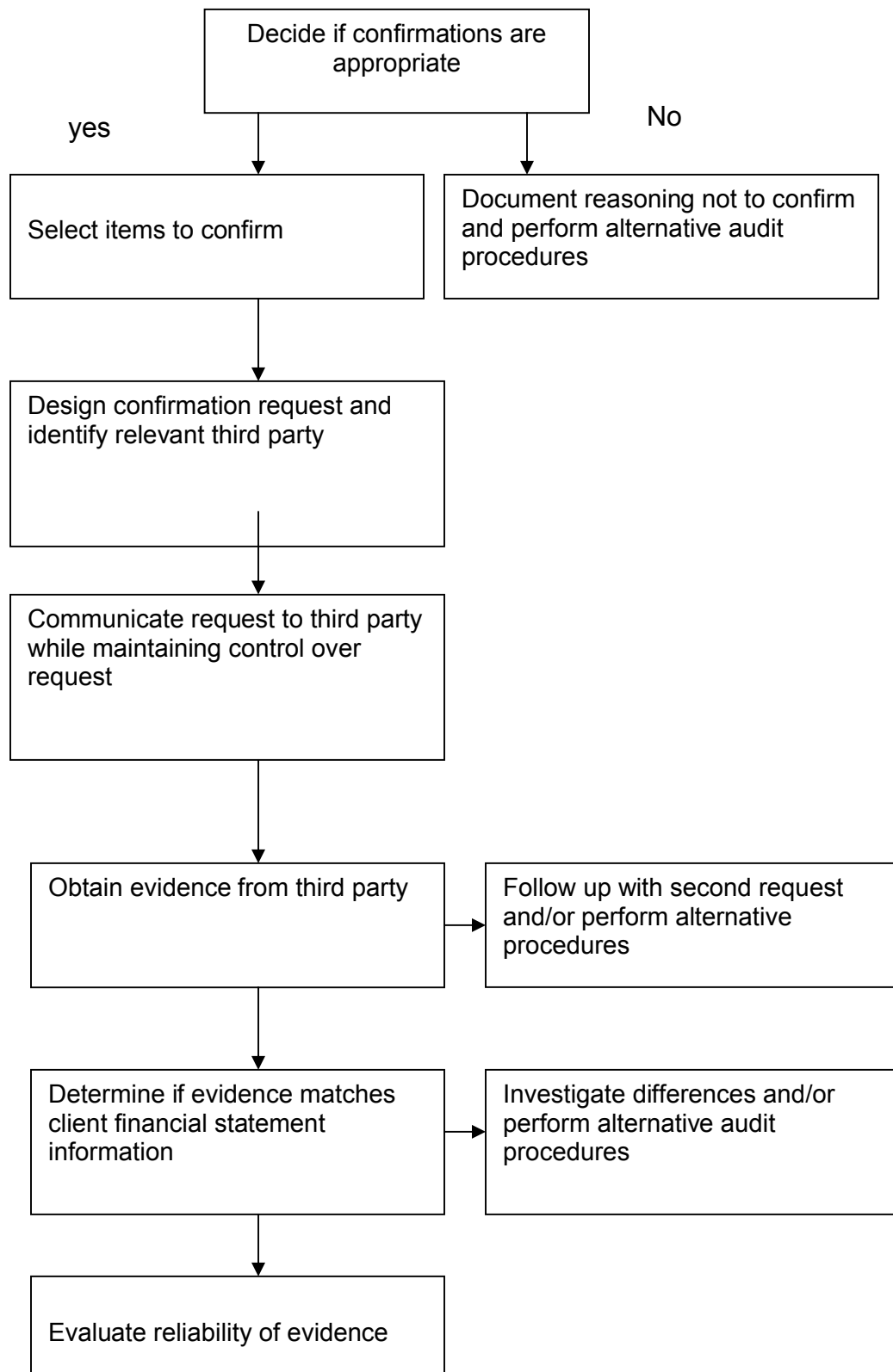
External Confirmations

Introduction

ISA 500: Audit Evidence identifies seven audit procedures amongst which is External Confirmation. This article looks at the specific procedure of external confirmations, identifies the steps that should be followed in the audit confirmation process, the design of the confirmation request, confirmations for specific accounts (trade receivables, bank, trade payables, contingent liabilities and other accounts) and lastly gives a brief overview of instances of audit failure involving confirmation evidence.

