

AUDIT PRACTICE BULLETIN NO 1 OF 2010

EXTERNAL CONFIRMATIONS

3 MAY 2010

1. Confirmation is a common audit procedure applied by auditors to ascertain the existence and/or completeness of assets and liabilities such as accounts receivables and accounts payables. However, in ACRA's practice reviews under the Practice Monitoring Programme, deficiencies in complying with SSA 505 were repeatedly noted in the way confirmation procedures are applied by public accountants. The key deficiencies had been highlighted in the annual public reports of ACRA's Practice Monitoring Programme for 2007, 2008 and 2009¹. The purpose of this Audit Practice Bulletin is to describe some of the sub-standard audit work pertaining to external confirmations and to reiterate the need to increase the level of rigor and professional scepticism expected of the public accountant in the areas identified, together with an illustrative practical example.
2. Confirmation is an audit process by which an auditor obtains and evaluates a direct communication from a knowledgeable third party in response to a request for information regarding account balances, transactions or other items that comprise a company's financial statements. It is one of the normal means by which the auditor may seek to satisfy himself as to the accuracy of account balance and to form an opinion as to the adequacy of the controls over the process giving rise to the account balance. It may also be useful as a check on the accuracy of the cut-off procedures for balance sheet purposes and may help to draw attention to irregularities. Where the auditor is not satisfied that the system is sound or properly carried out, the test will be useful in ascertaining whether the balances are genuine, accurately stated and not in dispute (Ref: AGS 2.5).
3. Confirmations do not address all financial statements assertions equally well. For example, account receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions while accounts payable confirmations are likely to be effective for both the existence and completeness assertions.
4. The key deficiencies observed during the audit inspections are:
 - Allowing the client to send out confirmations;
 - Failure to authenticate the validity of confirmations received via fax or email;
 - Use of excessively small sample sizes with tests not satisfactorily completed; and
 - Failure to carry out alternative procedures for all balances not confirmed, resulting in "samples of samples".

¹Practice Monitoring Programme public reports for 2007, 2008 and 2009 are available at <http://www.acra.gov.sg/Publications/PMP+Public+Reports.htm>

Maintaining controls over the confirmation process

5. Clarified SSA 505.7² requires the auditor to maintain control over external confirmation requests which include, *inter alia*, the sending or delivery of the requests to the confirming party. The need for the auditor to maintain control over communications with the intended recipient is to minimise the possibility that the results of the confirmation process will be invalidated by interception and alteration of the confirmation requests or responses. Maintaining control over external confirmations also means not involving the audit entity in the process of collecting the confirmations, a practice noted, particularly in some jurisdictions. It may even extend to requiring the auditor to collect the reply from the confirming party directly, where other means of obtaining the confirmation without client involvement are not available.

Failure to authenticate the validity of confirmations submitted via fax or email

6. Recent advances in technology have caused e-mail and fax to become regarded as acceptable methods of communication, in addition to traditional mail. While adding efficiency, confirmations received electronically adds opportunities for skilled individuals to intercept and change responses before they reach the auditor. The public accountant should apply an appropriate level of professional scepticism regarding electronic confirmations.
7. Electronic confirmations 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 (Ref: Clarified SSA505.A12). This is especially the case when the electronic confirmation is received via from the audit entity rather than directly from the confirming party. Clarified SSA505.10 states that 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.
8. The auditor is required by Clarified SSA 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence. Where doubts exist, the auditor should 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 (Ref: Clarified SSA505.A14), after taking reasonable steps to independently verify that he has obtained the correct telephone number. However, ACRA generally noted a low level of professional scepticism in this area in that the public accountants were rarely suspicious of faxed or email confirmations. There was frequently little or no evidence of consideration given to support the assumption that the electronic confirmation could be relied upon.

² The clarified SSA 505.7 is effective in respect of audits of financial statements for periods beginning on or after 15 December 2009. The equivalent SSA prior to this date was SSA 505.30.

9. Some of the factors to be taken into account by the public accountant in evaluating the reliability of electronic confirmations include (assessing whether):
- The response is from a proper source which is secure and properly controlled;
 - The information is obtained directly by the public accountant and the integrity of the transmission has not been compromised; and
 - The information is obtained from the third party who is the intended recipient of the confirmation request and is authorised to respond.

The public accountant should perform appropriate procedures and document the work performed in addressing the reliability of responses prior to placing reliance on confirmations received electronically. Such procedures may include checking the accuracy of the mailing addresses of the confirming parties prior to sending the confirmation and calling the confirming parties directly regarding the confirmed balances.

Sample size and evaluating results of audit sampling in external confirmation procedures

10. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptable low level (Ref: Clarified SSA530.7). The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
11. The objective of using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. Clarified SSA 530.8 requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection. Audit sampling may be either statistical or non-statistical. Statistical sampling is an approach to sampling that has the following characteristics:
- Random selection of the sample items; and
 - The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have the above characteristics is considered non-statistical sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgement (Ref: Clarified SSA530.A9) and the basis of the auditor's judgement should be documented.

12. In order for the auditor to draw a conclusion about the population from which the sample is selected, the use of any sampling methodology, whether statistical or non-statistical, requires that **all** of the sample items chosen be successfully tested without exceptions noted. If there are exceptions, **every** exception should be investigated and satisfactorily resolved before the results of the procedures can be considered as adequate to provide the relevant and reliable audit evidence necessary to address the assertions intended by the procedures. For example, if 20 items are selected for

external confirmations to enable the auditor to draw conclusions as to the existence assertion for trade receivables, then all 20 items should be confirmed without differences, or if there are differences, all differences should be investigated and satisfactorily resolved.