ISA 505: defines external confirmation as “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 other medium.” (para 6). For example, an auditor would in the normal course of the audit seek direct confirmation of trade receivables by writing to customers asking them to confirm amounts due by them to the client. As confirmations come from sources independent of the client, they are highly persuasive and therefore a much used type of evidence. However, they are also expensive and time-consuming and an inconvenience to those asked to supply them. ISA 505 (para A5) requires that auditors should determine “whether external confirmation procedures are an appropriate response to an assessed risk of misstatement” but does not mandate their use in any particular circumstances. In general auditors determine whether or not to use confirmations depending on the reliability needs of the situation as well as the alternative evidence available.

Audit Confirmation Steps



Design of the confirmation request

ISA 505 (para A8) states “The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of audit evidence obtained from responses”.

ISA 505 (para A9) goes on to outline a number of factors to consider when designing confirmation requests including:

- The assertions being addressed
- Specific identified risks of misstatement, including fraud risks
- The layout and presentation of the confirmation request
- Prior experience on the audit or similar engagements
- The method of communication (paper, electronic, other)
- Management’s authorisation to the confirming parties to respond to the auditor
- The ability of the intended confirming party to confirm or provide the requested information

The confirming party must have the permission of the client to release the information. To obtain this permission the auditor asks the client to sign an authority letter to the confirming parties authorising them to release any information the auditors may require directly to them. It would be extremely serious if the client refused to sign the authority letter. In this instance the auditor should explain that the confirmation request comprised routine enquiries with regard to the affairs of the client and ensure that client is made fully aware of its contents. If the auditor is not satisfied with the reasons given for the lack of co-operation by the client (it is unlikely that there could be any justifiable reason for non-co-operation), then the auditor consider the possibility of fraud and review their audit procedures accordingly.

Confirmation of Trade Receivables

The confirmation of trade receivables is typical of the confirmation process. Indeed confirmation of credit customers became a standard audit procedure as a result of the *McKesson and Robbins* case in the United States in the 1930’s. Highly reliable independent audit evidence can be obtained from circularising a sample of the client’s credit customers for direct confirmation.

Confirmations may be of two types: positive and negative.

- A *positive confirmation* requests the customer to confirm an account balance stated on the confirmation form or designate a different amount with an explanation. A second type of positive confirmation, often called a *blank confirmation request* does not state the amount on the confirmation but requests the customer to fill in the balance or furnish other information. It should be noted that using this second type of positive confirmation may result in lower response rates because additional work is required of the customers.
- A *negative confirmation* requests the customer to reply to the auditor only if they disagree with the account balance stated.

Positive confirmations are generally considered to be more reliable as the customer is requested to respond irrespective as to whether the amount stated is accurate or inaccurate. In the case of negative confirmations, failure to respond by customers is viewed as an accurate response, even though the customer may have chosen to ignore the confirmation request. Despite this disadvantage negative confirmations are *less expensive* because there are no follow-up procedures for non-responses, and therefore more can be despatched for the same total cost.

Deciding which type to send is a matter of judgement for the individual auditor. Generally negative confirmations are only sent in the following circumstances:

- Trade receivables is made up of a large number of small accounts
- Inherent risk and control risk is assessed as low
- There is no reason to suspect that customers are unlikely to respond

In some audits a combination of negative and positive confirmations are sent; the latter to accounts with large balances and the former to those with small balances.

Timing

The most reliable evidence from confirmations is obtained when sent as close to the year end date as possible, as opposed to confirming the balances several months before the balance sheet date. When this is the case, the customer's account balances are tested directly, without making any inferences about the transactions taking place between the confirmation date and the year end. However, sometimes in order to facilitate the timely completion of the audit, it can become necessary to confirm the accounts at an interim date. This is acceptable if internal controls are adequate and can provide reasonable assurance that sales, sales returns and cash receipts are properly recorded between the date of the confirmation and the period end.

Sample Size

In order to select the sample of customers to be confirmed a number of factors need to be considered:

- Materiality
- Inherent risk (size of total trade receivables balance, number of accounts, prior year results, the risk of material misstatement)
- Control risk
- The extent and results of substantive analytical procedures and other tests of transactions and details
- Type of confirmation used – negative normally requires a larger sample size

Selection of the Items for Testing

Some type of stratification of the total population of credit customers is generally involved. It is usual to stratify according to the monetary size of individual accounts and the age of outstanding balances. The emphasis should be on confirming large and old accounts because these are most likely to include a material misstatement. However, it is important to sample some items from every material stratum of the population.

Following up non-responses

When negative confirmations are used it is assumed that the amounts stated in confirmations not returned are accurate. When no response has been received after the second (or third) positive confirmation request to a customer, auditors should perform alternative procedures. The two main alternative procedures are examining subsequent collections and vouching unpaid invoices and supporting documentation comprising customer balances.