13. Clarified SSA 530.11 states that if the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of test of controls, or a misstatement, in the case of test of details. ACRA's main findings in this area were that (i) the planned sample sizes or confirmation response rates were not satisfactorily achieved based on the original risk assessment and thus may not have adequately supported the achievement of the audit objective; and (ii) there was no evidence of consideration given to increasing the sample sizes where there were deviations and misstatements identified during the confirmation process. Consequently, the objective of using audit sampling to draw conclusions about of the population from which the sample was selected was not met.

Failure to carry out alternative procedures for all balances not confirmed, resulting in "samples of samples"

14. Clarified SSA330 describes the auditor's responsibility to design and implement procedures 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 level (Ref: Clarified SSA330.5-6). The auditor may consider performing external confirmation procedures as part of the audit procedures in response to the assessed risk at the assertion level. Where external confirmation procedures are used, Clarified SSA505.12 requires the auditor to perform alternative audit procedures to obtain relevant and reliable audit evidence in the case of **each** non-response.
15. If the auditor has determined that the external confirmation procedure is necessary to obtain sufficient appropriate audit evidence for a given sample, it follows that for non-responses, the alternative procedures should be carried out to obtain relevant and reliable audit evidence on the unconfirmed account balance in its entirety. This is necessary to determine whether further tests are required for the auditor to satisfy himself that the account balance is fairly stated. "Samples of samples" are unacceptable as they do not permit the achievement of the original planned assurance level.

16. To illustrate how a more rigorous approach might be adopted when using external confirmations as a means of obtaining audit evidence, consider a circularisation of 20 (statistically determined) selected trade receivable balances performed with the following results:

TYPES OF RESPONSE RECEIVED	NO. OF RESPONSE
Original confirmations with no discrepancies	7*
Original confirmations showing differences	2 (of which 1* was fully reconciled and tested and 1 not fully reconciled)
Faxed confirmations with no discrepancies	4 (of which only 1* was authenticated)
Non-response traced to customer acknowledged (signed or initialled) delivery orders	3*
Non-responses (without subsequent receipts) traced to sales invoices	2
Non-responses not validated in any way	2
Total	20

17. In this example, the public accountant has only obtained appropriate evidence to confirm 12* out of the 20 trade receivable balances. As a result, the original planned assurance level was not achieved.
18. To obtain the planned level of assurance, the following procedures should be carried out in respect of the 8 items for which no or inadequate evidence has been obtained:

RESPONSE RECEIVED	AUDIT CONSIDERATIONS REQUIRED
1 original confirmation showing differences	<ul style="list-style-type: none"> ▪ Regardless of the quantum, differences between the balances in the client's records and balances confirmed by customers should be reconciled. The auditor should also review and understand the nature of these reconciling items and verify the items to the supporting documents. ▪ Clarified SSA505.14 also requires the auditor to investigate the exceptions to determine whether or not it is indicative of misstatement. ▪ Clarified SSA530.14 provides that for tests of details, the public accountant is required to project misstatements found in the sample to the population to obtain a broad view of the scale of misstatement and project the effects of the discrepancies to the

RESPONSE RECEIVED	AUDIT CONSIDERATIONS REQUIRED
	population.
3 faxed confirmations with no discrepancies	<ul style="list-style-type: none"> ▪ Prior to placing reliance on electronic confirmation, the public accountant should evaluate the reliability of such confirmations and document the procedures carried out to support conclusions in this area (including direct contact with the confirming party). ▪ Consideration should be given to whether the circumstances (such as during an economic downturn which may present heightened risk of fraudulent reporting) would require the public accountant to go beyond the customary authenticating procedures.
2 non-responses (without subsequent receipts) traced to sales invoices	<ul style="list-style-type: none"> ▪ This is a case of performing inadequate alternative procedures. Alternative testing to internally generated documents such as sales invoices is considered inappropriate. In an instance where there is no reply from the confirming entity after the public accountant has tried to contact the confirming party and has determined that there are no or insufficient subsequent receipts to confirm the entire balance, the public accountant should examine the supporting documents that indicates delivery of goods and services e.g. delivery notes acknowledged by customers, that represents the entire balance to be confirmed. ▪ The auditor should consider the relevance and reliability of the information to be used as audit evidence (Ref: Clarified SSA500.7).
2 non-responses not validated in any way	<ul style="list-style-type: none"> ▪ By not validating the 2 balances, the public accountant has not appropriately tested all the selected samples. Owing to the “samples of samples” approach taken, it cannot be concluded that the original planned assurance level intended by the external confirmation procedures has been met. ▪ Non-response may indicate a potential fraud or error. It may also indicate a previously unidentified risk of material misstatement in which case, the auditor may need to revise the assessed risk of material misstatement at the assertion level and modify planned audit procedures in accordance with Clarified SSA 315.31.
Total of 8	

19. ACRA expects auditors to continue to use confirmations as a means of obtaining audit evidence to ascertain the existence and/or completeness of assets and liabilities. As Singapore businesses continue to expand their global footprints and in light of the current global economic conditions, auditors will have to step up the level of rigour and professional scepticism in applying confirmation audit procedures. Compliance with Clarified SSA 505 will continue to be an area of focus in ACRA's practice reviews for the year.

Note: Please note that the contents of the Audit Practice Bulletin are provided for the guidance of public accountants to supplement prescribed professional standards, and include criteria that ACRA considers in evaluating the work of public accountants. They are not rules of the Accounting and Corporate Regulatory Authority and are not intended to serve as a substitute for the relevant auditing standards. The Public Accountants must observe, maintain and apply the prescribed professional standards, methods, procedures and other requirements in carrying out the audits of financial statements.