Analysis of Differences

When confirmations are returned to the auditor, it is necessary to determine the reason for any reported differences. In many cases these will result from timing differences between the client's and customer's records. However, these may also indicate errors in the client's accounts. The most common differences are:

- Payment has already been made
- Goods have not been received
- Goods have been returned
- Clerical errors and disputed amounts

Drawing conclusions

When all differences found in the sample of responses, including those discovered in performing alternative procedures, have been explained the auditor needs to:

- Reevaluate internal control
- Generalise from the sample to the entire population of trade receivables
- Evaluate the qualitative nature of the misstatements found in the sample, irrespective of the monetary amount of the projected misstatement
- Determine whether sufficient evidence has been obtained regarding the assertions being tested

Bank Confirmations

As bank is the most liquid of all assets in general the auditor seeks direct receipt of a confirmation from every bank or other financial institution with which the client does business. Also most companies have only a few bank accounts with a large volume of transactions during the year. The importance of bank confirmations extends beyond the verification of the the actual cash balance. Generally bank confirmations (usually a standard format) request several specific items of information, namely:

1. Full titles of all accounts in all currencies together with the account numbers and balances thereon including nil balances, held at the year end. Confirmation of these details would be sought on any account to which the client had title (including accounts held jointly or in a trade name).
2. Full titles and dates of closures of all accounts closed during the period being audited.
3. Details of any interest or charges accrued but not charged or credited at year end.
4. The amount of interest charged during the period being audited if not already disclosed in the client's bank statements.

5. Particulars of any written acknowledgement of set-off, comprising date, type of document and accounts covered.
6. Details of overdraft and loans repayable on demand, other loans and other facilities.
7. Details of any known client assets held as security, whether by a formal charge or informal charge.
8. Details of other client assets held, including share certificates, documents of title and deed boxes.
9. Details of any known contingent liabilities of the client at year end.
10. A list of banks, other branches of the same bank or associated companies where a relationship with the client had been established during the period being audited.
11. Details of any personal guarantees or personal assets of the directors of the client, held by the bank in connection with loans or facilities offered by the bank to the client.

If bank confirmations are not returned, they must be pursued until the auditor is satisfied as to what the requested information is. After the bank confirmation has been received, the balance in the bank account should be traced to the amount stated on the bank reconciliation. Likewise, all other information should be traced to the relevant audit schedules. If the information is not in agreement, an investigation must be made of the difference.

Trade payables confirmation

It is not normal to undertake a trade payables' confirmation for the following reasons:

1. For trade payables, much of the documentary evidence available is in the form of third party sourced suppliers' invoices and statements, in contrast to trade receivables for whom most of the available documentation is prepared by the client.
2. Confirmation offers no assurance that unrecorded liabilities will be discovered
3. Examination of documentary evidence is usually a cheaper form of substantive evidence than confirmation.
4. Although examination of third party sourced documentary evidence is less reliable than confirmations received directly by the auditor, it usually provides sufficient evidence.

A trade payables' confirmation should be considered in the following situations:

- A substantial proportion of the company's suppliers do not issue monthly statements.
- Statements from suppliers with whom the company does substantial business are unexpectedly unavailable for the last month of the year.
- Only fax or photocopies of statements are available whose authenticity is doubtful.

Contingent Liabilities confirmation

ISA 501: *Audit Evidence regarding specific financial statement account balances and disclosures* (para 10) states: "When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when the auditor believes that other litigation or claims may exist the auditor shallseek direct communication with the entity's legal counsel through a letter of general inquiry or specific inquiry, prepared by management and sent by the auditor, requesting the entity's legal counsel to communicate directly with the auditor".

The client's legal counsel are requested, in the letter of enquiry, to inform the auditor of any litigation and claims of which they are aware, their likely outcome, and the expected financial implications for the client. Where the auditor deems it likely that the legal counsel are not likely to respond in an appropriate manner to a letter of general enquiry they will send a letter of specific enquiry. ISA 501 (para 21) states that this letter should contain:

- "a list of litigation and claims;
- Management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered.....to be incomplete or incorrect".

Other confirmations

- If inventory, which is material to the financial statement, is held under custody and control of third party, ISA 501 (para 8) requires that the auditor "request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity"
- If investments are held by a third party, normally independent, reliable authorised custodians, on behalf of the client direct confirmation from the third party should be obtained
- If loans are made by client to third parties direct confirmation should be obtained from the borrower
- The auditor may also request confirmation of the terms of agreements or transactions a client has with third parties; the confirmation is designed to ask if any amendments have been made to the agreement and what the relevant details are.

What can go wrong!

Students are not expected to know details of the following examples taken from the Security and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases (AAERs) in the United States (<http://www.sec.gov/divisions/enforce/friactions.shtml>). They are described below to illustrate the risks an auditor may face if the confirmation process is not conducted properly.

- Lipper Holdings (2006) - The portfolio manager over three different Lipper Holdings mutual funds overstated the values of certain convertible, marketable securities held by the funds. Five broker-dealers were faxed the same confirmation request that listed 54 securities and the market prices assigned by the portfolio manager. The requests did not ask the salespeople to provide quotes for the specified securities or ask them to attest to the reasonableness of the values listed and were sent without regard to whether the firm made a market in the securities. One confirmation request was returned unsigned, but with exceptions to several market prices. The audit work papers did not indicate how the auditors followed up on the exceptions from the confirmation and the other external sources. The work papers did indicate "no exceptions noted."
- First American Health (2005) - overstated its trade receivables by \$892,000 in its fiscal 1999 financial statements. The reported value of accounts receivable was \$2.4 million. The audit partner knew that First American Health Concepts did not reconcile its trade receivables subsidiary ledger to the general ledger and that it was not in balance. He did not request the audit staff to send confirmation requests or to have the audit staff attempt to reconcile differences.
- Powerball (2004) - Powerball's president stole cash and hid this from the auditors by altering the bank statements and sending them to the auditors by fax. The auditor accepted the fax copies of the bank statements as audit evidence and did not send any bank confirmations, even though cash was over two-thirds of the total assets.
- Parmalat (2003-2004) - Auditors received a non-standard bank confirmation containing a forged signature when confirming cash balances regarding a wholly-owned subsidiary's claim of 3.95 billion euros in cash and marketable securities.
- Ebix (2002) - The audit partner ignored trade receivable confirmation differences. Several customers indicated that they were "entitled to refunds of deposits on software and would not pay certain outstanding invoices because they claimed the software Ebix had delivered did not function properly." No further investigation was made of these confirmation differences.
- Aura Systems (2002) - Auditors sent a trade receivables confirmation to Mag Innovision, but the actual address was Korea Data Systems. Korea Data Systems confirmed the trade receivables using a forged signature purported to be from Mag Innovision. Aura Systems's auditors also received two other forged confirmations from companies owned by Korea Data System's owner.
- Cronos (1999) – Cronos' CEO provided its auditors with a forged letter from the bank confirming a \$1.5 million cash transfer. Following US audit standards, when Cronos' auditors discovered the problem, they reported their concerns to the board of directors and resigned on Feb 3, 1997.
- Laser Photonics (1997-1999) - Management instructed certain customers to return confirmations to them rather than the auditors. Laser Photonics management altered one confirmation before forwarding it to the auditors.

- Sunrise Medical (1999) - External auditor allowed an internal auditor to assist with the confirmation process. Due to last minute time pressures, the internal auditor allowed an assistant controller to fax the confirmation request. For fictitious receivables, the assistant controller faxed blank pages instead of invoices, and then showed the auditors fax transmission sheets as if the actual requests had been made.
- Auditor for 18 related Utah companies (George I. Norman, 1987) allowed cash balance confirmation requests to be delivered by a secretary of a related party rather than sending the request directly to the banks involved.
- Flight Transportation Corporation (1985) - Flight Transportation's auditors accepted a "certification on actual Barclay's Bank letterhead certifying the balances of six accounts." One of the entries was a forgery. In addition, the auditors received the certification directly from a Flight Transportation employee rather than from the bank itself, thus failing to control the confirmation process. Further, the auditors received a trade receivables confirmation reply that was a forgery and the reply was different from the original request, including numerous typos and misspellings.
- J.B. Hanauer and Company (1983) imposed significant scope limitations on the auditors by routinely requesting that trade receivables and/or trade payables confirmation requests not be sent to certain customers. The percentage of receivables involved ranged from 17% to 26% of the total requests and/or dollars. The auditors agreed to the scope limitation, accepting as an explanation that certain J.B. Hanauer customers needed to maintain their anonymity. The auditors performed only minimal alternative procedures, mainly to see if the balances cleared subsequently. Certain J.B. Hanauer salesmen were defrauding customers by overcharging them and changing prices on brokers' advices (invoices). They then collected the excess amounts and pocketed the differences.

Hermetite Corporation (1982) - Hermetite had poor internal controls and the office manager took advantage and embezzled \$240,000 over several years, which was eventually discovered by the auditors. The auditors sent trade payable confirmations to suppliers because internal controls were so poor. Some suppliers reported significant differences, but the auditors failed to follow up on these differences